Mr Richard St John
Statutory Compensation Review
PO Box 6295
Kingston ACT 2604

Email: futureofadvice@treasury.gov.au

10 June 2011

Dear Mr St John

The Financial Planning Association of Australia (FPA)[1] welcomes the opportunity to provide input into the review of the need for, and costs and benefits of, a statutory compensation scheme for clients who suffer damage or incur loss as a result of misconduct by persons with whom they have dealt with in the financial services sector (the Review).

We believe consumers deserve a substantially improved consumer compensation regime in financial services. We believe that is best achieved by an improved consumer protection regime that protects consumers from poor products and poor advice in the first instance, supported by an improved obligation regime that will deliver better justice and better compensation to consumers in the event of fault.

In the attached submission, the FPA has focused on responding to the 'possible remedial measures' suggested in Chapter 5 of the Consultation Paper. The FPA has also provided feedback on some of the issues raised in chapters 2 and 3 of the consultation paper in relation to professional indemnity (PI) insurance, which we have received from insurance broker Jardine Lloyd Thomson (JLT).

The FPA also acknowledges the submission made by the Financial Ombudsman Service (FOS) and has provided comments on the Financial Services Claim Scheme (FSCS) as proposed in the FOS submission.

In developing our response to the Review, the FPA considered the public interest and consumer protection implications; the impact on the community standing of the financial planning profession; the effectiveness and efficiency of regulation; and the alignment with the FPA's professional obligations.

If you have any questions regarding the FPA's submission, please contact me directly on 02 9220 4534 or deen.sanders@fpa.asn.au.

Yours sincerely

Dr Deen Sanders
Chief Professional Officer

[1] The FPA is the peak professional body for financial planning in Australia. The 8,000 individual professional members of the FPA have an enforceable Code of Professional Practice, including the Client First principle. 5,700 of our members have achieved CFP certification, which is the global standard of excellence in financial planning. FPA practitioner members manage the financial affairs of more than 5 million Australians whose investments are valued at $630 billion.

FINANCIAL PLANNING
ASSOCIATION *of* AUSTRALIA

Consumer Compensation

FPA SUBMISSION TO RICHARD ST JOHN CONSUMER COMPENSATION REVIEW| DATE: 10.06.2011

Introduction

The Financial Planning Association of Australia (FPA) would like to acknowledge the research into and understanding of the issues with the existing professional indemnity insurance-based compensation system, as detailed in the Consultation Paper. As a result of the presentation of these issues by Richard St John, the FPA will refrain from reiterating the problems with the current system in this submission. Rather the FPA will focus on responding to the possible remedial measures suggested in Chapter 5 of the Consultation Paper.

The FPA has worked with insurance broker Jardine Lloyd Thomson (JLT)[2] to provide feedback on the issues raised in chapters two and three of the consultation paper in relation to professional indemnity (PI) insurance.

The FPA also acknowledges the submission made by the Financial Ombudsman Service (FOS) and the EDR Scheme's recognition of the issues with the existing system. The FPA has provided comments on the Financial Services Claim Scheme (FSCS) as proposed by FOS in its submission.

Key Points

Australian consumers of financial services deserve a compensation regime that not only offers comprehensive redress but that also acts to improve the financial services industry for future consumers.

Achieving that goal requires a complete overhaul of Australia's compensation regime to recognise its influencing role in a broader consumer protection regime designed to protect consumers from poor products and poor advice in the first instance. When supported by an improved obligation regime that attaches responsibility for compensation to the parties with a causal link to the fault, we can deliver better compensation to consumers and positive reform to the industry.

In addition, the opportunity to improve consumer compensation should be considered in the context of improving the link between causal responsibility (fault) and the remedies that should be available (both in terms of justice and compensation).

On this front, our key concern with the Treasury paper, and the subsequent proposal for a FSCS (Financial Services Claim Scheme) as a potential solution, is that both fail to offer solutions to the underlying issues in the marketplace and supporting laws, seeming to prefer an *addition* to the system that is intended to only apply to financial advice and fail to address the opportunity for application to the entire system of financial services more broadly. Such an approach is only likely to exacerbate the problems in the future.

Not only is such a conclusion at odds with the facts and arguments provided through the consultation papers detailed presentation of the issues, but in taking such a narrow perspective it limits the opportunity for genuine reform that will deliver better protection and improved compensation for consumers.

It is well established that, rather than all fault lying with the advice provider, there are multiple stakeholders who offer products or services within the financial planning value chain, all of whom influence consumers' decisions on financial matters. However accountability of these participants to the end client is variable, limited and for some practically non-existent. They include:

[2] JLT is a party of the FPA's tripartite Pro PI Service which assists FPA's members to gain appropriate and affordable PI cover.

- Product manufacturers and fund managers
- Platforms
- Property schemes
- Ratings agencies and research houses
- Investment banks (funding the development of financial products sold to consumers)
- Auditors (of products and product manufacturers)
- Accountants (of product manufacturers)
- Accountants (of consumer) operating under the accountants exemption
- Stockbroker / share broker
- Futures broker
- Australian Deposit Institutes (banks, building societies, credit unions)
- Insurance brokers and companies
- Unregulated participants (including some Accountants) acting as Advisers
- Regulatory agencies including ASIC and the ACCC
- Professional Indemnity Insurers

Each of these stakeholders play some part, either directly or indirectly, in influencing a consumers' decision to invest in a financial product and the ongoing stability of that product, and each has responsibility to the client and their compensation needs for the role they play.

Instead of a suggestion for another layer of financial obligation that will deliver additional redress to only a few consumers without any concomitant improvement in the overall compensation and protection regime, the FPA's proposal for an improved compensation system includes:

- Improved regulation of financial products
- Introduction of consumer protection and risk assessment of financial products
- Introduction of best interest obligations of client accessible components of the financial services system
- Improved quality and type of product disclosure
- Introduction of a penalties regime for product manufacturers
- Improve standards of licensee conduct
- Improve consumer financial literacy and supportive education
- Improve the market for Professional Indemnity Insurance
- Improve professional indemnity policy compliance, coverage, adequacy and wording

This view aligns to the intent and benefits of the Government's Future of Financial Advice (FoFA) reforms and the FPA's regulatory reform agenda of ensuring better gatekeeper regulation that works in the full interests of Australian consumers.

As proposals for change to Adviser obligations, in particular formalised 'best interest' obligations for industry participants, are dealt with in other aspects of the FoFA reform program, we will not deal with them in this submission, although acknowledge the important contribution to an improved consumer protection and compensation regime that these proposals will make.

It is the FPA's contention that a better consumer protection and appropriate consumer compensation regime is the responsibility of all participants who have a role in causing, or an influence in allowing, consumer detriment. Until the regulatory and compensation framework is able to ensure that each stakeholder has responsibility and financial accountability to the end client for their role in ensuring the effective and ethical delivery of products and services, then the FPA is unable to support a proposal for a Financial Services Claims Scheme (FSCS) that appears to attach further liability and obligation to the financial advice community alone or at least in a disproportionate way to other participants with an often greater capacity to cause detriment on a community wide scale.

The FPA is therefore asking Mr St John to recommend to government against a last resort compensation scheme and address the following issues:

- The role of gatekeeper regulation and proportionate liability
- The role of investor behaviours and financial decision making
- The regulatory alignment to product selection as the measure of advice appropriateness
- A focus on prevention, not just compensation after the fact
- A focus on risk minimisation programs
- Review how various systems or retail compensation work with each other to ensure umbrella protection but with appropriate proportionality of obligation and costs

The Australian public and the industry itself are calling for and deserve:

- Better protections for consumers
- Better surety of compensation for consumers when they are a victim of a failure (anywhere in the system)
- A complete compensation system that ensures these outcomes
- Better gate-keeping by regulators
- A more comprehensive, considered, policy framework for compensation in Australia
- A more responsive and client oriented financial services community that sees its role as a protector of clients financial future first
- Confidence that the critical policy considerations have all been thoroughly considered.

The FPA strongly believes that the debate must encompass all in the financial services community and we must all, as participants, take responsibility for our actions. Continuing to only concentrate on one aspect or participant of the financial services sector continues to deny consumers their right to fair and equitable justice when failure occurs.

Submission

Failure to consider causal relationship in current compensation

As the compensation regime is currently constructed, Australian Financial Advice Licensees (erroneously referred to as financial planners) are responsible for the resolution of client claims for compensation sought through the Internal and External Dispute Resolution mechanisms. In practice, most client claims for compensation arise after a financial loss has been experienced and a financial loss usually arises because a product fails to deliver on the investment promise made to the client.

At the centre of the debate regarding compensation are the two questions of:

- Why did the client engaged in the investment promise for this product? and
- Who was responsible for the failure of the product to achieve its investment promise?

The current approach to consumer compensation (and proposed to be perpetuated by the FSCS model) only seeks to answer the first question and begins with the assumption that the Adviser is solely responsible for that answer. For instance, a product can only fail because of an event outside of the planner's control (such as market failure or product illegality), however the planner is nonetheless held responsible for compensating the full client loss on the assumption that the product did not fail but that rather it should not have been advised to the client in the first instance.

Not only is such an approach a denial of justice for both the client and the adviser but it is a clear failure of causal linkage for the financial loss experienced. Compensation should be based on:

1. first identifying that a financial loss is appropriate to be compensated
2. secondly identifying the causal links in the financial loss experienced

Assuming that a client loss meets the justification of compensation then those with causal responsibility for the loss should be assessed on a basis of materiality, perhaps in a concept similar to proportionate liability in tort law. There is little doubt that instances will arise where the Adviser has some causal responsibility for the loss and in such instances relative materiality should be identified in conjunction with the other parties with causal links to the loss.

The consumer compensation system requires the capacity to consider the breadth and depth of such circumstances when resolving disputes, so as to ensure consumers are protected and compensated in cases of clear and extreme negligence or inappropriate advice, while providing a fair outcome in disputes of less significant wrongdoing.

ASIC acknowledges the scope for proportionate liability as demonstrated by its actions in response to the Westpoint collapse. ASIC has pursued charges and sought consumer compensation from Westpoint directors, the CEO and founder, and even the auditors of Westpoint for their role in the loss incurred by investors from the collapse.

However, the consumer compensation system does not explicitly support the principle of proportionate liability as only the planning profession is required to hold professional indemnity insurance to cover compensation claims.

Therefore, the FPA would encourage Richard St John to reconsider the possible measures suggested in the consultation paper, in favour of a more holistic approach to consumer protection encompassing all members in the value chain. Enhancing the responsibility and accountability of the actions of all financial services providers would increase consumer protection, increase the pool of funds available for consumer compensation, and add extra preventative incentives to encourage the ethical delivery of financial services and products to consumers throughout the value chain.

To this end, the FPA disagrees with the position taken by FOS that some of the measures [proposed in the Consultation Paper] may reduce risk and improve the overall operation of the advice market[3]. The FPA is disappointed that the views put forward by FOS narrowly focus on advice and do not recognise the role of all financial services in the value chain in the issue of consumer compensation.

The FPA is concerned that the suggested measures proposed in the Consultation Paper will not fix the underlying problems with the current system and will not deliver full compensation to all consumers. Whilstever failure in gatekeeper obligation and financial accountability is allowed to continue there will be financial collapses and product failures that will potentially have widespread community impacts, ruining the clients invested with them and the financial planning businesses that worked with those clients.

If reforms to the consumer protection and compensation regimes are not dealt with during this opportunity, our concern is that the next version of financial crisis may have equally widespread consequences.

Until a more holistic approach to consumer compensation is implemented that recognises and apportions accountability to the role of all contributors in the value chain that influence consumers' decisions, the FPA is unable to support a last resort statutory compensation scheme.

Availability of Professional Indemnity Insurance

There is an extreme inadequacy and unavailability of professional indemnity insurance for financial advisers and licensees in Australia. This issue differs significantly from other global jurisdictions, hence the FPA would caution against assuming compensation methods of other countries would work effectively in the Australian market.

For example, in the UK the average planning firm has approximately 16 PI underwriters to choose from and are able to source complete coverage for their policy needs. The average PI premium for an advice firm in the UK is approximately 2,000 pounds. In Australia, there are three to four underwriters in this space offering policies with multiple exclusions and inadequate cover to meet the RG126 requirements. The minimum premium for PI insurance in Australia is $45,000.

This is not a fault of the advice industry but the lack of regulation of other financial service providers, namely product providers. In assessing the risk if a licensee, the PI industry commonly look at the products in the market and assess the risks associated with the products, rather than the quality of the advice.

The lack of regulation and accountability on product providers, the absence of proportionate liability from the compensation system, and the reliance on adviser PI requirements for consumer compensation, essentially means that PI insurers charge licensees for all risks in the financial services market as advisers are the most likely avenue for consumers to access compensation.

[3] Financial Ombudsman Service, Richard St John submission, May 2011, pg 6

Australia cannot afford to have an adequate compensation system or a penalty system for inadequate PII (which is what the FSCS as well as Maurice Blackburn are both essentially asking) if there is not an adequate PI market to choose from in the first place.

The PI problem in Australia will not be fixed by the introduction of a scheme of last resort. This will only exacerbate the issue as licensees seek to gain additional cover against the likelihood of incurring a future levy for someone else's wrong-doing.

The PI problem in Australia can only be fixed with appropriate regulation and accountabilities place on all financial services providers in the value chain, and a proportionate liability compensation system that attaches blame to the causal parties.

Response to suggested measures

1. Protection of consumers at the outset

Items 5.48 and 5.49 of the Consultation Paper discuss the need to consider measures to protect consumers through preventative measures to reduce the risk of misconduct and the problems that lead to the events that cause consumer loss or damage. The FPA agrees with the principle of and need for preventative measures however we are concerned that the measures proposed by the Review in this regard are limited to conduct standards of licensees and consumer financial literacy. The FPA recommends a more holistic approach that considers all financial services is required. A starting point would be to examine the types of financial services providers that have played a role in passed events that resulted in significant consumer loss.

Focusing on advice and those licensed under Chapter 7 of the Corporations Act (as per the limited scope of the Review[4]) excludes many parties who have been proven in the past to have contributed significantly to dishonest and fraudulent behaviour and insolvencies that have resulted in detrimental consumer loss, such as Westpoint. For example, ASIC has pursued charges and sought consumer compensation from Westpoint directors, the CEO and founder, and even the auditors of Westpoint for their role in the loss incurred by investors from the collapse. In addition, some reputable research houses continued to give the product a highly positive rating. However, a high proportion of consumers impacted by the Westpoint failure did not seek advice. Most consumers invested directly with the product provider or through a broker. In the case of Basis Capital, glowing reports and high ratings were received from several research houses. This influenced planners' views of the product and consumers decision to invest in the product.

Even the new ASIC Chairman, Greg Medcraft, in a recent speech to the Senate Economics Legislation Committee[5] stated his view that gatekeepers are important in our system. "Gatekeepers actually form a cornerstone of the system. Making sure they are held to account is actually quite important. I include in that accountants, advisers, product manufacturers and distributors and also lawyers—even though we do not regulate them, they are advisers to key participants in the system."

Further in the UK the FSA has recently provided a warning through the release of their latest quarterly consultation paper to product manufactures stating that the financial services industry has developed a growing and innovative market for products, including structured products, which are often described as 'guaranteed', 'protected' or 'secure'. We have reviewed this market and concluded that some firms promote these products without any clear and adequate justification for the descriptions used. We believe that this could be implicitly

[4] Compensation arrangements for consumers of financial services, Consultation Paper by Richard St John, April 2011, pg 2, Item 1.9 point 1
[5] Hansard Senate Economics Legislation Committee, 31 May 2011

misleading and could lead to consumers misunderstanding what is actually offered to them.[6] This follows comments made by the outgoing CEO of the FSA Hector Sants that “our focus has been too late in the product lifecycle to ensure that we identify potential issues early enough to prevent consumer detriment”[7]

As demonstrated by the following table, there are a variety of financial services providers who can and have played a part in dishonest and insolvency events that have impacted on consumers, while not always providing a service directly to a retail client. Such financial service providers currently fall outside the existing consumer compensation system and the measures in the Review’s Consultation Paper as they are not regulated under Chapter 7 of the Corporations Act, do not have EDR or PI requirements, and in some cases are not licensed. The ‘liability standard for claims’ acknowledges that current compensation arrangements are confined to a breach by a licensee of Chapter 7 obligations, which negates the accountability of many financial services providers.

Financial services provider	**AFSL License**	**Chapter 7**	**EDR requirement**	**PI requirements** (for the purposes of paying consumer compensation as required by ASIC)	**Compensation arrangements required under 912B**
Licensed product providers only operating in superannuation (including licensed platform providers)	Yes	Yes	No (Complaints mechanism through the Superannuation ComplaintsTribunal (SCT) in relation to conduct; not a compensation focus)	No APRA regulated	No Regulated under the Superannuation (Industry Supervision) Act with complaints to the SCT under the Superannuation (Resolution of Complaints) Act 1993. No have compensation requirements.)
Licensed product providers (including licensed platform providers)	Yes	Yes	Yes	No (if entity is APRA regulation or related to APRA regulated entity) Yes (if not APRA regulation or related to APRA regulated entity)	Yes
Unlicensed product providers where a PDS is required (ie. is a managed investment product or able to be trade on a financial market) (including unlicensed platform providers)	No	No	Yes	No (Only licensees are required to have PI cover)	No (Only licensees are required to have adequate compensation arrangements)
Unlicensed secondary sellers where a PDS is required (ie. is a managed investment product or able to be trade on a financial market)	No	No	Yes	No (Only licensees are required to have PI cover)	No (Only licensees are required to have adequate compensation arrangements)

[6] FSA CP11/11 Quarterly Consultation no.29 (chapter 5)
[7] Hector Sants, CEO, FSA, 2009

Unregistered/privately operated MIS (no PDS required to be given to ASIC under 601ED(2) and the 20/ 12/2 rule)	No	No	No	No	No
Property schemes	No (Unless an MIS, not required to hold an AFSL)	No	No	No	No
Ratings agencies and research houses	Yes (if provide services to retail clients) No (if provide services only to wholesale clients)	Yes (if provide services to retail clients) No (if provide services only to wholesale clients)	Yes (if provide services to retail clients) No (if provide services only to wholesale clients)	Yes (if provide services to retail clients or give consent for their information to be included in a product provider's PDS) No (if provide services only to wholesale clients)	Yes (if provide services to retail clients or give consent for their information to be included in a product provider's PDS) No (if provide services only to wholesale clients)
Investment banks (funding the development of financial products)	Yes	No	No redress for retail clients Service wholesale clients, though actions impact retail clients in relation to insolvencies and fraud/dishonesty of the products they fund	No (due to APRA regulation or related to APRA regulated entity)	No
Auditors (of products and product manufacturers)	No	No	No	No (only as a professional requirement to cover business risk; not for consumer compensation)	No
Accountants (of product manufacturers)	No	No	No	No	No
Accountants (of consumer) operating under the accountant exemption and not as an Authorised Representative	No	No	No. Consumers can sue through courts Complaints mechanism through the Tax Practitioners Board and professional bodies (eg. CPA) for breaches of professional obligations; not compensation focus	No mandatory PI requirement for consumer compensation. Regulated cap liability scheme in which accounts *may* participate in a PI scheme with cap on compensation.	
Stockbroker / share broker	Yes	Yes	Yes	Yes	Yes

Futures broker	Yes	Yes	Yes	Yes	Yes
Australian Deposit Institutes (banks, building societies, credit unions)	Yes	Yes	Yes	Yes	Yes
Insurance brokers and companies	Yes	Yes	Yes	Yes	Yes
Financial adviser and accountants operating as Authorised Representatives	Yes	Yes	Yes	Yes	Yes

Many products are sold directly to consumers who may not have the capacity to clearly identify and assess the complex elements that would go into making such a determination. It should be noted that a significant proportion of Westpoint investors invested directly with the product provider. Though such investments may be appropriate for some investors, a degree of protection is needed for those who are vulnerable.

There are a large number of financial products available to consumers, both directly and via an intermediary. FPA members are troubled by the lack of accountability of product providers and research houses when products do not live up to the claims of their promotions. The financial planning profession is often targeted with all the blame for product failures, which are wholly outside their control. Planners are attractive targets because of the ease of access to their professional indemnity insurance cover for consumer compensation. However, the source of most complaints is failed products.

The FPA acknowledges that the following recommendations may be outside the scope of the Review however, the Association would urge Mr St John to encourage the Government to examine, consider and conduct a broad consultation into how strengthening the regulation of financial products would significantly enhance the protection of Australian consumers and deliver a more equitable and accessible compensation system.

1.1 Regulation of brokerage services and financial products

The FPA recommends a more holistic and appropriate solution to consumer protection should be considered by reviewing the regulation of financial products available to consumers.

Problems with products should be addressed through product regulation, rather than advice regulation. Product providers should be held accountable for failing to deliver on product benefits due to dishonest conduct or insolvency, or if there are fundamental flaws in products.

Australian consumers rely on information from credit rating agencies and research houses to make investment decisions, so they play an important gate-keeping role in the financial system. The role of such organisations is to provide specialist assessments and detailed due diligence research on financial products for consumers and intermediaries. It is a specialised service which comes at considerable expense. While the FPA acknowledges recent changes by the International Organisation of Securities Commissions (IOSCO) and ASIC to the regulation of Credit Rating Agencies (CRAs) and research houses, CRAs and research houses should also be held accountable for their roles in product failures.

The FPA recommends:

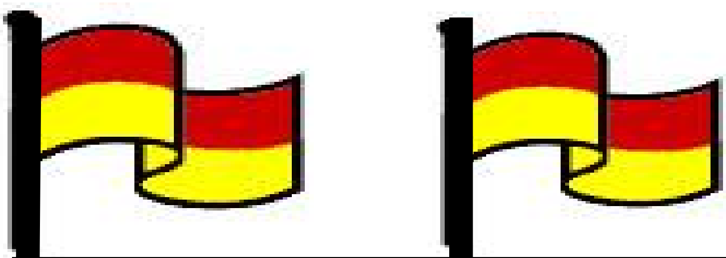
- A more robust risk assessment process from product providers, which would include:
    - Identifying specific categories or classes of risk to help the consumer gain a better understanding of the risk involved in investing in a product;
    - Stipulating disclosure requirements and specific risk warnings for each category;
    - Carrying out stress testing of products and disclosure of possible outcomes;
    - Stipulating the level of professional support needed to utilise products;
    - Establishing requirements for different documentation for different classes of products; and
    - Establishing requirement for different compensation regimes to be applied or proportionately funded, on the basis of product risk or complexity.
- Products sold directly to consumers should include point of sale warnings identifying the risk level and need for appropriate advice to assess compatibility with client's objectives.
- Stronger advertising controls should be adopted to ensure truth in advertising.
- The requirements of the Financial Services Council's Superannuation Charter, which calls for better controls relating to promotion of superannuation investment performance, should be extended across the industry to all products.

The FPA also recommends the development of a framework aligned with the Australian Securities and Investments Commission's (ASIC) 'Investing between the flags' concept, to address the lack of disclosure by brokers and product providers in relation to complex financial products available to consumers, whether retail or non-retail clients. The framework should provide a model that separates products more effectively based on distinctions in risk in three key areas:

1. Complexity of product
2. Complexity of client needs
3. Complexity of advice

Below is an example framework that categorises products into three categories that could be adopted to support an 'investing between the flags' approach to product regulation.

Investing Between the Flags (example framework model)



Safe products	Grey products	High risk products
	Risk →	
For example: • Superannuation products • Deposit products • General insurance • Retirement savings account products; • First Home Saver Account products • Investment life insurance products • Debentures, stocks or bonds issued, or proposed to be issued by a government • Shares	For example: • Managed investments • Securities • Derivatives	For example: • Margin lending • CFDs • Structured products • Leveraged products • CDOs • CDS
Consumers generally act unaided	If consumer purchases the product under advice, the adviser accepts the risk liability	Negotiation of who accepts liability of risk: • If using an adviser – client and adviser to negotiate who accepts risk if product purchase; could be apportioned. • If buying direct – consumer negotiates with product provider over risk liability

The framework should include requirements for appropriate product disclosures and warnings to be provided to consumers when crossing the boundaries of the 'safe', 'grey' and 'high risk' product types. Irrelevant of the product type, the FPA supports the use of appropriate consumer disclosure on all financial products.

Though it was noted that at least some of the solutions to the global financial crisis should come from better design of financial products, there was no description of how and by whom ratings would be determined as to which products fall between the flags and outside the flags. Product regulation should identify which products are 'inside or outside the flags' to enable a consideration to be made as to whether a product is appropriate. A well thought out system of warnings and disclosures at points of direct sale would be an improvement, in this regard.

1.2 Other preventative measures to enhance to consumer protection

There is a vital need to enhance the responsibility of product providers and fund managers in developing products for consumers.

The FPA recommends:

- Enhance manufacturer liability for misleading representations
- Ensure the introduction of a 'best interest' duty (as being introduced under the FoFA reforms) also applies to product manufacturers, fund managers, and research houses to impose a duty on such providers to consider the consumer (end user) of the financial product when developing the product and associated materials.
- Introduce standardised product categories to help consumers understand the level of risk involved in investing in certain types of product and to clearly identify the complexity of the products.
- Mandate 'true to label' obligations for product providers.
- Increase the quality and type of disclosures required by product manufacturers, including a requirement to publish product objectives and information on how consumers should use the product
- Introduce appropriate penalties for product manufacturers not meeting these requirements, particularly for poor or inaccurate disclosure of product objectives.

1.3 Improve standards of licensee conduct

The FPA acknowledges and agrees with the comments in items 5.51 to 5.56 of the Review. The FoFA reforms are significant and should play a role in improving the provision of quality advice for consumers.

However, there is concern as to how the insurance market will respond to the reforms in relation to their assessment of the risk profile of advisers and the provision of PI to advisers. Recent changes in some financial services laws have resulted in some insurers increasing the exclusions in the cover while maintaining the high premium level. Exclusions in PI cover serve to control the advice provided to consumer (purely based on an insurers willingness to underwrite the risk to them), and creates a potential conflict in the adviser's ability to adhere to the pending 'best interest' duty, which impacts on the quality of the advice provided to consumers.

The FPA would like to reinforce the statement made in item 5.51 of the Review that "the [FoFA] proposals do not generally extend to other financial service licensees. This will allow the current gap in consumer protection to continue and in many circumstances widen.

The FPA re-iterates the need for Government to consider the recommendations articulated in 1.1 and 1.2 above, and again calls on Mr St John to encourage the Government to examine, consider and conduct a broad consultation into the need to strengthen the regulation of financial products to significantly enhance the protection of Australian consumers and deliver a more equitable and accessible compensation system.

1.4 Improve consumer financial literacy

The FPA wholeheartedly supports the need to improve consumer financial literacy and the efforts of ASIC under its new National Financial Literacy Strategy.

Anecdotal evidence shows consumers' attitudes and levels of comfort with an investment decision have been seen to change depending on product performance. A consumer may be comfortable with a product when they make a decision to invest, even if aware that the investment may be in a high risk category. This attitude often changes if product performance becomes unsatisfactory.

The FPA recommends financial literacy and capability programs should not be based on the 'how to' of financial management alone. Programs should incorporate consumer rights and responsibilities for ensuring they are informed, that they fully understand and are comfortable with investment options prior to making their decision, regardless of whether a consumer purchases a product directly through a product provider, via a intermediary or seeks professional advice.

2 Enhance insurance cover

2.3 Assurance that licensees have cover

While the FPA believes there are flaws to the consumer compensation system as it is based PI which covers the insured not the third party consumer, the Association supports the possible measure to require licensees to report through their annual financial statements whether they hold a current policy of professional indemnity insurance, or have made alternative compensation arrangements, and on the adequacy of their cover for the needs of their business. The FPA also agrees that PI insurance certifications be subject to confirmation in the independent audit of the licensee's financial statements.

2.4 Promotion of standard insurance cover

The Review proposes the development of standard PI policies to meet the basic needs of licensees, or particular classes of licensees such as financial advisers, or the development of a standard policy on a group basis, where the development of a standard policy would need to be market based and negotiated between professional bodies and the insurance industry. The scope for run-off cover could be examines further in the development of standard forms of insurance cover for licensees.

The FPA has had in place a mandatory PI requirement for its members since 1996. Since this time the FPA has had significant experience in working with the insurance industry and other relevant parties to identify and establish a mechanism to deliver affordable PI cover for financial planners that included appropriate and necessary coverage. The FPA currently runs for its members a single broker, multiple insurer scheme with model terms aligned to RG126, called FPA Pro PI Service. It has arranged policies for 35 FPA members and has received no claims against these policies.

Other options the FPA has investigated, all of which failed, include:

- Single underwriter, multiple brokers;
- A model policy;
- A cap scheme issued through offshore markets (this option fell through when ASIC issued its 2003 Shadow Shopping Report. Insurers walked away from the deal when the Report was released.); and
- Group schemes including a discretionary mutual scheme (the development of a discretionary mutual scheme remains a potential option pending the capacity to gain industry wide data on complaints).

The reason for the failure of these options which FPA investigated was unrelated to the requirement for run-off cover. These options failed because of the capacity in the market, the lack of transparency of product regulation, and the lack of proportionate liability particularly between financial advice and products. The PI insurers cannot respond to the advice market as advisers are being lumped with the totality of consumer loss even when the advice is sound and the loss is outside the adviser's control and caused by the failure of product. This makes it very difficult for insurers to identify the risk they would be covering. The result of this situation, as currently being seen in the market, is the introduction of more and more exclusions of cover with no reduction in premium.

Insurers now appear to be providing advisers cover based on product recommendations not the appropriateness of advice. For example, recent exclusions include products like managed investment schemes, mezzanine finance, unlisted or unrated securities, unsecured loans and property developments. The PI exclusions can commonly contradict the licensee's Approved Products Lists. The FPA questions how these PI exclusions will interact with the pending 'best interest' requirement under FoFA.

Insurers are now looking to FOS determinations to assess how to respond to the advice market. The fact that FOS does not consider proportionate liability in its deliberation of complaints spirals this issue even further.

The FPA notes the reference to the establishment of LawCover Insurance and suggests the difference between the legal industry and the financial services industry must be understood in this regard. The liabilities faced by lawyers are clear and transparent as they relate to the activity of the lawyer themselves. The way the financial services consumer compensation system works, the risks faced by advisers include the liabilities of third parties, such as products, which are outside the control of the adviser and an unknown risk that cannot be assessed. Hence, insurers are reluctant to cover the unknown risk.

The FPA does not support the development of standardised PI cover for the following reasons:

- It again lays the blame and resulting provision of compensation squarely at the feet of the advise industry, which may not be responsible for causing the consumer loss.
- It is a bandaid approach to consumer compensation as it does not address the underlying issues of the current system.

2.5 Coverage of claims after licensees cease to trade

The FPA acknowledges the Review's proposal for consideration to be given to the commerciality of a separate group policy that deals specifically with run-off cover and pools the risk of claims arising from multiple licensees that had ceased to trade, without replicating the terms of prior/other PI policies held by the licensees.

It is unclear how this run-off cover measure would interact with other proposals being considered by the Review especially a compensation scheme of last resort.

The FPA does not support the proposal to develop a standard group policy specifically for run-off cover. This would establish an approach of separate cover for each exclusion, resulting in multiple policies for licensees. It is also a bandaid measure that does not address the underlying issues of the system.

2.6 Increase disclosure to consumer of PI cover of licensee

The Review proposes to require licensees to provide detailed information about their PI cover to consumers. Proposed disclosure requirements include the monetary limits of the cover, the level of any excess, any significant exclusions and whether there is any run-off.

The FPA does not support this proposal as it could confuse and mislead consumers if they do not fully understand the structure, purpose and role of PI, which is to cover the insured, not the third party consumer.

The FPA recommend a more appropriate measure would be to promote the complaints process and availability of avenues for complaints, including IDR and EDR schemes, to consumers, and encourage consumers to make a complaint.

The FPA also does not support the proposal to require licensees to disclose the name of their insurer to the consumer. It would be more appropriate for the name of the insurer to be included in the financial statement provided to ASIC (as per proposal in 2.3 above). ASIC would then be in a position to assist consumers in the event that a licensee becomes insolvent and does not respond to a client's claim.

2.7 Third party rights

The FPA acknowledges the 2010 consideration of s51 of the Insurance Contracts Act in relation to assisting third parties, such as consumers, to recover directly from an insurer in respect of an award of compensation against an insured that does not meet the award.

The FPA recommends any reintroduction into Parliament of the Insurance Contracts Act Amendment Bill 2010, amending s51, would need to consider its interaction with any proposed compensation scheme of last resort.

3 Increase / Review licensee financial resources requirement

The Review proposed for licensees to be required to hold an additional form of financial security as a general condition of license, such as a capital holding or security bond or guarantee from a financial institution or related entity, to give the licensee more capacity to meet awards of compensation that are not covered by PI.

The FPA believes the proposal to increase licensee financial resource requirements again places a bandaid option with the emphasis on the advice industry rather than fixing the underlying problem of the system.

The FPA suggests this measure should be considered in the context of the access to advice objective under FoFA. There is concern that the potential impact on non-APRA regulated licensees could significant increase the cost of advice for consumers.

In addition, this measure raises concerns for small licensees. Increasing capital adequacy requirements may increase the reliance on large licensees as small AFSL holders will need to rely on larger APRA-regulated entities to meet this requirement. It may also create barriers for entry into the advice industry, and will impact on accounting practices who will be required to be licensed under pending FoFA changes.

The FPA would like to see further consideration on the requirements under this measure, and investigation on the impact of this proposal, prior to providing the Association's support.

4 Compensation scheme of last resort

It is the FPA's contention that a better consumer protection and appropriate consumer compensation regime is the responsibility of all participants who have a role in causing, or an influence in allowing, consumer detriment.

Until the regulatory and compensation framework is able to ensure that each stakeholder has responsibility and financial accountability to the end client for their role in ensuring the effective and ethical delivery of products and services, then the FPA is unable to support a proposal for a last resort compensation scheme.

Further the FPA notes that the 'liability standard for claims' acknowledges that current compensation arrangement are confined to a breach by a licensee of Chapter 7 obligations and suggests a scheme of last resort should also be restricted in this way. The FPA outright rejects this proposal which negates the accountability of many financial services providers who have played the leading role in past events that have resulted in detrimental consumer loss.

The FPA would expect a compensation scheme of last resort to have the following characteristics:

- the Rules, operations and claims procedures of the proposed last resort scheme appropriately covered and considered the role of all types of financial services provides, including product manufacturers, in contributing to consumer losses, had clearly articulated boundaries, and filled a gap in the provision of consumer compensation rather than served as a bandaid to the problems of the existing system.
- a requirement to apply the principle of proportionate liability to all claims considered by the Scheme. This requirement must be articulated in the Rules of the Scheme.
- the Scheme operated as a safety net only, not an alternative to EDR.
- the Scheme had the ability to apportion levies weighted on the involvement of each section of the industry that is found to be liable or accountable, this includes considering the role of all types of financial services that contributed to the consumer loss.
- be limited to considering claims against a failed financial service provider for misappropriation, fraud and dishonesty, and a breach of the criminal provisions of the Corporations Act.
- be managed by industry
- recognise advice is a professional service and is not responsible for product performance or the actions of those associated with the design, manufacture or performance of products, or the solvency of product providers. This should be included in the Scheme Rules.
- be required to attribute evidentiary blame for who is at fault for loss (eg. Fraud; product failure),
- if blame lies with the product, the EDR Scheme must be required to separate the professional services (advice) part of the claim and pass off the rest of the claim to the compensation Scheme of last resort for award of compensation against the product sector. The EDR Scheme award should then be limited to the refund of the professional fee charged (to avoid double up on compensation) as a 'small claims'

jurisdiction. The compensation Scheme of last resort would award contributory damages for loss caused by product failure/fraud etc.

- restrict client's ability to 'double dip' between EDR, ASIC Section 50, class actions, and the compensation Scheme of last resort.
- have clear delineation around how the Scheme interacts with EDR, ASIC Section 50 and run-off PI. (For example, it could only accept claims against the failed entity, while the EDR Scheme considered claims against third party providers resulting from the collapsed entity. However, EDR compensation would have to be limited to the service provider fees charged if inappropriate advice was proven, and not for the loss of investment due to product failure, for example.
- provide equity restoration on a contributory basis for damages (versus small claims).
- clearly identify the gap in the existing consumer compensation mechanism that a compensation Scheme of last resort is seeking to fill, how such a scheme fills this gap, and how it would work consistently and effectively with existing mechanisms.
- require the effect of downward pressure on PI premiums for AFSL's.

The FPA has provided below a direct response to the Financial Services Claims Scheme proposal as referenced in the Consultation Paper and detailed in the FOS submission.

Response to Financial Services Claims Scheme proposal

It is the FPA's contention that a better consumer protection and appropriate consumer compensation regime is the responsibility of all participants who have a role in causing, or an influence in allowing, consumer detriment.

Until the regulatory and compensation framework is able to ensure that each stakeholder has responsibility and financial accountability to the end client for their role in ensuring the effective and ethical delivery of products and services, then the FPA is unable to support a proposal for a Financial Services Claims Scheme that appears to attach further liability and obligation to the financial advice community alone or at least in a disproportionate way to other participants with an often greater capacity to cause detriment on a community wide scale.

The FPA does not support the establishment of a Financial Services Claims Scheme (FSCS) as proposed in the submission by the Financial Ombudsman Service for the following reasons:

- Access to the proposed FSCS is reliant on a complaint determination by an EDR scheme, a court or tribunal, or a trustee regarding bankruptcy. EDR schemes have a strong history of blaming the adviser for the entire loss incurred by the consumer and do not take into account the role of other parties. Some parties responsible for consumer loss in the case of fraud (as evidence in the Westpoint and Basis Capital cases) have no standing for a retail client to bring a complaint against them in existing mechanisms without incurring extreme cost and would therefore not be considered as a claim under the proposed FSCS Rules.
- The proposed funding model will have a significant impact on small licensees and could result in the closure of many small advice businesses. It creates a moral hazard as licensees would have to seek PI cover to insure against the risk of incurring a levy for someone else's mistake/action, even though their business may have a 'clean sheet'. Larger licensees and large dealer groups who are self-insured would

be the only businesses able to afford to maintain their business, forcing advisers to tie themselves to large dealer groups.

- It does not articulate a claims process for the FSCS. The proposed FSCS appears to rely on the claims determination of other compensation mechanisms such as EDR schemes, court and tribunals, and insolvency trustees (etc), and the FSCS just administers the award of the compensation. This means there is no application process for defendants, which is against the principle of natural justice.
- The proposed Rules do not require the FSCS to consider the principle of proportionate liability.
- Will potentially result in the financial services industry funding laywers representing consumer class actions.

1. Scheme coverage of financial service providers

While the suggested name of the proposed compensation of scheme of last resort is the Financial Services Compensation Scheme (FSCS), the preamble in the FOS submission refers to the FSCS improving protection for consumers of financial advice. It does not make reference to other financial service in relation to its commentary on the FSCS.

The FPA is concerned that while the Rules articulate the coverage of different financial services under Rule 3.4(b), the discussion about the proposed FSCS sections 4, 5 and 6 of the FOS submission[8] clearly focuses on advice not financial services. The discussion seems to equate a financial services dispute as an advice dispute. It does not consider other providers in the financial services sector. This is the underlying and fundamental problem to the approach of FOS and the proposed FSCS.

Rule 3.4 states that a covered claim includes any act or omission by a provider in the provision of a financial service, including financial products (which are listed). However, a ‘participant’ is defined as “any AFS licensee providing financial services to retail clients”. In addition, the FPA notes that the Richard St John Consultation Paper states that the Review is limited in its scope to Chapter 7 of the Corporations Act 2001[9]. However, not all financial services providers hold an AFSL and are required to meet the obligations under Chapter 7 of the Corporations Act to which the Review is limited (please refer to table 1.1 above.). Therefore, the FPA suggests the financial services listed as “covered claims” in Rule 3.4(b) is misleading. The FPA recommends any scheme of last resort must accept relevant claims against all financial services, except those covered by other last resort schemes such as the Financial Claims Scheme. It should not be limited to the stated scope of the Review.

It is unclear how a consumer who purchases a financial or investment product directly through the provider can access the proposed FSCS. For example, a consumer may decide to invest in a financial product after hearing it promoted on the radio, and the product manufacturer becomes insolvent due to fraudulent activity by the directors. Can the consumer access the proposed FSCS?

Many consumers invested in ACR after it was promoted in shopping centres. The FPA questions, under the proposed Rules particularly if the scheme was limited to those licensees obliged under Chapter 7 of the Corporations Act, whether consumers who purchased this product directly through the manufacturer and suffered loss would be able to access the FSCS. If consumers caught in such a situation were not able to access compensation through the FSCS, the FPA would question the value to consumers or industry of such a scheme if it fails to assist those consumers who have been blatantly taken advantage of. In these circumstances, consumers remain unprotected and unsupported as such products are so loosely regulated.

[8] Financial Ombudsman Service, Richard St John submission, May 2011, pgs 10 -18
[9] Compensation arrangements for consumers of financial services, Consultation Paper by Richard St John, April 2011, pg 2

When consumers suffer significant loss and damage after investing in a financial product, the underlying cause of the loss is usually dishonest/fraudulent behaviour or insolvency of the product provider. This was the case in Westpoint, Trio, ACR, Great Southern, and Timbercorp. While there were some incidents of inappropriate advice which lead to the investment in the first place and therefore contributed to the loss, many consumers were direct investors. The underlying cause of the consumer loss was instigated by the product provider.

The FPA is concerned that the introduction of a last resort scheme may be limited to financial advisers, creating a significant gap in compensation arrangements for consumers of financial services and products. It does not fix the problems with the current system, rather offers a bandaid solution with the main focus on advice. Consumer protection can only be achieved by employing preventatives measures and improving product regulation.

2. Types of claims covered (Rule 3.4)

Rule 3.4 a) states that "a covered claim is a claim brought in relation to any act or omission by a participant or any act or omission for which a participant may be responsible". This is very broad and implies it could cover anything and everything. FSCS should be limited to dishonesty / fraud or insolvency

The FSCS should only serve as a scheme of last resort and not as an alternative to EDR and other existing compensation mechanisms. Therefore, the FSCS should be limited to considering claims against a failed financial service provider for misappropriation, fraud and dishonesty, and a breach of the criminal provisions of the Corporations Act only. Hence, clause 3.4a) of the proposed Rules is too broad.

The FPA recommends Rule 3.4 a) be replaced with the last two paragraphs (i and ii) of 3.4. Rule 3.4 should state:

A covered claim is a claim:

a) in relation to a failure of the relevant person to pay or deliver money or property that was received by the relevant person in the course of providing financial services, where the failure arises from or is constituted by an act or omission that involves dishonesty; or

b) a fraudulent dealing with property that was received by the relevant person in the course of providing financial services, where the fraudulent dealing arises from or is constituted by an act or omission that involves dishonesty;

c) in relation to the provision of a financial service on or after [date], including the provisions of all forms of financial services, financial advice or financial products such as …….; and …..d) (existing c))

This would provide significant clarify on the purpose and criteria for accessing the FSCS for both consumers and industry and adequately and appropriately address the coverage of claims resulting from fraudulent dealings or dishonesty on the part of the financial services provider.

There is currently no restriction within the Rules to limit claim coverage of the FSCS only to those claims where the claimant has not received payment of compensation that has been awarded to them (by an EDR scheme, court or tribunal, or insolvency trustee).

The FPA recommends a last resort scheme should be limited to circumstances where the financial services provider has ceased trading, is insolvent or otherwise unable to meet a claim by a retail client.

3. Fair access to hold all responsible parties accountable

Rule 3.4(c) states that a claim is only covered by the FSCS when there has been a determination in favour of the claimant by an EDR scheme, a court or tribunal or a trustee in bankruptcy, liquidator to insolvency practitioner.

While the FPA appreciates the efficiencies that would be afforded to the FSCS by utilising these existing mechanisms, this would heavily weight the claims bought to the FSCS from EDR Schemes as they are free and more accessible to consumers. Requiring a consumer to undertake the cost and effort to gain a decision from a court/tribunal or insolvency trustee, would significantly hinder access to the FSCS for these types of claims. It would also incentivise claimants to chase the adviser for compensation, therefore significantly reducing the accountability of other financial service providers who may be responsible for the consumer's loss.

Consumers are currently limited in their recourse against product providers, usually to some form of class action through the legal system or via the Regulator. It is very timely and can come at a cost to consumers[10]. However, the FPA does not believe the FSCS would fill this gap under the proposed Rules.

As previously mentioned, the majority of events that have left consumers suffering significant financial loss in the past have resulted from dishonest/fraudulent behaviour or insolvency of the product provider. Under the proposed Rules, consumers who invested in such products directly would have to go through the expense and effort of class action through the legal system, or file an application for compensation claim through the product provider's liquidator, and receive a favourable determination, in order to access the proposed FSCS. The FPA suggests the effort, time and cost involved in completing this process would deter consumers from seeking compensation against the party who caused the loss.

The FPA recommends the most effective means of protecting consumers against unethical behaviour is through preventative measures such as improving product regulation.

4. Claims process and the application of the principle of proportionate liability

The proposed FSCS appears to rely on the claims determination of other compensation mechanisms such as EDR schemes, court and tribunals, and insolvency trustees (etc), and the FSCS just administers the award of the compensation. Rule 6.4.1 permits the proposed FSCS to rely on determinations of EDR schemes, a court, or a trustee in bankruptcy, liquidator or other insolvency practitioner in calculating compensation payable.

The Rules do not articulate a claims process for the FSCS. This means there is no application process for defendants, which is against the principle of natural justice.

The FPA is most concerned about the reliance on decisions by EDR schemes who do not take into account the principle of proportionate liability when considering a claim and place the entire blame and responsibility for compensation at the hands of the advice industry. The FPA questions how a scheme of last resort can appropriately attribute blame and allocate payable compensation across all financial services providers in the absence of a claims process, and therefore by relying solely on the decisions of other jurisdictions who have limited scope.

Under the 'FOS revised funding model', item 5.2.2 states "the costs of compensation would first be allocated to the intermediary or advisory contribution group out of which the loss arose"[11]. This demonstrates FOS's attitude

[10] The FPA notes the launch of a new "no-win, no-fee" legal service for investors wishing to pursue a class action, Daily Telegraph, 30 May 2011, pg 29

that the advice industry is the cause of any consumer loss, and ignores the role of other financial service providers such as research houses, credit rating agencies, and in particular product providers. The FPA again states its concern that it is this attitude and approach to compensation that creates the gap in consumer protection. It also reinforces the FPA's concern that the focus of the proposed FSCS is the advice industry.

This issue is again demonstrated in item 5.7(a) which states "a special compensation levy might be required if the scheme face the prospect of compensating clients who had been advised by participants....to invest in Westpoint, which had since been determined in 'default'". Does this mean that only consumers who were advised can access the scheme? If so, this would be a duplication of FOS. This example ignores the fact that Westpoint failed because of the improper behaviour of other gate-keepers such as the product provider and auditors.

While the proposed FSCS acknowledges the issue of contributory negligence under Rule 6.4.4, it does not employ the principle of proportionate liability, especially in the unforeseen event of a product insolvency caused by dishonesty or fraud.

The FPA recommends a scheme of last resort must have in place a fair and transparent claims process with a mandated ability to attribute blame and allocate responsibility for paying compensation to multiple types of providers based on the principle of proportionate liability.

5. Interaction with other consumer compensation mechanisms

Outside of proposed Rule 3.4, which requires a claimant to have received a determination from another compensation mechanism, and Rule 6.4.1 relating to determinations from other compensation mechanisms, the Rules do not articulate the relationship and interaction between the proposed FSCS and other consumer compensation mechanisms available.

There is a need for clear delineation to be included in the Rules around how the proposed FSCS interacts with EDR schemes, ASIC Section 50, legal class actions, run-off PI, and other schemes of last resort such as the Financial Claims Scheme. While the FPA supports the provision of fair compensation for consumers who suffer a financial loss due to the dishonest or fraudulent action of a financial services provider, the system should ensure that consumers are not permitted to 'double dip' between EDR, ASIC Section 50, class actions, and the FSCS. This clarity is necessary to provide clear parameters on the options available to consumers, as well as clarity for industry, PI insurers, and other compensation mechanisms.

The FPA acknowledges Rule 6.4.4 which may attempt to address the issue of double dipping by requiring the proposed FSCS to take into account any payments made to the claimant by any person if it is connected to the liability of the claim. However, the FPA believes this Rule does not adequately address this issue as neither the proposed FSCS Rules or the governing rules of other compensation mechanisms clearly articulate the need to firstly and appropriately identify and attribute blame for the loss based on the cause, and then secondly apportion appropriate responsibility for considering the claim to the relevant compensation jurisdiction, with limits on compensation award. For example, the EDR scheme for inappropriate advice; the last resort scheme for the fraudulent behaviour resulting in the product demise.

The FPA recommends the FSCS should only accept claims against the entity at fault, and should not accept claims against third party financial services providers impacted by the 'at fault' entity's actions. For example, a scheme of last resort should not be permitted to accept claims against financial planners accused of inappropriate advice if the underlying cause of the consumer loss was the fraudulent activity of a product provider which resulted in the provider's insolvency. Any claims regarding inappropriate advice should clearly remain

[11] Financial Ombudsman Service, Richard St John submission, May 2011, pg 13

within the jurisdiction of the relevant EDR scheme. However, the EDR scheme must also be required to limit compensation payable under the Scheme to the professional fee for the inappropriate advice, and apportion blame and payment of compensation having regard to the monies awarded under the FSCS.

Currently EDR schemes commonly attribute full blame of a consumer's loss on the adviser, who is then ordered to pay compensation commensurate to the full amount of the consumer loss, even if the underlying cause of the loss was dishonest/fraudulent behaviour by a product provider. If a scheme of last resort were introduced, changes would be required to be made both in the Terms of Reference of the EDR schemes and in the way EDR claims are currently considered and determined, to ensure clear boundaries are put in place in awarding compensation. In this case, EDR schemes should be limited to compensation awards of professional fees, and the last resort scheme for consumer's investment loss.

This is also inline with the principle of proportionate liability and, with the proposed introduction of a scheme of last resort, would ensure natural justice is employed in an appropriate way throughout all parts of the consumer compensation system.

The FPA recommends:

- clear delineation to be included in the Rules around how the proposed FSCS interacts with other compensation mechanisms including EDR schemes, ASIC Section 50, legal class actions, run-off PI, and other schemes of last resort such as the Financial Claims Scheme..
- any scheme of last resort should only accept claims against the entity at fault, and should not accept claims against third party financial services providers impacted by the 'at fault' entity's actions.
- the proposed FSCS Rules and the governing rules of other compensation mechanisms must clearly articulate the need to
    - appropriately identify and attribute blame for the consumer loss based on the cause,
    - apportion appropriate responsibility for considering the claim to the relevant compensation jurisdiction, with limits on compensation award for each jurisdiction based on the part of the claim before them; and
    - EDR schemes should be limited to compensation awards of professional fees, and the last resort scheme for consumer's investment loss
- Any claims regarding inappropriate advice should clearly remain within the jurisdiction of the relevant EDR scheme. However, the EDR scheme must also be required to limit compensation payable under the Scheme to the professional fee for the inappropriate advice, and apportion blame and payment of compensation having regard to the monies awarded under the FSCS.

6. Off-sett of recoveries

Rules 4.4 refers to compensation paid under Rule 6.1.3. However, Rule 6.1.3 does not appear to exist.

The FPA seeks clarification around Rule 4.4 Off-set of recoveries and Rule 6.1.3.

7. Payment of compensation

Rule 6.1.2 proposes that the FSCS may postpone paying compensation if it considers that the claimant should exhaust their rights against another party (etc). Similarly Rule 6.3.3 allows the proposed FSCS to reduce the payment if the claimant has a reasonable prospect for compensation from a third party or another person.

The FPA suggests this creates a flawed process which encourages the FSCS to refer consumers back to EDR to chase advisers because they have PI cover, rather than to pursue a claim through the FSCS. This issue highlights the need for clear boundaries on how a scheme of last resort works within the existing system.

The FPA seeks clarity as to the intent of Rule 6.1.2 and reinforces the need:

- for clear delineation between the scheme of last resort and other compensation mechanism; and
- to ensure compensation awarded by EDR schemes is limited to awards of professional fees and the last resort scheme awards compensation for consumer's investment loss as a result of dishonest/fraudulent behaviour of product providers.

8. Timing and Transition

In its submission, FOS has suggested an FSCS be introduced "either in advance of or simultaneously with other [FoFA] changes to the licensing regime"[12].

The FPA does not support the introduction of a compensation scheme of last resort until the current consumer compensation system is fixed. There is no point rushing to introduce a bandaid solution just to meet a deadline related to unrelated reforms. Time should be taken to fix the current system. Precedent has been set in this regard as some of the FoFA reforms have been delayed beyond the original July 2012 to give Government time to ensure any changes are effective and that they work together. The same approach must be applied to compensation.

The FPA does not support the rushed introduction of a scheme of last resort. Time should be taken to fix the current compensation system.

The FPA also notes that the transition provisions under Rule 7 (also referenced in 3.4 b)) effectively make the FSCS a retrospective scheme from 6 years PRIOR to the commencement date of the Scheme.

The FPA understand the logic of a six year complaint period, however in the principle of fairness and equity the FPA does not support the introduction of a retrospective six year complaint period to apply from the date of commencement of a last resort scheme.

Events that occurred six years ago have been or are in the process of being settled under the rules and systems available at that time. The retrospective application of a scheme of last resort would confuse consumers (as to accessibility) and impose an unfair addition liability for industry for which they have not be allowed to budget for.

The FPA suggest that, if a last resort scheme were to be introduced (which the FPA does not support), a six year claim period may be introduced one year at a time from the date of commencement, building up to six years.

9. Levy limit and distribution

The proposed FSCS Rules articulate five different funding levies:

1. Establishment levy
2. Management expenses levy
3. Standard compensation levy
4. Special compensation levy

[12] Financial Ombudsman Service, Richard St John submission, May 2011, pg 5

5. Fidelity fund levy

The FPA questions the need for so many levies. The multiple levies differ significantly from the "post-event" funded concept branded in the media as a 1% levy, as the 1% levy only applies to one of the five levies mentioned in the proposed Rules. In addition to other costs, the proposed FSCS levy model could conceivably end up as high as 10% of revenue of some service providers. The accumulation of these multiple levies will create a significant drain on small businesses even if they are not responsible for any consumer loss.

Claims made by FOS in the media also state that the proposed FSCS is post-event funding. However, the proposed multiple levy model imposes start-up, ongoing, pre-event and post-event levies.

Item 5.4 of Appendix B – Head of funding agreement, states "the establishment levy will be at least [scheduled dollar amount] for each financial year". The FPA believe an establishment levy should be a one-off levy for setting up the scheme only and hence it is inappropriate for it to apply "each financial year".

Items 5.9(ii) and 5.10(iii) relate to calculating the levy payable by a contribution group and an individual participant taking into account the contribution group's / participant's proxy revenue. This implies and gives the proposed FSCS the ability to 'chase the money' and impose levies on those groups / participants with the largest revenue pools, regardless of their liability of the consumer loss. The FPA believes this is a completely inappropriate approach to consumer compensation.

The proposed Rules are also silent on the interaction of the multiple levies with other costs such as PI. The FPA suggest that the proposed FSCS will create a moral hazard for advisers and licensees as they will seek to insure against the possible levy risk and for someone else's possible future mistake, even though their business may have a 'clean sheet'. This cover will apply like an 'unknown excess'.

The approach to funding of the proposed FSCS will force the closure of small licensees and tie advisers to large dealer groups who would be the only businesses able to afford the imposed costs. It will also impact on entry into the advice market. The FPA questions how this proposed scheme would apply to and impact on the policy initiative of affordable and accessible advice under the current proposed FoFA reforms.

The FPA strongly suggest the introduction of such a scheme, particularly in the absence of fixing the problems in the current compensation system, will significantly impact on the Government's access to advice agenda.

The FPA does not support the proposed FSCS or the multiple levy funding model.

The FPA is confused by the 'funding limits' table on page 55 of the FOS submission. Firstly, the sectors named in column one of the table overlap in the services they provide consumers and do not align with the contribution groups named in the proposed Rule (so seem irrelevant).

10. Contribution groups

Item 5.8 Contribution Groups, give the proposed FSCS the "absolute discretion" to determine which contribution groups will be levied for any particular default. The FPA questions the appropriateness and transparency of this authority, particularly in the absence of any claims process. Any compensation scheme should, under the principle of natural justice, permit the claimant, defendant and other relevant parties to the claim, or an appropriate representative, to make a case in relation to the claim. This process should be mandatory for any compensation scheme, including a scheme of last resort.

The FPA recommends a scheme of last resort must permit the claimant, defendant and other relevant parties to the claim, or an appropriate representative, to make a case in relation to the claim. The cases

presented should be considered in detail by the scheme of last resort in determining and apportioning blame to a contribution group.

The FPA notes the list of contributions groups provided in item 5.8. While it is refreshing to see non-advice industries included, the FPA suggests the list could be improved by reflecting on those participants who have played a role in events that have lead to significant consumer loss in the past.

The FPA recommends the addition of the following financial services providers to the list of contribution groups:

- Product manufacturers
- Research houses / Credit Rating Agencies
- Auditors
- Accountants (operating under the accountant exemption and not as an Authorised Representative)
- Accountants operating as Authorised Representatives
- Stockbroker / share broker / Futures broker
- Investment banks (funding the development of financial products sold to consumers)
- Auditors (of products and product manufacturers)
- Platforms
- MIS and property schemes
- Margin lenders
- Hedge funds

Response to Financial Ombudsman Service submission

The FPA provides the following feedback in response to certain comments and statements included in the FOS submission. The FPA is concerned that the submission from FOS focuses on financial advice and advisers even though the scope of Review is to consider compensation arrangements for consumers of **financial services**. The FPA would strongly encourage Richard St John to consider the role and impact of the behaviour and stability of all financial services providers in influencing (directly or indirectly) consumers decisions and causing consumer loss.

1. Scaled advice

The FPA would like to clarify FOS claim that the Government is extending the licensing regime to include 'scaled advice'[13]. The legal ability for advisers to scale advice, while unclear, already exists within the law. It is not a new type of advice or an extension of the licensing regime. The Government's intention is to provide clarity around the ability to scale the advice and 'know your client' obligations under s945A based on the client's needs and the advice sought, to provide greater certainty for industry in delivering this service to consumers.

The FPA would strongly encourage FOS to ensure the ability to scale advice is considered in all determinations undertaken by the EDR Scheme.

[13] FOS submission to the Review of compensation arrangements for consumers of financial services, May 2011, pg 26

Other issues

1. Response to Professional Indemnity questions

The FPA would like to acknowledge the assistance of insurance broker Jardin Lloyd Thomson (JLT) in preparing responses to the following questions.

Consultation Paper Question 2.1
The capacity of the insurance market to supply licensees with professional indemnity insurance cover that is adequate to the needs of licensees considering the specific features ASIC requires the licensee to take into account such as minimum levels of cover, excess amounts the licensee can confidently sustain, and coverage of EDR scheme awards.

Response
The current insurance market has capacity via various underwriters to meet the requirements under RG 126 and RG 210

Consultation Paper Question 2.2
The circumstances in which the market has been able to supply run-off cover to a financial services licensee.

Response
Run-off cover is available during the policy period. However underwriters generally do not consider run off cover for a client that was not a current client when they were trading.

Consultation Paper Question 2.5
The longer-term outlook for the insurance market in terms of the supply, cost and coverage of professional indemnity insurance for financial service licensees in accordance with the requirements of s912B, associated regulations and guidance from ASIC.

Response
JLT has experienced a general hardening of PI premiums and policy coverage in the market, whereby increases in excesses and changes to policy endorsements. Examples include a reduction in coverage for specific investment products including primary industry, agricultural investment scheme products and mezzanine finance.

Consultation Paper Question 2.6
The circumstances in which licensees have found it difficult to acquire professional indemnity insurance cover that meets their needs.

Response
JLT has found limited market capacity available whereby the Financial Planner provides Managed Discretionary Account (MDA) services to their clients.

Consultation Paper Question 3.1
The trend in premiums for professional indemnity insurance taken out by financial services licensees, and the factors behind that trend.

Response
JLT has experienced a general hardening of PI premiums. One of the available markets has experienced a increase in claim notifications from five per month prior to the global financial crisis, now to approximately 60

claim notifications per month from financial planners and investment advisers. Other markets have experienced a large increase in claim notifications, which in has placed upwards pressure on insurance premiums.

Consultation Paper Question 3.4
The typical grounds upon which claims under professional indemnity insurance policies are not met.

Response
Non disclosure is a concern whereby PI claims are denied. Typical example include whereby the Financial Planner is providing services that are excluded by the policy, or the non-disclosure of business activities on the completed proposal form. It is imperative that the underwriter has a thorough understanding of the services provided by the Planner to ensure the correct premium is paid for the risk, with particular attention where the policy needs to be tailored to their specific requirements. If the Financial Planner is uncertain their policy is providing coverage for all their business activities they should contact their Insurance Broker to seek clarification.

2. Westpoint

The FPA would like to refute the statement in the Consultation Paper that "retail clients generally made their investments in a Westpoint financial product following advice from a financial adviser"[14]. This statement would be understandable if it were based on statistics provided by FOS as only Westpoint claims related to the provision of financial advice were within the Scheme's jurisdiction.

An illustrative example emerges from Westpoint, where consumers who rightly deserved maximum compensation for a corporate collapse in which they were defrauded, were met with relying on the PII of their financial advisers to recoup their losses. Notwithstanding that recipients of poor advice deserve to be compensated, inevitably the compensation available through this channel is less than the loss incurred, and it is limited by the proportionate role of advice in a corporate fraud that was enacted many layers higher in the product provider. Further, because requirements to have PII and be a member of an EDR are applied via licensing obligations, clients who engaged in Westpoint via an unlicensed adviser are unlikely to be able to avail themselves of compensation via PII or FOS. Compensation via these mechanisms would be unavailable to those who had directly engaged in Westpoint. Thus, model of resolution and compensation punishes the regulated, fails the consumer, and does not address underlying structural problems inherent to the compensation system.

While we recognise that there were indeed advisers involved in the collapse, and outline the FPA's actions in relation to Westpoint and issues emerging from Westpoint because these will demonstrate actions that we have taken over the past two years that we can make public, as follows:

Number of FPA Members	Complaints discontinued	Members Expelled	Members Suspended	Members fined	Membership terminated as a result of actions
13	2	1	1	7	11

The above actions reflect different sanctions depending on the type of breach that occurred. Each investigation went through the FPA's professional accountability process, culminating in Hearings conducted by the Conduct Review Commission (CRC).

[14] Review of compensation arrangements for consumers of financial services, Consultation Paper by Richard St John, pg. 58, April 2011