MAURICE BLACKBURN SUBMISSION IN REPLY TO RICHARD ST JOHN'S 'REVIEW OF COMPENSATION ARRANGEMENTS FOR CONSUMERS OF FINANCIAL SERVICES' CONSULTATION PAPER

1 INTRODUCTION AND CASE STUDY

1.1 Introduction

1.1.1 Maurice Blackburn represents investors who have suffered losses as a result of substandard financial advice. We act for both groups in class actions and individuals, and we provide representation either at the Financial Ombudsman Service or in Court.

1.1.2 We are concerned at the lack of protection for consumers in this industry, and in particular the difficulties with and uncertainty surrounding the recoverability of compensation when there is an entitlement to compensation.

1.1.3 With a combination of the *Corporations Act*, the *ASIC Act*, contract and the common law, there is a robust system in place which ensures that investors receive advice that is appropriate for them, of a reasonable standard and in their best interests. This framework goes a long way to ensuring consumer confidence in the financial planning industry.

1.1.4 However, there are circumstances where investors suffer losses as a result of a breach of the law but are not compensated for their losses due to, for example, no or no adequate insurance cover. These scenarios are eroding the confidence in the industry. Preventative action must be taken to prevent the further erosion of confidence, which is in our view inevitable as instances of like scenarios increase and the issue becomes known to the wider public.

1.2 Case Study

1.2.1 In 2010, we encountered a Licensee with a limit of $2 million for all claims in one year (2008-9). During this one year period, the Licensee had at least fifteen claims against it, which were accepted by the professional indemnity insurer. Maurice Blackburn had one client in this 'top fifteen' and issued legal proceedings on the client's behalf. At the Mediation, the Licensee did not appear to dispute liability but argued that the insurance limit was almost exhausted and the organisation expected to go into liquidation in the near future. The client was faced with the choice of accepting a settlement which did not reflect the value of her losses, or continuing to a hearing and risking that the insurance was exhausted by the time the hearing came around, or the company was insolvent.

1.2.2 Between 2008-2010 Maurice Blackburn received scores of inquiries regarding the same Licensee. Maurice Blackburn heard allegations of negligence against not less than four of the organisation's authorised

representatives. Maurice Blackburn came to the view that the Licensee was liable for many of these people's losses. However, when Maurice Blackburn advised these people about the issues regarding the recoverability of damages, eventually all the remaining people decided not to continue their claims.

1.2.3 The Licensee went into liquidation and the liquidator informed unsecured creditors, including those with legal proceedings on foot, that there were no assets and no professional indemnity insurance cover left to meet claims.

1.2.4 The liquidator also informed Maurice Blackburn that the following year (2009-2010), the Licensee continued to provide financial advice but had no professional indemnity insurance at all.

1.2.5 The Licensee went into liquidation and a new company was formed by at least one of the directors. This company continues to provide financial advice from the same office.

1.2.6 The individual advisers did not have assets in their names.

1.2.7 Maurice Blackburn complained about this possible phoenix activity to ASIC and ASIC responded that they had decided not to investigate it. Maurice Blackburn complained again to ASIC on behalf of a client and ASIC responded that they would reconsider whether or not to investigate.

2 STRENGTHENING THE EXISTING FRAMEWORK

2.1 Adequacy

2.1.1 Corporations Regulation 7.6.02AA requires a licensee to hold professional indemnity insurance which is adequate having regard to specified considerations that relate to the licensee's business, clients and exposure to claims.

2.1.2 In Maurice Blackburn's experience, it is apparent that this regulation is not sufficient to ensure adequate levels of PI insurance (see case study in part 1, above).

2.1.3 The concept of adequacy therefore should not be a matter for the Licensees to determine. Principle 2 in ASIC Regulatory Guide 126 should be amended to remove the notion that Licensees are responsible for assessing what is adequate cover in their circumstances.

2.1.4 Further, the adequate (minimum) levels need to be increased, that is Regulation 7.6.02AAA and Table 4 of ASIC Regulatory Guide 126 should be amended.

2.1.5 We note that currently, "a PI insurance policy must have a limit of at least $2 million for any one claim and in the aggregate for licensees with total revenue from financial services provided to retail clients of $2 million or

less. For licensees with total revenue from financial services provided to retail clients greater than $2 million, minimum cover should be approximately equal to actual or expected revenue from financial services provided to retail clients (up to a maximum limit of $20 million." (Table 4)

2.1.6 In Maurice Blackburn's submission:

- The minimum of $2,000,000 is grossly inadequate for any one claim or in the aggregate.
- It is not useful or necessary to have a maximum limit.
- Limits of cover should be similar to, for example, health professionals. It is noted that standard cover for an individual doctor in private practice is $20,000,000 for any one claim, and for hospitals it is also $20,000,000 for any one claim, with the Commonwealth government paying any amount which exceeds the limit.
- In our submission the minimum should be not less than $5,000,000 for any one claim and there should be no limits in the aggregate, or the Commonwealth should guarantee any amount which exceeds the limit.
- If it is necessary to adjust the minimum limit depending on the size of the Licensee's business, then the adjustment should not be made according to the business's revenue but instead the amount of funds under management by that business.
- When assessing the level of cover required, the question should not be "How much money is the business bringing in?" but rather "How much of the clients' funds are at risk?"
- The question of revenue is of little relevance to the level of insurance cover, whereas in order to estimate the cover required to protect clients' funds, the amount of those funds at stake should be the central consideration. A business may bring in less than $2 million revenue, yet be responsible for managing $20,000,000 of its clients' funds. If an adviser's negligence resulted in the loss of 10% or more of those funds, the business would be underinsured and the clients may be left without recourse.

2.2 Disclosure to the consumer

2.2.1 We note that Regulation 7.7.03A(1) requires disclosure of information on compensation arrangements by a licensee to a consumer, in particular the Financial Services guide must include a statement about "the kind of compensation arrangements that the licensee has in place" and "whether those arrangements satisfy the requirements for compensation arrangements under section 912B of the Act". These disclosure requirements are unhelpful to consumers.

2.2.2 The relevance of and consequences that flow from the nature of compensation arrangements would not be understood by many members of the general public and in particular vulnerable investors with little understanding of law or insurance.

2.2.3 Similarly, a statement that, for example: "*Our compensation arrangements satisfy the requirements of the Corporations Act*" generally contains little meaning for consumers.

2.2.4 Moreover, these disclosure requirements are not sufficient to ascertain whether insurance exists at the time of an investor wanting to make a claim. Financial Services Guides are often outdated and in any event Licensees are not required to disclose, for example, whether or not it's a "claims made and notified" policy or if run-off cover exists, therefore it is impossible to even determine whether or not the claim would come under the period of insurance.

2.2.5 One of the greatest problems that investors encounter when trying to ascertain whether compensation is recoverable following a loss that resulted from a breach of Licensee's duties, is working out whether there is insurance and/or assets to meet the claim. There is no mechanism for ascertaining whether or not professional indemnity insurance exists at any given point in time, and in our experience Licensees will not provide this information.

2.2.6 This uncertainty makes it very difficult for consumers to judge the benefit of pursuing compensation in order to balance it against the cost. It also results in money and time being spent in the pursuit of compensation when the exercise is pointless. For the clients in the case study in part 1 of this submission, some could have saved themselves thousands of dollars and two years of work and emotional hardship if they had been informed at the outset that there was no insurance or that the insurance had been exhausted.

2.2.7 In Maurice Blackburn's submission, Licensee's should be subject to an ongoing statutory duty of disclosure in circumstances when there is a real risk of there being no insurance or assets to meet claims. There should be a presumption that Licensees have either adequate insurance or the means to meet all claims made against it, and if this is not the case Licensees should be required to notify claimants in writing as soon as a claim is received.

2.2.8 We note that the Consultation invites submissions regarding the contribution of the current compensation arrangements in maintaining consumer confidence.

2.2.9 Confidence in the industry amongst those who have missed out on compensation due to inadequate insurance or compensation arrangements is clearly extremely low. Currently, these instances are not well known in the general public. As they continue to occur, they will become better known, and the erosion of confidence in the industry will become more widespread.

2.2.10 We have several clients who state that they specifically asked their advisers about insurance in the course of receiving financial advice (as

opposed to after the loss was suffered). This indicates that the existence of insurance instills confidence to some consumers.

2.3 Disclosure to ASIC

2.3.1 We note the Consultation Paper stated: "Once a licence is granted it is not subject to annual or other periodic renewal. However, a licensee is expected to notify ASIC if it is unable to meet its licence obligations, including the requirement to have adequate professional indemnity insurance" (2.26) and "If ASIC becomes aware that a licensee does not have professional indemnity insurance, it could take action to suspend or ultimately cancel the licence" (2.27).

2.3.2 In our experience, under the current regime either financial advice firms cannot be relied upon to notify ASIC if they do not have adequate PI insurance, or ASIC cannot be relied upon to take appropriate action. The Licensee discussed in the case study in Part 1 traded for approximately 18 months with no insurance at all. Either this Licensee did not notify ASIC or ASIC failed to stop it from trading.

2.3.3 In our submission, the consequences to the Licensee of breaching section 912(2) (i.e. having a license suspended or cancelled) are not commensurate with the consequences to individual investors who may, for example, be unable recover their retirement savings or lose their family home as a result of the breach.

2.3.4 It is possible for companies to wind up and for the same directors of that company to start a fresh company with a new licence (such as the one in the case study above). In this scenario, the company which had its licence cancelled would not incur any sanction for the breach of its duty to have adequate compensation arrangements.

2.3.5 In our submission the discretionary power to suspend or cancel a licence is not a sufficient deterrent to prevent Licensees from having inadequate insurance.

2.3.6 A more effective deterrent would be a non-discretionary, substantial penalty.

2.3.7 A substantial penalty would be not less than $1,000,000 or 15% of the previous year's revenue.

2.3.8 We note that a stockbroker must advise ASIC within 10 business days of the renewal of its insurance policy, including the amount and nature of cover, and to advise ASIC immediately of any notification to its insurer of a claim, and that failure to meet these obligations attracts a maximum penalty of $20,000.

2.3.9 In Maurice Blackburn's submission, the same obligations should apply to Licensees, accompanied by a substantial penalty.

2.4 One policy for both Licensees and authorised representatives

2.4.1 We note that authorised representatives are not required to have separate compensation arrangements of their own because they are covered by their Licensee's compensation arrangements.

2.4.2 The disadvantage of this is that because there are only approximately 3,300 Licensees, competition in the PI insurance market for this industry will not be high. It may be that only two insurers provide this cover. It may also mean that premiums are more expensive than in other industries where there is more competition for insurance. However, there are numerous countervailing advantages.

2.4.3 Because the law operates so that Licensees are liable for the actions of their authorised representatives, financial advisers are in the fortunate position of not being required to take out separate PI insurance. This is a very different scenario to, for example, doctors who work as consultants in hospitals.

2.4.4 This is a huge advantage to this industry. If there are around 3,300 relevant licensees and 40,000 authorised representatives, this is 36,700 less insurance policies required to be taken out.

2.4.5 Claims should be much easier to resolve because there are less parties who could be held responsible for the loss – i.e. the common scenario of the doctor blaming the hospital and the hospital blaming the doctor is not replicated.

2.4.6 The industry is spared complex employment relationships and corporate structures aimed at reducing liability, such as those that may exist in, for example, the health industry.

2.4.7 On the other hand, this is also an added danger to the potential for underinsurance. Whereas both individual doctors and hospitals take out insurance, in this industry there is one policy covering potentially hundreds of authorised representatives and thousands of clients, and therefore only one opportunity to ensure that it is adequate.

2.4.8 In Maurice Blackburn's submission, this supports the argument that the Regulations should be more proscriptive and the minimum cover higher.

2.4.9 Further, any perceived issues with affordability of insurance should not be considered without factoring in these advantages.

2.4.10 In any event, in Maurice Blackburn's submission a Licensee who cannot afford to pay for insurance to protect investors should not be operating.

2.5 Run-off cover

2.5.1 We note the Consultation's finding that: "In introducing its administrative guidance, ASIC initially proposed to require professional indemnity insurance to provide automatic run-off cover. However, following consultation with industry, ASIC concluded that insurers were generally not willing to provide this risk feature for licensees. ASIC did not proceed with the proposed requirement for run-off cover." (2.21)

2.5.2 It appears that the decision not to require run-off cover has made following consultation with the industry and not with consumers or their representatives.

2.5.3 It is unclear whether any consultation has occurred with insurers in this regard. We suspect that run-off cover would be available to Licensees for a premium.

2.5.4 This decision has been made purely in the interests in industry and to the detriment of investors, and will ultimately dissuade people from investing with financial advisers.

2.5.5 Due to the "claims made and notified" nature of PI policies generally offered in this industry, it is essential for the protection of consumers to have run-off cover.

2.5.6 In Maurice Blackburn's submission, Licensees should be required to have PI policies with automatic run-off cover.

2.6 Compliance

2.6.1 We note: "ASIC does conduct some risk-based surveillance of licensees through which it can check whether a licensee is complying with a range of statutory obligations including the adequacy of its professional indemnity insurance. It does not however conduct systematic or periodic compliance checks on the insurance held by a licensee." (2.25)

2.6.2 Oversight of Licensees' compliance with their obligations is essential and entirely consistent with ASIC's role as Regulator.

2.6.3 The obligation to have adequate PI insurance should be subject to no less scrutiny as all other Licensee obligations and, in light of the current concerns regarding the adequacy of arrangements, should in the immediate future be subject to higher levels of scrutiny (such as approved by ASIC in writing).

2.6.4 The minimum level of scrutiny should be systematic auditing of Licensees to determine if they hold adequate insurance cover, coupled with substantial penalties for non-compliance.

2.6.5 Further, in Maurice Blackburn's submission, it should be considered (as an alternative to prescribing higher minimum levels of cover) whether the word "or" in s912B(2)(a) should be changed to "and", so that the section reads:

912B(2) The arrangements must:
(a) if the regulations specify requirements that are applicable to all arrangements, or to arrangements of that kind satisfy those requirements; **and**
(b) be approved in writing by ASIC.

2.7 Financial Ombudsman Service (FOS)

2.7.1 The Consultation Paper invites submissions regarding "awareness by retail clients of the available dispute resolution scheme and compensation arrangements, and the degree of clarity to consumers about using those processes".

2.7.2 In our experience consumers are not aware of the existence of NGF or FCS.

2.7.3 Maurice Blackburn represents clients at FOS in financial advice disputes, as well as insurance disputes. In our experience, retail investors have a relatively good awareness of the existence of FOS. However, there is a very low degree of clarity surrounding the FOS process.

2.7.4 We regularly receive calls from investors who are frustrated after having attempted to pursue a claim at FOS. The most common criticisms are:

- FOS try to discourage me from pursuing my complaint
- FOS are acting as if they are on the other side
- FOS have asked me to provide figures/information/documentation which I do not have, but which should be readily available from the other side
- I have been at FOS for several months and only just been advised that there is a cap on how much they can award
- Months go by and I do not receive any correspondence or have my calls returned
- I have been at FOS for up to two years and I have not received a decision.

2.7.5 We therefore believe better communication, more transparency and the presence of more staff with consumer rather than industry backgrounds would improve FOS. (It should also be noted that this type of feedback was not generally received in relation to FICS, but has increased since the merger of several EDRs into FOS.)

2.7.6 The Consultation Paper invites submissions regarding our experience of the time, cost and outcomes of EDR versus court.

2.7.7 Maurice Blackburn advises consumers of the advantages and disadvantages of going to FOS and going to court. The main advantage of FOS is that it is free and there are no adverse costs risks. The disadvantages include: Cap on damages, no compensation for indirect loss, low rate of settlement, no court-ordered discovery and up to two years for a decision (Victorian County Court cases for example currently take approximately six to nine months to get to a mediation, or nine to fifteen months to get to a hearing).

2.7.8 Overall Maurice Blackburn is of the view that FOS is a useful and important alternative dispute resolution forum which is of significant benefit to consumers.

3 A Financial Services Compensation Scheme

3.1 The need for an FSCS

3.1.1 In Maurice Blackburn's submission, the aforementioned suggestions for strengthening the existing framework will go some way to improving the current compensation arrangements, but will not solve problems arising from a number of scenarios. The most common of those scenarios in our experience are:

- When a Licensee or authorised representative has behaved fraudulently or engaged in unlawful conduct
- When an authorised representative has provided advice without a letter of authority/licence or without insurance
- When a Licensee becomes insolvent
- When an insurance limit is exhausted

3.1.2 It is clear that these issues, discussed in the Ripoll Report and other evidence used in the Parliamentary Joint Committee on Corporations and Financial Services, Inquiry into financial products and services in Australia, are known to this Review, and therefore it is not necessary to explain how they come about.

3.1.3 In terms of the magnitude of the problem, we advise approximately half of the people who telephone seeking advice that it is likely that they would encounter issues in relation to recoverability due to one of the four reasons listed above.

3.1.4 Inevitably these claims do not proceed, regardless of their merits, due to the added uncertainty, the low prospects of there being assets or insurance to meet the claims and the costs and risks associated with trying to recover from individual advisers, many of whom hold no assets in their names.

3.1.5 In the past 12 months we have read about several Ponzi schemes in Australia. We infer that the victims of these schemes will have no recourse to compensation.

3.1.6 Insurers cannot be expected to cover unlicensed financial planners and the current regime provides no protection for investors who have acted on the advice of unlicensed or uninsured financial planners reasonably and in good faith.

3.1.7 In Maurice Blackburn's submission, the risk of a Licensee underinsuring should be borne by a fund or the Commonwealth government and not by the consumer.

3.1.8 For these reasons we believe that the current compensation scheme, even if strengthened, is inadequate and consumers require more protection. An adequate compensation scheme is a necessary part of any business that provides professional advice and is essential for consumers to have confidence in the industry, therefore a last resort compensation scheme is required.

3.2 Features of an FSCS

3.2.1 Maurice Blackburn supports a two-tier scheme similar to the UK model.

3.2.2 In our submission such a scheme should not replace the role of PI insurance and is a last resort scheme only. It should be available for retail and wholesale clients.

3.2.3 An investor should be able to look to the scheme for compensation where a financial services provider is unable to pay claims against it because it has stopped trading, has insufficient assets or is insolvent.

3.2.4 The scheme should have two roles: 1. Paying claims determined in the claimants favour by the court or an EDR scheme and 2. Stepping into disputes as an agent of the financial service provider if said provider is unable to defend itself.

3.2.5 In Maurice Blackburn's submission it is important for investors to have their entitlements determined by court or by FOS. If part of the scheme's role was to assess the merits of a claim, this would increase confusion around the compensation arrangements and potentially create a whole new set of precedents and/or rules.

3.2.6 If the scheme was responsible for assessing the eligibility for receiving compensation from the fund as in the UK scheme, this would also add another layer to the claim. Investors who may have spent years going through the complaint and then FOS and/or court process and who have obtained a decision in their favour would be stuck having to go through yet another process to establish their entitlement. Going through FOS and/or court is emotionally taxing, and by the end of the process investors are fatigued and we suspect some would not be willing to face yet another claims process – and the end result would be the same as currently: they would not be compensated.

3.2.7 We believe the court or alternatively FOS have the expertise and are in the best position determine the merits of claims. If claims were either accepted by the financial services provider or determined by the court or FOS, there would be no uncertainty regarding eligibility for compensation from the fund. This would substantially improve efficiency and effectiveness.

3.2.8 The financial service provider should be required to notify the fund and the consumer if they do not have adequate insurance or the means to meet all claims made against it. This should occur as soon as their liabilities exceed the assets available to meet claims and thereafter as soon as new claims are made.

3.2.9 For example:

- A financial service provider has $5,000,000 insurance for all claims in the aggregate (excluding defence costs) and no other available assets.
- Five people make claims estimated at $1,000,000 each.
- Two more people then make claims valued at $1,000,000 each.
- When the sixth person makes a claim, the financial services provider is required to notify the FSCS and all seven claimants immediately.
- When the FSCS receives notification, it nominates someone to oversee the claims process for the financial services provider and/or defend the claim if required.
- The insurer remains responsible for the first five claims. If these claims resolve for over $5,000,000, the fund will pay for the additional amount. If these claims resolve for under $5,000,000 the insurer is to notify the fund and elect to either take responsibility for more claims, or provide up to the balance of the limit to the fund if these claims are determined in the claimants' favour.
- If any further claims are lodged, notification should be sent to the new claimants immediately.
- If the matter is resolved by negotiation and an amount of compensation is agreed upon, the scheme would pay the compensation from the fund under the terms of settlement.
- If the claim is accepted by the financial services provider or determined by FOS or court in favour of the claimant, the scheme meets the obligations of the financial services provider pursuant to that decision.

3.2.10 The scheme should be funded by levies on financial service providers authorised by ASIC and should be able to receive recoveries and have access to borrowings.

3.2.11 We believe that such a scheme could potentially generate a substantial profit. We note the UK scheme has a retail pool of approximately £4.03 billion.

3.2.12 We believe the £50,000 cap on the UK scheme is grossly inadequate. We believe that if it is feasible there should be no cap, however while the

scheme is in the early stages a cap of $500,000 would be reasonable, subject to a review in three years.

3.2.13 The very existence of the fund would remedy the uncertainty surrounding recoverability for those who have suffered losses as a result of a breach of duty and do immeasurable good for the confidence of consumers in the industry.

3.2.14 We would not object to the scheme rather than ASIC having a role to play in approving insurance arrangements and the other matters discussed in parts 2.3 and 2.6, above.

4 GENERAL

4.1 We note that the Consultation Paper has invited submissions regarding "measures to lift the standards of licensee conduct or assist consumers in looking after their own interests".

4.2 Many suggestions are being discussed in the wider FOFA review. Of those, Maurice Blackburn especially supports an opt-in system and either removing the distinction between retail and wholesale clients or using a financial literacy test rather than wealth alone to determine who is a sophisticated investor.

4.3 In addition, we note that the current minimum training requirement (the RG 146) for financial planners can be obtained in a four day course. Maurice Blackburn submits that much higher level of education, such as an undergraduate degree, should be required.

4.4 Maurice Blackburn notes that Licensees are seemingly able to relieve themselves of liabilities by becoming insolvent (and in some cases starting again) with a great deal of ease. In our view this issue requires examination.

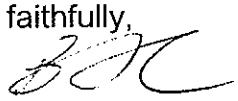
4.5 Maurice Blackburn is not of the view that Defence costs should be a compulsory feature of PI policies in this industry as if the financial service provider were paying the bills rather than an insurer, they may be more inclined to resolve the dispute.

In Maurice Blackburn's submission, a compensation scheme of last resort should be set up as a priority in order to fill the void that is currently leaving investors with compensable claims in financial ruin with no avenue of recourse.

Strengthening of the current arrangements including review of PI insurance and disclosure requirements should happen as soon as possible thereafter.

Please do not hesitate to contact Briohny Coglin should you require any more information in relation to these submissions.

Yours faithfully,



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