HAYES JOHNSTON PTY LTD

Chartered Accountants

Submission to Treasury: Review of the Australian Financial Complaints Authority

22 March 2021

Introduction & Overview

Hayes Johnston Pty Ltd are a Hornsby based Chartered Accountancy practice. We have been assisting, since January 2018, our client, who does not have any investment experience, who lost funds in investments in unlisted securities facilitated by a financial firm. The financial firm did not provide appropriate product disclosure documentation and failed to conduct appropriate checks on our client, as a new investor, to conclude that he was anything but a retail investor. We lodged, on his behalf, a complaint initially with the Financial Ombudsman Services (FOS) and then with the Australian Financial Complaints Authority (AFCA) which eventually resulted in a Determination in favour of our client on 29 January 2020. Under the Determination, the financial firm was required to repay the funds invested plus interest and a small allowance for professional costs, however, except for payment of an instalment in August 2020 of approximately 25% of the compensation awarded, no further funds have been received from the financial firm.

Over the time that we have been assisting our client with this matter, the financial firm has undergone several name changes whilst continuing to operate under the same Australian Financial Services Licence number. The matter has been referred from the Ombudsman to the Systemic Issues team within AFCA as well as to various areas within ASIC and, although there seem to be issues relating to the compliance of the financial firm with its obligations as an Australian Financial Services Licensee, neither AFCA nor ASIC seem able to compel the firm to meet its obligations under the Determination. The Ombudsman dealing with the case has advised that the remaining options include expelling the financial firm from membership of AFCA (which is used in extreme cases only) or pursuing legal options, which they were not prepared to do at that time, and have concluded that they have done all they can reasonably do unless circumstances change. AFCA have also referred the matter to ASIC who have contacted us from time to time to check if any further payment has been received under the Determination but they have been unable to discuss the matter with us or advise us if there has been any progress on the case as it relates to our client.

We are assisting our client on a no-fee basis and have spent time in excess of $31,000 (excluding GST) on this matter. AFCA, in its Determination, acknowledged that, in respect to this case, “responding to submissions has been a complex and lengthy process. I conclude that the accountant submissions have assisted AFCA undertake a detailed investigation of the issues and facilitated our assessment of the merits of the complaint”. The external dispute resolution (EDR) process in this instance has proved cumbersome, largely ineffective and does not seem to safeguard the interests of the consumer.

A copy of the Determination for case number 625358, as published by AFCA, is attached for your reference.

Key issues

Our submission in respect to AFCA delivering against statutory objectives draws on our experience assisting our client to navigate the external dispute resolution (EDR) scheme in the context of their complaint which is detailed in the attached Determination and is confined to the following questions as outlined in the "Review of AFCA Terms of Reference and guidance for submissions":

1. Is AFCA meeting its statutory objective of resolving complaints in a way that is fair, efficient, timely and independent?

In respect to the fairness and efficiency of the EDR framework, AFCA stated that it intends that the complaint resolution process is designed so complainants generally do not need representation to pursue a complaint and this is reflected in the low cap on the professional costs it will award against a financial firm. In the particular circumstances of our client, the financial firm did not have an effective complaints procedure nor did it make him aware of the options available to him in respect to external dispute resolution and by his own enquiries, our client was unable to determine how to take the matter forward. Further, the subject matter of the complaint was complex, our client was not provided with adequate documentation by the financial firm, at the time the investments were made and the complaints process has proved cumbersome as our client did not have sufficient knowledge of the issues in order to present his complaint without significant assistance.

We are aware that there were other investors caught in the same scheme as our client who also lost significant funds but did not pursue complaints against the financial firm. As the financial firm had changed its name and there was minimal documentation provided at the time the investments were made, we surmise that other investors were either not aware of the options available to them under EDR or, given the circumstances, found it daunting to commence a complaint against the financial firm. This would suggest that there are a significant number of consumers of financial services or products who are not aware of the existence of the dispute resolution process and that the process depends to an extent on the consumer having sufficient knowledge and understanding of the system and the financial products or services acquired in order to successfully navigate the system, particularly in more complex cases involving smaller financial firms or less conventional products.

Finally, we consider that a complaint is not resolved until any compensation awarded has been paid and in this respect AFCA, and subsequently ASIC, has been ineffective in enforcing the Determination. Despite receiving a portion of the compensation in August 2020, over 6 months after the Determination was accepted, approximately 75% of the amount awarded to our client remains unpaid. It is concerning that once the Determination was issued and accepted by our client, AFCA effectively closed the case and it seemed that the complainant, despite the necessity to resort to the external dispute resolution process to compel the financial firm to address the complaint, was then expected to navigate technical legal areas (signing of a Deed of Release and attending to share transfers) as well as deal directly with the financial firm who had consistently demonstrated through their conduct, from his early enquiries with the firm and throughout the complaints process, their disregard for the merits of the complaint and towards meeting their obligations, both as an Australian Financial Services Licence holder and in respect to our client.

1.1. Is AFCA's dispute resolution approach and capability producing consistent, predictable and quality outcomes?

We acknowledge the role that the AFCA process played in compelling the financial firm to produce offer letters and other documents which were not in the possession of our client at the time of making the complaint and which assisted us in investigating the merits of the complaint and therefore in presenting our client's case to AFCA.

The AFCA Determination clearly sets out the summary of the complaint, the issues determined and supporting facts about the case and any applicable rules and relevant law.

1.2. Are AFCA's processes for the identification and appropriate response to systemic issues arising from complaints effective?

In the experience of our client, the response to systemic issues arising from the complaint has not been effective. The Determination was issued in favour of our client on 29 January 2020 and since then there have been extensive emails and telephone calls with AFCA and ASIC representatives, representing time costs in excess of $10,000 (excluding GST), to comply with Determination and to attempt to compel the financial firm to comply with the Determination. A summary of our efforts to obtain payment of the compensation owed to the complainant under the Determination and the associated issues that arose from those efforts is included as an Appendix to this submission document.

Systemic issues, including the possibility that the financial situation of the financial firm was uncertain, were identified as a result of efforts to obtain payment under the Determination. Systemic issues seem to have been referred appropriately but the responses have not been effective both in compelling the financial firm to meet its obligations under the Determination and in the considerable amount time and effort required to make any progress at all. Further, the circumstances of the complainant seem to have been given a lower priority than other factors, for example, the decision to expel a financial firm from membership is taken in extreme circumstances only so as not to deny access to AFCA by other clients of the firm, however, it seems that the protection afforded to all clients of the financial firm is undermined if the financial firm is not compelled to meet some of its licence obligations.

Although systemic issues seem to have been identified and referred appropriately, in our experience, the processes have not enhanced consumer confidence in the regulatory system applicable to the financial services sector. The financial firm, which was the subject of our client's complaint, seems to have at least two Determinations awarded against it and has breached a number of obligations as an Australian Financial Services Licence holder so it is incomprehensible that they are still operating. It seems that the consumer is not afforded effective protections under the regulations applicable to the financial services sector if the financial firm can simply refuse to comply. There is no meaningful outcome for the consumer when the only remaining recourse is through the courts and the compensation amount would be quickly consumed by legal fees.

Recommendation – Compensation Scheme of Last Resort coverage expanded

We refer you to the attached document "Submission to Treasury Discussion Paper – Establishing a Compensation Scheme of Last Resort" prepared by AFCA in February 2020 in response to the Discussion Paper "Implementing Royal Commission Recommendation 7.1 – Establishing a Compensation Scheme of Last Resort" released by Treasury on 20 December 2019.

An effective external dispute resolution framework should enhance consumer confidence in the financial services sector. Our client has suffered financial loss and been awarded compensation by AFCA but has not received full payment of the amount owed to him due to the financial firm's inability or refusal to pay. There is significant injustice to our client that, despite having successfully exercised his rights through external dispute resolution and despite the responses by both AFCA and ASIC, our client has not received full payment of the compensation owed to him. There seems to be a significant power imbalance between the financial firm and our client and achieving a fair and just resolution through the Courts is out of reach of our client as it would quickly erode the compensation awarded to him. Legal costs are prohibitive and as such there is no effective recourse for the average investor. This exposes deficiencies in the mechanisms meant to provide redress for breaches of the law, represents a major gap in protection for consumers of financial services and undermines the external dispute resolution framework as well as consumer confidence in the financial services industry.

It is our understanding that the Federal Government is developing a compensation scheme of last resort (CSLR) covering eligible unpaid determinations from 1 November 2018 onwards to fill the gap in protection for consumers of financial products and services. A CSLR should cover unpaid compensation arising from the provision of any financial service and product that comes within AFCA's jurisdiction. If the financial firm ceases its business, including due to insolvency or having its licence cancelled, or in responding to systemic issues AFCA makes a decision to not pursue a particular course of action available to it against the financial firm, with the result that the likelihood of full payment of the compensation awarded to the consumer is unlikely, then a CSLR should be available to those consumers if the complaint fell within the jurisdiction of AFCA.

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Appendix – Summary of efforts to obtain payment under the Determination

Following is a summary of our efforts in attempting to obtain payment of the compensation owed to the complainant under the Determination, and the associated issues that arose from those efforts:

- 29 January 2020 - Determination awarded in favour of our client with compensation to be paid within 14 days of the Determination being accepted.
- 4 February 2020 - AFCA confirmed our acceptance of determination, advised that we contact the financial firm directly in respect to implementation of the determination, advised that AFCA's involvement in the case has concluded and that the case has been closed. We expressed our concern that, based on their previous conduct, the financial firm may not pay the compensation unless compelled to do so and that the case should not be considered as closed.
- 5 February 2020 - Sent email to financial firm with bank details and request for payment by 17 February 2020.
- 13 February 2020 - Received email from solicitors of the financial firm advising that they do not have funds immediately available and requesting to pay by instalments with the first payment due by 29 February 2020 and the final payment to be made by 30 April 2020. We wrote to AFCA, forwarding the email from the solicitor of the financial firm and requested guidance.
- 14 February 2020 - Received response from AFCA advising that the financial situation of the financial firm is understood to be uncertain and that there may not be adequate compensation arrangements in place as required by law and that the matter was being dealt with through reporting to the regulator.
- 18 February 2020 - Sent email to the financial firm confirming acceptance of the proposed payment arrangement and, advising the total payable including interest and confirming the steps we agreed to undertake in respect to assigning the rights and responsibilities in the securities as required by the Determination.
- 1 March 2020 - Received email from solicitor of the financial firm with transfer documents and Deed of Release for signature and list of required documents to facilitate transfers. No payment was received. On 3 March 2020 we wrote to AFCA to provide update in respect to email from solicitor, request that the Deed is checked to ensure it is in accordance with the Determination and advise that the first instalment of the compensation payment had not been received as agreed.
- 9 March 2020 - Sent email to solicitor advising payment not received and that we are arranging for the documents to be signed and waiting for advice from AFCA in respect to

the Deed of Release. Received further email from Solicitor requesting confirmation that we hold the required executed documents.

- 13 March 2020 - Received response from AFCA in respect to the questions asked in our email sent on 3 March 2020, advising that they could not advise in respect to the Deed and advising that the compliance team will also follow up on the issues.
- 16 March 2020 - Sent email to AFCA requesting that the terms of the Deed of Settlement be reviewed to ensure they are consistent with the outcome of the complaint and the principles governing AFCA as outlined in the relevant AFCA guide. On 17 March 2020, AFCA responded advising that one clause was unacceptable but that the rest of the Deed is not unreasonable.
- 17 March 2020 - Sent email to solicitor of the financial firm advising that we have in our possession the required signed documents. This email was acknowledged by the solicitor on 18 March 2020 and emailed to the financial firm.
- 1 April 2020 - Sent an email to AFCA advising that the financial firm had missed the agreed payment dates for the first two instalments of the compensation payments and that no payment has been received from them.
- 2 April 2020 - Received a telephone call from a representative from the AFCA Systemic Issues team asking us if any payment had been received from the financial firm. We advised over the telephone and in a follow up email that no payment had been received and forwarded copies of relevant emails.
- 27 April 2020 - Received a further telephone call from a representative from the AFCA Systemic Issues team asking us if any payment had been received from the financial firm. The representative was not at liberty to discuss the case with us.
- 8 July 2020 - Sent an email to AFCA advising that no payment had been received from the financial firm and requesting what further enforcement actions were available to AFCA to compel the financial firm to pay. Email response received from AFCA on 9 July 2020 with an undertaking to follow up with the Systemic Issues team to determine if there are any issues or just waiting on ASIC.
- 15 July 2020 - The financial firm contacted AFCA requesting bank details. On 17 July 2020 we sent an email to AFCA with the bank details, an updated calculation of the current outstanding balance and a copy of another Determination against the financial firm for reference.
- 24 July 2020 - Sent an email to AFCA advising that payment had still not been received and requesting advice and follow-up. Email response received on 28 July 2020 advising that the matter will be discussed with relevant representatives and next steps worked through.
- 20 August 2020 - Sent an email to AFCA requesting an update in respect to the case.
- 25 August 2020 - Telephone call to AFCA requesting an update. We were advised that there was nothing new to add and everything that could be done has been done. There has been no formal update to the complainant.

- 26 August 2020 - Sent an email to AFCA requesting advice in respect to possible remaining options to compel the financial firm to meet its obligations and make payment.
- 27 August 2020 - Received an email from AFCA outlining some remaining options which include expelling the financial firm from membership and legal options and advising that these would be considered in extreme cases only and so are not being pursued at this time. We were advised that if circumstances change, then these options may be revisited but that at this time AFCA have actioned all they can reasonably perform.
- 31 August 2020 - Received instalment of 25% of the compensation awarded. On 8 September 2020 we sent an email to AFCA advising that the payment was received and providing an updated calculation of the amount outstanding.
- 13 October 2020 - Sent an email to AFCA advising that no further funds have been received and outlining possible avenues that we may explore to try to obtain payment of the funds owing
- 26 October 2021 - Received telephone call from a Compliance Analyst at ASIC requesting to know if further funds have been received. He indicated that there was a possibility of some further funds being received by 31 December 2020 but could not elaborate.
- 12 February 2021 - We telephoned the Compliance Analyst at ASIC and advised no further payment has been received. He is not able to comment on the case. On 16 February 2021 and 17 February 2021, we telephoned him again to try to ascertain if we should lodge our own complaint or Report of Misconduct in respect to the matter but he could not elaborate if this would be helpful or not.
- 23 February 2021 - Sent an email to AFCA advising that no further payments have been received, advise that we have been contacted from time to time by a representative from ASIC to ask if payment has been received and that we are considering submitting a Report of Misconduct to ASIC in respect to the financial firm. To date we have not had a response to this email.

Determination

Case number	625358
Financial firm	APC Securities Pty Ltd

1 Determination overview

1.1 Complaint

This complaint centres around two investments made by the complainant. The complainant is the trustee of a family trust who says that the financial firm did not disclose relevant conflicts of interest, failed to provide adequate disclosure of the risks and failed to act in the complainant's interests.

The financial firm states that the offer was made to wholesale investors who were former clients and not to the complainant. Further the advice was general advice only and there was no obligation to act in the complainant's interests.

The case manager provided the parties with a recommendation on the issues in dispute. The recommendation was in favour of the complainant. A copy of the recommendation is attached to this determination.

1.2 Issues and key findings

Were the reasons and outcomes of the recommendation correct?

The reasons and outcomes contained in the recommendation were correct and are adopted in this determination.

What was the relationship between the parties?

The financial firm provided a financial product to the complainant as a wholesale client under general advice.

Did the financial firm's failure to properly assess the complainant lead to the losses suffered?

The financial firm should have prevented the complainant from investing as he did not meet the relevant criteria.

1.3 Determination

This determination is in favour of the complainant. Within 14 days of the date of the complainant accepting this determination, the financial firm should pay:

- $35,840 plus interest at a rate of 1.7% per annum this amount from 30 July 2014 to the date of payment, and
- $1,500 for professional costs

On request of the financial firm, the complainant must agree to assign the rights and obligations in the securities to the financial firm.

2 Reasons for determination

2.1 Were the findings in the recommendation correct?

I am satisfied that the case manager's recommendation contains an accurate summary of the complaint, the issues to be determined, any applicable paragraphs of the Rules and any relevant law.

2.2 What was the relationship between the parties?

The complainant was not a prior client of the financial firm

There are a range of parties who were involved in the complainant investing in the two batches of securities.

- Between November 2013 and August 2014, the financial firm contacted investors that it had previously dealt with about possible investments in North Korean mining by way of letters of offer from Mr DS, one of the directors of the financial firm.
- Mr U was one of these investors. He was a director of two of the companies invested in and the uncle of a friend of the complainant.
- Mr U introduced the complainant to the idea of investing in North Korea minerals and arranged a meeting attended by Mr U, Mr LS and 7-9 other people. Mr LS was a geologist and a non-executive director of one of the companies invested in.
- The complainant was advised by another friend, Ms G, to establish a Family Trust to "keep the shares in a holding structure to reduce the tax paid from the investment". Ms G facilitated the establishment of this arrangement for the complainant.
- The Family Trust invested $35,840 in two batches in mid- and late-2014.
    - SRE Minerals Ltd ($15,000), Black Eagle Gold Ltd ($6,240) and EHG Corporation ($9,600) on 30 July 2014; and
    - SRE Minerals Ltd ($5,000) on 5 December 2014.

  These investments were facilitated by the financial firm. Mr DS, was also a director of one of the companies invested in.
- From May 2015 onwards, the complainant became concerned about the investments. He telephoned Mr TA, a senior investment adviser at the financial firm, to seek information and clarifications in respect of his concerns. Mr TA was also a substantial shareholder in one of the companies invested in.

There were several conflicts of interest apparent

The share offer was communicated to the complainant primarily by Mr U. The direct involvement of Mr U and Mr LS in the operations of the relevant companies made any advice that they provided to invest inherently conflicted, thereby increasing the risk to the complainant.

I am satisfied however, that it is more likely than not that part of the 'sales pitch' by Mr U and Mr LS would have been that they were directly involved in the relevant companies. In the context of the introduction to the offer, this would likely have been mentioned to provide assurances that they knew what they were talking about.

I am also satisfied that the 'sales pitch' would have been designed to encourage investment and would have downplayed the investment risks.

However, understanding the precise details of the meeting is not necessary for the purposes of this determination as I am not satisfied that any representative from the financial firm was at that meeting.

The offer was general advice only

The complainant accepts that the first direct contact with the financial firm (except for the applications) was some six months after the last investment.

As a result, I am satisfied that the financial firm had no knowledge of the complainant's financial objectives, situation and needs and that it was not reasonable for the complainant to expect that the financial firm would have considered any of these. The offer letter was therefore not personal advice.

As the offer was general advice only, there was no requirement for the financial firm to understand the complainant's risk profile and financial circumstances, or to assess why these investments were suitable for the complainant in his circumstances.

The financial firm facilitated the investments

Mr DS of the financial firm was the author of the Placement Confirmation Letters (offer letters) which set out the terms and conditions of the relevant offer. The offer letters are substantively similar for the purposes of this complaint.

I accept the financial firm's submissions that:

- The offer of securities in the various entities was not specifically made to the complainant as the letters were addressed 'Dear Investor'.
- The share placement offers do not constitute personal advice to a retail client and were intended to be made to wholesale clients only and relevant disclosures were not made in reliance on this.
- The complainant, in completing the share application forms, provided various warranties and acknowledgements including that he had conducted his own investigations and independent enquiries sufficient to make his own informed decision about whether to accept the offer.

No checks were performed on the complainant

The offer letter for SRE, dated 19 November 2013, states:

> As no formal disclosure document (such as a prospectus) will be lodged with the Australian Securities and Investments Commission (ASIC) or otherwise prepared, the Placement Shares will only be issued or sold to one of the categories of investors to whom such an offer can be made without the preparation of a disclosure document.

The letters go on to provide a list of 16 representations, warranties and acknowledgements that were to be given by the investor to the financial firm, relevantly including:

> • By accepting this offer of Placement Shares, you represent and warrant for the benefit of the Company and any persons acting on its behalf (including directors and other officers, employees, contractors, agents and advisers), that:
>
> a) if you are in Australia, you are one of the following:
>
> 1. A 'sophisticated Investor' within the meaning of section 708(8) of the Corporations Act; or
>
> 2. A 'professional Investor' within the meaning of section 708(11) of the Corporations Act,
>
> and that, upon request by the Company at any time, you undertake to provide without delay all necessary documents and assistance to establish this as a matter of law.

The complainant accepted the offer and so held himself out to be either a 'sophisticated investor' or a 'professional investor'. Despite never having had any dealings with the complainant, the financial firm did not seek any documents or assistance to establish this.

The offer letter for EHG is dated 28 February 2014 and is functionally identical to the SRE offer letter.

However, the offer letter for Black Eagle Gold Ltd (BEG), dated 5 May 2014, is much briefer. It made the offer to the unnamed investor without disclosure on the basis that BEG shares were already held and the investor had both a track record of making similar investments and there was a past relationship. This was not the case with the complainant.

The complainant was not a sophisticated or professional investor

The default position is that all clients are retail clients unless an exemption applies to make them a wholesale client. As stated in the letter of offer, a relevant exemption is if the person is a 'sophisticated' investor.

The financial firm accepts that the complainant did not meet the test to be a wholesale client.

Despite this, the solicitor acting for the financial firm, in objecting to the recommendation, argued that as the financial firm was not providing advice, it was not required to establish the status of the complainant and determine what documents should be provided.

No basis is provided for this assertion; however, the financial firm relies on the wholesale only nature of the offer to explain why the complainant was not provided with various disclosure documents about the investments.

Section 761GA of the Act sets out the meaning of 'retail client – sophisticated investors'. See Section 3.2 for details. The test requires all of the aspects at ss(a)-(f) to exist.

Section 761GA(d) requires the financial firm to be satisfied on reasonable grounds that the complainant had previous experience sufficient to make the warranties and acknowledgements that he provided in the share application form. Section 761GA(e) then requires the financial firm to provide the complainant with a written statement of its reasons for being satisfied as to those matters.

The financial firm had no understanding of the complainant at the time of processing the share applications, aside from the fact that the complainant had made the application and was therefore deemed by the financial firm to have met the sophisticated investor or professional investor test. As noted above, it did not seek any further documents or assistance to establish the complainant's status.

As the financial firm had never had any dealings with the complainant until this point, I am satisfied that it had no reasonable basis for being satisfied that the complainant could make an appropriate or informed assessment of the merits, value or risks of the investments as required by s761GA(d). It should have made the further enquiries that it foreshadowed might have been necessary.

Further, on this basis, I am satisfied that the financial firm could not, and did not, provide an appropriate written statement as required by s761GA(e) in respect of the SRE and EHG offers. I note that it did provide this written statement in the BEG offer letter, but it had no reasonable basis to do so.

2.3 Did the financial firm's failure to properly assess the complainant lead to the losses suffered?

The offer letter for BEG contained no risk warnings

There were no statements made in the BEG offer letter about the risk of the investment.

The offer letters for SRE and EHG contained a number of risk warnings

The financial firm relies, in part, on an argument that the letter of offer set out that the investment was high risk. With respect to any risk assessment that could have been performed, the SRE and EHG letters of offer state:

- In making an investment decision, you must rely on your own examination of the Company and the terms of the offer, including the merits and risks

- You are aware that publicly available information about the Company can be obtained from the ASIC and ASX

- You have had access to all information that you believe is necessary or appropriate in connection with your purchase of the Placement Shares

- You have conducted your own investigations with respect to the Placement Shares and the Company including, without limitation, the particular tax consequences or purchasing, owning or disposing of the Placement Shares in light of your particular situation as well as any consequences arising under the laws of any other taxing jurisdiction, and have determined that the Placement Shares are a suitable investment for you, including regarding the nature, number and price of the Placement Shares being acquired

- The issue of Placement Shares pursuant to your acceptance of this offer is not covered by the provisions of the Corporations Act applicable to the National Guarantee Fund

- That an investment in the Placement Shares may involve a high degree of risk and that the Placement Shares are, therefore, a speculative investment

- That you have not, in accepting this offer, relied upon information made available to you by the Company, or its officers, employees, contractors, agents or advisors but have made and carried out sufficient independent enquiries and investigations adequate for you to make an informed decision regarding whether to accept this offer; and

- That you understand

    - The value of and rights attaching to the Placement Shares

    - The information that is needed to assess the merits and risks in respect of, and associated with the acceptance of this offer for, the Placement Shares, and

    - The risks involved in accepting this offer and accept those risks.

No specifics were provided of the risks and investors were left to try to source publicly available information to make their own assessment. As the complainant was not a sophisticated or professional investor, it was not reasonable to expect him to do so.

The risk warnings were inadequate for a retail client

If the financial firm had undertaken the assessment that it was required to make under s761GA in order to justify the non-provision of relevant disclosures to the complainant, then it would not have been able to reasonably assess that the complainant was a sophisticated investor.

As a result, under its own approach set out in the letter of offer, it should not have issued or sold the Placement Shares to the complainant as he did not fall into "one of the categories of investors to whom such an offer can be made without the preparation of a disclosure document".

The financial firm's failure resulted in the investment losses

I am satisfied that if not for the financial firm's failure to conduct checks on new investors, the complainant would not have invested.

The financial firm is therefore liable for the investment losses suffered by the complainant.

The complainant accepted the outcome of the recommendation which was that the financial firm should pay:

- $35,840 plus interest at a rate of 1.7% per annum this amount from 30 July 2014 to the date of payment, and
- $1,500 for professional costs

On request of the financial firm, the complainant must agree to assign the rights and obligations in the securities to the financial firm.

3 Supporting information

3.1 Process

This complaint has been determined based on what is fair in all the circumstances, having regard to the relevant law, good industry practice, codes of practice and previous decisions of the AFCA or its predecessor schemes (which are not binding).

A full exchange of the relevant information has taken place between the respective parties. Each party has had the opportunity of addressing any issues raised.

All the provided material has been reviewed and considered. The parties have raised numerous issues in their submissions to AFCA. However, commentary in this determination is restricted only to those submissions considered relevant to the outcome.

How we assess complaints

AFCA is not a court of law. We do not have the power to take or test evidence on oath, or to require third parties to give evidence. When we assess complaints, we consider available documents, the recollections of the parties, and all relevant circumstances. We give more weight to contemporaneous documentary information. If there is no relevant documentation, we will decide what is most likely to have occurred based on the information provided to us. If there are conflicting recollections and these are evenly weighted, we may find that a claim cannot be established.

3.2 Relevant law

CORPORATIONS ACT 2001 - SECT 761GA

Meaning of retail client--sophisticated investors

For the purposes of this Chapter, a financial product, or a financial service (other than a traditional trustee company service or a crowd-funding service) in relation to a financial product, is not provided by one person to another person as a retail client if:

(a) the first person (the licensee) is a financial services licensee; and

(b) the financial product is not a general insurance product, a superannuation product or an RSA product; and

(c) the financial product or service is not provided for use in connection with a business; and

(d) the licensee is satisfied on reasonable grounds that the other person (the client) has previous experience in using financial services and investing in financial products that allows the client to assess:

(i) the merits of the product or service; and

(ii) the value of the product or service; and

(iii) the risks associated with holding the product; and

(iv) the client's own information needs; and

(v) the adequacy of the information given by the licensee and the product issuer; and

(e) the licensee gives the client before, or at the time when, the product or advice is provided a written statement of the licensee's reasons for being satisfied as to those matters; and

(f) the client signs a written acknowledgment before, or at the time when, the product or service is provided that:

(i) the licensee has not given the client a Product Disclosure Statement; and

(ii) the licensee has not given the client any other document that would be required to be given to the client under this Chapter if the product or service were provided to the client as a retail client; and

(iii) the licensee does not have any other obligation to the client under this Chapter that the licensee would have if the product or service were provided to the client as a retail client.

Recommendation

Case number	625358
Financial firm	APC Securities Pty Ltd

4 Overview

4.1 Complaint

The complaint is about an investment of $35,840 into three share placement offers made by the financial firm. The complainant (Mr P) claims that in relation to these investments, the financial firm:

- failed to provide him with proper and appropriate advice
- failed to confirm his investor status prior to accepting share applications.

Mr P seeks compensation for the losses he made on the investments.

4.2 Issues and key findings

Did the financial firm provide Mr P with personal financial advice?

No. The letters of offer relating to each share purchased by Mr P do not constitute personal financial advice.

Was the financial firm required to confirm if Mr P was a wholesale client before accepting share applications?

Yes. The financial firm sent share offer letters to investors it had previous dealings with on the basis they were either sophisticated or professional investors. Mr P did not satisfy requirements to be classified as a wholesale client.

Is Mr P entitled to any compensation?

The firm's conduct caused the Mr P to lose a substantial part of his investments, which he should not have been allowed to make.

4.3 Recommendation

The recommendation is in favour of the complainant which should be compensated as outlined in section 2.3. Within 14 days of all parties accepting this recommendation:

- financial firm should compensate Mr P $35,840 plus interest for investment losses
- financial firm should pay Mr P $1,500 for professional costs

On request of the financial firm, Mr P must agree to assign his rights and obligations in the securities outlined in section 2.1 to the financial firm.

5 Reasons for recommendation

5.1 Did the financial firm provide Mr P with personal financial advice?

Mr P had no previous dealings with the financial firm

Between November 2013 and August 2014, the financial firm contacted investors that it had previous dealings with about share placement offers. The investments were considered high risk, including mining entities with operations in North Korea.

The weight of evidence shows Mr P came to learn about the share placement offers through a friend, Ms G who was interested in the investment opportunities. I am satisfied that Ms G was not a representative of the financial firm. She chose to promote the share opportunity to Mr P on her own accord.

In addition, Mr U was an existing client of the financial firm who did receive share placement offer letters. I consider that Mr U mentioned the investment opportunities to a family member, and as word spread in the local community, Ms G and Mr P came to learn about the share offers.

Mr P applied for shares on his own accord in 2014

Mr P made the following share applications:

30 July 2014

- SRE Minerals Limited – $15,000
- Black Eagle Gold Limited – $6,240
- Asian Tiger Gold (EHG Corporation) – $9,600

5 December 2014

- SRE Minerals – $5,000

The total amount invested was $35,840.

The share placements do not require provision of personal financial advice

The share placement offers do not constitute personal financial advice to a retail client. They were a general offer to investors that had been previously established as sophisticated or professional investors by the financial firm. The offers did not consider the goals, objectives or circumstances of Mr P.

The agent representing the Mr P wrote in a letter dated 30 July 2019, 'Mr P did not initially directly seek advice from [the financial firm]'. This is consistent with the submission made by the financial firm stating no financial advice was provided to Mr P and they only accepted the share applications.

The financial firm was not required to provide personal financial advice to investors. Mr P did not seek advice, and there was no evidence presented to me that allows me to conclude that any personal advice was given.

5.2 Was the financial firm required to confirm whether Mr P was a wholesale client before accepting share applications?

The onus is on the financial firm to demonstrate Mr P's investor status

The financial firm sent share offer letters to investors on the basis they were either a sophisticated or professional investor, meaning the offer could be made without disclosure documents.

The financial firm had no previous dealing with Mr P prior to receiving the signed share applications in 2014. Hence, they had no reasonable grounds to be satisfied that Mr P was a 'Sophisticated investor', within the meaning of section 708(11) of the *Corporations Act* or a 'Professional investor', within the meaning of section 708(11) of the *Corporations Act*.

The share applications were not sent to Mr P

The financial firm disclosed in an email dated 20 August 2019:

> *The application relative to the [Mr P] application was sent to Mr U who was accepted by [the financial firm] as a sophisticated/professional investor*

As the application was sent to Mr U and not Mr P, it is reasonable to conclude that Mr P did not have an opportunity to review the offer letter or consent to the terms before submitting the share applications. It is my view that the financial firm should not have provided the applications to Mr P through a third party.

For the financial firm to rely on the warranties and indemnities contained within the offer letters, Mr P must have reviewed the terms of offer prior to submitting the share applications. The terms of offer should have been signed by Mr P declaring he understood the terms and accepted the implications of being treated as a wholesale investor. The signed terms of offer should have been attached to the application form, returned to the financial firm and retained for record keeping purposes.

I consider a signed application form does not constitute an acknowledgement to the warranties contained within the share offer letters. The financial firm had to confirm the Mr P's investor status prior to dealing.

The financial firm had to satisfying itself that Mr P was a wholesale client

It is my view that the financial firm had to satisfy itself that Mr P was a wholesale client prior to accepting share applications. Legislation contemplates that for Mr P to be accepted as a 'Sophisticated investor', within the meaning of section 708(8) of the *Corporations Act*, the financial firm must have viewed a certificate provided by a

qualified accountant verifying Mr P's income and/or assets prior to the share offers. Furthermore, in accordance with section 708(10) of the *Corporations Act,* to offer securities without disclosure documents the financial firm had to be satisfied Mr P had previous experience investing in securities. The financial firm was required to have grounds to substantiate that Mr P could assess the merit, value and risks of the share placement offers.

I consider that it was not fair to expect Mr P to understand his investor status and self-assess his eligibility to apply for share offers. The financial firm had an obligation to confirm whether Mr P met the criteria of a wholesale client.

In an email dated 20 September 2019, the agent representing Mr P affirms that nothing indicated Mr P qualified as a sophisticated investor:

> *Mr P could never been classified as a sophisticated investor based on net assets and gross income, nor could he have, on any reasonable grounds, satisfied a financial services licensee on any basis that he had previous experience in using financial services and investing in financial products that would allow him to assess the merits, value and risks associated with holding the product as well as his own information needs and the adequacy of the information provided by the licensee.*

I conclude that Mr P was not a wholesale client and did not possess the relevant expertise to assess the benefits and risks of the share placement offers. In the absence of disclosure documents he could not make an informed decision about investing in high risk securities, such as mining entities with operations in North Korea.

5.3 Is Mr P entitled to any compensation?

The financial firm should not have accepted the share applications

Compensation for loss does not automatically follow a finding that the advice firm has breached the law. The onus is on a complainant to prove they suffered a loss and that a breach by the adviser caused that loss. This will generally be established by asking whether Mr P would have acted differently and avoided or reduced their loss but for the breach.

The financial firm has argued that they have not acted outside of their license and submit they are able to rely on the terms prescribed in the offer letter. However, I conclude that Mr P is a retail client and the share applications should not have been accepted by the financial firm.

Mr P incurred losses after having his applications accepted

Of the $35,840 invested in the share placements, only Invitrocue Limited (formerly EHG) is listed on the Australian Stock Exchange (ASX). However, it is noted that

Invitrocue Limited has not traded on the ASX since 8 August 2019. Furthermore, the other share investments Mr P holds are unlisted offshore securities.

Item	Amount
SRE Minerals Ltd	$20,000
Black Eagle Gold Limited	$6,240
Invitrocue Ltd (see notes)	$9,600
Actual Loss	$35,840
Professional costs	$1,500
Actual Loss calculation	**$37,340**

- Asian Tiger Gold (EHG Corporation) is known as Invitrocue Limited (ASX Code IVQ). Although, the security last traded on 8 August 2019.

The financial firm should pay interest

In calculating loss, the objective is to restore the complainant as closely as possible, to the position he would have been in but for the conduct of the financial firm.

Therefore, interest is payable on the compensation amount (ensuring that the real value of the compensation is maintained).

The financial firm should pay interest at a rate of 1.7% per annum (assumed average rate of inflation) on $35,840 from 30 July 2014 to the date of payment.

Assignment of the interest in securities to the financial firm

The investments in SRE Minerals Limited and Black Eagle Gold Limited are not listed on the Australian Stock Exchange. It is difficult to identify the value of these investments and the process to sell these investments has not been disclosed. Furthermore, Invitrocue Limited has not traded on the ASX since 8 August 2019 and I am concerned Mr P is unable to sell his holdings.

That being the case, it is fair in all the circumstances that upon request of the financial firm, Mr P must agree to assign his rights and obligations in these securities to the financial firm.

The payment is subject to the ownership transfer of SRE Minerals Limited, Black Eagle Gold Limited and Invitrocue Limited, and payment by the financial firm of any relevant transfer or assignment fees and any outstanding management or investment fees.

Mr P should be compensated for professional costs

The complainant claims contribution for his professional costs in relation to this dispute.

AFCA may decide that a financial firm should contribute, in most cases to a maximum of $5,000 (unless exceptional circumstances exist), to the “legal or other professional costs or travel costs incurred” by the complainant in the course of the dispute.

The AFCA complaint resolution scheme is designed so complainants do not generally need representation to pursue a complaint. However, the subject matter of the complaint has led Mr P to seek specialist assistance from his accountant, who has act as his agent. It is noted that the financial firm has had legal representation and responding to submissions has been a complex and lengthy process. I conclude the accountant submissions have assisted AFCA undertake a detailed investigation of the issues and facilitated our assessment of the merits of the complaint.

Although an invoice has yet to be issued, the cost for professional services rendered, are disclosed to be more than $19,000. In the circumstances, I consider it fair for Mr P to be compensated $1,500.

The firm must pay total compensation of $35,840 plus interest

Interest on the above amounts must be paid at 1.7% p.a. from 30 July 2014 until the date of payment.

Submission to Treasury Discussion Paper - Establishing a Compensation Scheme of Last Resort

Australian Financial Complaints Authority

February 2020

afca
Australian Financial Complaints Authority

Contents

Overview

The Australian Financial Complaints Authority[1] (AFCA) is the independent external dispute resolution (EDR) scheme for the financial sector.

We welcome the opportunity to respond to the Discussion Paper *Implementing Royal Commission Recommendation 7.1 – Establishing a Compensation Scheme of Last Resort* released by Treasury on 20 December 2019.

For many years, our predecessor ombudsman schemes[2] and more recently AFCA, have advocated and supported the establishment of a compensation scheme of last resort (CSLR) to fill a major gap in protection for consumers of financial services.[3] Our strong support for a CSLR has been influenced by the experience of over 400 people who, since 2010, have suffered financial loss through no fault of their own and, been awarded compensation by the Financial Ombudsman Service (FOS), the Credit Investments Ombudsman (CIO) or AFCA, but have not received any payment because of a financial firm's inability to pay them. This amounts to over $30 million in unpaid compensation.

The Government has recognised this injustice, and in the May 2019 Federal budget announced its intention to compensate these individuals. We warmly support the Government's grants program for unpaid FOS and CIO determinations which is processing payments to these individuals and will provide them with redress.

The CSLR proposals that are the subject of this consultation should provide the same protection to consumers who have gone through the AFCA process from 1 November 2018, and to consumers who will do so in the future. Without this measure there is a significant gap that will cause considerable hardship to consumers who have done nothing wrong, who have suffered financial loss, and taken appropriate action through AFCA only to have those EDR awards not honoured.

The road to the development of this policy has taken a long time but we commend the leadership shown by the current Government on this important issue.

Consumer confidence in the financial services industry has been badly impacted by unfair treatment, misconduct and uncompensated loss. As was evidenced by both the Ramsay Review[4] and the Financial Services Royal Commission, consumers need to have confidence that if things go wrong, they will be compensated when a decision is made in their favour. Establishing a broad based CSLR that holistically covers the financial services industry without carve outs is an important part of restoring

[1] Appendix 1 provides a brief overview of AFCA. For comprehensive information about AFCA, see our website www.afca.org.au.
[2] Financial Ombudsman Service (FOS) and Credit and Investments Ombudsman (CIO).
[3] http://www.fos.org.au/public/download/?id=53753 & http://www.fos.org.au/custom/files/docs/fos-response-to-supplementary-issues-paper.pdf
[4] Review into dispute resolution and complaints framework chaired by Professor Ian Ramsay. See Supplementary Final Report of the review, released on 21 December 2017.

consumer trust and confidence in the financial services industry following the Royal Commission. This re-building of trust is in the interests of all financial services firms and all Australians.

As we saw through the case studies presented at the Financial Services Royal Commission, the impact of a financial firm's actions can be devasting on an individual consumer and their family. There is often a big power imbalance between the parties and achieving a fair and just resolution through the Courts is out of the reach of most people. It is for this very reason that the Government established AFCA on 1 November 2018 to provide a one stop shop EDR scheme with a significantly enhanced jurisdiction and increased compensation limits. Over 91,000[5] consumers have now used this service; 81% of their complaints have already been resolved and $245 million has been obtained in compensation. There is a significant injustice and disillusionment though if a consumer successfully exercises their rights through dispute resolution, but the compensation awarded is not paid. This also significantly undermines the EDR framework.

Consumers deserve more from their relationship with financial firms. Whilst most of the financial services industry is responsible and quickly pays compensation when ordered to do so, this issue, caused by a few participants in the industry, must be addressed urgently. We are pleased to see the Government implement this recommendation of the Royal Commission. This is good policy and will improve the operation of the financial services industry sector as a whole. It will improve trust and confidence which underpins all dealings. This in turn is good for the whole economy.

As stakeholders work through the details required to implement a CSLR we do not underestimate the task and work ahead. However, when things get difficult the key focus should be on the impact of unpaid compensation on consumers and the broader implication this has on trust and confidence in the financial sector.

A CSLR will also enhance the reputation of relevant markets and consumer confidence in EDR, the regulatory system and financial services sector more broadly. We consider that it will also maintain existing incentives for both retail clients and licensees to recognise and manage their risks.

Our submission[6] draws on the experience of AFCA and its predecessor ombudsman schemes – organisations that have handled financial services complaints for more than 25 years.

[5] Figures are for period from 1 November 2018 to 31 January 2020.
[6] This submission has been prepared by the staff of AFCA and does not necessarily represent the views of individual directors of AFCA.

1 CSLR coverage

What is the appropriate coverage for the CSLR, beyond the coverage of personal advice?

AFCA strongly supports the 'broad-coverage approach' outlined in the Discussion Paper.

The CSLR should cover unpaid compensation arising from the provision of any financial service and product that comes within AFCA's jurisdiction, in the same way as the Government's grants program for FOS and CIO determinations did so.

In our view, it is essential that the CSLR covers financial firms of all forms of regulated financial services, financial advice or financial products.

If a consumer has been awarded compensation and this has not been paid by the firm due to insolvency, the type of financial service or product it concerns should not be a determining factor as to whether or not the consumer is compensated for their loss. It would raise significant issues of fairness and cause confusion for consumers if certain types of financial services are excluded from the scheme.

While many of the unpaid determinations have arisen from the provision of financial advice that has caused financial loss, the evidence indicates non-compliance with determinations is not limited to financial advice firms. The types of firms who have unpaid determinations extends past financial advisers who provide personal and general financial advice to include; credit providers; managed investment scheme operators; finance brokers; mortgage brokers; securities dealers and derivatives dealers. In our view, all firms are responsible for restoring trust in financial services and ensuring that their EDR obligations are met.

In our view, it is important that the CSLR also covers managed investment schemes (MIS). This is due to:

- the potential for unpaid determinations and consumer detriment to flow from this group;
- the involvement of other financial firms or their subsidiaries in the funding, distribution or other arrangements with MIS, and
- funding contributions to a scheme across the whole 'value chain' would support increased accountability of all participants, including MIS operators.

In our view including MIS and other financial products in the CSLR coverage should also be considered in the context of other relevant regulatory reform that has been implemented, including the recent introduction of ASIC's product intervention powers and unfair contracts legislation which apply to this group.

As outlined in a range of submissions previously made on establishing a CSLR[7], the need for a CSLR is separate to considerations of professional indemnity (PI) insurance-coverage and reform. PI covers business risk and is not a consumer compensation mechanism. Notwithstanding any need for further PI reform in relation to how firms meet their legal obligation to have adequate compensation arrangements in place, there is a need for a CSLR to cover loss where PI will not respond. These circumstances include fraud, amounts above PI limits and other situations where PI does not provide coverage or is not available.

We also consider that a broad-based scheme would assist in spreading the funding load across sectors, while including appropriate mechanisms in its funding model to minimise cross subsidisation. The CSLR is of benefit to all the financial services sector as it will help re-build trust in the industry as a whole. Without a broad funding base, the cost could fall heavily on parts of the sector that are least able to fund it. AFCA believes there is significant advantage in keeping the scheme and its administration as simple as possible.

Coverage should include all AFCA determinations

We believe the proposed CSLR should cover all unpaid determinations made by AFCA from 1 November 2018 onwards. This is to ensure there is no gap between the Government's unpaid determinations program (which covers AFCA's predecessor scheme unpaid determinations) and AFCA determinations.

Limited data exists relating to unpaid AFCA determinations given that AFCA only started receiving complaints from 1 November 2018. However, we have already seen several financial firms have their licences cancelled; cease business or enter into insolvency since 2018. Since our commencement there have been more than 40 AFCA determinations awarding compensation to consumers that have not been paid due to the insolvency of the financial firms involved. For this reason, we consider it is critical that CSLR cover any unpaid determinations issued by AFCA from 1 November 2018.

[7] See previous submissions made by FOS to the 2017 Ramsay Review - http://www.fos.org.au/custom/files/docs/fos-response-to-supplementary-issues-paper.pdf & http://www.fos.org.au/public/download/?id=53753

Coverage of voluntary AFCA members

There are only a small number of financial firms that are voluntary members of AFCA and we note that these firms are not currently subject to licensing or EDR requirements.

It is important to avoid any change that may discourage voluntary AFCA membership and prevent consumers from accessing no-cost, efficient EDR for redress.

We do consider that there should be further regulatory and licensing reform in a number of sectors that do not currently require an Australian Financial Services License or an Australian Credit License to operate, which is also relevant to whether a firm is a voluntary member of AFCA. This includes regulatory and licencing reform of debt management firms and buy now pay later providers. We acknowledge that in several of these sectors there are firms who currently voluntarily take out AFCA membership. In our view, licensing, IDR, and EDR requirements should be made mandatory in such sectors. Voluntary membership of EDR is not enough to protect consumers as the financial firm can choose to cease membership. Where this occurs, consumers would be excluded from accessing both AFCA and the CSLR and this could cause consumer detriment.

Inclusion of court and tribunal decisions should be considered later

To ensure equity to consumers irrespective of the forum from which they received compensation, AFCA believes the CSLR should eventually cover court and tribunal decisions as well as AFCA determinations. The compensation should be aligned with AFCA's compensation limits. It would be an unnecessary regulatory burden on the CSLR if the compensation limits were different to AFCA's. We see no benefit in having a different limit operating for the CSLR and there is a potential for consumer confusion as to their rights to access the CSLR if different limits existed.

We acknowledge that information about the extent to which court and tribunal decisions involving financial services are unpaid, needs to be gathered and analysed before they are included in the CSLR scheme.

Funding modelling of the impact of including court and tribunal decisions should be undertaken as part of this further work, and consideration needs to be given to how class actions would be dealt with by the CSLR. AFCA does not support the use of CSLR funds being made available to litigation funders.

As this further work is likely to take some time, a decision whether to include court and tribunal decisions should occur after the CSLR is established, so that it does not delay the commencement of the scheme for EDR determinations. We agree with the phased approach of considering this inclusion in the CSLR's first post-implementation review after three years.

2 Funding arrangements

AFCA considers that the CSLR should have an equitable broad-based funding model across financial firms, with an activity type (risk based component) and an ability to pay (sizing) component. Complexity in the CSLR funding model should be avoided and there should be appropriate flexibility built into the funding model to enable the CSLR to adjust and adapt funding arrangements to reflect any changing profile in unpaid compensation claims. It is important to keep the regulatory costs to a minimum.

AFCA's predecessor scheme FOS has previously provided high level modelling on how an industry funded model could operate. The modelling showed that if a broad coverage CSLR was implemented, when spread across all providers, both the establishment costs and annual contributions to the scheme's pool of funds and its administration could be kept quite low.[8]

Administrative and cost efficiencies could also be achieved by using existing AFCA systems and administrative infrastructure through a service agreement between the CSLR and AFCA.

Funding arrangements of the CSLR should cover:

- compensation paid by the CSLR;
- the CSLR's administration costs;
- capital costs (for establishing and maintaining an appropriate level of capital funds for future claims payments); and
- AFCA's claim handling costs arising from unpaid determinations against insolvent firms that are referred to the CSLR. Investigating and issuing Determinations on complaints against insolvent firms by AFCA is a CSLR related cost that requires coverage within the overall CSLR funding model.

Initial CSLR funding arrangements will also need to cover the once-off expense of establishing the scheme and covering eligible unpaid determinations issued by AFCA from 1 November 2018 onwards.

To what extent should the funding model be based on risk?

AFCA considers that the funding model should reflect risk and the type of activity firms are engaged in. This appears to be the most simple and equitable option and would reduce any potential industry cross subsidisation and keep the regulatory costs to a minimum. Obligations to collect and analyse data indicating risk should be kept to a minimum.

[8] https://www.fos.org.au/public/download/?id=53753

We favour an approach where funding is broad based across all licensees in which:

- some cost components, are covered by contributions based on both the size and the risk (determined by activity type) of the firm; and
- other cost components are covered by contributions based on the size of contributing financial firms.

CSLR levy calculations should be based on information for industry sectors or class rather than individual firms, which would also mean that work required and cost to collect and analyse information can be reduced. The CSLR would have an initial risk profile to apply to levy calculations which could change over time. In our view flexibility in funding future proofs to some extent the CSLR and reduces levy volatility.

AFCA metrics could be used to measure the size of financial firms

AFCA uses sizing metrics to classify its financial firm members. Using these metrics, levy cost components based on firm size can be calculated for each of AFCA's five size classes. We consider that these metrics could be leveraged and applied by the CSLR in its levy calculations. AFCA members already provide this data to AFCA annually and using this data would also assist in reducing CSLR administration costs. Appendix 2 contains more information about AFCA sizing metrics.

While this data is self-certified data provided by financial firms to AFCA, targeted validation of data provided could be considered. If there are relatively broad sizing groups applied, this would also minimise any impact of inaccurate data being provided.

AFCA activity groups could be used for the CSLR risk measurement

A key indicator of the risk presented by a financial firm is its activity type. This is an important factor that should be included in the CSLR's funding model and levy calculations.

AFCA currently collects and uses data relating to the business and activity type of each AFCA member. This information is used to calculate AFCA's membership levy.

We consider that these metrics could also be leveraged and applied by the CSLR in its levy calculations. AFCA members already provide this data to AFCA and using this data would also assist in reducing CSLR administration costs.

AFCA also has detailed information about determinations that have not been paid since 2010. Each of these determinations relates to particular financial services or activities.

When the CSLR is first established, levy cost components based on firm risk can be calculated using historical information about unpaid determinations. Over time, the calculations can use updated data on the number and amount of unpaid

determinations relating to particular activities to ensure levies appropriately reflect the risk.

Industry activity (risk rating) should be based on industry class/sector (type of financial services provided), rather than individual firm profile. The industry activity risk rating could be calculated based on historical unpaid determinations by each industry sector. This would enable progressive actuarial rating reviews over time, based on unpaid determination profiles, along with any other relevant factors.
To adopt a group – rather than individual – approach to classifying financial firms by their activities, existing AFCA complaints activity groups can be used or aggregated into broader categories. Appendix 3 contains a list of the activity groups AFCA uses.

To what extent should the funding model be based on a firm's ability to pay?

We consider that the CSLR funding model should take into account a firm's size and ability to pay. This will help ensure the CSLR is funded sustainably and will spread costs more broadly across financial services sectors. Cross subsidisation by industry sectors can be minimised by components of the CSLR levy taking into account a firm's risk and type of activity at a class level.

How should the funding model address unexpected costs?

Unexpected costs need to be further defined and clarified. However, the Ramsay Review[9] noted a range of measures that could be used to deal with the potential problem of unexpected costs. They include:

- collecting extra levies;
- including an additional sum in annual levies, to cover any unexpected costs, until an adequate capital base is accumulated; and
- borrowing so that, even with unexpected costs, the scheme can make timely compensation payments.

We agree with the comments on these measures made in the Discussion Paper. We consider that the CSLR should have an appropriate minimum capital base to assist in reducing levy volatility and to provide an adequate buffer for unexpected costs. The CSLR should also have sufficient flexibility to be able to manage its financial risk through a number of means where appropriate and cost-effective, including: borrowing; insurance; payment of claims by instalments and the ability to apply additional levies where required.

Given the level of unpaid determinations in recent years, we consider a minimum capital base of between $10-15 million should be established by the CSLR. Any additional capital base amount should be determined by the CSLR through regular actuarial modelling of claims. The amount of the minimum capital base required as

[9] Review into dispute resolution and complaints framework chaired by Professor Ian Ramsay. See Supplementary Final Report of the review, released on 21 December 2017.

part of establishing CSLR should also take into account current unpaid determinations data from AFCA since 1 November 2018 up to the CSLR being established.

In relation to a capital base we consider that an appropriate capital base would ensure that levy volatility as a result of any significant event is reduced for industry. This provides greater certainty for industry and means it would be simpler and more cost effective to administer the scheme. We would expect that a reduction in CSLR claims would result in reduced levies in future.

All of the above measures will, in our view, ensure that the CLSR operates efficiently.

How should the funding model promote sustainability and affordability?

AFCA notes the option of capping the annual levies that financial firms can be required to pay as described on page 14 of the Discussion Paper. AFCA does not oppose this option. However, input from industry on this and other funding components will be very important.

3 Compensation payments

How should the CSLR balance the interests of consumers and financial firms?

AFCA's claim limits and compensation caps were set in 2018. We support aligning the CSLR claim limits with compensation caps with AFCA's limits and caps.

Our claim limits and compensation caps are specified in the AFCA Rules[10]. The rules require these figures to be adjusted through indexation regularly and also allow additional increases to be made.

If the AFCA compensation caps are adopted, we suggest similar indexation requirements should also be adopted. The CSLR could provide for any additional increases to the AFCA compensation caps to apply either automatically or if the scheme decides they should apply.

How should the CSLR manage claims associated with large unexpected failures?

On pages 16-17, the Discussion Paper describes measures to deal with events resulting in large uncompensated losses. We believe these measures are appropriate and could be put in place for cases where payments could exceed a clearly defined threshold.

[10] See AFCA Rules, especially Rule D.4.3.

The CSLR should be able to spread compensation payments over a reasonable period. We suggest up to three years would be a reasonable period. Where the CSLR decides to spread payments, consumers experiencing financial hardship or special circumstances such as terminal illness, should be able to apply for earlier payments and the CSLR should have discretion to make payments earlier in this situation. This should ensure that consumers are treated equitably in their access to the scheme.

We consider that a cap on total compensation payments resulting from a single significant event could be an option, to ensure the CSLR remains sustainable and its funding is appropriately scaled to such claims.

We do consider that further actuarial modelling should be conducted to consider any appropriate cap level, both as part of CSLR establishment and at regular intervals after establishment. If a cap was put in place, it should be set at a reasonable level, so it does not discount or reduce claim payments to consumers who have been awarded compensation and should receive payment of their claim.

Consideration should be given to providing the CSLR with discretion to determine any cap level between minimum and maximum amounts.

How should compensation for legal and professional costs be limited?

We suggest that compensation for legal and professional costs paid by the CSLR should be aligned with AFCA's professional cost limits. Under AFCA's Rules, unless there are special circumstances, a limit of $5,000 on such costs applies per complaint – regardless of the number of claims or issues raised or the types of costs incurred.[11] In our experience we rarely award costs at that level.

The CSLR will pay compensation as awarded in the determination issued by AFCA. For this reason, there is no need to have a different approach to compensation for legal and professional costs. Again, we see no benefit in having a different limit operating for the CSLR and would be concerned about consumer confusion.

To what extent should the operation of the CSLR be responsive to experience?

The Discussion Paper notes on page 18 that, as a new scheme, the CSLR will need flexibility and will need the capacity to respond quickly to experience and developments.

As an industry-based scheme, we consider that the CSLR should have legislative underpinning, but with appropriate flexibility pursuant to its governing constitution, Rules and any regulatory guidance to respond and adapt to changes. This would be more consistent with the AFCA regulatory model, including ASIC oversight.

[11] See Operational Guidelines effective 1 October 2019, pages 187-189.

In our view the legislative framework should provide for:

- the coverage of the CSLR;
- obligations of financial firms to pay levies and cooperate with the scheme;
- the framework for the scheme's funding model;
- the authorisation of the scheme, including conditions of authorisation; and
- ASIC regulatory oversight of the scheme.

We consider that the structure of AFCA and the arrangements for its regulatory oversight provide a useful model for the CSLR. For example, the scheme's operations could be governed by a constitution and rules that could be altered readily to respond to experience. While we anticipate that legislation will set the broad parameters for funding, this would leave scope for the constitution and rules to impose more specific funding requirements.

Independence

In our view, if AFCA is to administer the CSLR, it will be important to separate the CSLR from AFCA's dispute resolution service. This can be achieved through a separate entity and governance. AFCA is an EDR scheme that investigates and considers the merits of complaints, which is a different service to the function of a CSLR.

We believe that the operating model of the CSLR should be clearly separated from AFCA's decision making, with appropriate accountability and transparency measures to ensure the independence of the CSLR.

4 Commencement of the CSLR

The Government has committed to establishing the CSLR by 31 December 2020, with the CSLR to then commence accepting claims from 1 July 2021. This commitment acknowledges that the CSLR establishment is a long-awaited and important reform.

AFCA welcomes the decision establish the CSLR promptly. We also note, however, that a substantial amount of work needs to be completed to establish the CSLR. Some establishment activities also cannot start until after any required legislative changes are passed. In addition, it is important that an appropriate period of time is provided for the CSLR to consult with industry on its funding model and levy components and to consult publicly on its Rules.

In our view, consideration should be given to adjusting the date that the CSLR commences accepting claims by six months to 1 January 2022 to ensure that the CSLR is established effectively.

Appendix 1 - About AFCA

AFCA is the independent EDR scheme for the financial sector replacing the Financial Ombudsman Service, the Credit and Investments Ombudsman and the Superannuation Complaints Tribunal.

AFCA sees its purpose as providing fair, independent and effective solutions for financial complaints. It does this not only by providing complaint resolution services free to consumers, but also by working with its members to improve their processes and drive up industry standards of service, thereby minimising complaints.

More broadly, AFCA plays a key role in restoring trust in the financial services sector. In addition to providing solutions for financial complaints, AFCA has responsibilities[12] to identify, resolve and report on systemic issues and to notify ASIC, and other regulators, of serious contraventions of the law.

AFCA's service is offered as an alternative to tribunals and courts to resolve complaints about financial firms made by individual and small business consumers. We consider complaints about:

- credit, finance and loans
- insurance
- banking deposits and payments
- investments and financial advice
- superannuation.

AFCA's role is to assist consumers to reach agreements with financial firms about how to resolve their complaints. We are impartial and independent.

If a complaint does not resolve between the parties, we will decide an appropriate outcome, including awarding compensation for losses suffered or substituting the trustee's decision in the case of a superannuation complaint.

[12] See ASIC's Regulatory Guide 267 *Oversight of the Australian Financial Complaints Authority.*

Appendix 2 - AFCA sizing metrics

AFCA classifies members into five (5) categories that reflect their business. The categories are as follows:

Very small | Small | Medium | Large | Very large

In AFCA, these categories are taken into account when calculating the appropriate annual levy for a member based on the size and type of business.

Annual levy assessment

AFCA members are required to complete an annual levy assessment and are asked different metrics based on their business activity. Financial firms are categorised on a curve based on the distribution of information provided to us for that assessment.

Nine business size data metrics are used, with members completing the metrics that are relevant to their business.

The diagram below is a high-level summary example of how these categories are calculated.

Further information about how AFCA determines the size of a financial firm is below:

All business activity types

Size

We ask for the total number of employees and/or representatives (individual and corporate) engaged in the selling, advising and distribution of the firm's products and/or services.

Business activity type dependent

Clients loans

The size of the loan portfolio as a result of direct lending to customers (e.g. banks, finance companies, micro lenders and leasing firms).

The total value of loans the firm has written in (e.g. mortgage broker), is managing (e.g. mortgage manager) or trying to collect (e.g. debt collection agency).

Client funds

The amount of client funds held in deposits, under advice (e.g. financial planners) or under management by the firm.

Premiums

The amount of premiums received for a contract of insurance (e.g. general and life insurers).

Appendix 3 - AFCA activity groups

- Accountant
- Administration services provider
- Bank
- Building society
- Charity/community fund
- Clearing/settlement house
- Corporate advisor
- Cover holder
- Credit provider
- Credit repair or debt negotiation provider
- Credit reporting agency
- Credit union
- Custodial and depository service
- Debt collector or buyer
- Derivatives dealer
- Finance broker
- Financial advisor/planner
- Foreign exchange dealer
- Friendly society
- General insurance broker
- General insurer
- Life insurance broker
- Life insurer
- Make a market
- Managed discretionary account operator
- Managed investments scheme operator/fund manager
- Mortgage aggregator
- Mortgage broker
- Mortgage manager
- Mortgage originator
- Non-cash payment system provider
- Pooled superannuation trust
- Private health insurer
- Product distributor
- Product issuer
- Professional indemnity insurer
- Provider of lender of record services
- Reinsurer/reinsurance agent
- Research house
- Securities dealer
- Stockbroker
- Superannuation fund trustee/advisor
- Travellers cheques/foreign currency transfer provider
- Timeshare scheme operator
- Trustee
- Underwiring agency
- Warranty provider
- Other