Submission to Inquiry into Future of Financial Advice legislation

Introduction

This is the submission by the Financial Ombudsman Service ("FOS") to the inquiry conducted by the Parliamentary Joint Committee on Corporations and Financial Services into:

- the *Corporations Amendment (Future of Financial Advice) Bill 2011* ("First Bill"); and
- the *Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011* ("Second Bill").

This submission has been prepared by the office of FOS and does not necessarily represent the views of the Board of FOS. It draws on the experience of FOS and its predecessors in the resolution of disputes about financial services.

Information about FOS

FOS commenced operations on 1 July 2008. It is an independent dispute resolution scheme that was formed through the consolidation of three schemes:

- the Banking and Financial Services Ombudsman ("BFSO");
- the Financial Industry Complaints Service ("FICS"); and
- the Insurance Ombudsman Service ("IOS").

On 1 January 2009, two other schemes joined FOS, namely:

- the Credit Union Dispute Resolution Centre ("CUDRC"); and
- Insurance Brokers Disputes Ltd ("IBD").

FOS is an external dispute resolution scheme approved by ASIC. Membership of FOS is open to any financial services provider carrying on business in Australia including providers not required to join a dispute resolution scheme approved by ASIC. Replacing the schemes previously operated by BFSO, FICS, IOS, CUDRC and IBD, FOS provides free, fair and accessible dispute resolution for consumers unable to resolve disputes with financial services providers that are members of FOS.

Members of BFSO, FICS, IOS, CUDRC and IBD are now members of FOS. The members of those schemes included:

- BFSO – credit providers, mortgage brokers, payment system operators, Australian banks and their related corporations, Australian subsidiaries of foreign banks and foreign banks with Australian operations;

- FICS – life insurance companies, fund managers, friendly societies, stockbrokers, financial planners, pooled superannuation trusts, timeshare operators and other Australian financial services providers;
- IOS – general insurance companies, re-insurers, underwriting agents and related entities of member companies;
- CUDRC – credit unions and building societies;
- IBD – insurance brokers, underwriting agents and other insurance intermediaries.

FOS and its predecessor schemes have over 20 years experience in providing dispute resolution services in the financial services sector, and it is estimated that FOS covers up to 80% of banking, insurance and investment disputes in Australia.

FOS provides services to resolve disputes between member financial services providers and consumers, including certain small businesses, about financial services such as:

- banking;
- credit;
- loans;
- general insurance;
- life insurance;
- financial planning;
- investments;
- stock broking;
- managed funds; and
- pooled superannuation trusts.

As well as its functions in relation to dispute resolution, FOS has responsibilities to identify and resolve systemic issues and obligations to make certain reports to ASIC.

FOS is a not for profit organisation funded by its members, which are financial services providers. It is governed by a board with consumer representatives, financial services industry representatives and an independent chair.

Submission

<u>First Bill</u>

1. Charging ongoing fees to clients

1.1 Renewal of ongoing fee arrangements ("opt-in reform")

1.1.1 No obligation to provide ongoing service

FOS understands that one of the key issues the opt-in reform is designed to address is the situation where a retail client pays ongoing fees but their adviser is not obliged contractually to provide ongoing service. Our dispute resolution experience indicates that this situation is relatively common and consumers,

understandably, consider it unsatisfactory. The case study in part 1.2.2 below is based on this situation. Examples of disputes that have arisen in this situation and been considered by FOS and its predecessor FICS are provided in the decisions published on our website fos.org.au (under "Cases").

These decisions include:

- Adjudication 19299 issued by FOS, in which the adjudicator found that "a trail commission of itself does not create an obligation on the member to provide further advice"; and
- Adjudication 15849 issued by FICS, in which the adjudicator stated that "there was no industry standard that imposed a requirement that the receipt of trailing commissions by the advisers meant that there be any ongoing advice."

Accordingly, the proposed opt-in reforms should significantly address this area of consumer concern and help reduce these types of disputes between financial services providers and their clients.

1.1.2 Clients not responding to notices

FOS has also dealt with a number of disputes involving circumstances where a consumer has been sent a form for completion in order to enter, renew or revise the terms of a financial arrangement with the financial services provider and the consumer has failed to do so for reasons such as illness, long holiday or difficulty in understanding technical language.

We consider clear communication by financial service providers to clients of the importance of the renewal decision is important, especially where the relationship involves an obligation of the financial services provider to provide ongoing advice and non- renewal would remove that obligation. We, however, note that compared to the current situation the opt-in proposal would provide clear incentives for financial service providers to take all reasonable steps over the relevant period to actively engage and facilitate the renewal notice process given the consequences for ongoing fee arrangements should clients decide not to, or fail for any reason to, renew.

We consider there are a number of possible ways to ensure clear communication by financial services providers on the renewal process and its consequences for clients.

One option could be to enhance the legislation by including requirements for a renewal notice to include a clear statement on the issues involved in renewal or non-renewal and or other procedural steps where there has been a failure to renew. Requiring this for all renewals could add administrative costs for what might be a relatively small number of cases. Another more flexible option would be to deal with these issues as part of ASIC guidance or to provide ASIC with the ability to establish additional steps for vulnerable and disadvantaged consumers should this emerge as an issue during the implementation of the scheme.

ASIC has recently stated it intends to provide guidance on aspects of the new regime when it comes into force. This guidance could set out the expectations of the steps financial services providers should take in contacting vulnerable and disadvantaged clients as part of the opt-in renewal process. In addition, ASIC could as part of its consumer education efforts provide consumer information on the importance of the renewal decision and the types of considerations consumers should take into account when doing so. In accordance with our usual approach, we would be able to take into account this guidance, among other matters, when dealing with disputes involving vulnerable or disadvantaged consumers who for one reason or another fail to renew.

1.2 Fee refunds

1.2.1 Rationale for subsection 962F(3)

Subsection 962F(3) states that, if a client makes a payment of an ongoing fee after a failure to comply with section 962G (the disclosure obligation) or section 962K (the renewal notice obligation), the fee recipient is not obliged to refund the payment. Section 1317GA allows a court to order the fee recipient to refund the payment if the fee recipient knowingly or recklessly contravened section 962P in charging the fee and it is reasonable to make the order.

Paragraphs 1.27 and 1.37 of the Explanatory Memorandum for the First Bill deal with subsection 962F(3). We do not think that paragraphs 1.27 and 1.37 explain why it would not be fair for the legislation to provide for a refund of overpaid fees and question the rationale for subsection 962F(3).

1.2.2 Disputes about fee refunds

In the year to 30 June 2011, we accepted 1,886 disputes about investment products and services. This represented a 15% increase from the previous year. Many of these disputes relate to advice. The table below shows the percentage of investment disputes accepted in the year to 30 June 2011, in five product categories, that related to advice.

Table: Investment disputes accepted in year to 30 June 2011

Product category	Number of accepted disputes	Percentage of accepted disputes that related to advice
managed investments	1157	43%
superannuation	379	26%
securities	213	16%
derivatives/hedging	115	18%
real property	12	67%

We estimate that in more than 50% of the financial advice disputes that we receive, the applicant claims to be entitled to a fee refund. We observe that, where consumers complain about financial advice, they often seek fee refunds.

Further information about fee refund disputes that we receive at present is provided in the examples and case study below.

Examples of fee refund disputes

- The most common scenario in a fee refund dispute is where the client alleges the adviser has provided defective investment advice and seeks a fee refund as well as compensation for investment losses. The basis of the claim for a fee refund is usually the breach of the implied term that the financial services are to be provided with due care and diligence (under subsection 12ED(1) of the *Australian Securities and Investments Commission Act 2001*).

- Another common scenario in a fee refund dispute is where the client:
  - alleges the adviser has failed to provide advice to dispose of a financial product that performs poorly or acquire a financial product that performs well and
  - seeks a fee refund and compensation for investment losses or loss of opportunity.

  This claim will only succeed if the contract of service requires the adviser to provide ongoing advice.

CASE STUDY

The Applicants alleged they had suffered a loss as a result of the financial services provider ("B") failing to provide ongoing investment reviews and sought compensation for the loss and a fee refund. B said it offered an ongoing review service but the Applicants had not taken up the offer. The Applicants said they had paid fees to B for a number of years and must be entitled to service on that basis. They argued it was unfair that they had paid fees in excess of $10,000 without receiving any service from B.

The documents indicated that B had offered the Applicants an ongoing review service, but the Applicants had rejected the offer. The Applicants had paid fees based on the value of their investments. However, B had clearly explained how it would be remunerated for its advice and that an extra charge would apply to the ongoing review service. FOS found the parties had not contracted for B to provide that service even though B received passive income as a result of its initial advice.

After the reforms are introduced, to the extent that financial advice disputes decrease, we expect fee refund disputes to also decrease. A new category of fee refund disputes may arise, in which clients allege that they paid fees after the adviser/client relationship terminated under the provisions in the First Bill. If subsection 962F(3) remains as drafted, however, we would need to take it into account when dealing with disputes concerning the obligations of financial services providers to provide fee refunds after termination. We consider it would be important that consumers and their advisers understand the potential effect of

this provision on fee refund claims, to reduce lodgement of disputes with FOS that have little prospect of success. In the absence of subsection 962F(3), we would handle any fee disputes after termination in accordance with our general approach to similar fee related disputes.

1.3 Application of disclosure, renewal and termination provisions

The disclosure, renewal and termination provisions in the First Bill ("Subdivision B") are designed to apply in relation to new clients. However, it is possible for business that at first is not subject to Subdivision B to later become subject to it. Paragraph 1.59 of the Explanatory Memorandum for the First Bill explains that this may occur where business is transferred and the fee arrangement for the business changes so substantially that it becomes a new arrangement. Paragraph 1.59 states "It is up to fee recipients to determine on a case by case basis whether a transfer of business results in the creation of a new arrangement to which the additional obligations would apply.".

We consider that the industry should be given guidance on when a transfer of business results in a new arrangement subject to Subdivision B. This is an important issue that may be difficult to determine

2. Enhancing ASIC's powers

2.1 Competency of financial advisers

FOS welcomes the reforms to enhance ASIC's licensing and banning powers. Through our involvement in disputes, we have observed many cases in which ASIC's current powers have proved inadequate for the reasons outlined in Chapter 2 of the Explanatory Memorandum for the First Bill.

Financial advice disputes that we consider often raise questions about whether advisers have adequate knowledge and skills. We provided dispute statistics to illustrate this in our submission to the *Inquiry into financial products and services in Australia* by the Parliamentary Joint Committee on Corporations and Financial Services in 2009. We note that the committee's report stated "The major criticism of the current system is that licensees' minimum training standards for advisers are too low, particularly given the complexity of many financial products".

Based on our dispute resolution experience, we believe that competency standards need to be raised significantly to restore public confidence in the financial industry.

CASE STUDY

The Applicant received advice from a financial planner ("Mr L") to make an investment in a managed discretionary account ("MDA") operated by a stockbroker ("Company C"). Mr L described the leveraged investment strategy used by Company C in its MDA as a covered options trading strategy. In fact, the leverage strategy was identified in Company C's

Product Disclosure Statement ("PDS") as being a securities lending arrangement. The Applicant made a $100,000 investment.

Company C acquired securities on behalf of the Applicant and transferred the title of the securities to Company P under a securities lending arrangement. Company P became insolvent and was unable to return an equivalent number of identical securities to the Applicant as provided by the securities lending arrangement. The Applicant received less than $10,000 of his investment capital from the receiver of Company P.

FOS asked Mr L to provide evidence of his investigation into MDA and the investment strategy used. Mr L said that he relied on information in the PDS and information provided to him by Company C who described the investment strategy as being similar to a covered options trading strategy. While the PDS stated the leveraged investment strategy to be used was a securities lending arrangement, Mr L believed the strategy was the same as a covered options trading strategy.

FOS found that Mr L failed in his duty to understand the product he was recommending to the Applicant and that a reasonably competent adviser would have known the difference between securities lending and covered options trading.

We note the work that has already been done towards the raising of competency standards. This work is referred to in documents such as:

- the Financial Planning Association of Australia's papers *Education strategy for the financial planning profession* and *Educational expectations for professional financial planners*; and
- ASIC's Consultation Paper 153 *Licensing: Assessment and professional development framework for financial advisers*.

In our view, it will be important for consumers that these initiatives deliver clear improvements in competency standards in the industry over the next few years..

2.2 "Phoenix activity"

In the course of our dispute resolution work, we see Phoenix activity. Where this occurs, consumers can be left with unrecoverable losses while the financial advisers responsible for the losses can continue to provide advice. Over the past two years, we have identified four cases of Phoenix activity that affected about 125 disputes.

There are many forms of Phoenix activity. One example is outlined below and a case study is also provided.

Example of Phoenix activity

- A large number of disputes against one licensee are lodged with FOS.
- The licensee's directors incorporate a new company with a name virtually identical to the licensee's name.
- The new company applies to ASIC for a licence.

- ASIC grants the licence.
- The new licensee grants authority to the old licensee's authorised representatives.
- The new licensee (and its authorised representatives) continue to advise clients of the old licensee, commence "new" client/adviser relationships with those clients and receive payments such as trailing commissions that follow the clients.
- The old licensee goes into voluntary administration or liquidation.
- There are no assets in the administration or liquidation to pay unsecured creditors (including applicants in the disputes lodged with FOS) and the old licensee's professional indemnity insurer has denied liability.
- The new licensee continues to carry on a financial services business.

CASE STUDY

Mrs V, a retiree in her mid-70s, received financial advice from Company X between 2004 and 2007 including recommendations to invest about 25% of her retirement savings in various unlisted property and mezzanine mortgage schemes. All of these schemes failed in 2007 and 2008 and all of the investment capital has been lost.

Mrs V lodged a dispute with FOS seeking compensation for the loss, alleging that the advice was inappropriate for her circumstances. About 50 other people advised by Company X to make the same investments as Mrs V also lodged disputes with FOS.

The directors of Company X, realising the company would be insolvent if it was found by FOS to have provided poor advice to even one of the Applicants, incorporated Company Z and applied for a financial services licence for the new company. Company Z was licensed and commenced trading after purchasing the business of Company X. The directors then appointed a liquidator over Company X.

Mrs V is devastated to learn that there is little or no chance of receiving any compensation. Her devastation is complete when she realises the people who provided the advice continue to operate as financial advisers.

The question Mrs V reasonably asks is – *"How can the people who caused my losses continue to trade while I have to deal with the consequences of their actions?"*

In disputes relating to instances of Phoenix activity, we see that the Applicants are frustrated and angry. They are left with losses that may not be compensated while the financial advisers considered responsible for the losses continue to operate under new licences.

We support reforms to prevent Phoenix activity. We consider that the proposed enhancements to ASIC's powers through items 2 to 9 of Schedule 1 to the First Bill should enable ASIC to deal with various forms of Phoenix activity.

Second Bill

3. Best interests obligations

FOS operates in accordance with Terms of Reference, which are on our website fos.org.au (under "About Us"). The Terms of Reference require us, when deciding disputes, to do what is fair in all the circumstances, having regard to:

- legal principles;
- applicable industry codes or guidance as to practice;
- good industry practice; and
- previous relevant decisions of FOS or its predecessors.

As noted above, we consider large numbers of investment disputes, such as disputes about inappropriate advice and conflicts of interest. When considering investment disputes, we have regard to factors including:

- the current financial services legislation;
- guidance issued by ASIC; and
- industry guidelines.

When the proposed reforms are introduced, we will continue to follow the approach described above. We will have regard to the same factors in decision making, but those factors will themselves change. For example, ASIC's guidance will change.

From our dispute resolution experience, we have developed considerable expertise in relation to the existing law governing investment advice and other relevant material such as regulatory guidance and industry standards. There are many common elements between the proposed legislation and the legislation it is to replace.

We already routinely deal with section 945A disputes where we assess the financial services provider's consideration of the relevant personal circumstances of the client, investigation of the subject matter of the advice and its suitability. These matters are relevant to the proposed best interests obligations.

Further, we routinely consider the following matters in financial planning disputes.

- Whether the information provided to the adviser is complete or inaccurate and whether the adviser should have made further enquiry.

  We consider it good practice for advisers to obtain complete and accurate information from clients. A failure to do so will often lead to a conclusion that the adviser has not properly considered the client's relevant personal circumstances.

- Whether it is reasonably apparent that the client's objectives could be better achieved or met by obtaining advice on another subject matter.

For example, where a client's current course of action is likely to achieve the objectives and the adviser recommends a change, we are more likely to consider the advice to be inappropriate and, under the new regime, not in the best interests of the client.

- Whether or not the adviser has the expertise to give the advice.

  We have dealt with this issue in the past in the context of the duty of care.

- Whether the client's objectives could have been achieved through means other than the acquisition of financial products.

  We have dealt with this issue when considering disputes about advice to use gearing or double gearing strategies to reduce debt. Better options may have been budgeting by the client or, if necessary, refinancing.

Our existing experience and expertise provides a good basis on which we can draw in dealing with disputes under the proposed regime.

4. Conflicted remuneration

Paragraphs 2.2 to 2.6 of the EM discuss evidence that conflicted remuneration arrangements adversely affect the quality of financial advice. We have considered numerous disputes in which advisers who received conflicted remuneration provided inappropriate advice to retail clients. The evidence and our experience cause us to support the proposed ban on conflicted remuneration on the basis that it may reduce financial services disputes.

We understand the rationale for imposing the ban only in respect of advice to retail clients. It may be necessary to introduce regulatory measures to ensure that clients are correctly classified as wholesale or retail.

We note that an Options Paper released by Treasury in January 2011 considered the distinction between wholesale and retail clients under the *Corporations Act*. We refer to our submission in response to the Options Paper, which is on the Treasury website.

5. Disputes

A number of the investment disputes considered by us or our predecessors arose where there were:

- conflicted remuneration arrangements; and/or
- conflicts of interest.

We welcome the reforms to address these issues, which promise to reduce complaints and disputes.

We deal with disputes about the appropriateness of geared investment strategies and advice to acquire financial products that pay higher than usual commissions. The proposed ban on conflicted remuneration should, in our assessment, reduce the number of these disputes.

We also deal with disputes where a representative of a licensee has recommended a financial product issued by an entity related to the licensee. Currently, these disputes are typically dealt with as inappropriate advice disputes. Alleged conflicts of interest are usually disclosed in accordance with requirements under the *Corporations Act*. We expect that there will be fewer disputes about a financial product issued by an entity related to the adviser who recommended the product if the proposed best interests obligations are introduced.