Submission

FINANCIAL SYSTEM INQUIRY

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Introduction

This submission addresses some of the terms of reference of the Financial System Inquiry (FSI). These terms of reference are extremely broad and can cover a range of issues from the financial services regulatory framework to the superannuation rules. This broad review can 'offer a blue print for the financial system over the next decade.'[1] However, we submit that the current financial system does not need radical change as the regime has great potential. It has allowed Australia to survive the Global Financial Crisis with minimum negative impact on the economy. However, cracks in the system are getting more pronounced and need to be remedied.

As the foundation of a great financial system is already in place, we recommend that some of the key areas that should be reviewed and enhanced to improve the current cost, quality and availability of financial services and products are:

- The financial service licensing regime – We recommend that harmonisation of the financial services licensing regimes takes place;
- The retail and wholesale distinction – We recommend a review of the retail clients definition and a harmonisation with the consumers' definition under the *Australian Securities and Investments Commission 2001* (Cth);
- The disclosure relevant to the issue of financial products – We recommend a simplification of the disclosure regime regarding financial products and services; and
- The limitations for effective remedies and compensation – We recommend an enhancement to the compensation regime and other relief available to retail clients to ensure the available remedies are more accessible to retail clients.

If any of the responses require further explanation please contact Dr Marina Nehme (UNSW Australia) at m.nehme@unsw.edu.au and/or Dr Ulysses Chioatto at Ulysses.Chioatto@uts.edu.au

Financial services licensing regime

An effective licensing regime is essential for the protection of consumers as it would exclude untrained and unqualified people from the financial services industry and it will set professional standards that have to be met by financial services providers.[2] Additionally, Finkelstein J stated that 'one of the reasons for requiring financial service providers to be licensed is to promote "consumer protection in [the] financial services" [industry].'[3]

[1] *Financial System Inquiry*, <http://fsi.gov.au/>.
[2] *Cairnsmore Holdings Pty Ltd v Barsden Holdings Pty Ltd* [2007] FCA 1822, [32]; Baxt, Black and Hanrahan, above n 4, 458; Office of Regulation Review, *Submission: Review of the Licensing Regime for Securities Advisers* (1995) 2.
[3] *Australian Securities and Investments Commission, Re Giann & Giann Pty Ltd* (2005) 141 FCR 278 at [19] where Finkelstein cited the Parliamentary Joint Statutory Committee on Corporations and Securities, *Report on the Financial Services Reform Bill 2001*, [4.12].

Following the recommendation of the 1997 FSI report, the *Financial Services Reform Act 2001* (Cth) (FSRA) introduced 'a single licensing regime for financial sales, advice and dealings in relation to financial products.'[4] The Explanatory Memorandum of the Financial Services Reform Bill 2001 (Cth) noted the important of this move and the need for change by stating:

> ... a sector that is rapidly consolidating, where banks now offer stockbroking services and financial advisers provide advice on a broad range of financial products. These entities are obliged to obtain multiple licences and to comply with a range of legislation and non-legislative instruments that may be inconsistent in conduct and disclosure standards. Potential competitors are discouraged from entering the market by these complexities, and those involved in offering a range of services and products incur high compliance costs and an increased administrative burden.[5]

While the FSRA attempted to harmonise the licensing of financial services providers, this harmonisation attempt which can lead to cutting red tape has not been successfully implemented over the decade. For example, a new superannuation licensing regime began on 1 July 2006.[6] This introduction of a new licensing regime means that trustees of registrable superannuation entities (RSE) have to apply for a licence from the Australian Prudential Authority (APRA).[7] In addition, the trustee may be required to apply for an Australian financial services licence.[8]

These two licences have a different focus. The RSE licence is prudential in nature. ASIC's licence mainly focus on consumer protection and market integrity. However, even though this is the case, there is still an overlap between the two licences. For example, when issuing a financial services licence, ASIC relies on prudential requirements such as financial resources and risk management when assessing an application for an Australian financial services licence.[9] Consequently, the Association of Superannuation Funds of Australia Ltd noted the following:

> The requirements to qualify for an RSE Licence are extremely high and comprehensive. Trustees should not be required to obtain an AFS [Australian

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[4] Revised Explanatory Memorandum, Financial Services Reform Bill 2001 (Cth), [1.4].
[5] Explanatory Memorandum, Financial Services Reform Bill 2001 (Cth) [2.40].
[6] *Superannuation Safety Amendment Act 2004* (Cth), s 2.
[7] *Superannuation Industry (Supervision) Act 1993* (Cth), ss 29A, 29B and 29C.
[8] *Corporations Act 2001* (Cth), s 911A.
[9] *Corporations Act 2001* (Cth), s 913A. However, it is important to note that ASIC and APRA have taken certain steps to minimise the overlap. See for example, ASIC, 'How Do the RSE and AFS Licensing Application Processes Work Together?' <http://www.asic.gov.au/asic/asic.nsf/byheadline/How+do+the+RSE+and+AFS+licensing+application+processes+work+together%3F?openDocument >. However, business submissions to the government have highlighted concerns regarding the relations between ASIC and APRA: Productivity Commission Research Report, *Identifying and Evaluating Regulation Reforms* (December 2011) [H Regulators Performance] <http://www.pc.gov.au/__data/assets/pdf_file/0018/114165/regulation-reforms.pdf >.

Financial Services] Licence in addition to an RSE just to provide members with general advice.[10]

Accordingly, the sectors subject to both ASIC and APRA licensing regimes must apply and pay for two licences and then must fulfil the requirements of the multiple licensing rules. This may raise the cost of compliance for these businesses. Further, the dual licensing regime may create a barrier to entry into the industry and this, in turn, may limit competition and give certain entities monopoly powers.[11] As a result, the number of trustees of RSE has fallen over the years as a number of businesses have viewed that the members' best interest would be served if the business was part of a bigger institution.[12] This is also illustrated in Table 1.

Year	Number of Trustees of RSE	Percentage of change from year to year
30 June 2006	307	---
30 June 2007	306	-0.3%
30 June 2008	292	-4.6%
30 June 2009	278	-4.8%
30 June 2010	251	-9.4%
30 June 2011	225	-10.5%
30 June 2012	209	-7.1%

Table: Licensed Trustees of RSE since the introduction of the licensing system in 2006[13]

In addition to the dual requirements that certain industries may face, the Parliament has introduced a whole new licensing regime for ADIs and other financial institutions that provide credit or credit-related services to consumers as part of their product offering. ADIs are now required under s 29 of the *National Consumer Credit Protection Act 2009* (Cth) (NCCPA) to hold an Australian credit licence (ACL), in addition to the Australian Financial services licence (AFSL) that many of them will hold. The NCCPA licensing regime is modelled on the AFSL regime and subjects' licensees to similar, but not identical, ongoing compliance requirements (see the wording in section 47 of the NCCPA and section 912A of the *Corporations Act 2001* (Cth)). This move may also impact on competition due to the compliance cost that an ACL may involve. The cost may include the payment of fees to lodge the application with ASIC, annual compliance costs and costs of External Dispute Resolution Scheme membership.[14] This may also raise the cost of business for smaller entities. For instance, Abacus Australian Mutual stated:

[10] The Association of Superannuation Funds of Australia Ltd, *Submission to the Productivity Commission: Annual Review of Regulatory Burdens on Business* (2010), 3 <http://www.pc.gov.au/__data/assets/pdf_file/0006/96027/sub020.pdf >.

[11] Pearson, above n 12, 105.

[12] APRA, *Annual Report 2011*, 29.

[13] The data has been collected from APRA's Annual Reports: APRA, *Annual Report 2012*, 46; APRA, *Annual Report 2011*, 47; APRA, *Annual Report 2010*, 39; APRA, *Annual Report 2009*, 39; APRA, *Annual Report 2008*, 33; APRA, *Annual Report 2007*, 31; APRA, *Annual Report 2006*, 31.

[14] Revised Explanatory Memorandum, National Consumer Credit Protection Bill 2009, 7.

> The additional regulatory burden imposed by financial services licensing and credit licensing has not advanced the interests of credit union and building society customers.[15]

Accordingly, for certain entities, the FSRA did not necessarily reduce their licensing burden as they are required to obtain a second licence, over and above the authorisation, registration or licence required under their governing legislation to sell their primary products.

In view of the fact that a number of industries are subject to a dual licensing regime, the harmonisation of the licensing regime has not reached fruition. As such this inquiry may consider the introduction of a more streamlined licensing regime for all industries to save cost to the businesses. Accordingly, we suggest that a review of the licensing regime may be opportune today to assess ways that may simplify the current licensing regime and to achieve one of the purposes of the FSRA which was to introduce 'a single licensing regime for financial sales, advice and dealings in relation to financial products.'[16]

Retail/wholesale investors

Chapter 7 of the *Corporations Act 2001* (Cth) distinguishes between retail and wholesale clients. The Wallis Report advocated for the introduction of such a distinction because retail clients are perceived to lack the necessary sophistication and experience to make informed decisions. They are deemed as vulnerable investors. Consequently, protecting their interests would require putting in place a set of protective legal rules. These rules would enhance confidence in financial advisers and dealers. The explanatory memorandum of the FSR Bill further notes:[17]

> The FSR Bill draws a distinction between retail and wholesale clients. Generally the consumer protection provisions will apply only to retail clients, as it is recognised that wholesale clients do not require the same level of protection, as they are better informed and better able to assess the risks involved in financial transactions.

Table 1 represents an overview of some of the requirements that a person working in the financial services area has to meet when providing a financial service to retail and wholesale clients.

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[15] Abacus Australian Mutual, *Submission to the Productivity Commission: Annual Review of Regulatory Burdens on Business* (2010) 2, <http://www.pc.gov.au/__data/assets/pdf_file/0006/96261/sub022.pdf>.

[16] Revised Explanatory Memorandum, Financial Services Reform Bill 2001 (Cth), [1.4].

[17] Commonwealth of Australia, Explanatory Memorandum, Financial Services Reform Bill 2001, [2.27].

	Australian Financial Services Licence	Financial Services Guide	Statement of Advice	Product Disclosure Statement	Compensation	Complaints/ Dispute resolution	Cooling-off period
Retail	**x**	**x**	**X (for personal advice)**	**x**	**x**	**x**	**x**
Whole-sale	**x**						

Table 1- overview of requirements that may apply for wholesale v retail clients

Consequently, the distinction between retail and wholesale clients is crucial to determine when the additional requirements under Chapter 7 of the *Corporations Act 2001* (Cth) will apply, including the disclosure obligations. This distinction is central to the Australian financial services regulation and should be retained. However, it needs to be reviewed as the current system does not provide protection to all vulnerable people.

The problematic nature of the definition under s 761G of the *Corporations Act 2001* (Cth) may be highlighted in the following points:

- The definition of 'small business' under s 761G(12) needs to be revisited. In certain instances, the definition is too narrow in focus and may mean that people who are vulnerable are excluded from the definition of retail client. For example, strata title body corporate of a residential building may be characterised as a wholesale client as they do not fall under the definition of small business for the purpose of insurance products (s 761G(5) of the *Corporations Act 2001* (Cth)) or the business test (s 761G(7) of the *Corporations Act 2001* (Cth)). However, they may not necessarily have the skills or competencies that are needed to be treated as wholesale investors. In other instances, the definition may be viewed as too broad as it may include in the definition of retail client small businesses who have the necessary skills to make informed decisions about complex financial products.
- The current definition of retail investors should be broadened to include other vulnerable member of the public. For example, under the current laws, Australian councils may be classified as wholesale clients despite the fact that they may not have the necessary skill or knowledge to assess a financial product. This problem was especially highlighted when councils invested in complex financial instruments such as collateralised debt obligations (CDOs) sold by Lehman Brothers. As the case of *Lehman Brothers Asia Holdings Limited (in Liquidation) v City of Swan & Ors; Lehman Brothers Holdings Inc v City of Swan & Ors*[18] illustrates these councils did not have the necessary financial expertise to purchase these products despite the fact that the law has classified them as wholesale clients.

[18] [2010] HCA 11.

- The wealthy investor test does not necessarily reflect the knowledge of the person. It only focuses on wealth. Wealth does not mean that the person may have the necessary financial literacy to deal with complex financial products. For example, a number of retired people have net assets worth $2.5 million. However, the rate of financial literacy in elderly people is low.[19] But even though this is the case, they may be deemed as wholesale clients. Similarly, people who may not be characterised as wealthy investors may fall under the definition of retail client and yet they may have the necessary knowledge and skill to enable them to make informed financial decisions without any help.
- The price/value test also raises the issue of who should really be qualified as a retail client. If a person purchases a financial product (other than insurance, superannuation or retirement saving accounts) worth $400,000 in 2010, the person will be considered as a retail client. However, if the product's value increases over the next year to $550,000 for example, the person will then be deemed as a wholesale client. Yet the knowledge and competencies of the person may not have changed but he/she will still be treated differently for that product.
- A person may be deemed as a retail client for one financial product and a wholesale client for another. As such, the current distinction between wholesale and retail clients does not take into account the competency or the knowledge of the person. The fact that the person may be treated differently under the same regime is an issue that has to be resolved to ensure that the Australian financial system provides the necessary protections to investors based on their competencies.

In addition to the above comments, another issue that should be considered is a review of the definition of retail and wholesale clients under the *Australian Securities and Investments Commission Act 2001* (Cth) which is different from the definition under the *Corporations Act 2001* (Cth). The *Australian Securities and Investments Commission Act 2001* (Cth) does not rely on the term 'retail client'. It uses the term 'consumer' instead. Under s 12BC of the *Australian Securities and Investments Commission Act 2001* (Cth), a consumer is defined as a person who acquires financial services for use in connection with the business at or below $40,000, or acquires services of a kind ordinarily acquired for personal, domestic or household use. A consumer may also be a small business which acquires financial services for use in connection with the business at or below $40,000 or, if above this amount, of a kind ordinarily acquired for business use. This lack of consistency between both legislations may cause some duplications and confusions regarding the treatment of financial products and services. As such it should be remedied.

[19] Annamaria Lusardi and Olivia Mitchell, 'Baby Boomer Retirement Security: the Roles of Planning, Financial Literacy, and Housing Wealth' (2007) 54 *Journal of Monetary Economics* 205; Tullio Jappelli, 'Economic Literacy: An International Comparison' (2010) 120(584) *The Economic Journal* F 429; Annamaria Lusardi and Olivia Mitchell, 'Financial Literacy and Retirement Preparedness: Evidence and Implications for Financial Education' (2007) 42(1) *Business Economics* 35; Maarten Van Rooij, Annamaria Lusardi and Rob Alessie, 'Financial Literacy and Retirement Planning in the Netherlands' (2011) 32(4) *Journal of Economic Psychology* 593;J Conrad Glass Jr and Beverly B Kilpatrick, 'Gender Comparisons of Baby Boomers and Financial Preparation for Retirement' (1998) 24(8) *Educational Gerontology* 719.

Disclosure

The core promise of the FSRA was the establishment of a regulatory regime that would deliver 'consistent and comparable financial product disclosure.'[20] Currently there are three main documents used by AFSL holders in their interactions with retail clients. They are a Product Disclosure Statements (PDS), a Financial Services Guide (FSG) and a Statement of Advice (SOA).

PDS:

Concerns may be raised regarding the complexity of PDSs especially regarding what information can be included and excluded and when the disclosure document needs to be issued. Even with ASIC guidance regarding the need for clarity in the establishment of a PDS, the aim to have a 'consistent and comparable financial product disclosure'[21] has not been achieved.

Further, the disclosure regime for PDS adopts a very different approach to the disclosure regime that applies for securities: For example, there is no express or implied requirement to undertake due diligence enquires – the PDS only has to include information that they actually know[22]. This is a flaw of the system that needs to be rectified to ensure the protection of consumer.

Additionally, there is inconsistency in the way the disclosure and continuous disclosure is handed in a PDS. A more uniform approach is needed. For example, there are special, more limited disclosure requirements for PDSs for continuously quoted securities, reflecting the fact that they are subject to the continuous disclosure regime in Part 6CA (s1013FA). There are also modifications in the Regulations to the PDS content requirements for warrants (r7.9.07A), market traded derivatives (r7.9.07B), FHSA products (rr7.9.10-7.9.10E), margin loans (7.9.11-7.9.11H), superannuation products (7.9.11K-7.9.11R), simple managed investment schemes (7.9.11S-7.9.11Z), general insurance products (r7.9.15D and 7.9.15E), consumer credit insurance (r7.9.16) and unauthorised foreign insurers (r7.9.15). Further, the s1017B of the *Corporations Act 2001* (Cth) effectively sets up a continuous disclosure regime for issuers of financial products. However, it does not apply if the financial product is a managed investment product that is an ED security (s 1017B(2)). Instead the continuous disclosure provisions in Chapter 6 *Corporations Act 2001* (Cth) apply to these products. Lastly, the requirement to give periodic statements applies to managed investment products, superannuation products, RSA products, FHSA products, investment life insurance products, deposit products, margin lending facilities and any other products specified in regulations made for these purposes (s1017D(1)(b)).

[20] Financial Services Reform Bill 2001, Revised Explanatory Memorandum, para 1.4.
[21] Financial Services Reform Bill 2001, Revised Explanatory Memorandum, para 1.4.
[22] CA s1013C(2) – Information Only Needed in PDS if Actually Known

FSG:

FSGs are currently failing to achieve their objectives. Client's attention must be drawn to the fact that FSG:

- is designed to assist the client in deciding whether to use any of the services offered in the FSG;
- contains information about remuneration that may be paid to the licensee/representative and other relevant persons in relation to the services offered; and
- contains information on how complaints against the licensee/representative are dealt with (rr7.7.03(2) and 7.7.06(2)).

Simplifying the information contained in an FSG is harder to be achieved as s 942B(2) requires the FSG to contain a range of information including 'any other statements of information required by the regulation.' For example, r7.7.03A requires an FSG given by financial services licensee to include a statement about the kind of compensation arrangements that the licensee has in place for clients and whether those arrangements satisfy the requirements of s912B. This was added by Corporations Amendment Regulations 2007 (No 6) SR 197/2007. The Explanatory Statement for those regulations said that: 'It is expected that the statement will be in general terms - for example, it may refer to professional indemnity insurance without necessarily providing details of the cover.' The question that the author pose is whether such statements are necessary in an FSG or whether they will make the disclosure document more cumbersome.

SOA

The SOA is the main disclosure document regarding financial advice and s 961H of the *Corporations Act 2001* (Cth) specifies the warning that must be given if the advice is based on incomplete or inaccurate information. This also requires, in relation to CR r7.7.11 that an SOA given by a financial services licensee is to include, in a manner that is easy for the client to understand, information about all remuneration (including commission) and other benefits that a person has received, or is to receive, for referring another person to the financial services licensee. This disclosure requirement regarding the SOA has been significantly challenging for the sector to achieve and the corporate and financial services regulator to police.

This is the case even though ASIC has provided guidance in Information Release IR 04-61 on how it expects licensees to prepare SOAs. It has also published Class Order CO 04/1556, Statements of Additional Advice, to facilitate shorter SOAs where the adviser has an ongoing relationship with the client. The class order provides relief to permit SOAs to incorporate by reference certain information that the client has already received in a previous SOA.

Advice and the Bank Teller Issue

Under s 961Q licensee or authorised representative potentially contravenes a civil penalty provision if an adviser for whom they are responsible fails to comply with ss 961B, 961G, 961H and 961J of the *Corporations Act 2001* (Cth). The licensee may also be liable to compensate a client for any loss or damage they may suffer as a result of the contravention (s961M) and subject to various other remedial orders, such as an order declaring a contract void or requiring the repayment of the client's money (s961N). The adviser in question may be subject to a banning order for breaching a financial services law (s920A).

The most significant issue that may be raised regarding this matter is that the obligations under the Act do not apply if the subject matter of the advice sought by the client is solely a basic banking product and the adviser is an agent or employee of an Australian ADI (such as a bank teller – as currently being debated in the media, as the products and services in fact require detailed advice which is not being provided), or otherwise acting by arrangement with an Australian ADI under the name of the Australian ADI (s961J(2)). It also does not apply if the subject matter of the advice sought by the client is solely a general insurance product (s961J(3)). There is no reason why advice in this area should not be subject to the same obligation especially if the products and services are in fact more complex than otherwise deemed by the bank. Protection of consumers is paramount in the end.

Remedies and dispute resolution processes

ASIC’s powers and remedies

When a retail client has a problem with their financial services products and services, in the first instance, a retail client turns to internal and then external dispute resolution schemes which are backed by and AFSL holders' compensation arrangements. All of these are seen as the "first line of defence" for retail clients seeking a remedy in terms of financial services losses due to some form of negligence or fraud in terms of misrepresentation. Beyond dispute resolution and licensees compensation arrangements the remedies or compensation arrangements for retail clients are limited to nine heads of remedies enforcement mechanisms:

1. criminal sanction
2. Civil penalties
3. Banning and disqualification orders
4. Cancellation and suspension of AFSL
5. Stop Orders
6. Enforceable Undertakings
7. Court orders
8. Court enforcement
9. Public interest action

Whilst this appears to be a significant array of tools available by the regulator to ensure protection for retail clients, by way of compensation and relief in terms of remedies, the fact is that the execution of these nine heads of remedy enforcement mechanisms are generally ineffective at providing a meaningful remedy for the retail client in a timely manner. The processes are slow, cumbersome and not focussed on realistic outcomes for the 'retail client' in terms of the ‘doing all things efficiently honestly, and fairly’ (s 912A of the *Corporations Act 2001* (Cth) – General Obligations of a Licensee).

Under these nine heads of remedies, ASIC enforces and investigates matters and refers them the Commonwealth DPP or makes applications to a court for orders or application for enforcement of orders. ASIC can also ban, disqualify cancel and suspend license holders and issue interim and final stop orders from engaging in specific conduct by licensees or their representatives. ASIC's process of investigation and then enforcement by way of making application to a court or undertaking criminal or civil proceedings seems to be the roadblock to effective outcomes for retail clients when you consider the following indicative cases involving retail clients:

- **Westpoint Corporation Pty Ltd** was the head Company of the Western Australian based Westpoint Group of Companies ("Westpoint Group") engaged in property development and raising finance for that purpose. Receivers and managers were appointed on 2 February 2006. Prior to the collapse the corporation was worth $1.7 billion. Westpoint Corporation and its mezzanine funds constituted a Ponzi scheme, in which retail clients own money was used to pay their interest. A total of $304,370,984 was invested by 3524 people in a series of seven mezzanine funds. The money was immediately and entirely transferred into the same number of property development companies which in turn churned it back into Westpoint Corporation from which it was spent.
- Almost six years on for the collapse, on 30 September 2011, ASIC made payments totalling approximately $57 million (plus accrued interest) to the liquidators in accordance with the Federal Court orders made on 1 September 2011 and the terms of the settlements. ASIC continues to hold the balance of the proceeds from the settlements (approximately $10 million) for the benefit of certain Westpoint Group companies subject to a number of conditions which are confidential. ASIC has stated it will continue to keep the former retail clients of Westpoint informed in relation to the ongoing class actions;
- **Storm Financial Limited** was a financial advice company, based in Queensland, Australia. It was founded in May 1994 went into external administration on 9 January 2009. The main creditor Commonwealth Bank appointed receivers and managers KordaMentha on 15 January 2009. This is a complex case involving margin lending and related advice to retail clients which involved the Commonwealth Bank. The trigger to the collapse turned on the issuing of notices of demand to Storm Financial calling up Storm's entire commercial facilities by the Bank, the ultimate consequence of the bank's demands forced Storm Financial into administration, the Company had A$88 million in debts at the time. In December 2008, ASIC began investigation of Storm Financial's margin lending and related advice; the 13,000 Storm retail clients lost more than $4 billion with the Company with no possibility of a return of their funds. Many retail clients continue to face economic hardship.

Ultimately the most significant but limited power available to ASIC which has managed to make a difference in Storm Financial rests with a 'public interest action' (ASIC Act s50)[23] if as a result of an investigation it appears in the public interest to begin or carry on a proceeding

[23]Australian Financial Review "ASIC queries CBA offer to Storm-struck", Wednesday, June 12, 2009 and also ASIC information sheets setting out its approach to: i. involvement in private court proceedings (information sheet 180); and ii. providing information to private litigants (information sheet 181) published in 25 June 2013,in explaining ASIC involvement in the Storm related cases of Mr. and Mrs. Doyle; proceedings against Commonwealth Bank; and the settlement of the Richards class action.

in relation to the recovery of damages for fraud, negligence, default, breach of duty or other misconduct. Such power needs to be expanded to empower ASIC to take action to compensate investors that have lost their investments as a result of poor financial advice or fraudulent activities.

Dispute Resolution

AFSL holders are required to maintain both internal and external dispute resolutions schemes (s 912A (1)(g) and (2) of the *Corporations Act 2001* (Cth)) for retail clients. In the case of certain product issuers and 'regulated persons' who are not financial services licensees there is a requirement for them to also have corresponding internal and external dispute resolution systems for retail clients(s1017G of the *Corporations Act 2001* (Cth)).

- **Internal dispute resolution:** A criticism that can be levelled at the internal dispute resolution process (see ASIC Regulatory Guide 165 Licensing: Internal and external dispute resolution) is that it does not establish a forum in which the consumer can voice his or her concerns. There is a lack of interest-based options for the consumer. For example, there is no requirement for the bank to have a negotiation model in place. The process at this initial stage is unilateral as the consumer is not involved in the decision-making process. This may be due to the fact that the vast majority of complaints revolve around legal rights. The reliance on the Australian Standard 4269–1995, entitled 'Complaint Handling' suggests that the bank will hear the complaint and deliver a decision. It could be that a more bilateral approach would resolve many more disputes at the initial stages**.**

- The regulations provide that when making or approving standards or requirements for IDR procedures, ASIC must take AS ISO 10002-2006 Customer satisfaction – Guidelines for complaints handling in organisations into account, as well as any other matter it considers relevant: see r7.6.02(1). The information available in the internal dispute resolution standards does not set out the remedies available to the consumer. They only highlight the need for a range of remedies, yet do not set out the need for this range to be communicated to the consumer. This needs to be changed to advise consumers on their rights.

- **External dispute resolution:** If the consumer is not satisfied with the outcome under the internal dispute resolution scheme, then they have recourse to an external dispute resolution scheme. Under ASIC's policy statement 165, an entity must also establish appropriate links between its internal dispute resolution procedures and the relevant external dispute resolution scheme for the complaints that it cannot handle directly. A criticism that can be levelled at the interchange of information between internal and external dispute resolution processes is that links are weak and retail clients seem to be in a position of starting from the beginning when moving their complaint to an EDR.[24]. ASIC considers that an entity must provide for these links and its staff must inform its customers of their right to pursue their

[24] Financial Ombudsman Service Terms of Reference Issues Paper November 2008, page 12.

complaint with an external dispute resolution scheme. The presumed benefit of an external dispute resolution scheme is that it is independent and, as many financial institutions subscribe to the same scheme, its decisions are also presumed to be consistent.

- **Compensation Arrangements:** An AFSL holder who provides financial services to retail clients must have arrangements for compensating those clients for loss or damage suffered because of breaches of Chapter 7 of the *Corporations Act 2001* (Cth) by the licensee or its representatives (*Corporations Act 2001* (Cth) s 912B - Compensation Arrangements for Retail Clients). In this regard ASIC has put forward guidance (see Regulatory Guide 126 *Compensation and insurance arrangements for AFS licensees)*, the guide outlines ASIC's policy for administering the compensation and professional indemnity insurance requirements for licensees providing financial services to retail clients. Unless exempted, a financial services licensee must hold professional indemnity insurance cover that is adequate, having regard to: he licensee's membership of any schemes mentioned in s 912A (2)(b) CR r7.6.02AAA – Approved Compensation Arrangements. Before ASIC approves alternative compensation arrangements under s 912B (2)(b), it is required to have regard to the same matters (r7.6.02AAA(2)). General and life insurance companies and ADIs regulated by APRA, and certain related bodies corporate guaranteed by them, are exempt from these requirements (r 7.6.02AAA (3)). Although the current financial services legislation mandates compensation arrangements be made available as a compensation remedy for the losses of retail clients; the reality of the situation is far from satisfactory. The summary of findings from recent AIC research[25] on this problem has found that:

- The loss was different for retail clients in failed or frozen funds compared with share-based investments.
    - The impact was the limited amount received was a very small proportion; and
    - Timing: It either took a few years with the speediest return in this ASIC study took 6 – 9 months. (This followed legal action by ASIC to recover investor funds.)
- Retail clients who could have sought compensation did not do so. The clients of financial planners had no idea that they had any recourse except to take individual legal action.
- Retail clients were unwilling to spend money on getting legal advice when they had lost all their money and were not confident that the financial planner or scheme owner was actually to blame.
- The most popular avenue for compensation was to join a class action because it was free, mostly risk free and easy to do.
- Retail clients of financial planners did not seek compensation at all because they were unable to contact their financial planner to initiate a complaint.

[25] ASIC Report 240 "*Compensation for retail investors: the social impact of monetary loss*" – May 2011

One approach in dealing with compensation of retail clients as the most fundamental of remedies is to continue with the approach set out by the Parliamentary Joint Committee on Corporations and Financial Services (PJC)[26], which recommended in February 2009 that the Australian Government investigate the costs and benefits of a statutory compensation scheme[27]. This was following a number of high profile failures of financial services firms. The proposed scheme would compensate consumers and investors, as a means of last resort, for financial losses suffered as a result of the wrongdoing of their financial services provider, an AFSL licensee. As ASIC research has found, there are wider social ramifications of this problem:

> The main finding of this study is that failure to fully compensate investors who lost money because of some form of wrong doing by a managed investment scheme or financial planner can cause the investor severe emotional and financial distress. The second key finding is that investors were unable to fully utilise the current compensation system. Thirdly, the loss experience can have a corrosive effect on trust in the financial system[28]

Conclusion

This submission addresses some of the terms of reference of the Financial System Inquiry (FSI). We have submitted that the current financial system does not need radical change as the regime has great potential. However, we have identified some of the cracks in the system which need to be remedied. In conclusion we recommend:

- the harmonisation of the financial services licensing regimes;
- a review of the retail clients definition;
- a simplification of the disclosure regime regarding financial products and services; and
- an enhancement to the remedies, compensation and other relief available to retail clients .

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[26] See: http://www.aph.gov.au/senate/committee/corporations_ctte/fps/index.htm
[27] See Recommendation 10, Parliamentary Joint Committee on Corporations and Financial Services Report – Inquiry into financial products and services in Australia, p 156.
[28] ASIC Report 240 "*Compensation for retail investors: the social impact of monetary loss*" – May 2011