

**Submission to the Parliamentary Joint Committee on Corporations and Financial Services – Inquiry into the collapse of Trio Capital and any other related matters**

This submission has been prepared by the Investments, Life Insurance and Superannuation (“ILIS”) team of FOS. The contents of this submission may not reflect the views of

The submission draws on the experience of ILIS in its consideration of Disputes<sup>1</sup> by Applicants<sup>2</sup> who made investments in the Astarra Strategic Fund (which was operated by Trio Capital Limited).

This submission is not confidential.

**Information about FOS and ILIS**

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”).

Upon consolidation of the three schemes under the FOS name, FICS internally became known as ILIS.

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 (“EDR”) 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:

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<sup>1</sup> A “Dispute” is defined in the FOS Terms of Reference as *“an expression of dissatisfaction with a Financial Services Provider.”*

<sup>2</sup> An “Applicant” is a person who lodges a Dispute with FOS.

- 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 has 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 governed by an independent board with consumer representatives and financial services industry representatives.

### **General comments**

This submission will focus on only the following of the Inquiry's Terms of Reference:

2. the points of failure in relation to products and advice;
6. the access to compensation and insurance for Trio Capital investors including in circumstances of fraud;
9. the appropriateness of information and advice provided to consumers, and how the interests of consumers can be best served in regulated and unregulated environments.

FOS has not yet issued any determinations for any of the Disputes related to investments in Astarra Strategic Fund ("Astarra").<sup>3</sup> FOS is therefore not in a position to make any comments in this submission about the merits of allegations made by Applicants. The submission is limited to the identification of issues that are common to the majority (if not all) of the relevant Disputes.

Further, as the Disputes lodged with FOS about Astarra only relate to alleged defective advice provided by financial planners, this submission will not touch on matters related to product failure and fraud said to have been committed by Trio Capital Limited.

### **Disputes lodged with FOS about Astarra Strategic Fund**

As at the date of this submission, FOS had received thirty-two (32) Disputes from Applicants who were advised by financial planners to invest in Astarra. Twenty-eight of those Disputes have been lodged against one Australian financial services licensee. The remaining four (4) Disputes are shared between three (3) other licensees.

Sixteen (16) of the Disputes have been closed. Most of the closed Disputes were withdrawn by Applicants after they were notified that the licensee was being wound up as insolvent. One Dispute was closed after the parties agreed to a commercial settlement.

FOS has not received any Disputes against the Responsible Entity of Astarra, Trio Capital Limited.<sup>4</sup>

<b>Dispute No.</b>	<b>Claiming Entity</b>	<b>Claim Amount</b>
214439	SMSF & Direct	\$57,647 (SMSF) \$77,828 (Direct)
220325	SMSF	\$409,000
220433	SMSF	\$97,000
222482	SMSF & Direct	\$139,602 (SMSF) \$159,308 (Direct)
222764	SMSF, Corporate Super Fund & Direct	\$285,500 (SMSF) \$128,614 (Corp) \$40,000 (Direct)
223406	SMSF & Direct	\$128,614 (SMSF) \$75,562 (Direct)
224294	SMSF & Direct	\$106,359 (SMSF) \$118,641 (Direct)
224741	SMSF & Direct	\$196,436 (SMSF) \$109,259 (Direct)
224944	Direct	\$217,462
224503	SMSF	\$252,510
222904	SMSF	\$249,188
224943	Direct	\$35,184

<sup>3</sup> Fifteen (15) of the thirty-two (32) Disputes received about Astarra are in the final stage of the FOS process and determinations are expected to be issued in most of these Disputes by 31 December 2011.

<sup>4</sup> Trio Capital Limited was formerly a member of FOS. FOS cannot accept new Disputes lodged against former members.

224248	SMSF & Direct	\$220,000 (Direct) \$107,180 (SMSF)
224384	Unknown	Unknown
222904	SMSF	\$249,188
224943	Direct	\$35,184
224426	Direct	\$450,000
224417	Unknown	Unknown
223244	SMSF	\$418,931
224484	Direct	\$66,000
224507	Direct	Unknown
224468	Unknown	\$91,000
216379	Direct	Unknown
224422	Unknown	Unknown
224154	SMSF	Unknown
225041	SMSF	Unknown
224652	Unknown	Unknown
224419	Unknown	Unknown
224486	Unknown	Unknown
201335	SMSF	\$190,000
225131	Direct	\$82,700
229658	Direct	\$200,000
229119	Direct	\$200,000

### **Inquiry's Terms of Reference**

As the Disputes lodged with FOS relate exclusively to personal financial advice provided to retail clients, FOS limits its submissions to the following of the Inquiry's Terms of Reference:

2. the points of failure in relation to products and advice;
6. the access to compensation and insurance for Trio Capital investors including in circumstances of fraud;
9. the appropriateness of information and advice provided to consumers, and how the interests of consumers can be best served in regulated and unregulated environments.

### **2. Points of Failure in relation to products and advice**

FOS is not in a position to make submissions on product failure. None of the Disputes received by FOS in relation to Astarra are against Trio as the Responsible Entity and the issue has not been raised.

All of the Disputes concern advice received from licensed financial planners to invest in Astarra.

Applicants in all of the open Disputes have made allegations of the following breaches:

- inappropriate advice<sup>5</sup>;
- misleading or deceptive conduct<sup>6</sup>;
- failure to disclose matters that may be reasonably expected to be capable of influencing the adviser<sup>7</sup>; and,
- failure to adequately disclose the risks associated with geared investment strategies.

### Inappropriate advice

Generally, Applicants who have lodged Disputes:

- were at or approaching retirement age;
- were retail clients;
- had \$500,000 or more to invest;
- were assessed as having a long term investment horizon of 5 years or more;
- were assessed as having an “assertive” or “aggressive” risk profile; and,
- were said to be comfortable with geared investment strategies.

The advice received by the Applicants to invest in Astarra generally shared the following features:

- investments were both direct and via Self Managed Superannuation Funds (“SMSFs”);
- recommended gearing strategies, via “portfolio warrants” in the case of SMSFs and margin lending facilities in the case of direct investments; and,
- had a large proportional capital exposure (in some cases, up to 40% of available investment capital) to Astarra.

In general, Applicants allege the advice was inappropriate because:

- the recommended gearing strategies exposed them to unsustainable levels of debt;

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<sup>5</sup> Subsection 945A(1) of the Corporations Act

<sup>6</sup> Subsection 12DA(1) of the Australian Securities and Investments Commission Act and Section 1041H of the Corporations Act

<sup>7</sup> Paragraphs 947B(2)(d) and 947C(2)(e) of the Corporations Act

- there was inadequate diversification of assets within their portfolio (largely due to the alleged “overexposure” to Astarra);
- the assets (including Astarra) used as the leverage security carried significant liquidity risks; and,
- the licensee used poor or inadequate “know your client” practices.

FOS is not currently in a position to comment on the merits of the above allegations because its investigations are ongoing and none of the Disputes have been determined as at the date of this submission.

#### Misleading or deceptive conduct

Applicants allege the risks associated with Astarra were understated by their advisers. A common theme is that the Astarra investments and the gearing strategies used (where a gearing strategy was recommended) were presented as being “safe”.

In this regard, some Applicants have identified a “Table” that was often included in advice documents (“SOAs” and “SOAAs”) as evidence of the above allegation. Following is a reproduction of the “Table” (which is identified in advice documents as being sourced from a research house):



In most SOAs and SOAAs provided to FOS, Astarra is described as an “absolute return fund”. “Absolute return funds” are then identified as being hedge funds. Applicants allege the above table makes a representation that hedge funds are low risk and that the representation amounts to misleading or deceptive conduct.

#### Disclosure of matters that may be reasonably expected to influence advice

FOS has insufficient information at this time to allow any comment on the level of commissions paid by Trio to advisers but does note that most Applicants argue the commissions were higher than usual.

In Disputes lodged against the insolvent licensee, Applicants also allege Trio paid a marketing allowance which was calculated as 3.3% of client monies placed with Astarra.

The implication of the above is that the commissions and marketing allowances paid by Trio were a significant incentive for the licensee to not only recommend Astarra but also recommend gearing strategies.

#### Disclosure of risks

Applicants allege they were not informed of risks associated with the gearing strategies recommended. The following risks are said not to have been disclosed to Applicants:

- they may lose all of their investment capital;
- in the case of gearing via “portfolio warrants” in SMSFs:
  - the power vested in the warrant issuer to sell underlying securities without notice where:
    - the maximum loan to value ratio is exceeded; and,
    - the income and distributions received were less than the interest charged.
  - the implications that arose from there being no secondary market for the warrants (i.e. they were effectively “locked in”).

Many (if not all) Applicants also argue they did not understand how the Astarra product worked. The implication from this allegation is that their advisers did not describe the product, including its benefits and risks, in a manner that the Applicants were likely to understand.

#### **9. Appropriateness of information and advice provided to consumers, and how the interests of consumers can be best served in regulated and unregulated environments**

The main allegations made by Applicants are:

- the geared investment strategies were recommended without any regard to ability to service the loan obligations for the life the loan. (The basis of the allegation appears to be the adviser assumed the income and distributions paid by the underlying securities would be sufficient to meet the loan obligations);
- it was not appropriate to recommend a leveraged investment in Astarra because of liquidity risks associated with the product. (The basis of this allegation appears to be the adviser failed to appreciate the implications of

there being no secondary market for the “portfolio warrants” and the interests in Astarra);

- their Astarra investments caused a lack of diversification in their portfolios. (The basis of this allegation appears to be the advisers recommended an inappropriate proportion of investment capital to be invested in Astarra);
- advisers did not employ robust “know your client” processes. (All Applicants deny they were investors with “aggressive” or “assertive” risk profiles.)

FOS is not in a position to comment on the merits of the above allegations.

#### **6. Access to compensation and insurance for Trio Capital investors including in circumstances of fraud**

Under FOS’ Terms of Reference, a determination that is accepted by an Applicant will be binding on the FSP.<sup>8</sup> In the usual course – where the FSP is solvent – noncompliance with a determination by a Financial Services Provider may lead to FOS acting to enforce the determination.

However, the FSP that is the respondent in the bulk of the Disputes is insolvent and is currently being wound up. The liquidator’s initial opinion is there will not be any distributions to unsecured creditors. This being the case, there is no utility in FOS moving to enforce its determinations.

This means the role of the professional indemnity insurer who was “on risk” is the key to the question of whether Applicants will receive any compensation.

In this regard, the insurers wrote to clients of the relevant FSP in a letter dated 7 July 2011. It states, in part:

*“[Company X] did have professional indemnity insurance in place when the liquidator was appointed on 6 August 2010. However, that professional indemnity insurance expired on 16 October 2010. The cover was written on a ‘claims made’ basis meaning it was triggered by the making of a claim against [Company X] rather than the date of any alleged breach of duty or the date when a third party is alleged to have suffered a loss in respect of which a liability is alleged against [Company X].*

*The insurance cover provides an indemnity to [Company X] for its civil liabilities to third parties subject to the terms of the cover provided (including qualifications and exclusions on cover). The cover does not indemnify any third party (including you).*

*As matters stand, the professional indemnity insurers for whom we act have not indemnified [Company X] for any claims made against it.*

*The liquidator has notified the insurers of claims made against [Company X] and sought an indemnity in relation to those claims.*

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<sup>8</sup> Paragraph 8.8 of the FOS Terms of Reference



*The insurers are currently in the process of investigating [Company X's] entitlement to indemnity for claims made against [Company X] which includes both assessing the individual claims made against [Company X] and determining whether those claims give rise to any liability for which [Company X] is entitled to an indemnity from the insurers under the relevant insurance cover."*

It is not possible to comment with any certainty on whether the level of cover provided under the professional indemnity policy is sufficient to compensate all Applicants who have lodged Disputes against the insolvent FSP through FOS (and those who have not lodged Disputes and/or are pursuing claims via the Courts).

It is FOS' experience that the professional indemnity cover is often limited and may not be sufficient to pay out all claims. It is often the deficiencies in the professional indemnity cover which lead to the insolvency of the licensee. Where the licensee is insolvent, it is likely that Applicants will not receive all or partial compensation.

In FOS' view, the plight faced by the former clients of the insolvent FSP (including those who have not lodged Disputes with FOS and are seeking alternative forms of redress) brings into sharp focus:

- the inadequacy of the current legislative requirement for Australian financial services licensees to have in place arrangements for compensating retail clients for loss or damage<sup>9</sup> where this obligation is met by holding "adequate" professional indemnity cover;<sup>10</sup>
- the need for a compensation scheme in addition to the above obligation.

### **Additional matters of potential concern**

The matter discussed in this section of the submission has been identified as one of concern to Applicants in relation to the conduct of advisers.

This matter has been included in this section of the submission as it does not relate directly to any of the Inquiry's Terms of Reference.

There is some indication the insolvent FSP had entered into an arrangement with Trio Capital to place a portion of its clients' investment capital into Astarra. In this regard, FOS has been provided with a letter prepared by the insolvent FSP's principal and sent to an Applicant in one of the Disputes lodged with FOS. The letter states:

*"At the time of writing the statement of advice I had not committed [Company X] or promised to place a set amount of [Company X's] clients' monies with Astarra."*

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<sup>9</sup> Subsection 912B(1) of the Corporations Act

<sup>10</sup> Subsection 912B(2) of the Corporations Act and regs 7.6.02AAA(1) and (3) of the Corporations Regulations

FOS is of the view that the above matter may require further investigation by the Inquiry.