FINANCIAL PLANNING
ASSOCIATION *of* AUSTRALIA

Mr Bernie Ripoll, MP
Chair, Parliamentary Joint Committee on Corporations and Financial Services
PO Box 6100
Parliament House
Canberra ACT 2600

Email: corporations.joint@aph.gov.au

26 August 2011

Dear Mr Ripoll

**Inquiry into the collapse of Trio Capital and any other related matters**

The Financial Planning Association of Australia (FPA)[1] welcomes the opportunity to provide input into the Parliamentary Joint Committee on Corporations and Financial Services (PJC) Inquiry into the collapse of Trio Capital and related matters.

The FPA believes consumers deserve substantially improved protection measures when receiving services and products from financial services providers in Australia. This is best achieved by an improved regime that protects consumers from poor products and poor advice in the first instance, supported by an improved obligation regime that will deliver better justice and compensation to consumers who suffer loss.

In the attached submission, the FPA has focused on responding to the underlying cause of the collapse of Trio Capital and the associated issues that led to and exacerbated the loss and detriment suffered by consumers.

We acknowledge that this Inquiry must be considered in the context of the initiatives already flowing from the Future of Financial Advice (FoFA) reforms initiated by the PJC's 2009 Inquiry into financial products and services in Australia. In our view though, few of the FoFA regulatory enhancements will have any impact on the prevention of future similar events, as they have focussed too exclusively on the issues of Adviser level activity and missed the opportunity to engage in a reform debate that would deliver transparent markets and product safety that would benefit all Australians, ultimately failing to deliver the effective consumer protection reform that FoFA promised.

There is still much for government to do in this area and to this end, the FPA's submission concentrates on identifying and addressing the consumer protection gaps that genuinely led to the Trio Capital collapse, with the strong encouragement to government that it seize this opportunity to resolve the glaring consumer protection gaps in the financial services market.

If you have any questions regarding the FPA's submission, please contact FPA's General Manager Policy and Government Relations, Dante De Gori, on 02 9220 4505 or dante.degori@fpa.asn.au.

Yours sincerely

**Dr Deen Sanders**
Chief Professional Officer

[1] The FPA is the peak professional body for financial planning in Australia. The 8,000 individual professional members of the FPA have an enforceable Code of Professional Practice, including the Client First principle. 5,700 of our members have achieved CFP certification, which is the global standard of excellence in financial planning. FPA practi ioner members manage the financial affairs of more than 5 million Australians whose investments are valued at $630 billion.

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# Inquiry into the collapse of Trio Capital and any associated matters

## FPA submission to the Parliamentary Joint Committee on Corporations and Financial Services

26 August 2011

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# Inquiry into the collapse of Trio Capital

FPA SUBMISSION TO PARLIAMENTARY JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES | DATE: 26.08.2011

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# Inquiry into the collapse of Trio Capital

FPA SUBMISSION TO PARLIAMENTARY JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES | DATE: 26.08.2011

## Introduction

The FPA supports the Federal Parliament's decision to call on the PJC to undertake an Inquiry into the collapse of Trio Capital. However we must first state our disappointment with the narrow Terms of Reference and the subsequent public media positioning of the Inquiry, that threaten to direct the Inquiry members and submissions to assumptions of Adviser fraud, rather than the far more complex set of issues that contribute to this consumer protection failing.

The FPA notes the Terms of Reference for the Inquiry are heavily focused on financial advice, even though the *cause of the collapse* of Trio Capital is a clear and legally proven case of fraudulent activity by the product provider. The FPA unequivocally accepts that financial advice is likely to have been a contributor to the instances of consumer loss and where those Advisers were members of our professional community, the publicly recognised full professional enforcement regime of the FPA will be applied, as well as the full regulatory capacity of ASIC. Where they are not professional participants, and therefore only subject to the scrutiny of ASIC, we believe the FoFA reforms will enhance ASIC's capacity to respond to these issues in the future.

However, the issues associated with the collapse of Trio Capital are not purely issues of financial advice. There were various financial services industry participants who played a significant role in the collapse and influenced consumers' decision to invest in Trio products. Considerations of future reform should consider the accountability of all participants to consumers for the role they played.

The financial advice industry has learnt a great deal from the previous PJC Inquiry into financial products and service in Australia. Many changes have been made both at a legal and professional level, and these changes will seek to bring increased transparency and professionalism to this sector. However, there remains a significant gap in the consumer protection measures to be introduced under these changes, notably that the government has resisted the consideration of product, gatekeeper and compensation reform.

The full benefit of this Inquiry will only be realised if it firmly focuses on those gaps in the current and proposed regulatory regime.

It is the FPA's contention that a better consumer protection and appropriate consumer compensation regime is the responsibility of all participants who have a role in causing, or an influence in allowing, consumer detriment. Until the regulatory and compensation framework ensures that each participant has responsibility and financial accountability to the end consumer for their role in ensuring the effective and ethical delivery of products and services, the Government and regulators will be unable to provide protection against fraud, misconduct and conflicted behaviour.

The Australian public and the industry itself are calling for and deserve:

- Better protections for consumers
- Better surety of compensation for consumers when they are a victim of a failure (anywhere in the financial services system)

- A complete compensation system that ensures these outcomes
- Better gatekeeping by regulators
- A more comprehensive, considered, policy framework for compensation in Australia
- A more responsive and consumer oriented financial services community that sees its role as a protector of consumers' financial future first
- Confidence that the critical policy considerations have all been thoroughly considered.

The FPA strongly believes that the debate must encompass all in the financial services community so that as participants in the consumer chain, we all take responsibility for our actions. Continuing to only concentrate on one aspect or participant of the financial services sector continues to deny consumers their right to appropriate and adequate protection measure in the first instance, and fair and equitable justice when failure occurs.

The FPA has developed the following submission and recommendations with consideration to:

- What will prevent a repeat of the collapse of Trio Capital
- What will safeguard consumers in the event of a similar collapse in the future.

Recent findings by the Supreme Court of Australia show that the collapse of Trio Capital was a clear case of fraud by the product providers. Tighter regulation and greater scrutiny of product providers and gatekeepers will reduce the opportunity for fraud and provide greater transparency and protections for consumers from the outset.

The FPA strongly urge the Committee to recognise the differences in the role each industry sector plays in providing services and investment opportunities to consumers and:

- Fully understand each individual issue, and its underlying cause, involved in the Trio Capital collapse
- Clearly identify the party responsible for each issue and the cause of each issue (that is, does the fault lie in the hands of a product provider, research house, licensee, financial planner, or broker?)
- Ensure the PJC recommendations serve to address the cause of the identified issues and are placed on the industry sector at fault.

In order to protect consumers and minimise the consumer impact of the risk of such events in the future, the FPA believes a one-size-fits all approach to developing solutions would be inappropriate. Each industry sector provides a different service to consumers - some directly, some indirectly - and therefore the FPA suggests industry specific recommendations are required to improve consumer protection.

The FPA has also made a number of the following recommendations to Richard St John as part of the consultation process undertaken for his Review of Compensation Arrangements for Financial Services.

### *Structure of the submission*

As a Professional Association, the FPA takes very seriously its obligation to provide advice to Government that is credible and that considers: the public interest and consumer protection implications; the impact on the community standing of the financial planning profession; the effectiveness and efficiency of regulation; and the alignment with the FPA's professional obligations.

With that in mind, we have taken the opportunity to provide a detailed submission that not only addresses the stated Terms of Reference but also that seeks to address the real issues that we believe will lead to better consumer protection and a more efficient marketplace in financial products and services.

For the benefit of the committee and readers, our submission is constructed as follows:

*Section 1: The current environment –* this section sets the backdrop on what has happened since the Global Financial Crisis (GFC) and the Inquiry into Storm Financial, including the Future of Financial Advice (FoFA) reforms. In particular we explore the problems that contributed to the Trio Collapse and whether FoFA will address these. We also detail the New FPA and how we have encouraged change at a professional and industry level to better prevent and respond to these issues and we introduce the 'gatekeeper' concept that is often neglected in their importance and the role they play in the financial advice chain.

*Section 2: The (Gatekeeper) participants –* when a serious financial loss occurs, investors and clients are left shocked, angry and confused. It is also natural to direct this anger to the personal adviser they have a relationship with, often the financial planner, despite the cause of failure occurring elsewhere in the system. This section will discuss the role of product manufactures, research houses, Australian Financial Services Licensees (Licensees) and financial planners, and highlight the failings and gaps in consumer protection that will likely contribute to future financial losses if we continue to ignore the evidence and the role of all participants.

*Section 3: SMSFs and compensation –* suffering a financial loss through no fault of your own raises questions of compensation and redress. Though it is agreed that compensation should not be confused with a form of guarantee for investors who choose to be more aggressive in their investment selections, it is intended to protect them from events out of their control, such as fraud and theft. The FPA would like to see all investors protected from fraud and theft and in this section we identify the most appropriate way of responding to that so as to ensure equity and justice.

## 1. The current environment

The collapse of Trio Capital occurred in late 2009. It also occurred after the collapse of Storm Financial, Opes Prime, and other notable corporate collapses, and the completion of the previous Parliamentary Joint Committee Inquiry into financial products and service in Australia in November 2009.

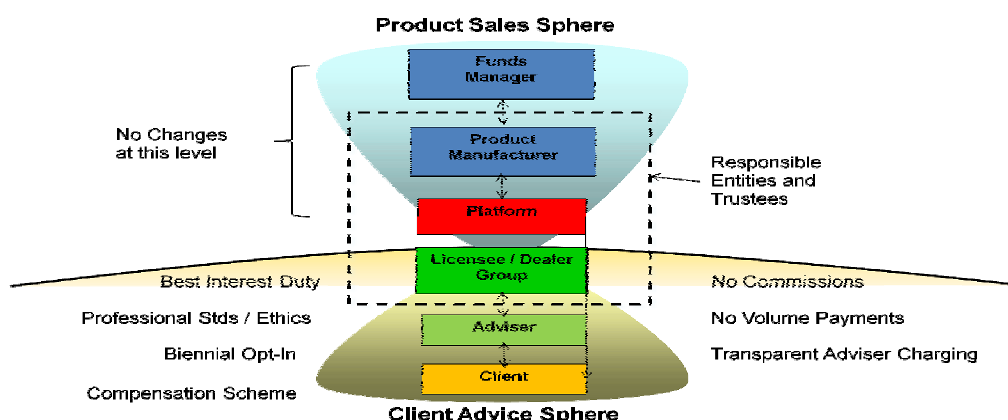
Many lessons were learnt as a result of these events, and many changes have been made both at a legal and professional level, including the resulting and current Government reform agenda of the Future of Financial Advice (FoFA) reforms. This section of the FPA's submission provides a snapshot of these changes.

The FPA asks the Parliamentary Joint Committee to recognise that much has been done in the field of Regulatory and Professional change in its considerations of issues in the Inquiry into the collapse of Trio Capital and other matters. Instead we encourage the Inquiry to focus its attention on those issues that remain outstanding from the current reform program, such as substantially improved product and gatekeeper regulation.

### Future of Financial Advice (FoFA) reforms

On 26 April 2010, the then Minister for Financial Services, Superannuation and Corporate Law, Chris Bowen MP, announced the *Future of Financial Advice* (FoFA) reforms in response to the Parliamentary Joint Committee on Corporations and Financial Services' *Inquiry into financial products and services in Australia.* (Please refer to Attachment 1: Summary of FoFA reforms.)

It is important to note that, as depicted in the following Treasury schematic[2], the FoFA reforms have been focused exclusively on the advice industry (those issues below the curve line in Treasury's diagram) and as a consequence have failed to address the issues which limit the effectiveness of the vital gatekeeper roles of other participants within the financial services sector. Most notably issues in the product provider and funds manager space.




[2] Treasury presentation FPA National Conference Gold Coast QLD *November 2010*

The FoFA reforms focus on the space in the 'client advice sphere' and do not address any issues identified in the 'product sales sphere.

The key elements of the FOFA reforms include:

- a prospective ban on conflicted remuneration structures, such as commissions and volume-based payments on all product,
- a prospective ban on up-front and trailing commissions and like payments for both individual and group risk within superannuation from 1 July 2013.
- a duty requiring financial planners to act in the best interests of their clients when giving personal advice,
- A prospective requirement for financial planners to get clients to opt-in (or renew) their advice agreement every two years from 1 July 2012.
- A prospective ban on any form of payment relating to volume or sales targets from any financial services business to dealer groups, authorised representatives or financial planners, including volume rebates from platform providers to dealer groups.
- A prospective ban on soft dollar benefits, where a benefit is $300 or more (per benefit) from 1 July 2012. The ban does not apply to any benefit provided for the purposes of professional development and administrative IT services if set criteria are met.
- Expanding a new form of limited advice called scaled advice, which can be provided by a range of advice providers, including superannuation trustees, financial planners and potentially accountants, creating a level playing field for people who provide advice. Scaled advice is advice about one area of an investor's needs, such as insurance, or about a limited range of issues.
- A limited carve out from elements of the ban on conflicted remuneration and best interests duty for basic banking products where employees of an Australian Deposit-taking Institution (ADI) are advising on and selling their employer ADI's basic banking products. Basic banking products are basic deposit products (e.g. savings accounts), first home saver account deposit accounts and non-cash payment products (e.g. travellers cheques and cheque accounts).

An important consumer protection measure of the FoFA reforms is undoubtedly the proposed fiduciary duty (best interest) obligation on the individual financial planner. However, as we highlight throughout this paper, there are other participants in the 'advice value chain' that indirectly or directly influence the consumer in purchasing a financial product, which we believe should also be subject to a best interest duty obligation. In particular we believes that a failure of the reforms is not applying a Licensee best interest duty, which was part of the original information pack [26 April 2010 p. 5] announced by Minister Chris Bowen:

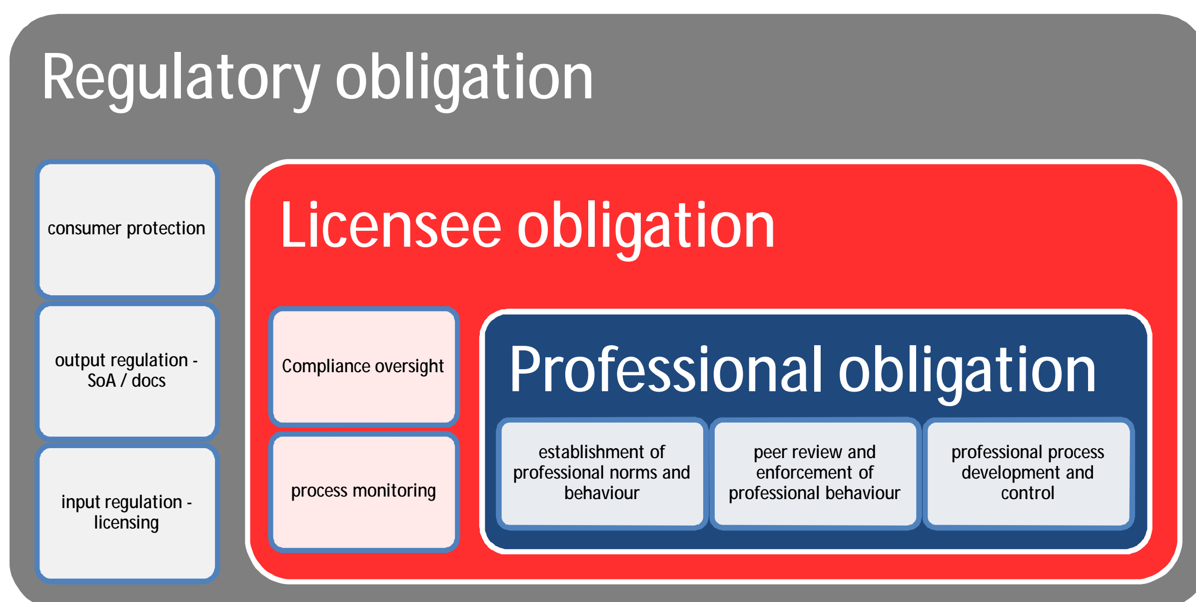
> "In order to ensure that consumers receive personal financial advice that is in their best interests, the reforms will introduce a statutory fiduciary duty on Australian Financial Services Licensees and their authorised representatives which will require them to act in the best interests of their clients".

The final detail of the FoFA reforms is pending the release of draft legislation reportedly due to be tabled to Parliament in the Spring Sitting 2011. The FPA strongly recommends the Parliamentary Joint Committee take into consideration the draft legislation of the FoFA reforms as part of its Inquiry into the collapse of Trio and other related matters. To this end, the following section – *Collapse of Trio and other related matters* - includes a high level analysis of the expected impact of the FoFA reforms on the underlying and associated issues that caused the collapse of Trio.

## The New FPA

As the preeminent Professional Association in this marketplace, the FPA has the view that individual professionals are required to submit themselves to professional obligations and community scrutiny in order to earn the title of 'professional'. These professional obligations play a partnership role with regulatory obligations in the delivery of quality advice and consumer protections, and serve to complement the FoFA reforms.

It is our view that the regulation of financial planners should be a dynamic interaction between the Government imposed legal requirements, the licensee business imposed rules and the expectation of professional participants, as codified in professional obligations. This model is based on the 'best practice' Accountable Governance approaches proposed by O'Brien (2010) and Sanders (2010) and also the Australian government's Office of Best Practice Regulation Handbook 2007, all of which emphasise the regulatory benefits of the separation of roles between the regulator, the regulated and the professional bodies.



# Inquiry into the collapse of Trio Capital



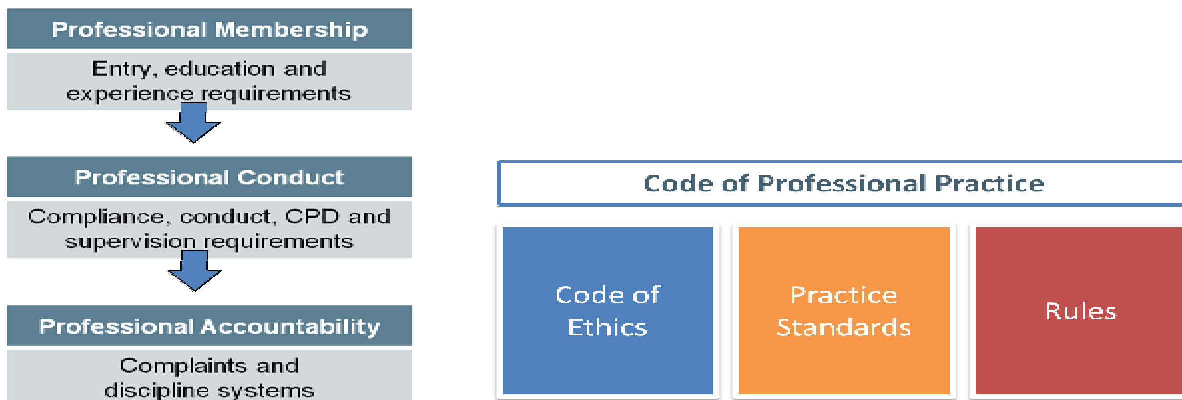
In order to fulfil our obligations as a Professional Association the FPA has not only led the global community in the development of professional regulation, but as an organisation we ourselves undergone substantial changes. Since 2009, the FPA has changed with a new look and leadership, however more importantly we have undertaken the following initiatives to strengthen the professional obligations on our members:

- Effective 1 July 2012, the FPA changed its membership structure with the support of members, to move to a professional body with a membership solely of financial planner practitioners (this received a 94% yes vote from membership at our EGM in April 2011).
- The membership change ensures the accountability to adhere to professional obligations sits with the financial planner when providing services to consumers, which works with regulatory obligations to enhance consumer protections.
- The FPA is transitioning to higher standards of membership which will require, for all new members, a minimum degree qualification and one year experience from 1 July 2013.
- Continued to build a Professional Framework for financial planners, as evidenced by the introduction of a new Code of Professional Practice;
- Put in place new disciplinary regulations for enforcing the FPA's Code and professional practice obligations;
- In October 2009 (prior to FoFA), the FPA launched a Remuneration Policy on our members, banning investment commissions on new business from July 2012;
- Updated the FPA's Continuing Professional Development (CPD) policy, ensuring a qualitative approach is taken to ongoing training of financial planners.

All these initiatives served to change the professional landscape under which members of the FPA operate in Australia.

The FPA Code of Professional Practice is made up of the Code of Ethics, the Practice Standards, and Rules. This is world leading, but in itself it is not enough. A profession must also have a professional framework. The FPA has a framework for:

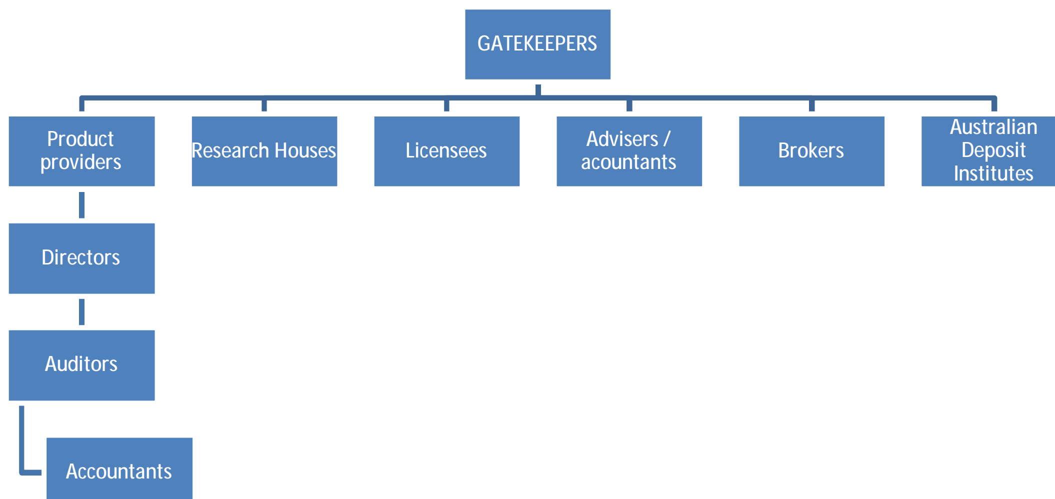
- professional membership
- professional conduct
- professional accountability




## The role of Gatekeepers and prevention

Regulators in Australia serve a vital role in protecting consumers of financial products and services. This role includes the oversight of the various gatekeepers in the market. While each sector of the financial market has a gatekeeper role to play, the current regulatory system fails to hold all gatekeepers accountable for their actions.

The new ASIC Chairman, Greg Medcraft, in a recent speech to the Senate Economics Legislation Committee[3] stated his view that gatekeepers are important in our financial system. “Gatekeepers actually form a cornerstone of the system. Making sure they are held to account is actually quite important. I include in that accountants, financial planners, product manufacturers and distributors and also lawyers—even though we do not regulate them, they are advisers to key participants in the system.”




[3] Hansard Senate Economics Legislation Committee, 31 May 2011

There is a need to consider preventative measures to reduce the risk of misconduct and the problems that lead to the events that cause consumer loss or damage. A holistic approach that considers all financial services is required. A starting point would be to examine the types of financial services providers that have played a role in passed events that resulted in significant consumer loss.

The FPA urges the Committee to ensure they take an holistic approach to the issues involved in the collapse of Trio Capital and consider the role of each participant in the financial services industry.

Only focusing on advice and those licensed under Chapter 7 of the Corporations Act excludes many parties who have been proven in the past to have contributed significantly to dishonest and fraudulent behaviour and insolvencies that have resulted in detrimental consumer loss, such as Trio Capital, Opes Prime and Westpoint.

For example, ASIC has pursued charges and sought consumer compensation from Westpoint directors, the CEO and founder, and even the auditors of Westpoint for their role in the loss incurred by investors from the collapse. In addition, some reputable research houses continued to give the product a highly positive rating. However, a high proportion of consumers impacted by the Westpoint failure did not seek advice. Most consumers invested directly with the product provider or through a broker. In the case of Basis Capital, glowing reports and high ratings were received from several research houses. This influenced financial planners' views of the product and consumers decision to invest in the product.

It is well established that, rather than all fault lying with the advice provider, there are multiple participants who offer products or services within the financial advice value chain, all of whom influence consumers' decisions on financial matters. However, accountability of these participants to the end consumer is variable, limited and for some practically non-existent. They include:

- Product manufacturers and fund managers
- Platforms
- Property schemes
- Ratings agencies and research houses
- Investment banks (funding the development of financial products sold to consumers)
- Auditors (of products and product manufacturers)
- Accountants (of product manufacturers)
- Accountants (of consumer) operating under the accountants exemption
- Stockbroker / share broker
- Futures broker
- Australian Deposit Institutes (banks, building societies, credit unions)
- Insurance brokers and companies

- Unregulated participants (including some Accountants) acting as financial planners
- Regulatory agencies including ASIC and the ACCC
- Professional Indemnity Insurers

Each of these stakeholders play some part, either directly or indirectly, in influencing a consumers' decision to invest in a financial product and the ongoing stability of that product, and each has responsibility to the consumer and their compensation needs for this 'gatekeeper' role they play.

## The collapse of Trio Capital and other related matters

Trio Capital was the trustee of four superannuation funds (the Astarra Superannuation Plan, the Astarra Personal Pension Plan, the My Retirement Plan and the Employers Federation of NSW Superannuation Plan) and one pooled superannuation trust. Trio invested some assets of the funds into a managed investment scheme, however most of its assets were directed into hedge funds located in the Caribbean. There is little, if any, credible evidence that the purported investments were actually made, or if they were, that they have any realisable value. Most of the assets invested were subsequently lost.[4]

While it is true that some consumers invested in Trio products under the advice of a financial planner, some consumers also invested in these products directly (without advice) and outside their superannuation.

The following table provides a high level analysis of the underlying and associated issues associated with the collapse of Trio Capital and the proposed FoFA reforms.

[4] www.asic.gov.au

## Table 1: Will FoFA Impact on issues relating to the collapse of Trio Capital?

| Product provider | FoFA impact | Research houses | FoFA impact | Licensees | FoFA impact | Financial planners | FoFA impact | Regulators | FoFA impact |
|---|---|---|---|---|---|---|---|---|---|
| Found guilty of fraud by the Supreme Court of Australia, which was the cause of the failure of the products and the collapse of the product provider. | No. | Failed to investigate underlying investment of fund | No | Received conflicted remuneration from product provider, including advanced payments, payments on geared investments and marketing allowance or similar volume based payments | No<br>Absence of a licensee best interest duty obligation and ability to become a Responsible Entity | Evidence that conflicted remuneration was received by some financial planners | Yes<br>Banning of commissions and the introduction of the financial planner best interest duty. | Neither APRA nor ASIC detected the warning signs hidden and abnormal risks associated with the product and provider. | No<br>FoFA does not address issues in product space. |
| Product failure and insolvency of the product provider excluded from the usual financial services compensation system. APRA provided compensation to individual consumers invested in Trio super funds. | No<br>The FPA has raised this issue with Richard St John's Review of the Compensation System for consumers of financial services and products, which is part of FoFA. Review Report is pending. | Apparent lack of investigation beyond analysis of information and statistical data provided by the fund and relied heavily on information from the investment manager of the fund rather than independent enquiries. | No | Received conflicted remuneration from margin lenders. | No<br>Absence of a licensee best interest duty obligation and ability to become a Responsible Entity | Concerns of inappropriate advice and the level of product research undertaken in relation to the 'suitability rule' under s.945A of the Corporations Act. | No<br>The role of research houses are not addressed in FoFA and this issue will be further compounded by the absence of a licensee best interest duty. | ASIC didn't pick up on warning signs of hidden and abnormal risks associated with the products and providers, indicating the oversight of products is inadequate | No<br>FoFA does not address issues in product space. |
| Paid forms of remuneration to licensees, some in advance. | No | Demonstrated a lack of understanding of how to identify risks of a ponzi scheme operation. | No | Re-classified Trio product as an international equity product for the purpose of the APL and client portfolio construction.. | No.<br>A licensee best interest duty and the introduction of standard asset class definitions would assist in addressing this issue. | Authorised representatives and employed financial planners were disempowered to provide advice of their own accord, independent of their licensee. | No<br>The absence of a licensee best interest duty will further disempower the financial planner. | ASIC capacity to protect consumers in their ability to license and ban individuals. | Yes<br>ASIC will receive enhanced powers to restrict entry into the AFSL regime. |
| Information provided to research houses was restricted based on 'private investment contracts'. | No. | | | Potential breach of licensee 'product suitability' obligations in the Corporations Act as there was an apparent lack of reasonable due diligence of the product beyond that provided by the product provider and the research house reports. | No<br>A licensee best interest duty and the introduction of standard asset class definitions would assist in addressing this issue. | | | | |
| Inconsistent information released from the product provider | No. | | | | | | | | |
| **All gatekeeper parties appear to have failed to question and undertake further investigations on warning signs of hidden and abnormal risks associated with the products and product provider.** | | | | | | | | | |

The above analysis, though high level, clearly demonstrates the gaps in consumer protection that remain in the 'Product Sales Sphere' despite the FoFA reforms. The entities within this sphere have a dramatic impact on consumers' financial well-being as clearly demonstrated in the collapse of Trio Capital which was caused by fraudulent conduct at the hands of the product manufacturer.

### *FPA Investigations*

The FPA is investigating nine complaints against four members regarding recommendations in the Astarra Strategic Fund (ASF). These four investigations are on going, therefore in adherence to natural justice principles we cannot provide written details but would be available to discuss these separately if required.

### *Evident warning signs of hidden and abnormal risks*

The FPA suggests that it is plausible that the following issues with the Trio Capital products offered warning signs that high and abnormal risks associated with the products and product provider warranted further investigation. It is unclear to what extent these issues were questioned and investigated further by the gatekeeper participants involved.

In undertaking our investigations in these matters FPA has gained substantial insights on ASF and the advice provided. Further it should be noted that there were clear inadequacies in the advice circumstances as well as warning signs that should have triggered concerns by the financial planner(s). We therefore feel suitably informed to highlight these warning signs.

- Trio products provided frequent redemptions, which is abnormal for hedge funds as they are a very illiquid product. It is the FPA's understanding that unlisted companies are not required to register the distribution of redemptions, so such warning signs are often not detected by regulators.

- Investment statistics provided to research houses showed no volatility, which is extremely abnormal and could indicate issues with the underlying investment.

- The Astarra Strategic Fund (ASF) had a very wide and flexible investment mandate and provided little clarity around their investment strategies bias. This lack of transparency and the multitude of investment options provided great scope for ASF management to justify their investment returns and should have raised concerns about the products' risks.

- The results produced by the ASF illustrated a steady, near linear progression with limited volatility. More importantly, this progression was maintained in environments of high volatility for many asset classes and financial instruments, which was abnormal for such products.

- The use of both merger arbitrage strategies and fixed income arbitrage strategies, two prominent examples of relative value strategies, exemplifies that there would have been some volatility in the product's returns. However, it would have been extremely difficult to achieve

solid returns from capital gains with a very low volatility, as reported by ASF, and should have been questioned.

- In 2005, when most Hedge Fund Managers were posting negative returns, the ASF was returning 25% with very low volatility, which should have raised questions about the underlying investments of the product and the associated risks for consumers. The returns suggest that the most likely asset would have been debt instruments.

- The ASF frequently alleged changes to their investments, which should warrant deeper investigations. This was probably done to justify their investment performance and is dependent on the movement of market variables.

- It appears that inconsistent information was released from the product provider, which would have been misleading and a potential breach of Corporations Act disclosure obligations, and warranted questioning by gatekeepers closely monitoring the products.

- Offered advance commission payments to licensees, which is not either an accepted or common practice within Australia's advice industry.

- Information provided to research houses was restricted based on 'private investment contracts'. While this is not a direct warning sign, accompanied with the other issues, it should have been a concern to gatekeepers and industry participants, particularly research houses that deeper independent investigations were required.

All gatekeeper participants have a responsibility to question and investigate financial products and services available to consumers, and refer any concerns to the relevant authority for further investigation. It is evident that the participants involved in the collapse of Trio Capital either did not detect, question or act on the warning signs and/or high and abnormal risks associated with the products or provider.

The FPA recommends better processes for detecting and reporting concerns of high and abnormal risks of products and providers are needed across all financial services participants and gatekeepers to minimise the risks for consumers.

**Please note** that the FPA is happy to make available for the committee a copy of the *FPA Analysis of available information on Trio Capital products* that we have learned through our investigations.

## 2. The (Gatekeeper) Participants

### Product Providers (including platforms)

There are a variety of financial services providers who can and have played a part in dishonest conduct and insolvency events that have impacted on consumers, while not always providing a service directly to a retail client.

Many products are sold directly to consumers who may not have the capacity to clearly identify and assess the complex elements that would go into making such a determination. Though such investments may be appropriate for some investors, a degree of protection is needed for those who are more vulnerable.

A product provider such as Trio Capital is the "Responsible Entity" of the company. It has legal obligations to employ a series of 'third-party gatekeepers', such as auditors to audit the companies finances and sign off on compliance plans. As stated in submissions to the PJC by some SMSF investors, auditor reports indicated the Trio funds complied with all requirements and were included in positive reports on the funds produced by various research houses.

An article by journalist Stuart Washington details concerns about the third-party gatekeepers involved with Trio Capital [5]:

> "The fund grew by a staggering $75 million over the year. But $47 million of that was tipped in on June 30, apparently stripped from related-party funds. There is only one mention of this transaction in the whole annual report, and no mention of it under the section in the annual report devoted to related-party transactions.
>
> This transaction had the effect of almost doubling the size of the fund. Yet the auditor was still able to sign its letter saying the accounts gave a true and fair view of the scheme's financial position as at June 30, 2009.
>
> Where did the $47 million come from? Who moved it? Why the rush on June 30?
>
> Which brings us to another gatekeeper. KPMG was paid to perform another gatekeeping role for Trio as its responsible entity, an audit of the compliance plan for 24 schemes to test whether Trio was doing what it said it was doing.
>
> Each scheme has a compliance plan based on what the fund can and cannot do with its investments. On September 28 - less than three weeks before regulators froze all of Trio's management investment schemes - KPMG signed an audit of the compliance plans stating Trio had "complied with the compliance plans for each of the schemes".

[5] Trio problems are a failure on the part of its gatekeepers, Stuart Washington, The Age, 2 January 2010

> It remains unclear whether KPMG's audit asked questions of Trio. But a large June 30 movement of $47 million into one Trio fund investing offshore affecting several other Trio funds was not something that was noted in particular. KPMG signed off on all the affected funds' compliance plans.

The FPA recommends a holistic and appropriate solution to consumer protection should be considered by reviewing the regulation of financial products available to consumers.

Problems with products should be addressed through product regulation, rather than advice regulation. Product providers should be held accountable for failing to deliver on product benefits due to dishonest conduct, fraud or insolvency, or if there are fundamental flaws in products.

The FPA absolutely acknowledges that financial advice and some financial planners played a role in the consumer detriment resulting from the collapse of Trio Capital. The banning of investment commissions and the introduction of the adviser 'best interest duty', in particular, under FoFA will significantly reform the advice industry and improve the protection of all consumers who receive financial advice. What is still not being addressed are the issues of product reform.

In the UK the Financial Services Authority (FSA) has recently provided a warning through the release of their latest quarterly consultation paper to product manufactures stating that the financial services industry has developed a growing and innovative market for products, including structured products, which are often described as 'guaranteed', 'protected' or 'secure'. The FSA has reviewed this market and concluded that some firms promote these products without any clear and adequate justification for the descriptions used. We believe that this could be implicitly misleading and could lead to consumers misunderstanding what is actually offered to them.[6] This follows comments made by the outgoing CEO of the FSA Hector Sants that "our focus has been too late in the product lifecycle to ensure that we identify potential issues early enough to prevent consumer detriment"[7]

There is a vital need to enhance the responsibility of product providers and fund managers in developing products for consumers, and ensuring compliance with Responsible Entity requirements. There is also a need to ensure product providers and their appointed third-party gatekeepers are held accountable for any wrong-doing resulting in consumer loss.

## FPA Recommendations – Product providers

### *Risk assessment and product labelling*

1. The Government work with all stakeholders to establish a standard system for product category labelling. The FPA understands the complexity of implementing a product labelling system and suggests this could focus on developing 'standard terms' of the top five most common product categories, as a starting point.

[6] FSA CP11/11 Quarterly Consultation no.29 (chapter 5)
[7] Hector Sants, CEO, FSA, 2009

2. The Government should work with product providers, research houses, and all stakeholders, to establish a comprehensive system of rating for product risk that ensures disclosure of key product risks and includes:

    - Identifying specific categories or classes of risk to help the consumer gain a better understanding of the risk involved in investing in a product;
    - Stipulating disclosure requirements and specific risk warnings for each category;
    - Carrying out stress testing of products and disclosure of possible outcomes;
    - Stipulating the level of professional support needed to utilise products;
    - Establishing requirements for different documentation for different classes of products; and
    - Establishing requirement for different compensation regimes to be applied or proportionately funded, on the basis of product risk or complexity.

### *Product disclosure*

1. Increase the quality and type of disclosures required by product manufacturers. This should include a requirement to publish UPFRONT in the product disclosure statement (PDS):

    - product objectives. How the product is intended to perform and why;
    - information on how consumers should use the product;
    - ‘suitability’ criteria to help consumers determine whether the product would suit their needs and circumstances. This should include the type of consumer and the circumstances of the consumer that the product is designed for.
    - how the product should be used and managed. This should include a suggested limit for investment in the product base on a percentage of a consumer’s overall investment portfolio. A warning about the benefits of investment diversification should also be included.

2. Products sold directly to consumers should include point of sale warnings identifying the risk level and need for appropriate advice to assess compatibility with client’s objectives.

3. Stronger advertising controls should be adopted to ensure truth in advertising.

4. The requirements of the Financial Services Council's Superannuation Charter, which calls for better controls relating to promotion of superannuation investment performance, should be extended across the industry to all products.

5. Product manufacturer liability for misleading representations and misrepresentation should be strengthened

6. Mandate 'true to label' obligations for product providers.

7. Introduce appropriate penalties for product manufacturers not meeting these requirements, particularly for poor or inaccurate product disclosures.

### *Best interest duty*

1. The FPA recommends the introduction of a 'best interest' duty to apply to product manufacturers and fund managers to impose a duty on such providers to consider the interests of 'consumers as a whole' (ie. the end user or collective investors) of the financial product throughout the life of the product, including when developing the product and associated materials.

The FPA notes the current requirement under s601FD of the Corporations Act which requires Responsible Entities of managed investment schemes (MIS) to, amongst other things 'act in the best interests of their members'. This requirement is inadequate for the following reasons:

- It is limited to MIS and it therefore is not applicable to other products in the market
- It applies to 'members' of the MIS and therefore is only applicable once a consumer has purchased the product
- It does not require the product manufacturer to consider the end consumer, and the risks to the end consumer, at the product development or pre-sale stages of the product life
- No equivalent obligation on licensed trustee companies
- It is not supported by consumer redress or compensation mechanisms in the current system
- It lacks accountability on the product provider

While we acknowledge the desire for 'baby steps' in relation to enhancing the regulation of financial products, the FPA believe a best interest duty must require all product providers to put the interests of 'consumers as a whole' ahead of the commercial and other interests of the company at all times – that is, for the whole of product life from product conception to the disposal of the product by consumers – especially when a conflict of interest arises.

The objective of a Best Interest Duty is to ensure the conduct and motivation of the product manufacturer is to consider the interest of the public or intended client/investors of the product ahead of their own commercial interest in developing the product. This is not designed to replace the existing requirement under s601FD but rather strengthen this by imposing the duty upfront in the development – before the investor becomes a member of the scheme. It is also intended to apply consistently to all product providers, irrelevant of the product type or asset class, and therefore should not be limited to MIS.

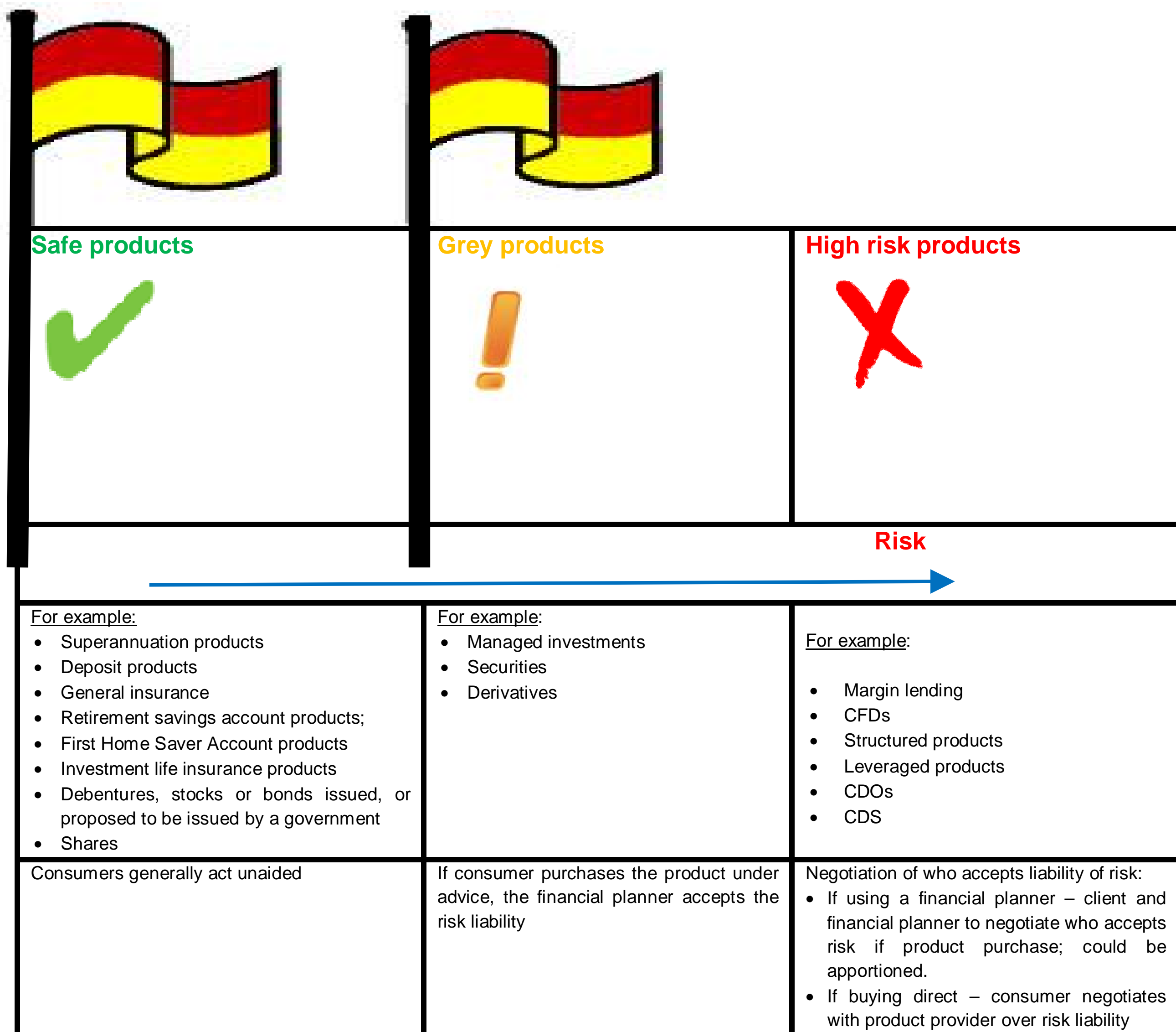
There is a need for a fundamental change in motivation and attitude when it comes to those designing and manufacturing products. The FPA suggests that there needs to be more of a balance to ensure the product manufacturers' motivations are driven by the interests of the investor and not solely their own commercial interests as is the case at the moment.

### *Investing Between the Flags product framework model*

The FPA also recommends the development of a framework aligned with the Australian Securities and Investments Commission's (ASIC) 'Investing between the flags' concept, to address the lack of disclosure by brokers and product providers in relation to complex financial products available to consumers, whether retail or non-retail clients. The framework should provide a model that separates products more effectively based on distinctions in risk in three key areas:

1. Complexity of product
2. Complexity of client needs
3. Complexity of advice

Below is an example framework that categorises products into three categories that could be adopted to support an 'investing between the flags' approach to product regulation.



| Safe products | Grey products | High risk products |
|---|---|---|
| | | Risk → |
| For example:<br>• Superannuation products<br>• Deposit products<br>• General insurance<br>• Retirement savings account products;<br>• First Home Saver Account products<br>• Investment life insurance products<br>• Debentures, stocks or bonds issued, or proposed to be issued by a government<br>• Shares | For example:<br>• Managed investments<br>• Securities<br>• Derivatives | For example:<br>• Margin lending<br>• CFDs<br>• Structured products<br>• Leveraged products<br>• CDOs<br>• CDS |
| Consumers generally act unaided | If consumer purchases the product under advice, the financial planner accepts the risk liability | Negotiation of who accepts liability of risk:<br>• If using a financial planner – client and financial planner to negotiate who accepts risk if product purchase; could be apportioned.<br>• If buying direct – consumer negotiates with product provider over risk liability |

The framework should include requirements for appropriate product disclosures and warnings to be provided to consumers when crossing the boundaries of the 'safe', 'grey' and 'high risk' product types. Irrelevant of the product type, the FPA supports the use of appropriate consumer disclosure on all financial products.

Though it was noted that at least some of the solutions to the global financial crisis should come from better design of financial products, there was no description of how and by whom ratings would be determined as to which products fall between the flags and outside the flags. Product regulation should identify which products are 'inside or outside the flags' to enable a consideration to be made as to whether a product is appropriate. A well thought out system of warnings and disclosures at points of direct sale would be an improvement, in this regard.

### *Dispute resolution and consumer compensation*

See consumer compensation section below.

## Research Houses

Australian consumers rely on information from credit rating agencies and research houses to make investment decisions, so they play an important gatekeeping role in the financial system. The role of such organisations is to provide specialist assessments and detailed due diligence research on financial products for consumers and intermediaries. It is a specialised service, which comes at considerable expense. While the FPA acknowledges recent changes by the International Organisation of Securities Commissions (IOSCO) and ASIC to the regulation of Credit Rating Agencies (CRAs) and research houses, CRAs and research houses should also be held accountable for their roles in product failures.

There are multiple stakeholders who offer products or services within the retail wealth management value chain whose accountability to the end consumer remains unclear, particularly with regard to significant unforeseen events. Each of these stakeholders influences consumers' financial decisions, either directly or indirectly.

There is a need for effective regulation within the retail wealth management chain so that each stakeholder takes responsibility and accountability to the end consumer for their role within the chain for the effective and ethical delivery of services to consumers.

The FPA acknowledges the current licensing and regulatory requirements placed on research houses, including the requirement to hold an Australian Financial Services License (AFSL), meet general advice obligations, disclosure of conflicts of interest, and dispute resolution membership. However, the FPA believes the current requirements are not effective in protecting consumers given the influence research houses have, either directly or indirectly, on consumers' investment decision. *Refer to Appendix 1 for further issues on research houses.*

### *The role research houses play in consumers' investment decisions*

The role of research houses must be determined by the way in which their clients use their publications and services, the different industries within the financial services sector, and the influence their research has (directly or indirectly) on the end consumer.

The FPA believes there is a disconnect between the role research houses believe they have and the role they actually play in the provision of financial service to Australian consumers.

- Australian consumers rely on information from research houses, either directly or indirectly, to make investment decisions;
- Consumers and intermediaries use/view the material produced by research houses as detailed due diligence research and specialist assessments of financial products.
- Product information available to financial planners (from product providers) is generally inadequate in relation to assessing suitability for individual clients. Therefore they must utilise the specialised research capabilities research houses offer.
- Licensees and financial planners use the information provided by research houses as an input for approving funds and products for Licensees' Approved Product Lists (APLs) and ultimately for recommendations to consumers.

Research houses play an important gatekeeping role in the financial system. This must be recognised.

### *Role of research houses in product failures*

A US Congress Joint Economics Committee Report[8] found systemic biases and methodological errors at credit rating agencies distorted investment decisions and had a profound negative effect on financial markets, financial institutions, and the broader economy. The Report concluded that when credit rating agencies award overly high ratings to any class of debt or derivative securities, financial institutions and other investors purchase more of these securities for their investment portfolios. At the same time, systemic biases and errors in credit ratings encourage issuers to supply more of these overly rated securities to financial markets. Thus, systemic biases and errors in credit ratings erroneously stimulate the flow of credit to economic sectors that are receiving funds through these overly rated securities.

[8] The US housing bubble and the global financial crisis: Vulnerabili ies of the alterna ive financial system, Research Report #110-26, October 2008

Further, the Report found the “issuer pays” business model of credit rating agencies made them financially dependent upon a the providers of the products they were assessing. These agencies pressed their analysts to give favourable ratings to maintain or increase market share with these product providers. Credit rating agencies were found to employ flawed methodologies to evaluate structured credit products resulting in higher ratings to many structured credit products than they deserved.

While credit rating agencies in the main assess and rate credit products, and research houses assess and rate non-credit products (or all other classes of financial products), this is their only point of difference. The systemic biases, conflicts of interest, and potential for errors in assessment and ratings of products, are the same across credit rating agencies and research houses. Hence, the FPA suggest it is relevant and important to consider international findings on these issues.

A clear example of an Australian product failure with the same symptoms to those of the credit rating agency issues faced in the US, is Basis Capital. Basis received glowing reports and high ratings from several research houses. This influenced financial planners' views of the product and consumers decision to invest in the product. The majority of consumers who invested in Basis were under advice.

Westpoint is another notable example where some reputable research houses continued to give the product a highly positive rating. However, many consumers impacted by the Westpoint failure did not seek advice. Consumers invested directly with the product provider or through a broker.

In the case of Trio Capital, it appears research houses relied on information provided by the product provider and failed to conduct independent investigations even though the information released by the product provider was restricted based on ‘private investment contracts’ and was inconsistent.

While Government and regulators have strengthened the regulations around product advertising (for example), little has been done to address the underlying issues within the research house industry that played a significant role in the collapse of Trio Capital and other financial products.

The role research houses play in providing research and specialist assessments of financial products which influence consumers' investment decisions is not recognised by the research house industry, or in the regulatory and dispute resolution environment.

Further, the licensing requirements for research houses are dependent on the services the entity provides. If they provide services to wholesale clients only, they are not required to be licensed; if they provide services to retail clients, they are. In addition, we note that ASIC has recently changed its requirements regarding product manufacturers including in their PDS information sourced from research houses. Now product manufacturers must gain consent from the research house to include any information they provided to the product manufacturer (wholesale client) in the PDS. In giving consent the research house is in effect agreeing to the provision of its information (via the product manufacturer) to retail clients, and as a result must have professional indemnity (PI) insurance and be a member of an external dispute resolution (EDR) scheme to support the provision of information to retail clients.

However, the FPA questions the benefits of EDR, compensation arrangements and PI for research houses as, in the main, their clients are wholesale clients (usually other licensees who are prohibited under the Corporations Act from making a claim through these mechanisms) even though the service provided by research houses influences the retail clients' decision. It is also very difficult, near impossible, for a retail client to provide causal link evidence of the failings of the research house to the event at the cause of the loss. This is exacerbated by the exclusion from PI cover (RG126.23) and EDR (RG139 and FOS Terms of Reference) of product failures and claims for loss solely as a result of the failure (e.g. through insolvency) of a product issuer, such as Trio Capital. (See Consumer compensation section for further detail.)

### *Financial planners and research:*

The FPA strongly supports the fundamental requirement for financial planners to consider and investigate the subject matter of the advice they provide under s945(1)(b). In fact, the FPA's Code of Professional Practice goes beyond these legal obligations to require our members to conduct thorough independent research to ensure suitability to client needs, objectives and risk tolerance and circumstances.

However, research published by research houses plays a role in financial planners' consideration of client suitability of a product or service. As highlighted by FPA members in our meeting with ASIC on this issue (held 6 April 2011), research houses are used in different ways by financial planning professionals and licensees depending on their size and business model.

It is unclear how much and in what way licensees and financial planners can rely on research house research and ratings in relation to errors of fact, timing of ratings and adjustment of ratings. There is no accountability for research houses in this regard.

- Small dealer groups do not have the capacity of dedicated research teams and compliance officers other than the Responsible Officer who is usually the Principal of the organisation.
- The practicalities/ability of licensees and financial planners in regional areas conducting their own research on all products is questionable, as they do not have the ability/access to meet with fund managers on a regular basis in order to carry out the indepth research expected by FOS and ASIC due to geographical and resource limitations. Hence the role of research houses is vital.
- Without being able to rely upon research houses, financial planners must rely upon publicly available product information. Research house information offers greater insight into the products.

### *Self Managed Super Funds and research*

SMSF trustees also utilise and are strongly influenced by research house reports. This was clearly evident in the case of Trio Capital. The FPA understands that some SMSF investors have called on the Government to include the role of research houses in its Trio Capital investigations as positive reports from various research houses were used extensively by SMSF trustees and auditor reports indicated the Trio funds complied with all requirements[9].

## FPA Recommendations – Research houses

1. The FPA recommends the introduction of a 'best interest' duty to apply to research houses to impose a duty on such providers to put the interests of the 'consumers as a whole' (ie. end users or investors collectively) ahead of the interests of the research house, including their relationship with product manufacturers and commercial interests, when analysing, assessing and reporting on a financial product. This should extend to the release of unfavourable product research reports.

2. ASIC to undertake a thorough and public review of the regulation of research houses operating in Australia.

3. Require research houses to publish all research reports they produce, whether they are used or not by product providers, even if they are unfavourable of the product.

4. Introduce obligations on research houses to produce unbiased product research and ratings, irrelevant of the product manufacturer relationship.

5. To improve transparency, introduce a framework which ensures that all research houses disclose their research and ratings methodology, and how/why they determined the ratings on a product/fund.

6. Place obligations on research houses to notify consumers and intermediaries that their research should not be relied upon if the information from product manufacturers used in the research house analysis and assessment is not transparent, up-to-date, or adequate.

7. Require research houses to disclose matters not researched, such as 'black boxes', risks to consumers, etc.

8. Require research houses to notify consumers and intermediaries of their complaints process and EDR membership, beyond the current requirement to include this information in their FSG.

[9] Trio clients lobby Government over negligence, Kate Kachor, Investor Daily, 25 July 2011

9. Increase the quality and type of considerations and information research houses should include in the analysis reports on financial products. This should include a requirement to publish research and analysis of the:

    - product objectives. How the product is intended to perform and why;
    - information on how consumers should use the product;
    - 'suitability' criteria to help consumers determine whether the product would suit their needs and circumstances. This should include the type of consumer and the circumstances of the consumer that the product is designed for.
    - how the product should be used and managed. This should include a suggested limit for investment in the product base on a percentage of a consumer's overall investment portfolio.
    - Underlying investment of products

10. Introduce appropriate penalties for product manufacturers not meeting these requirements, particularly for poor or inaccurate product disclosures.

11. Introduce consumer accountability for research houses by legislating for a causal link between the role and publication of the research house and the consumer loss to enable proportionate liability to be introduced into Australia's consumer compensation system.

## Australian Financial Services License (Licensees)

As the Committee would be aware from previous Inquiries, the role of Licensees differs from the role of financial planners, in the provision of financial advice.

- Licensees hold an Australian Financial Services (AFS) licence. A Licensee does not usually provide a direct advice service to consumers. Ownership of the business can affect the services and products recommended by the financial planners it authorises. The licensee services the client base 'as a whole'. Licensee's primary responsibility / focus is to their shareholders. Licensees provide support to financial planners in providing advice to consumers.
- Financial planners deliver advice services directly to individual consumers and can be employed by or authorised to represent a business that holds an AFSL. Financial planners provide a direct service to individual clients. This is their primary responsibility.

These differences are recognised under law with separate and different obligations placed on licensees to financial planner obligations. Financial planners and licensees have unique roles and responsibilities in delivering services to consumers, and therefore should be treated differently and separately.

In order to ensure the necessary consumer protection measures are put in place, the FPA would urge the Committee to separate out the issues and related recommendations for licensees and financial planners, and not to put issues that are clearly and solely the fault of licensees, onto the individual financial planner.

The following exert from the above table clearly demonstrates the different role the licensee played from the financial planner in the case of the collapse of Trio Capital.

| Licensees | Financial planners |
|---|---|
| Received conflicted remuneration from product provider, including advanced payments, payments on geared investments and<br>marketing allowance or similar volume based payments | Evidence that conflicted remuneration was received by some financial planners |
| Received conflicted remuneration from margin lenders. | Concerns of inappropriate advice and the level of product research undertaken in relation to the 'suitability rule' under s.945A of the Corporations Act. |
| Incorrectly re-classified Trio product as an international equity product for the purpose of the APL and client portfolio construction.. | Authorised representatives and employed financial planners were disempowered to provide advice of their own accord, independent of their licensee. |
| Potential breach of licensee 'product suitability' obligations in the Corporations Act in respect to due diligence of the product beyond that provided by the product provider and the research house reports. | |

The issues relating to both the financial planner actions and underlying motivations of the financial planner actions in the Trio collapse will be addressed by the banning of commissions and the financial planner best interest duty under the FoFA reforms.

### *Conflicted remuneration*

There is evidence that licensees received remuneration from Trio Capital that could be deemed or perceived as conflicted, including advanced payments, payments on geared investments and margin loans, and in some cases a marketing allowance or similar volume payment. There is also evidence that some licensees received remuneration from margin lenders.

While it is important to acknowledge these issues occurred between Trio Capital and licensees, the pending legislation of the FoFA reforms will ban all forms of commissions (except on risk insurance) and volume payments, payments on geared investments, and introduce restrictions on soft dollar benefits.

While the FPA supports the introduction of the changes to conflicted remuneration under FoFA, the Association recommends a licensee best interest duty would strengthen the consumer protections afforded by these measures.

### *Licensee Best interest duty*

While the banning of commissions will go some way to addressing the licensee issues involved in the Trio collapse, without a best interest duty requiring the licensee to put the end consumers' interests ahead of their own, many of the issues will go unaddressed and a gap in consumer protection will remain. At this stage, the FoFA reforms do not include a licensee best interest duty and do not consider issues related to the development of a licensee's Approved Product List (APL) and the rebranding of products.

A statutory best interest duty should be introduced at the level of the licensee to ensure:

(a) Financial planners have licensee support and influence to meet the pending statutory financial planner best interest duty under the FoFA reforms; and

(b) That the licensee gives priority to the interests of its financial planners' clients over its own commercial interests in relation to the activities of the licensee which directly influence the quality of advice provided to retail clients including, the construction of the licensee's approved product list, the arrangements by which it's financial planners are remunerated for the provision of advice, and its arrangements for obtaining product research.

Like the trustee duty in s601FC of the Corporations Act, the authorising licensee duty to clients is usually directed towards the licensee's client base as a whole, whereas the duty on the individual providing the advice is directed towards that financial planner's individual client.

The individual financial planner owes duties to their licensee via employment contracts and/or authorising contracts. The contractual duties owed by the financial planner to their licensee will often place the financial planner's interests in conflict with their client's interests.

It should be recognised that the authorising licensee's interests are commercial – to act in the interests of their shareholders. More often than not those interests are in conflict with the interests of consumers.

Licensees should be encouraged to take appropriate measures to ensure that the licensee's commercial interests do not unduly interfere in the individual financial planner's performance of his or her best interest duty to their client.

In this sense, the duty on the licensee should be three-fold:

- A separate statement of the best interest duty on licensees in terms of the licensee's duty to clients collectively:

  - this should mirror the trustee duty to give maximum protection to consumers;
  - it should recognise advice licensee's as a special case like RE's; and
  - it should be reflected in the individual duties on directors and responsible officers of advice licensee corporations

- License obligations should require licensees to assist and support their authorised representatives to comply with the financial planner best interest duty when providing advice to their clients; and
- Consistent with the existing licensee obligations, the licensee should have vicarious responsibility for the individual financial planner's performance of the financial planner best interest duty to each client.

In the absence of reciprocal obligations on licensees, the individual financial planner needs statutory protection when they are required by their licensee to act in their licensee's interest, contrary to their client's best interest, or simply contrary to their client's interest. The FPA suggest this issue will be of particular concern to the Financial Services Union (FSU) regarding the pressure placed on some financial planners by certain licensees to recommend specific products such as Trio Capital to clients.

The FPA believes the Government's consumer protection objectives of the financial planner best interest duty cannot be met without a supporting licensee best interest obligation. A statutory best interest duty should be introduced at the level of the licensee to ensure the licensee, as an influencer of financial planner conduct, should have a duty to make sure this influence is not going to conflict the financial planner in their duty to act in the best interest of the client.

The FPA is concerned that many stakeholders do not appreciate the pressure that would be generated on the individual financial planner who will be forced to navigate between competing duties to their employer and their duty to their client, if a best interest duty was not imposed on the licensee. There is anecdotal evidence that such pressure was created by licensees who had entered into commercial arrangements with Trio Capital. An appropriately worded licensee best interest duty will successfully empower the individual financial planner to champion the interests of their clients against potential commercial interests of the licensee.

It is the FPA's view that the licensee duty is fundamental to the success of the overall best interest duty on the individual financial planner and is the cornerstone to the success of the FoFA reforms.

To generate the behavioural shift that the Parliamentary Joint Committee Inquiry into financial products and services in Australia, the community and the profession have been demanding, there must be a duty on licensees that fetters their commercial interests and places a focus on consumers' interests.

The FPA acknowledges the work undertaken by Treasury thus far in developing an appropriate best interest duty for financial planners and calls on the Committee to reinforce this work by recommending a best interest duty for licensees.

### *Approved Product Lists*

ASIC has a mandate to ensure that licensees and their representatives giving financial advice meet the standards required by the law. These standards have two important elements – knowing your client and knowing your product. Due to the wide range of products available in the retail market and the complexity and risk associated with some of them, ASIC's focus is on the compliance arrangements licensees have in place to support obligations to 'know your product'.

By law, licensees must know enough about the products they allow their financial planners to recommend to be satisfied that they are suitable for their clients as a whole. They must undertake research on the products to the extent that it is warranted in the circumstances and, if necessary, carry out their own enquiries. Many licensees manage this responsibility by establishing an Approved Product List (APL), which involves doing due diligence on products before approving them for financial planners to recommend for clients, if the financial planners determines them suitable to the individual client. Some licensees only permit their representatives to recommend products that are on the approved product list. Others require sign-off from management if a representative wishes to recommend a product that is outside the approved product list.

The law requires licensees to conduct due diligence on financial products to the extent that it is reasonable in the circumstances. This means that the research can be tailored to the product. For example, if a licensee is recommending a simple deposit product from a financial institution, the research might be limited to the product terms and the interest rate. At the other end of the spectrum, due diligence on a complex financial product, like an interest in a mortgage fund or a derivative, may require a licensee to carry out a detailed analysis of product features and the institution standing behind the product.

With over 16,000 products in the market, the licensee's APL offers a significant first step for financial planners in assessing the risks, stability, validity, returns, management, governance and relationships associated with the product, in filtering suitable products for clients. However, FPA's professional obligations ensure that financial planners do not solely rely on the licensee's due diligence in developing the APL.

FPA's Conflict of Interest Principles require "all FPA members to undertake due diligence necessary to offer products which suit the needs of the individual client". The FPA Code of Professional Practice goes further - "a member must not recommend a product or service unless the member understands its characteristics, risks and key features". ASIC also requires the Statement of Advice (SOA) to clearly disclose if a financial planner's recommendations are restricted to products from an approved product list.

Given the sheer breadth of products in the marketplace and the open regulatory product space that exists in Australia, Licensees cannot (and should not) have all possible products available for their client base in an open platform. Limitations of product pool, through the use of an Approved Product List, are necessary and beneficial as they include only those products deemed appropriate following extensive due diligence and research. They protect clients by minimising the risk of inappropriate products being recommended and by ensuring that clients with specialised needs get specialised advice that might then deal with specialised products.

The FPA is concerned that many of the 16,000 products in the market are not subject to adequate oversight before issuance. The responsibilities placed on licensees and financial planners under the Corporations Act and the Regulator's approach to consumer protection against poor products clearly misplaces the regulatory burden of ensuring the validity of all products on the individual financial planner.

The FPA is concerned about the due diligence undertaken by some licensees in assessing the Trio Capital and Astarra products; and the methodologies used by these licensees to determine which products are deemed appropriate for their Approved Product List (APL).

Financial planners should and do have responsibility for ensuring the understanding and suitability of products for individual clients. However, licensees should be required to warrant to their representatives and their 'clients as a whole', that the products selected on their Approved Product List (APL) are suitable in a 'fiduciary' (read best interest) sense to those 'clients as a whole'. This warranty might be given around a licensee research process. It might also be limited either as to the proportion of the market reviewed for the supply of a particular type of product, or limited as to the circumstances in which the product is likely to be suitable to the licensee's 'clients as a whole'.

For example, an equity fund might, due to anticipated exposure to market volatility, not be considered suitable to recommend to investors other than growth investors. Licensees should also be required to provide information to financial planners that enable financial planners to assess and compare the likely suitability of products on the APL for a financial planner's particular clients; and between products on the APL and similar products not on the APL. For example, at the licensee APL level, such information could show how a retail superannuation fund is likely to perform across a range of comparators versus the leading industry fund comparator.

A licensee 'fiduciary' warranty would enable financial planners to select the most competitive and appropriate product amongst similar competing products on their licensee's APL, or if a better product lies elsewhere – to decline to make a recommendation.

Further, as detailed above, the FPA suggests a more proactive environment of legal and regulatory requirements on products and research houses would provide greater prevention of product failures than the regime currently allows.

*Product rebadging*

Licensee/dealer groups rebadge products and act as trustees for their own superannuation products, or become a Responsible Entity (RE) for their own managed investment schemes. There is evidence of this occurring with the products provided by Trio Capital.

It is an entirely legal activity for a licensee to rebadge a financial product with a name associated with the licensee. To be permitted to rebadge a product a licensee must meet very strict criteria to become a Responsible Entity of that product. As a Responsible Entity the licensee must then adhere to higher legal obligations around the product. By rebadging the products, a licensee also becomes the 'promoter' of the product and can receive revenue from the sale of that product. In the case of Trio Capital the licensee was entitled to receive 50% of the Responsible Entity and administration revenue from the product provider for recommending the products.

The FPA is concerned that the ban on volume payments under the FoFA reforms will likely result in licensees to look at ways that they can retain their share of the market which will include the prospect of many more licensees becoming trustees and/or Responsible Entities and offering their own products to their clients, effectively replacing one type of conflict with a seemingly more inherent conflict.

However, the FPA is also concerned about the transparency of the product once it has been rebadged and the product disclosures to provided consumers. It is unclear whether this impacted on consumers' understanding of the product they were investing in.

## FPA Recommendations – Licensees

*Licensee Best interest duty*

The FPA recommends a best interest duty require AFSL holders to place the interests of the 'consumer as a whole' ahead of the interests of the licensee.

The FPA has provided the following draft wording for appropriate licensee and financial planner best interest duties to Treasury.

The statutory licensee best interest duty should be expressed as additional license conditions in s.912A(1) requiring the licensee:

(a) To have in place adequate arrangements to support each of its representatives to meet the statutory financial planner best interest duty; and

(b) To have due regard for the best interest of its clients in the conduct of its activities which relate to the provision of financial product advice, and if there is conflict between its clients' interests and its own interest in relation to such activities, give priority to the interests of its clients.

### *Approved Product Lists*

The FPA recommends the licensee best interest duty captures the development of Approved Product Lists to ensure the due diligence undertaken when assessing products places the consumer interest above the commercial interest of the licensee.

### *Product rebadging*

The FPA recommends more detailed consumer disclosures are required when a product has been rebadged.

### *Strengthening Licensee Governance*

The FPA recommends:

1. Strengthening the criteria, requirements and assessment process to gain an AFS licence, to include:

    - Office based audits to finalise licensee authorisation on a random basis to facilitate greater prevention rather than cure, when it is often too late.

    - Segregation of duties for key responsibilities which should take into account the nature, scale and complexities the licensee undertakes. Strict separation may apply to firms above a specific size, such as those with 20 financial planners or more.

    - Consideration of Independent Directors for licensees with 20 or more financial planners.

    - Stronger governance around the development of Approved Product Lists (APL), to ensure the methodology used is robust, research-based, and professional, and is not subject to any monetary influence.

    - A check of whether applicants or their Responsible Manager have had complaints upheld against them with a professional body, dispute resolution service, or other relevant jurisdiction. Consideration should be given to the nature of the complaint and severity of any financial planner/licensee action that led to the complaint.

    - A review of the roles and competencies of Responsible Managers and others in the company making application, and apply minimum guidelines or qualifications.

    - Agreement to ongoing regulatory supervision requirements to facilitate more proactive action based on deeper market intelligence, once granted.

2. Establishing a public register which is managed by ASIC, of all AFSLs and Authorised Representatives, that details licensing conditions and professional obligations for the provision of financial planning advice and possibly for all other types of 'financial product advice'. The register should include whether the provider has been banned by ASIC or a relevant professional body.

3. Amending the ASIC Act and ASIC Regulations to encourage greater information sharing and co-operation between the Regulator and professional bodies where it can be established that there is mutual interest and community benefit.

## Financial Planners

Incidents of inappropriate advice and dishonest conduct by financial planner must be investigated with appropriate penalties imposed and appropriate consumer compensation paid. The FPA encourage any consumers who believe they may have received inappropriate advice to contact the Financial Ombudsman Service (FOS) or the FPA if they believe a financial planner may have breached their professional obligations. Any regulatory systemic consumer protections issues identified from consumer complaints or intelligence investigations should be considered by Government and the professional to ensure effective regulatory measures or professional obligations are put in place to minimise the risks for consumers.

The following table details the financial planner issues evident in the case of Trio Capital and demonstrates how these issue will be addressed by the FoFA reforms and the FPA Code of Professional Practice.

| Financial planner misconduct in Trio collapse | Will issue be addressed by FoFA reforms? | How will FoFA address issue? | Further measures required? |
|---|---|---|---|
| Evidence that conflicted remuneration was received by some financial planners | Yes | Through the banning of commissions and the introduction of the financial planner best interest duty. | No |
| Concerns of inappropriate advice | Yes | Will be addressed by the financial planner best interest duty. | No |
| Authorised representatives and employed financial planners were disempowered to provide advice of their own accord, independent of their licensee. | No | n/a | A best interest duty should apply to licensees, to assist in addressing this issue (see FPA Recommendations – Licensees above for more detail) |
| Financial Planners failed to identify warning signs of fraudulent activity within the products and by the product provider | No | n/a | Better processes for detecting and reporting concerns of fraudulent activity are needed across all financial services participants and gatekeepers to minimise the risk of fraud for consumers. |

### FPA Recommendations – Financial Planners

In considering the current reform agenda the FPA does not support further advice regulation.

The FPA recommends the Committee allow the FoFA reforms to be embedded by industry and Government, and the effectiveness of the reforms be thoroughly evaluated and tested, prior to introducing additional reforms on financial planners.

## 3. Self Managed Super Funds (SMSF) and Compensation

### Self-Managed Super Funds (SMSF)

There is a plethora of benefits and risks associated with establishing an SMSF over membership of an APRA-regulated superannuation fund. While SMSF structures offer an individual greater flexibility and control over their superannuation and retirement savings, it comes with increased responsibility of trustee obligations and reduced access to consumer protection measures. These risks and benefits must be clearly disclosed, understood and considered when deciding to establish an SMSF.

It has been widely reported that many SMSF trustees had invested in Trio Capital products. As discussed in the *Consumer access to compensation* section below, the current compensation system excludes compensation for product failures or for loss solely as a result of the failure (e.g. through insolvency) of a product issuer. As a result, in the case of Trio Capital, the Government stepped in to provide compensation via APRA to those invested in Trio Capital superannuation funds which were APRA-regulated.

SMSF trustees were not compensated for their loss even though they had acted appropriately and met their trustee obligations, and the loss was outside their control and a direct result of fraud at the hand of the product provider. This meant that some investors were compensated while others were not.

While SMSFs fall within the jurisdiction of the Financial Ombudsman Service, they are currently excluded from other compensation mechanisms such as the APRA payments made to consumers impacted by the collapse of Trio Capital. This inequitable restriction to compensation, alongside the exclusion of product failures and insolvencies from the current system significantly impacts access to compensation for SMSF trustees who have suffered a loss as a result of fraud.

All investors who are doing the right thing should have fair and equitable access to compensation in situations where they suffer a financial loss as a result of fraud or theft. This distinction must be very clear and not interpreted as seeking compensation due to a SMSF gambling on a higher risk investment. In Trio Capital, the investment risk was exactly the same the distinguishing factor was the vehicle used to become an investor of Trio.

However, the FPA is not supportive of a last resort compensation scheme until the regulatory and compensation framework is able to ensure that each participant in the financial services industry has responsibility and financial accountability to the end consumer for their role in ensuring the effective and ethical delivery of products and services.

### FPA Recommendations – Self managed superannuation funds

The FPA recommends SMSFs obtain similar consumer protections as members of APRA regulated superannuation funds in respect to Fraud and Theft.

## Consumer access to compensation

As previously stated, the FPA provided a detailed submission and participated in the consultation process of the Government's Compensation Review, headed by Richard St John. The FPA would like to acknowledge the careful considerations of these issues by Mr St John and his team. The FPA urges the PJC to refrain from making recommendations on the financial services compensation system, including access to compensation for SMSFs, prior to the public release of Mr St John's Report.

In the case of Trio Capital, there were three types of investors:

1. Those who invested through a APRA-regulated superannuation fund
2. Self Managed Superannuation Funds (SMSF)
3. Retail investors

As no investor can foresee fraud, all investors should be protected and compensated for the resulting loss. Therefore, the FPA believe it is unfair that only those who invested in Trio Capital through an APRA-regulated superannuation fund have access to compensation. All investors should be protected and compensated for fraud. We are particularly concerned by the limitations of SMSF trustees and members to access compensation. However, the FPA is unable to support a proposal for a last resort compensation scheme until the regulatory and compensation framework is able to ensure that each participant in the financial services industry has responsibility and financial accountability to the end consumer for their role in ensuring the effective and ethical delivery of products and services.

Australian consumers of financial services deserve a compensation regime that not only offers comprehensive redress but that also acts to improve the financial services industry for future consumers.

Achieving that goal requires a complete overhaul of Australia's compensation regime to recognise its influencing role in a broader consumer protection regime designed to protect consumers from poor products and poor advice in the first instance. When supported by an improved obligation regime that attaches responsibility for compensation to the parties with a causal link to the fault, we can deliver better compensation to consumers and positive reform to the industry.

In addition, the opportunity to improve consumer compensation should be considered in the context of improving the link between causal responsibility (fault) and the remedies that should be available (both in terms of justice and compensation).

Such financial service providers and the cause of the loss (fraud), including Trio Capital, currently fall outside the existing consumer compensation system. The 'liability standard for claims' acknowledges that current compensation arrangements are confined to a breach by a licensee of Chapter 7 obligations, which negates the accountability of many financial services providers.

There are a large number of financial products available to consumers, both directly and via an intermediary. However, there is a lack of accountability of product providers and research houses when products do not live up to the claims of their promotions. The financial planning profession is often targeted with all the blame for product failures, which are wholly outside their control. Financial planners are attractive targets because of the ease of access to their professional indemnity insurance cover for consumer compensation. However, the source of most complaints is failed products.

As highlighted in the following table, there are various scenarios to the licensing, External Dispute Resolution and compensation arrangements for product providers, some of which raise great concern for the FPA and serve to reinforce some of the issues with the current system.

| Financial services provider | AFSL License | Chapter 7 | EDR requirement | PI requirements (for the purposes of paying consumer compensation as required by ASIC) | Compensation arrangements required under 912B |
|---|---|---|---|---|---|
| Licensed product providers only operating in superannuation<br><br>(including licensed platform providers) | Yes | Yes | No<br><br>(Complaints mechanism through the Superannuation ComplaintsTribunal (SCT) in relation to conduct; not a compensation focus) | No<br><br>APRA regulated | No<br><br>Regulated under the Superannuation (Industry Supervision) Act with complaints to the SCT under the Superannuation (Resolu ion of Complaints) Act 1993. No have compensation requirements.) |
| Licensed product providers<br><br>(including licensed platform providers) | Yes | Yes | Yes | No (if entity is APRA regulation or related to APRA regulated entity)<br><br>Yes (if not APRA regulation or related to APRA regulated entity) | Yes |
| Unlicensed product providers where a PDS is required<br><br>(ie. is a managed investment product or able to be trade on a financial market)<br><br>(including unlicensed | No | No | Yes | No<br><br>(Only licensees are required to have PI cover) | No<br><br>(Only licensees are required to have adequate compensation arrangements) |

| | | | | | |
|---|---|---|---|---|---|
| platform providers) | | | | | |
| Unlicensed secondary sellers where a PDS is required<br><br>(ie. is a managed investment product or able to be trade on a financial market) | No | No | Yes | No<br><br>(Only licensees are required to have PI cover) | No<br><br>(Only licensees are required to have adequate compensation arrangements) |
| Unregistered/privately operated MIS<br><br>(no PDS required to be given to ASIC under 601ED(2) and the 20/ 12/2 rule) | No | No | No | No | No |
| Property schemes | No<br><br>(Unless an MIS, not required to hold an AFSL) | No | No | No | No |
| Ratings agencies and research houses | Yes (if provide services to retail clients)<br><br>No (if provide services only to wholesale clients) | Yes (if provide services to retail clients)<br><br>No (if provide services only to wholesale clients) | Yes (if provide services to retail clients)<br><br>No (if provide services only to wholesale clients) | Yes (if provide services to retail clients or give consent for their information to be included in a product provider's PDS)<br><br>No (if provide services only to wholesale clients) | Yes (if provide services to retail clients or give consent for their information to be included in a product provider's PDS)<br><br>No (if provide services only to wholesale clients) |
| Investment banks (funding the development of financial products) | Yes | No | No redress for retail clients<br><br>Service wholesale clients, though actions impact retail clients in relation to insolvencies and fraud/dishonesty of the products they fund | No<br><br>(due to APRA regulation or related to APRA regulated entity) | No |
| Auditors (of products and product manufacturers) | No | No | No | No<br><br>(only as a professional requirement to cover business risk; not for | No |

| | | | | | |
|---|---|---|---|---|---|
| | | | | consumer compensation) | |
| Accountants (of product manufacturers) | No | No | No | No | No |
| Accountants (of consumer) operating under the accountant exemption and not as an Authorised Representative | No | No | No. Consumers can sue through courts<br><br>Complaints mechanism through the Tax Practitioners Board and professional bodies (eg. CPA) for breaches of professional obligations; not compensation focus | No mandatory PI requirement for consumer compensation.<br><br>Regulated cap liability scheme in which accounts *may* participate in a PI scheme with cap on compensation. | |
| Stockbroker / share broker | Yes | Yes | Yes | Yes | Yes |
| Futures broker | Yes | Yes | Yes | Yes | Yes |
| Australian Deposit Institutes (banks, building societies, credit unions) | Yes | Yes | Yes | Yes | Yes |
| Insurance brokers and companies | Yes | Yes | Yes | Yes | Yes |
| Financial planner and accountants operating as Authorised Representatives | Yes | Yes | Yes | Yes | Yes |

For example, consider a licensed product provider who only provides product (ie does not provide any other financial service). In this case, the product provider would hold an AFSL, be subject to disclosure and advice requirements under Chapter 7, be required to be a member of an EDR scheme, have adequate compensation arrangements, and adequate PI cover. However, it clearly states in RG126.23 that the "The compensation requirements are *not intended to cover*:

a) product failure or general investment losses;

b) all possible consumer losses relating to financial services;

c) claims for loss solely as a result of the failure (e.g. through insolvency) of a product issuer (i.e. it is not intended to underwrite the products of a product issuer); or

d) a return on a financial product that has not met expectations."

The primary risks faced by a retail client of an AFSL who only provides products relates solely to either the failure of that product or the insolvency of the product issuer. It is these risks that led to detrimental consumer loss in past significant events such as the collapse of Trio Capital and others including Westpoint and Australian Capital Reserve. Yet, these issues are specifically excluded from the PI cover requirements in RG126, making the PI adequacy requirement for licensed product providers completely redundant and pointless for consumers.

Similarly, the requirement for unlicensed product providers and unlicensed secondary sellers, where a PDS is required to be registered with ASIC (ie. It is a managed investment product or able to be traded on a financial market (s1015B)), to be a member of an EDR scheme is made redundant as EDR schemes also exclude complaints (under their Terms of Reference and in RG139) related to product failure or failure through insolvency of the product issuer. The exclusion of such complaints from EDR scheme jurisdictions has also impacted Trio Capital investors.

When considering these issues it is important to remember that not all retail clients invest under advice. Keeping this in mind, the above examples of the requirements on product providers highlights the gaps in the system and the risks these gaps pose for investors.

### *Failure to consider causal relationship in current compensation*

As the compensation regime is currently constructed, Australian Financial Advice Licensees are responsible for the resolution of client claims for compensation sought through the Internal and External Dispute Resolution mechanisms. In practice, most client claims for compensation arise after a financial loss has been experienced and a financial loss usually arises because a product fails to deliver on the investment promise made to the client.

At the centre of the debate regarding compensation are the two questions of:

- Why did the client engaged in the investment promise for this product? and
- Who was responsible for the failure of the product to achieve its investment promise?

The current approach to consumer compensation only seeks to answer the first question and begins with the assumption that the financial planner is solely responsible for that answer. For instance, a product can only fail because of an event outside of the financial planner's control (such as market failure or product illegality), however the financial planner is nonetheless held responsible for compensating the full client loss on the assumption that the product did not fail but that rather it should not have been advised to the client in the first instance.

The FPA acknowledges there was some wrong-doing by some licensees and financial planners in relation to Trio Capital as detailed in the above table, however the underlying cause of consumer loss was the failure of the products and the collapse of Trio Capital because of fraud by the product provider, whose investment manager was found guilty by the Supreme Court of Australia.

Not only is such an approach a denial of justice for both the consumer and the financial planner but it is a clear failure of causal linkage for the financial loss experienced. Compensation should be based on:

1. first identifying that a financial loss is appropriate to be compensated

2. secondly identifying the causal links in the financial loss experienced

Assuming that a consumer loss meets the justification of compensation then those with causal responsibility for the loss should be assessed on a basis of materiality, perhaps in a concept similar to proportionate liability in tort law. There is little doubt that instances will arise where the financial planner has some causal responsibility for the loss and in such instances relative materiality should be identified in conjunction with the other parties with causal links to the loss.

The consumer compensation system requires the capacity to consider the breadth and depth of such circumstances when resolving disputes, so as to ensure consumers are protected and compensated in cases of clear and extreme negligence or inappropriate advice, while providing a fair outcome in disputes of less significant wrongdoing.

ASIC acknowledges the scope for proportionate liability as demonstrated by its actions in response to the Westpoint collapse. ASIC has pursued charges and sought consumer compensation from Westpoint directors, the CEO and founder, and even the auditors of Westpoint for their role in the loss incurred by investors from the collapse.

While no action has been taken to date, there is concern about the role and accountability of ‘third-party gatekeepers, such as auditors, in securing investors for Trio and its ultimate demise which cause such significant consumer loss. (Please see ‘Product Providers’ section for further details on the role of auditors.)

However, the consumer compensation system does not explicitly support the principle of proportionate liability as the lack of accountability on other providers prevents to establishment of causal link, and the most common causes of detrimental consumer loss (being product failure and insolvency of the product issuer) are explicitly excluded from the system, making redundant and ineffective the requirements for many financial service providers to hold PI and be a member of an EDR scheme.

Enhancing the responsibility and accountability of the actions of all financial services providers would increase consumer protection, increase the pool of funds available for consumer compensation, and add extra preventative incentives to encourage the ethical delivery of financial services and products to consumers by all providers.

Whilst every failure in gatekeeper obligation and financial accountability is allowed to continue there will be financial collapses and product failures that will potentially have widespread community impacts, ruining the consumers invested with them.

An holistic approach to consumer compensation is needed that recognises and apportions accountability to the role of all financial product and service providers that influence consumers' decisions. This must commence with greater obligations and regulatory oversight of financial product providers and research houses, which will increase consumer protection from the outset and ensure such providers, are captured by the compensation system.

### *Availability of Professional Indemnity Insurance*

There is an extreme inadequacy and unavailability of professional indemnity insurance for financial planners and licensees in Australia. This issue differs significantly from other global jurisdictions, hence the FPA would caution against assuming compensation methods of other countries would work effectively in the Australian market.

For example, in the UK the average planning firm has approximately 16 PI underwriters to choose from and are able to source complete coverage for their policy needs. The average PI premium for an advice firm in the UK is approximately 2,000 pounds. In Australia, there are three to four underwriters in this space offering policies with multiple exclusions and inadequate cover to meet the RG126 requirements. The minimum premium for PI insurance in Australia is $45,000.

This is not a fault of the advice industry but the lack of regulation of other financial service providers, namely product providers. In assessing the risk of a licensee, the PI industry commonly look at the products in the market and assess the risks associated with the products, rather than the quality of the advice.

The lack of regulation and accountability on product providers, the absence of proportionate liability from the compensation system, and the reliance on financial planner PI requirements for consumer compensation, essentially means that PI insurers charge licensees for all risks in the financial services market as financial planners are the most likely avenue for consumers to access compensation.

Australia cannot afford to have an adequate compensation system or a penalty system for inadequate PII if there is not an adequate PI market to choose from in the first place.

The PI problem in Australia will not be fixed by the introduction of a scheme of last resort. This will only exacerbate the issue as licensees seek to gain additional cover against the likelihood of incurring a future levy for someone else's wrong-doing.

The PI problem in Australia can only be fixed with appropriate regulation and accountabilities placed on all financial services providers in the delivery of services to consumers, and a proportionate liability compensation system that attaches blame to the causal parties.

However, there is concern as to how the insurance market will respond to the pending FoFA reforms in relation to their assessment of the risk profile of financial planners and the provision of PI to financial planners. Recent changes in some financial services laws have resulted in some insurers increasing the exclusions in the cover while maintaining the high premium level. Exclusions in PI cover serve to control the advice provided to consumers (purely based on an insurer's willingness to underwrite the risk to them), and creates a potential conflict in the financial planner's ability to adhere to the pending 'best interest' duty, which impacts on the quality of the advice provided to consumers.

As highlighted in the table above, and in the Richard St John consultation paper: Review of compensation arrangements for consumers of financial services, the FoFA reforms do not extend to other financial service licensees. This will allow the current gap in consumer protection to continue and in many circumstances widen.

### FPA recommendations – consumer compensation

- The FPA strongly recommends the PJC refrain from making decisions related to the consumer compensation system until such time as Mr St John's Report has been publicly released and all stakeholders have considered its recommendations.

- Until the regulatory and compensation framework is able to ensure that each participant in the financial services industry has responsibility and financial accountability to the end consumer for their role in ensuring the effective and ethical delivery of products and services, the FPA is unable to support a proposal for a last resort compensation scheme.

The FPA provided a detailed submission and participated in the consultation process of the Government's Compensation Review, headed by Richard St John. The FPA would be happy to provide the PJC with the Associations detailed recommendations on the consumer compensation system if required.

## Appendix 1

*Research houses – further issues:*

- do not always accept the critical gatekeeper role they play in consumers' investment decisions.

- are usually paid by product manufacturers to produce a report with an associated recommendation - this is used primarily for marketing purposes and it is common for manufacturers to choose not to use/release ratings and reviews which are not favourable. (The FPA notes that some research houses who produced research reports on Trio products were not paid by the product provider.)

- While research houses are required by law to belong to an approved EDR scheme (and we note most are members of the Financial Ombudsman Service (FOS)), consumers do not see research houses as a valid option for compensation. The FPA is unaware of FOS ever receiving a complaint against a research house despite the involvement they have had in product failures. This shows that these dispute resolution requirements are ineffective for research houses. Financial planners and licensees are unable to access the FOS jurisdiction. FOS also does not consider the influence of the research houses in considering a complaint and do not therefore expand the complaint to include a research house member in the complaint.

- have no contractual or legal obligations to financial planners or the consumers who rely on their research as their client is usually the product issuer.

- tend to provide services on a 'all care no responsibility' basis. This attitude is demonstrated in ASIC's 2008 review of CRA and research houses which highlights that research houses do not, in many cases, believe they are providing financial product advice, rather information.

- the obligations under the research house licensing conditions do not recognise the influence research houses have over Licensee APL's, financial planner recommendations, or consumer investment decisions.

- are not held accountable for their roles in product failures. For example, the collapse of Basis Capital which was incorrectly categorised by research houses as a fixed interest product and received a very positive rating, when its characteristics were more like a hedge fund.

- research house classifications are often fed directly into licensees' software systems. To change these classifications, they have to be manually over-ridden. This issue is exacerbated by the lack of a universal classification system for financial products.

- generally, do not conduct a review of their original rating and research findings on products/funds. If they do change a rating or opinion of a product/fund, there is no requirement to report substantial negative or sudden changes to licensees or financial planners.

- are relied upon in the provision of financial services to consumers, as the cost of conducting research and maintaining a reasonably wide ranging APL without the ability to consider research house reports would be prohibitive and significantly increase the cost of advice.
- have been known to use selective reporting, choosing time periods or competitors to compare products against to make funds look more attractive and favourable.
- have no responsibility to notify financial planners or consumers that they are unable to update their research and that their latest research papers are out of date and should not be relied upon if information from product manufacturers is not transparent or adequate. (For example, Westpoint were 3 years in arrears in the lodgement of their accounts.).
- have no obligation to produce a timely review of ratings.
- As stated in ASIC's 2008 review of credit rating agencies and research houses: "As most research houses are dependent on issuers for research income, this creates a disincentive for them to provide negative ratings or research reports." (127). FPA notes the conflict of interest disclosure requirements in RG79 and RG181 however such requirements are inadequate in addressing these issues created by the research house relationship with product providers.