BY E-MAIL

25 January 2017

EDR Review Secretariat
Financial System Division
Markets Group
The Treasury
Langton Crescent
Parkes ACT 2600

Dear Sir/Madam,

Submission – Interim Report – Review of the financial system external dispute resolution and complaints framework

1. **Introduction and my background**

1.1 This letter is a submission with respect to Draft recommendation 2 made by way of the *Interim Report: Review of the financial system external dispute resolution and complaints framework*.

1.2 I am an Australian Legal Practitioner. My work, amongst other things, concerns disputes about financial advice. In this regard, since 2009, I have provided advice with respect to in excess of 60 disputes concerning financial advice and have prosecuted and defended multiple claims before the FOS, the CIO and the Supreme Court of Western Australia. My submission reflects issues that I have encountered in dealing with the claims dealt with by the FOS and the CIO in the context of also prosecuting and defending claims concerning similar issues in the Supreme Court of Western Australia.

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2. **Draft Recommendation 2 – Consumer monetary limits and compensation caps**

The difficulty with this Recommendation is that, in 2 respects, the current structures that underlie EDR schemes are inadequate with the result being that the implementation of this Recommendation will not achieve its intended result. These respects being:

(1) the processes currently adopted by EDR schemes to resolve complex high value disputes do not operate effectively; and

(2) the current system with respect to professional indemnity insurance does not reliably result in insurance cover being available where a Determination is made against a small to medium sized FSP by an EDR scheme.

3. **Respect 1 – processes adopted by EDR schemes to resolve high value complex disputes**

3.1 The processes currently adopted by EDR schemes are suited to the resolution of low value disputes that do not involve complex issues (this being the context in which these processes were developed). With respect to the resolution of high value disputes that involve complex issues of fact and law, in my experience the following issues often arise (with the result being that disputes of this type tend to be resolved in a sub-optimal manner):

(1) there is no process that is analogous to the discovery obligation that applies to Court proceedings (in particular, a process whereby parties are compelled to disclose documents, the contents of which are contrary to their interests) – parties to disputes before EDR schemes can (and do) withhold the disclosure of documents the contents of which are contrary to their interests. The result being that highly relevant evidence is not available to the EDR scheme decision maker;

(2) there is no means to compel a third party to give evidence – for example the financial planner who provided advice to a client can decline to give any evidence about what transpired with the result being that, again, highly relevant evidence is not available to the EDR decision maker;

(3) there is no means for evidence to be given orally – parties, on occasion, provide a written statement as to evidentiary matters or otherwise make assertions about factual matters in written submissions. This process works poorly where there is a dispute about important factual matters as the decision maker does not have the benefit of hearing witnesses giving their evidence orally and of seeing witnesses being cross-examined. This issue is particularly important where an issue arises (as it almost invariably does) about the level of knowledge about financial matters held by the complainant – without the decision maker hearing evidence from the complainant it is difficult for the decision maker to form an accurate view as to the complainant's capabilities (instead, and in accordance with the matters set out below, decision makers when considering this issue tend *to fall back on* assumptions based upon uncontested facts such as the complainant's occupation);

(4) there is no process whereby the parties can make oral submissions. At present the parties present their *case* by (sometimes voluminous) written submissions. The outcome of the process being that misunderstandings can arise on the decision maker's part as to important factual or legal issues (that adversely affect the proper resolution of the complaint) in circumstances where if the decision maker had heard oral submissions about these matters these misunderstandings would not have arisen; and

(5) some decision makers lack sufficient expertise about how to apply legal concepts and how to deal with complex factual issues (in circumstances where they are required to make decisions about complex legal and factual issues without having processes that apply in a Court, available to them). In the Court system decisions are made by persons (Magistrates, Judges, Registrars and Masters) who have both legal training and many years practical experience (before they are appointed) with the result being that the Court system produces outcomes that are more readily understandable (and predictable) than those that are, at times, produced by EDR schemes.

3.2 The combined effect of the matters identified above is that, on occasions, EDR schemes do not produce an outcome that is in accordance with the law and/or the facts that apply to the matter.

3.3 This issue (deficiencies in processes) flows into another issue (in the sense that it is causative) which is that there is a systemic bias in the way that EDR schemes resolve disputes. In my experience, it is a myth that EDR schemes are either biased towards consumers or FSPs. In fact (because of the deficiencies in their processes identified above – that is, these processes are unable to get to the truth of an issue – for example whether or not a complainant had a high level of knowledge about financial matters) EDR schemes tend to make decisions based upon pre-conceived notions about how complaints made by particular classes of persons should be resolved. The result being that (on occasions and contrary to the underlying facts and the applicable law) complaints made by certain classes of persons tend to be resolved in a particular way – that is, the bias is not for or against complainants (or FSPs) it is for or against particular types of complainants. For example, in my experience:

(1) complaints made by persons who are wealthy, relatively high income earners, who work in a professional occupation, who operate a business or who have a high level of formal education are unlikely to be upheld by EDR schemes – in dealing with complaints made by these types of persons, the reasoning process appears to be that it is assumed (whatever factual information to the contrary is presented and no matter how poor the financial advice that was provided) that such persons were, in fact, aware of the deficiencies in the financial advice that was provided to them and that they chose to implement that advice anyway. This reasoning, of course, ignore the obvious point that if these type of complainants, in fact, had a sophisticated understanding of financial issues and made their own mind up about financial matters why then did they take the trouble to obtain and pay for advice from a financial adviser and why did they decide to implement advice that was obviously flawed; and

(2) people who do not fall within the categories referred to above (for example an older person who does not generate a substantial income or who is not otherwise wealthy) tend to receive far more sympathetic treatment from EDR schemes (irrespective of the actual merits of the factual or legal issues raised by them). For example, EDR schemes will often proceed on the basis that an older complainant was a highly risk adverse investor (who had limited understanding of financial issues) whatever factual information is presented by the FSP to the contrary.

Suggestions for reform

3.4 In my view, the biases that I have referred to are applied because decision makers in EDR schemes have no way of making an accurate assessment as to important factual matters. For example:

(1) where a disputed allegation is made by the FSP that a doctor or a pharmacist who has made a complaint is financially sophisticated there is no way to resolve this dispute (in the Court system such disputes are resolved by hearing oral evidence from the complainant) and the decision maker, in resolving the complaint, falls back on an assumption that such a person must be financially sophisticated as they are a well-educated professional person; and

(2) similarly where a disputed allegation is made by a FSP that an older person who has made a complaint was financially sophisticated and willing to take on relatively high levels of risk the decision maker, because he or she cannot hear oral evidence given by the complainant in resolving the complaint, falls back on an assumption to the effect that older investors are always risk adverse and generally have a lower level of expertise about financial matters.

3.5 In this context, I make the following suggestions for reform – these being that the Rules for whatever EDS scheme that is implemented as a result of the *Review* should contain Rules to the following effect:

(1) the parties must disclose documents as directed by the EDR scheme and the fact that they have complied with this direction must be verified by way of statutory declaration made by their adviser or person who has the carriage of the matter;

(2) the parties can be directed to make a person available to give evidence and if a party is unable to do so it must produce a statutory declaration as to why it has been unable to comply with this direction;

(3) the parties can be directed that they must give evidence orally and be cross-examined in a manner that is controlled by the EDR scheme (for example as to how long the examination in chief/cross-examination can take and the topics that it will cover). This process could be undertaken by telephone;

(4) the parties can upon their request or upon the direction of the EDR scheme be given the opportunity to make oral submissions to the decision maker as to how the matter should be resolved; and

(5) the level and type of education and experience that an EDR scheme decision maker is required to possess.

4. Respect 2 – professional indemnity insurance

4.1 There is, of course, no point having an effective EDR scheme in place (or making changes to the current EDR scheme) unless successful claimants actually receive compensation. At present (as is well illustrated by the statistics released by the FOS but also in my own experience) there is a very significant likelihood that a Determination made against small to medium sized FSPs will not be paid because professional indemnity insurance coverage is not available. This issue is, in fact, far more significant than the FOS' statistics indicate because when it becomes apparent that a FSP's insurance cover will not meet a Determination valid claims that have already been made against the FSP will be abandoned and valid claims that would have otherwise been made will not be made. In my experience, the effect of this issue is also more severe than it initially appears as claims made against FSPs tend to concern the same firms (that is, ineffective financial advisers tend to have multiple claims made against them) – the issue being that when a Determination has not been paid with respect to one claim made against a FSP there are likely to be multiple clients who have also received poor advice and who will be unable to recover their loss.

4.2 In my experience, insurance coverage is not available to meet a Determination for the following reasons:

(1) some FSPs simply fail to take out professional indemnity insurance at all;

(2) some FSPs provide advice of a type that is not covered by their insurance policy (for example by providing advice about particular types of financial products that are excluded from the ambit of the coverage that is provided by the policy);

(3) some insurance policies are very restrictive in their operation with the result being that the circumstances in which the insurer will actually be required to respond to a Determination are very limited (that is, the insurance policy excludes liability for circumstances that would ordinarily be covered by a professional indemnity insurance policy); and

(4) some insurance policies have relatively high deductibles associated with them with the result being that if one substantial claim is made (or multiple claims are made where a deductible applies to each claim) the FSP may not have sufficient funds available to meet the deductible.

Suggestions for reform

4.3 In accordance with the matters set out above, in my view, the deficiencies that currently exist with respect to professional indemnity insurance coverage are of fundamental importance (they are, in fact, the single most important issue that is undermining the effective operation of EDR schemes). As I said above, there is no point in reforming the EDR system if complainants do not actually receive what they are entitled to receive. In this regard, I also reiterate the point that in my experience complaints are often clustered around particular advisers – the issue being that the FOS's statistics do not properly illustrate the real extent of the problem – for every Determination made by an EDR scheme that is not paid there may well be multiple claimants who would have made a complaint if insurance coverage had been available. In this context, I make the following suggestions as to how the professional indemnity insurance system could be improved:

(1) there needs to be a *real time* system put in place (by ASIC) that matches professional indemnity insurance coverage to each holder of an AFSL – where it is detected that an AFSL holder does not have insurance arrangements in place then the AFSL would be automatically revoked (the issue being that, at present, it appears from my experience to be possible for a FSP to operate for a substantial period of time without having professional indemnity insurance arrangements in place) More generally, providing financial advice without having appropriate professional indemnity insurance arrangements in place should be treated by ASIC as being a very serious regulatory issue (this being one where any person involved in this matter faces the real possibility of a banning order being made against them – the issue being that, at present, ASIC does not take aggressive enforcement action with respect to this matter and that therefore some persons involved in making decisions about professional indemnity insurance coverage do not give this matter proper attention);

(2) ASIC should set minimum standards (down to the level of the actual terms that the insurance policy must contain and as to the deductible that will apply) as to the insurance arrangements that an AFSL holder must put in place (otherwise, as is the case today, FSP's can comply with the obligation to have professional indemnity insurance in place but, in fact, they have obtained insurance cover that is effectively useless); and

(3) the provision of advice that is outside of the cover provided by the insurance policy (for example the provision of advice about a financial product that is not covered by the insurance policy) should be treated by ASIC as being a very serious regulatory issue (again, contrary to its current practice, ASIC needs to take aggressive enforcement action when circumstances of this type are brought to its attention – otherwise some advisers will not give this issue proper attention).

4.4 Generally with respect to this issue I note that, in my view, the implementation of Draft recommendation 2 (without the reforms I have suggested being put in place) will lead to consumers having a poorer outcome in using EDR schemes than they do today. This is because of the following:

(1) the raising of monetary limits and compensation caps will generally increase the risk faced by professional indemnity insurers (as they will be exposed to the risk of having to pay out significantly more with respect to a successful claim) and will widen the ambit of claims that can be dealt with by way of an EDR scheme;

(2) in accordance with the matters set out above, in my view, the current processes adopted by EDR schemes are not suitable to resolve high value claims that involve complex legal and factual issues. This issue (if the recommendation about increasing monetary limits and compensation caps is accepted) adds another layer of risk for insurers in that they will be exposed to increased financial risk (because the amount that can be awarded is higher and a wider class of claims can be considered) in the context of a dispute resolution framework that produces unpredictable outcomes (because it is not suited to resolving high value disputes that raise complex legal and factual issues); and

(3) the response by insurers to these factors will be to:

(i) increase premiums;

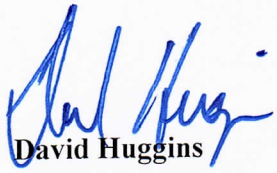
(ii) impose more restrictive terms in insurance policies;

(iii) require higher deductibles; and

(iv) decline to provide coverage to some FSPs that were previously able to obtain coverage or to only be willing to offer coverage at rates that are unaffordable for some FSPs.

4.5 In my view these factors will exacerbate the current deficiencies that exists with respect to the professional indemnity insurance system as it applies to FSPs (with the result being that the number of FSPs that have no or grossly inadequate insurance cover will increase). The result of this being that fewer complainants than is the case today will actually be able to recover compensation by way of an EDR scheme.

Yours faithfully,



David Huggins