



# Asia Region Funds Passport Consultation

Financial Ombudsman Service Submission



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## 1 Executive summary

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The Consultation Paper has asked for views on the practical operation of the proposed APEC passport arrangements. FOS has significant experience in dealing with disputes regarding Managed Investment Schemes within Australia and would like to share that experience in order to ensure that external dispute resolution (EDR) arrangements for relevant consumers are efficient and effective.

In our experience, cross border mutual recognition arrangements involve complications for EDR in terms of both the consideration of the law and practical implementation. We have sought to highlight some of the key issues that will need to be addressed. However, following a consideration of other submissions and further guidance from Treasury there may be other issues which warrant further discussion. We welcome the opportunity to discuss further the practical implementation of the APEC passport arrangements in person at an appropriate time.

We acknowledge that Treasury will consider a broad range of issues during the consultation process. Given FOS's specific role in the financial system, we have limited our submission to providing observations on:

- effective external dispute resolution within the broader framework of the passport arrangements; and
- practical matters in relation to how consumers, particularly Australian consumers, are likely to engage with passport fund operators.

The following are our key recommendations.

That passport fund operators are required to obtain approval to participate in the passport scheme prior to applying for EDR scheme membership. Regulators could require EDR scheme membership be obtained within a set time as a condition of approval.

That passport fund operators are required to nominate a suitable agent in the host jurisdiction who would be the primary contact for disclosure, EDR matters or other issues to which the host jurisdiction may apply.

That further assistance is provided by both the home and host regulators to host economy consumers and EDR schemes about the home jurisdiction rights and obligations at law of passport fund operators.

That some form of public industry partnership be established to fund and arrange appropriate training for staff of the regulator and FOS on the relevant laws and jurisdiction as part of the passport approval process.

That passport fund operators are required to submit to the full jurisdiction of the relevant EDR scheme to ensure that the whole of a consumer's dispute can be dealt with by a single EDR scheme.

That passport fund operators are prohibited from excluding an EDR scheme's jurisdiction through the drafting of the investment documents.

That the passport rules should expressly specify that the passport fund operator is required to submit to the jurisdiction of the host economy courts in respect of aspects of the passport arrangements that are governed by the host jurisdiction, including any actions that might be brought by an EDR scheme or regulator to enforce EDR contractual obligations, including compliance with determinations.

That decisions by approved EDR schemes should also be able to be taken into account by home regulator when making the assessment as to good standing.

## 2 Introduction

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FOS would like to thank the Treasury for the opportunity to make a submission to the Consultation: *Arrangements for an Asia Region Funds Passport*.<sup>1</sup>

We acknowledge that the Treasury will consider a broad range of issues during the consultation process. Given FOS's specific role in the financial system, we have limited our submission to providing observations on:

- effective external dispute resolution within the broader framework of the passport arrangements; and
- practical matters in relation to how consumers, particularly Australian consumers, are likely to engage with passport fund operators.

### 2.1 FOS's role in the financial sector

***At the heart of what FOS deals with is the loss of trust by consumers in financial services. We see our role largely as helping restore that trust.***

FOS's mission is to fulfil an important community role by providing an independent dispute resolution service in which people can place their confidence and trust.

FOS's perspective is informed by its unique position in the financial services sector as a non-government industry and consumer supported external dispute resolution (EDR) scheme funded by the financial sector industry. Approved by the Australian Securities and Investments Commission (ASIC), FOS's jurisdiction covers the majority of financial services providers across all sectors of the financial system.

In the 2012-2013 financial year, FOS received 32,307 disputes against 918 of our 4,885 licensee members. Our total membership, including Authorised Credit Representatives, numbered 16,038 members as at 30 June 2013.

## 3 Preliminary comments

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### 3.1 Application of home, host and passport rules

#### 3.1.1 How would the FOS membership contract work?

Each passport fund operator would need to make an application to FOS to become a member, and would need to enter into a Membership Agreement. As part of the membership application process, each would need to present evidence of their successful application to the passport scheme, along with any relevant supporting documentation, in order to be considered for membership.

It is important that the passport fund application is resolved prior to any EDR scheme membership being approved, given that ceasing membership of the EDR schemes, and FOS in particular, requires a 12 month notice period to be served. This is very inefficient

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<sup>1</sup> This submission has been prepared by the office of FOS and does not necessarily represent the views of the board of FOS. It draws on the experience of FOS and its predecessors in the resolution of disputes about financial services.

where membership was only applied for in anticipation of a permission that may not subsequently be granted.

**FOS recommends:**

That passport fund operators are required to obtain approval to participate in the passport scheme prior to applying for EDR scheme membership. Regulators could require EDR scheme membership be obtained within a set time as a condition of approval.

Once accepted, the passport fund operator would be bound by the contract formed by the FOS membership application form, the Constitution and the TOR. In this respect, the membership contract for passport fund operators would operate in exactly the same manner as for Australian FSP members. However, it needs to be recognised that disputes are likely to be raised with relevant EDR schemes in the host economy about conduct governed by the home economy laws, albeit augmented by the Passport Rules. This means that disputes involving a passport entity will be more complex, and costly, for FOS to deal with and resolve.

In order to mitigate this issue, and to ensure that the EDR mechanism available to consumers meets the required benchmarks for resolving disputes in a cooperative, efficient, timely and fair manner, we suggest that a local representative or agent of the passport fund operator should be nominated at the time of the membership application.

**FOS recommends:**

That passport fund operators are required to nominate a suitable agent in the host jurisdiction who would be the primary contact for disclosure, EDR matters or other issues to which the host jurisdiction may apply.

In addition, it would be useful if host regulators, through regulatory guidance or other advice, were required to provide an overview of the home jurisdiction laws relevant to passport fund operators. This could be sourced from the applicant as part of the approval process, or from the home regulator.

**FOS recommends:**

That further assistance is provided by both the home and host regulators to host economy consumers and EDR schemes about the home jurisdiction rights and obligations at law of passport fund operators.

### **3.1.2 How would the FOS Terms of Reference apply?**

Disputes brought by investors against passport fund operators will need to fall within the terms of reference of the relevant EDR scheme.

We note that, under the proposed draft of the Rules, disputes are likely to be brought to FOS about conduct by the passport fund operator which is governed by a combination of the home jurisdiction laws and the Passport Rules.<sup>2</sup> This creates two categories of dispute for the purposes of the present consultation – disclosure and non-disclosure related disputes.

As a result, for non-disclosure related disputes which go beyond the scope of the Passport Rules, FOS will be required to have regard to the relevant home jurisdiction laws in resolving the dispute.

This will require host EDR schemes to become familiar with, and have regard to, the relevant laws and regulations of multiple jurisdictions, as well as the IOSCO principles. This will involve extra costs for not-for-profit EDR schemes that would need to be recouped from relevant entities.

#### **FOS recommends:**

That some form of public industry partnership be established to fund and arrange appropriate training for staff of the regulator and FOS on the relevant laws and jurisdiction as part of the passport approval process.

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<sup>2</sup> See Section 4.4.1 below for more detailed information about the types of disputes which are presently brought against funds managers and responsible entities within Australia.

### 3.1.2.1 What types of disputes would FOS consider?

As the Passport Rules and FOS Terms of Reference are currently drafted, the table below sets out FOS' jurisdiction as it will relate to these types of dispute.

	<b>Australian Passport Fund Operators</b>	<b>Overseas Passport Fund Operators</b>
<b>Potential FOS Members</b>	Existing Australian Financial Services Licensees and FOS Members	Approved Passport Fund Operators
<b>Potential Applicants</b>	Overseas Consumers	Australian Consumers
<b>Threshold TOR Jurisdiction Clause</b>	<p>4.2 FOS may only consider a Dispute between a Financial Services Provider and an Applicant:</p> <p>a)...            i) that arises from a contract or obligation that arises under Australian Law;            ...            and            b) that arises from or relates to:            i) the provision of a Financial Service by a Financial Services Provider to the Applicant.            ...</p>	<p>4.2 FOS may only consider a Dispute between a Financial Services Provider and an Applicant:</p> <p>a) either            i) that arises from a contract or obligation that arises under Australian Law; or            ii) where the offer to invest was received in Australia by an Applicant in relation to a recognised Foreign Collective Investment Scheme<sup>3</sup>; and            ...            and            b) that arises from or relates to:            i) the provision of a Financial Service by a Financial Services Provider to the Applicant; or            ...            viii) an investment offered by a Financial Services Provider under a foreign recognition scheme to foreign resident investors unless expressly excluded from access to FOS by the investment offer document            ...</p>

<sup>3</sup> "Foreign Collective Investment Scheme" means either:  
 a) a managed investment scheme under section 9 of the Corporations Act 2001 (Cth); or  
 b) a foreign investment company, where the operator is incorporated (or is a foreign company that is formed) in a foreign jurisdiction and is regulated in that jurisdiction for the operation of the scheme or company.

	Australian Passport Fund Operators		Overseas Passport Fund Operators	
Types of Passport Fund Disputes	Disclosure	Other Issues	Disclosure	Other Issues
Does FOS have jurisdiction?	<p><b>Yes:</b> The Passport Rules state that host jurisdiction laws apply to disclosure only. However, the FSP's general membership obligations apply irrespective of the residency of the Applicant and so the FOS jurisdiction will apply regardless.</p>		<p><b>Yes:</b> The Passport Rules state that host jurisdiction laws apply to disclosure.</p>	<p><b>Yes:</b> 1) If the regulations made for the purpose of the Passport Rules give rise to an obligation under Australian law;  Alternately 2) If the Passport Fund can be defined as a Foreign Collective Investment Scheme and access to FOS is not expressly excluded by the investment offer document.</p>
Outstanding practical matters	FOS will need to have regard to home jurisdiction laws and Passport Rules in resolving disputes	None	None	FOS will need to have regard to home jurisdiction laws and Passport Rules in resolving disputes

In order to ensure that the appropriate EDR coverage is provided for Australian consumers who invest in passport funds, it is important to ensure that there are as few jurisdictional challenges from passport fund operators as possible, particularly where disclosure is only one part of a more complex dispute. It would therefore be useful if the enabling legislation, regulations or approvals process:

- Requires passport fund operators to submit to the full jurisdiction of the relevant EDR scheme to ensure that the whole of a consumer's dispute can be dealt with by a single EDR scheme; and
- States that the relevant investment documents cannot exclude EDR scheme jurisdiction.

In addition to the above, FOS will consider how best to amend its Terms of Reference and Operational Guidelines to:

- clearly set out the circumstances in which overseas consumers may lodge disputes about Australian Passport Fund Operators (including prohibiting jurisdiction for overseas investors who have invested in an overseas passport fund); and
- ensure that passport funds are clearly within the definition of Foreign Collective Investment Scheme.

**FOS recommends:**

That passport fund operators are required to submit to the full jurisdiction of the relevant EDR scheme to ensure that the whole of a consumer's dispute can be dealt with by a single EDR scheme.

That passport fund operators are prohibited from excluding an EDR scheme's jurisdiction through the drafting of the investment documents.

**3.1.3 How would the membership contract be able to be enforced?**

The Consultation Paper (at p 51) states that consumers, or any person who has the power to take action on behalf of members and is under an obligation to act in the best interests of members in exercising that power, will have the ability to take civil action against a passport fund and/or its operator:

- under the home economy laws and regulations where there is a breach of the home economy laws and regulations or the passport rules to the extent permitted under the home economy laws and regulations; and
- under the host economy laws and regulations where there is a breach of the host economy laws and regulations or the passport rules to the extent permitted under the host economy laws and regulations;

If such a right of action is not available in the home or host economy laws and regulations, the persons referred to above must have the right to consider civil action under the constituent documents for the passport fund in that economy.

Further, the ability to seek compensation, and the ability to obtain compensation, are very different. Enforcing a determination, judgment or court order against an overseas entity is complex and expensive.

In the case of EDR schemes, the contract exists between the EDR scheme and the relevant financial services provider. Whilst there is a Supreme Court of Victoria decision that states that a tripartite contract exists that includes the consumer, this has not been tested and the

law remains unclear about whether a sufficiently resourced consumer could take legal action directly to enforce an EDR scheme determination.

Accordingly, it has been the practice of FOS, where necessary, to act directly to enforce its determinations through seeking specific performance of the contract. Such actions are not currently covered by the consideration of Actions by Members or Regulators in Chapter 4 of the Consultation Paper.

**FOS recommends:**

That the passport rules expressly specify that the passport fund operator is required to submit to the jurisdiction of the host economy courts in respect of aspects of the passport arrangements that are governed by the host jurisdiction, including any actions that might be brought by an EDR scheme or regulator to enforce EDR contractual obligations, including compliance with determinations.

This would mean that the passport fund operator submits to the laws of Victoria for the purposes of any action initiated by FOS for the purposes of specific performance of the FOS membership contract.

### ***3.1.4 How to ensure compliance with EDR obligations?***

#### ***3.1.4.1 Refusal to cooperate with process i.e. provide information***

The Passport Rules state (p42) that Host economy laws and regulations will also apply to complaints handling including both internal dispute resolution and external dispute resolution, if applicable. This means an operator needs to comply with any requirements which apply in each host economy in relation to:

- the manner in which complaints are received, processed and responded to by CIS operators; and
- if applicable, in the host economy, be a member of an approved external dispute resolution scheme.

Membership would create the contractual authority and impose the FOS jurisdiction on overseas members, and TOR 4.2(a) states that FOS may consider a dispute that arises from a contract or obligation arising under Australian law. As these Passport Rules will be adopted through amendments to legislation and regulations, we would rely upon the obligation to follow the Passport Rules as the mechanism to accept disputes.

In the event that there is non-compliance with a process or request from FOS, the usual remedy of advancing the dispute to determination and drawing adverse inference from the refusal to provide the requested information can be applied.

The matter could also be referred to ASIC for action to revoke the passport fund operator's permissions to offer investments under the scheme.

## FOS recommends:

That a lack of cooperation with the EDR scheme requirements should lead to an automatic suspension of the passport fund operator's participation following appropriate formal notice from the host regulator

### 3.1.4.2 Refusal to abide by decision

If a passport fund operator refuses to comply with a determination, the options available will be to:

1. Expel the passport fund operator from membership of FOS;
2. Refer the non-compliance to ASIC for appropriate regulatory action; and/or
3. Seek specific performance of the contract in the Victorian Courts.

Expulsion from membership of FOS, unless the entity obtains membership of another approved EDR scheme, will result in a breach of the Passport Rules and so will be self-reported to ASIC, as well as being reported by FOS in the normal course of events.

This and the referral of the non-compliance to ASIC both then end with the same likely outcome, namely action by the regulators. Neither course of action provides a remedy to the adversely affected consumer.

Page 52 of the Consultation Paper states:

*The home regulator (or the relevant enforcement agency in that economy) will have the ability to take appropriate action including supervisory, enforcement or criminal action where there is a breach of the home economy laws and regulations or the passport rules including engaging in or being knowingly concerned in an intentional or reckless breach.*

*The host regulator (or the relevant enforcement agency in that economy) will have the ability to take appropriate action including supervisory, enforcement or criminal action where there is a breach of the applicable host economy laws and regulations or the passport rules, including engaging in or being knowingly concerned in an intentional or reckless breach.*

*In taking action against passport funds for breaches of the passport rules, home and host regulators will coordinate their efforts. Action will be taken by the regulator in the best position to do so, given the circumstances of the case. A passport economy regulator will only be able to commence criminal proceedings in the courts of its economy for breaches of the laws of its economy (this should include the passport rules as they will be incorporated into the law or regulations of each participating economy).*

There are a few concerns that we have with this approach:

- Given that administrative decisions by regulators are able to be reviewed by courts, tribunals and ombudsmen, it is likely that a final outcome of any regulatory action will take a significant amount of time to be reached;
- As there is a high-degree of cross-over between the possible avenues for regulatory action, further complications may arise from a passport fund operator submitting that a home regulator should bring the action, rather than a host regulator. This could occur where:
  - There is jurisdictional overlap between different causes of action in a single dispute. Disputes seen at FOS are often not limited to a single issue, and so issues of disclosure and other breaches of duty are often contained within the one dispute;
  - the EDR scheme determination which is not being complied with has been made following a determination that the home jurisdiction laws have been breached. The regulatory action could therefore be brought in response to a breach of the EDR scheme obligations, a host jurisdiction matter, but the underlying conduct giving rise to the consumer's issue is a home jurisdiction matter.

The third option, specific performance, is a last resort for FOS as litigation is contrary to the ethos of EDR and it is expensive and time consuming. These costs, and the resourcing expenditure, are amplified by the respondents being domiciled overseas.

Given these potential difficulties, we reiterate the recommendation above that a lack of cooperation with the EDR scheme requirements, including compliance with determinations, should lead to an automatic suspension of the passport fund operator's participation following appropriate formal notice from the host regulator.

#### ***3.1.4.3 Refusal to pay fees, charges and levies***

There is a possibility that disputes will arise in respect of fees, levies and charges payable by the passport fund operator to an EDR scheme. If any outstanding amounts are to be recovered, then it is likely that legal proceedings will need to be issued which suffers the same disadvantages as the specific performance actions listed above.

This will mean that it is likely that any outstanding amounts owing by passport fund operators will need to be written off as bad debt, adversely impacting the relevant not-for-profit EDR scheme, and causing increased cross-subsidies to be levied against the remainder of the EDR scheme membership.

#### ***3.1.5 What are the solutions?***

In summary, action by the host regulator to suspend, terminate or take action is likely to be most effective in ensuring compliance with the Passport Rules.

It would mitigate any potential future enforcement and compliance issues if the relevant regulators taking action in respect of a breach could do in support of failure to comply with EDR contract obligations.

This reduces the likelihood of EDR schemes, or consumers themselves, needing to bring legal proceedings against overseas respondents – something that is not feasible given the limited resources available to each.

### **3.2 Good standing**

The passport fund operator, and its directors and senior managers and persons having control or significant influence over the passport fund operator, must not have been the subject of a judgment or finding by a court or regulator that, in the opinion of the home regulator, indicates they are less than competent or are not of sufficient good standing to be permitted to operate a passport fund.

In Australia, approximately 30,000 disputes are received into the FOS process and the overwhelming majority are resolved without being subject to legal proceedings or regulatory investigation. However, some of these disputes may reveal serious misconduct or systemic issues.

Whilst these issues are reported to the Australian Securities and Investments Commission, often there will be a need for swift action in response to credible reports of passport fund operators being less than competent or lacking good standing, even if neither was apparent at the initial application stage.

FOS is required to identify, investigate and report to ASIC systemic issues and serious misconduct by its members, resolving such issues with the member, if possible. In the event that a report is made to ASIC following the FOS Systemic Issue and Serious Misconduct process finding that an issue has occurred and remains unresolved, this report should be able to be taken into account by ASIC in reviewing the competence or good standing of the passport fund operator as the circumstances of the passport fund operator change.

#### **FOS recommends:**

That decisions and misconduct referrals by approved EDR schemes should also be able to be taken into account by home regulator when making the assessment as to good standing.

## **4 Comments on the Substantive Requirements**

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### **4.1 Capital Requirements**

#### **4.1.1 Response to Q3.15**

Our experience is that professional indemnity insurance (PII) is not an adequate compensation mechanism for consumers of many financial services.

Under the Australian Corporations Act, Australian Financial Services licensees are required to have adequate compensation arrangements. This includes being able to cover EDR scheme compensation pay-outs. To date, PII policies have been used to fulfil that requirement.

Unfortunately, since 1 January 2010, approximately 150 consumers have received monetary awards under Determinations made by FOS which have not been paid by the relevant financial services provider. The extent of the monies outstanding to consumers is approximately AUS\$9 million, despite the requirement for financial services providers to hold adequate PII cover. Of Determinations made in favour of consumers in the investments sector, this represents a non-compliance rate of more than 30%.

Some reasons why professional indemnity insurance does not operate as an adequate compensation mechanism for unpaid FOS determinations include:

- aggregate funds available under the policy may not be sufficient to meet all awards
- conduct giving rise to the awarded compensation may not be covered by the policy
- the amount of the award may be below the applicable excess under the policy.

We have previously recommended the introduction of a limited last resort compensation scheme for consumers.<sup>4</sup> While there have been varying opinions on the most appropriate compensation models, we remain an advocate for some form of limited last resort compensation scheme for consumers whose determinations are not able to be paid by the financial services provider. If and when such a scheme is established, passport fund operators should be required to be participants in the scheme.

#### **4.1.2 Response to Q3.16**

The Australian Securities and Investments Commission released Regulatory Guide 126 and 210 to set out minimum requirements for the PII cover to be held by Australian financial services providers.

Unfortunately, the PI industry has not responded and does not offer policies which meet these minimum requirements. This is one of the fundamental issues with the use of PII as a capital adequacy substitute – it relies upon the market to assist and the commercial realities may be that the decision is taken not to provide such cover.

## **4.2 Financial reporting and audit**

### **4.2.1 Response to Q3.28**

Requiring the passport fund to be responsible for the translation of documentation into the official language of the host economy is sensible, as it places the obligation on the passport fund to ensure that the translation is correct and appropriately conveys the original intent. This is important for ensuring that investors in the host economy are fully informed when reading financial statements and audit reports prior to making an investment decision.

## **4.3 Consultation questions**

### **4.3.1 Response to Q3.29**

The following statistics may be useful in considering the proposed approach in terms of whether home, host or passport rules apply to this area of CIS regulation.

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<sup>4</sup> FOS submission to the *Review of Compensation Arrangements for Consumers of Financial Services*- Richard St John 2010: [http://fos.org.au/custom/files/docs/fos\\_response\\_to\\_richard\\_st\\_john\\_report\\_and\\_letter\\_july\\_2012.pdf](http://fos.org.au/custom/files/docs/fos_response_to_richard_st_john_report_and_letter_july_2012.pdf)

Since 1 January 2010,<sup>5</sup> FOS has received 3,469 CIS disputes. Of these, 998 were brought against the relevant Responsible Entity or Fund Manager, covering 1,024 different issues.

The issues raised against Fund Manager were in respect of:

Issue Type	Number	Percentage
Advice	42	4.10%
Charges	142	13.87%
Disclosure	258	25.20%
Financial Difficulty	27	2.64%
FSP Decision	273	26.66%
Instructions	95	9.28%
Non-TOR	29	2.83%
Privacy & Confidentiality	5	2.44%
Service	136	13.28%
Transactions	17	1.66%
<b>TOTAL</b>	<b>1,024</b>	<b>100%</b>

The top five issues, in order of frequency, are:

1. FSP Decision;
2. Disclosure;
3. Charges;
4. Service; and
5. Instructions.

'FSP Decision' or 'Financial Services Provider Decision' to provide its full title, covers a range of potential conduct, but includes:

- Denial of application (such as a redemption request);
- Denial of variation request;
- Error in debt collection;

<sup>5</sup> To the date of writing – 12 May 2014

- Inappropriate debt collection activity;
- Inappropriate margin call notice;
- Product Terms Features/Service.

We note therefore that it is likely that the majority of disputes in this area that will be raised with EDR schemes will need to be resolved having regard to a combination of the home jurisdiction laws and the Passport Rules.

#### **4.3.2 Response to Q3.36**

- Given the delays involved in regulatory action within a particular jurisdiction, how will the referral of misconduct to the home regulator be streamlined to ensure that action can be taken against passport fund operators in a timely manner;
  - As the decision to issue a stop order will be an administrative decision that is capable of being challenged in an appropriate tribunal, ombudsman or court, the Passport Rules should specifically state that the stop order continues in effect whilst the applicable challenge is resolved.
- Is deregistration the only penalty for a:
  - Breach of the Passport Rules or a stop order; or
  - Breach of obligations under an approved external dispute resolution scheme?