Review of compensation arrangements for consumers of financial services

Future of financial advice

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STATUTORY COMPENSATION REVIEW
FUTURE OF FINANCIAL ADVICE

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The then Minister for Financial Services, Superannuation and Corporate Law, the Hon Chris Bowen MP, engaged me to review and report to the Government on the need for, and costs and benefits of, a statutory compensation scheme for financial services.

The review is being undertaken in the context of the Government's response to the report of the Parliamentary Joint Committee on Corporations and Financial Services *Inquiry into financial products and services in Australia*. Recommendation 10 of the report was '*...* that the Government investigate the costs and benefits of different models of a statutory last resort compensation fund for investors'.

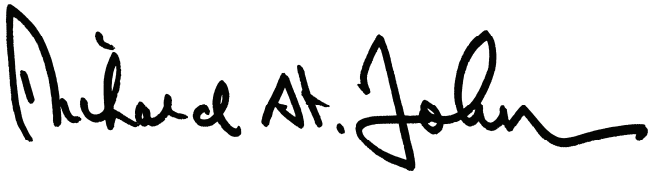
The review is an element of a broader package of changes for financial advice announced by the Government on 26 April 2010.

This consultation paper is a step towards the preparation of my recommendations to Government. It reflects initial research in which I have been assisted by a review secretariat in the Department of the Treasury and the outcome of preliminary consultations I have had with industry participants, regulators and other interested parties.

In releasing this paper, I draw attention to a number of issues on which comment is invited. These are raised at the end of Chapters 2 to 5. I am also seeking reactions to the preliminary observations I have made in Chapter 5. These observations are a pointer to issues I see as relevant to the review, but respondents should feel free to address other issues as well.

I intend to continue the consultation process in the period following the release of this paper and leading up to my preparation of recommendations to the Government.

I express my appreciation to the individuals and bodies who have already provided views or contributed information to the review including ASIC and FOS for their assistance.



Contents

Consultation process

This consultation paper provides information, frames issues and raises questions on the need for, and costs and benefits of, a statutory compensation scheme for clients who suffer damage or incur loss as a result of misconduct by persons with whom they have dealt in the financial services sector. It was prepared as part of a review being conducted by Richard St. John. The paper reflects the initial research and preliminary consultation with industry participants and other stakeholders.

The reviewer invites feedback and comments from interested parties on the issues outlined in this paper. The information obtained through this process will inform and assist him in reaching views and making recommendations to the Government on whether changes are required to the current compensation arrangements.

Electronic lodgment of submissions is preferred, with documents submitted in a Word or RTF format. An additional PDF version may also be submitted.

All information (including name and address details) contained in submissions will be made available to the public on the Treasury website unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information in a separate attachment marked 'in confidence'. Legal requirements, such as those imposed by the *Freedom of Information Act 1982*, may affect the confidentiality of your submission.

Submissions may also be lodged by post.

Closing date for submissions: Wednesday, 1 June 2011

Details for making submissions

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Outline of paper

- This paper provides information, frames issues and raises questions on the need for, and costs and benefits of, a statutory compensation scheme.
- Chapter 1 deals with the context and scope of the review. It also provides background on the overall regulatory framework for financial services and the regulatory philosophy on which it is based.
- Chapter 2 describes the current compensation arrangements within that regulatory framework.
- Chapter 3 addresses the operation of those compensation arrangements in practice.
- Chapter 4 provides a comparison with compensation arrangements in other countries and industry sectors.
- Chapter 5 provides some preliminary observations and draws out issues for further consideration.
- Attachment A sets out relevant regulations.
- Attachment B provides a summary of compensation arrangements in the EU, Canada and USA.

Chapter 1: Introduction and background

This chapter refers to the terms of reference, relevant concepts and issues of scope for the review and the context of the current regulatory framework:

- The review is directed to the adequacy of arrangements for the compensation of retail clients where they suffer damage as a result of a breach by a provider of financial services of its statutory obligations. The review is not concerned with compensation for loss in value of an investment in the absence of misconduct by a licensee. It will address in particular the need for, and costs and benefits of, a statutory compensation scheme.
- The review is being undertaken in the context of the *Future of Financial Advice* reform package announced in April 2010. It follows a recommendation of a Parliamentary Committee that the Government investigate the costs and benefits of different models of a statutory last resort compensation fund for investors.
- The regulatory framework for financial services, based on the Wallis Report, subjects deposit takers, insurers and superannuation funds to capital adequacy and other prudential requirements and applies to all providers of financial services a set of requirements governing the way they conduct their business.
- Providers of financial services are required to be licensed and to comply with stipulated standards in their conduct towards their clients and in the disclosure of information to clients.
- Licensed providers of financial services who deal with retail clients are also required to have in place a system for the resolution of disputes and arrangements to compensate clients for loss or damage arising from a breach of the licensee's statutory obligations.

Terms of reference

1.1 The reviewer has been asked to consider the need for, and costs and benefits of, a statutory compensation scheme for financial services.

1.2 The review follows a recommendation by a Parliamentary Committee that the Government investigate the costs and benefits of a statutory compensation scheme.

1.3 The Parliamentary Joint Committee on Corporations and Financial Services (PJC Inquiry) conducted an *Inquiry into financial products and services in Australia* following a number of corporate collapses in the financial sector which resulted in

substantial financial losses and damage to a large number of investors.[1] The Committee reported on its inquiry on 23 November 2009 (the Ripoll Report).[2]

1.4 In regard to compensation arrangements for investors, the Committee referred to submissions it had received advocating the establishment of a statutory compensation scheme. It noted deficiencies in current arrangements which largely rely on professional indemnity insurance as a basis for compensation.

1.5 The Committee recognised that 'deficiencies of (professional indemnity) insurance make a last resort statutory compensation fund covering licensee wrongdoing appealing'. The Committee recognised that more work would be required to overcome significant issues in design and to ensure that the cost on industry would be fair and equitable and justified by the protection offered to consumers.

1.6 Recommendation 10 of the Ripoll Report was:

> ... that the Government investigate the costs and benefits of different models of a statutory last resort compensation fund for investors.

1.7 In response to the Ripoll Report, the Government announced the *Future of Financial Advice* reforms on 26 April 2010.[3] The response adopted eight of the recommendations of the Ripoll Report, including one for the examination of a statutory compensation scheme. The response also included four additional measures.

1.8 In relation to the Committee's recommendation about compensation, the then Minister for Financial Services, Superannuation and Corporate Law, the Hon Chris Bowen MP, announced that Richard St. John had been engaged to undertake the review of the need for a statutory compensation scheme.

Relevant concepts and issues of scope

1.9 Reference is made to a number of concepts and issues that are relevant to and bear on the scope of the review:

- The review is directed to the adequacy of arrangements by which investors may be compensated where they suffer loss as a result of misconduct by a provider of financial services. Those arrangements arise in the context of the regulatory regime for financial services and markets provided under Chapter 7 of the *Corporations Act 2001* (Corporations Act).

- Licensees are required under Chapter 7 to have compensation arrangements in place in relation to their retail clients. The rationale for the focus on retail clients is presumably that they are less likely to be able to look after their own interests than are wholesale clients.

- Licensed providers of financial services are subject to a range of obligations under Chapter 7. The review is concerned with the position of a retail client who incurs a

1 Further references are to the PJC Inquiry or to the Committee and to its final report as the Ripoll Report.
2 Available at http://www.aph.gov.au/senate/committee/corporations_ctte/fps/index.htm
3 See press release at: http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/036.htm&pageID=003&min=ceba&Year=&DocType=0.

financial loss as a result of a breach of such an obligation by a licensee or its representative.

- The review is only concerned with the position of a retail client whose loss is attributable to the misconduct of a financial services licensee. It is not concerned with losses that result from failure of a financial product or general investment losses.

These points are expanded below and addressed further in Chapter 2.

Financial services

1.10 A person who operates a financial services business is required under Chapter 7 of the Corporations Act to hold an Australian financial services licence and is referred to in this paper as a licensee.

1.11 The financial services provided to clients by licensees generally relate to a financial product. The term 'financial service' includes, in relation to a financial product, providing advice, dealing, making a market, operating a registered managed investment scheme or providing a custodial or depository service. A 'financial product' includes securities, derivatives, superannuation, general and life insurance and deposit-taking facilities. [4]

Financial services industry

1.12 Almost 5,000 entities are licensed to offer one or more of the broad range of financial services described above. More than 4,500 licensees are authorised to provide advice, with almost 3,300 of those authorised to provide personal advice. More than 4,600 licensees are authorised to deal in a financial product, with almost 60 per cent of those licensees authorised to issue a financial product, including deposits, insurance, managed investment schemes, securities, superannuation products or margin lending. Table 1.1 provides more detail on the number of licensees authorised to undertake financial services.

1.13 Almost 93 per cent of licensees are licensed to undertake more than one financial services activity. Of these, more than 70 per cent are authorised both to provide financial product advice and to deal in a financial product. [5] Table 1.1 shows the number of licensees categorised according to the financial services activities they are authorised to undertake, whether a single activity or multiple activities.

4 Divisions 3 and 4, Chapter 7 of the Corporations Act. Unless otherwise stated further references to provisions of the law are references to the Corporations Act.

5 These licensees are authorised to undertake only the specific activities mentioned. Table 1.2 shows the number of licensees who are authorised to undertake a broader range of activities or other combinations of activities.

Table 1.1 Number of licensed financial service providers by activity

Total number of licensees authorised by type of activity (a)		By sub-activity
Provide financial product advice (licensees authorised to provide personal, general or wholesale advice, whether for one financial product, such as margin lending or life insurance, or for multiple financial products). This includes:	4,562	
Licensees authorised to provide personal advice(b)		3,294
Licensees authorised only to provide general or wholesale advice		1268
Deal in a financial product (licensees authorised to deal in financial products, including those applying for or acquiring a financial product, issuing a financial product, underwriting securities or interests in managed investments, varying a financial product or disposing of a financial product). This includes:	4,651	
Licensees authorised to deal by issuing a financial product		2,731
Other licensees authorised to deal in a financial product		1,920
Make a market for a financial product	203	
Operate a registered scheme	599	
Provide custodial and depository service	637	
Total number of licensees authorised to undertake more than one activity	4,544	
Authorised to provide both financial product advice and deal in financial products	3,321	
Authorised to provide financial product advice, deal in financial products and provide custodial and depository services	387	
Authorised to provide financial product advice, deal in financial products and operate a scheme	318	
Authorised to provide financial product advice, deal in financial products, operate a scheme and provide custodial and depository services	132	
Authorised to provide financial product advice, deal in financial products and make a market for a financial product	131	
Authorised to deal in financial products and operate a scheme	122	
Authorised to deal in financial products and provide custodial and depository services	53	
Authorised to provide financial product advice, deal in financial products, make a market for a financial product and provide custodial and depository services	50	
Authorised to provide more than one financial service (in various combinations other than above)	30	

(a) Licensees may be authorised to undertake more than one activity and thus the sum of the activity categories is more than the number of licensees.
(b) An authorisation to provide personal advice also allows the licensee to provide general or wholesale advice.
Source: ASIC data as at 31 December 2010.

1.14 The review is concerned with those licensees who provide financial services to retail clients. Around three quarters of licensees, that is just under 3,700, are authorised to provide services to retail clients. Around 270 of those licensees, being deposit takers or insurers, are also prudentially regulated by APRA and are not required to have compensation arrangements under s912B (see further Chapter 2).

1.15 Licensees may authorise representatives to carry out financial service activities for which they are authorised under their licence, and in so doing assume the responsibility that the representatives will conduct themselves in the manner required of the licensee itself. The number of licensees who operate through authorised representatives is shown in Table 1.2.

Table 1.2: Licensees with authorised representatives

	Number
Total number of licensees	4,888
Number of licensees who do not have agreements for authorised representatives (62 per cent)	3,039
Number of licensees who have agreements for authorised representatives (38 per cent)	1,849
Number of licensees with 1000 or more representatives	15
Number of licensees with between 100 and 999 authorised representatives	78
Number of licensees with between 10 and 99 authorised representatives	222
Number of licensees with between 2 and 9 authorised representatives	982
Number of licensees with 1 representative	552
Average number of authorised representatives per licensee who has representatives	33
Total number of authorised representatives	52,740
Of these, around 8,000 have agreements to represent more than one licensee	
Number of authorised representatives authorised to provide personal advice	41,556
Average number of authorised representatives per licensee authorised to provide personal advice	9

Source: ASIC data as at 31 December 2010.

1.16 Table 1.2 shows how the capacity of licensees to deliver financial services is expanded through the use of formal representation agreements. The capacity of the nearly 3,300 licensees authorised to provide personal product advice is expanded more than twelvefold, to over 40,000, through authorised representatives.

1.17 A subcategory of licensees who are authorised in broad terms to 'provide financial product advice' specialise in financial planning for their clients. ASIC estimates that there are '749 advisor groups operating over 8,000 practices and employing around 18,200 advisers'.[6] An advisor group is a financial advisory business or group of businesses which operate under a single licence. A group may have more than one practice and may use multiple trading names. Advisers can operate through their own licence, as authorised representatives, or as employees of a licensee or an authorised representative.

1.18 ASIC has characterised the financial advice industry as 'dominated by large dealer groups and financial institutions' with 'approximately 85 per cent of financial advisers ... associated with a product manufacturer'. ASIC added that 'most large financial planning firms (that is, dealer groups) are owned by diversified financial services groups that also include funds management entities (that is, product manufacturers).[7]

Retail clients

1.19 The review is concerned with compensation arrangements for retail clients of financial services providers. Those compensation arrangements are part of a package of consumer protection measures under the Corporations Act in favour of retail clients. Retail clients can include small businesses as well as individuals.[8]

6 ASIC submission to the PJC Inquiry, August 2009, pp 108-109, with information attributed to the *Rainmaker Financial Planning Report*, January 2009.

7 ibid, p 110.

8 A business is a small business if it employs fewer than 20 people or is a manufacturer employing fewer than 100 people. Additionally, certain financial products such as superannuation products are deemed to be provided to retail clients (section 761G and Chapter 7, Part 7.1, Division 2 of the Corporations Regulations).

1.20 The focus on retail clients reflects the view that, generally speaking, those clients are in greater need of protection than are wholesale clients who should be better informed and better able to assess the risks involved in financial transactions.[9]

1.21 It is noted, however, that access to the National Guarantee Fund (NGF) is not limited to retail clients of a stockbroker. A wholesale client of a stockbroker with a claim could recover compensation from the NGF.

1.22 The classification of superannuation funds, including a self-managed superannuation fund (SMSF), as wholesale or retail clients is complex. In ASIC's view financial services provided to a trustee of a superannuation fund are generally provided to them as a retail client if that fund has net assets of less than $10 million at the time the service is provided.[10] On this basis, a superannuation fund will in these circumstances be treated as a retail client even if its net assets exceed the general threshold for retail clients.[11]

1.23 It is also noted that separate consideration is being given within the *Future of Financial Advice* reforms to the appropriateness of the current tests by which a client is classified as retail or wholesale. On 24 January 2011, the Treasury released an options paper on the investor protection threshold which distinguishes between retail and wholesale clients.[12] A change in the threshold would have a flow on effect for the class of clients to whom the compensation arrangements under Chapter 7 are directed.

Obligations on licensees

1.24 Licensees are required, as part of holding a licence, to comply with a range of disclosure and conduct obligations depending on the financial service they provide. Licensees are also required to have in place a system for the resolution of disputes with retail clients and arrangements to compensate such clients for loss or damage arising from a breach of their obligations under Chapter 7.

1.25 The review is directed to compensation arrangements relevant to a retail client who incurs loss or damage as a result of a breach of such an obligation by a licensee or its representative. Such loss or damage could be incurred for example where a licensee:

- makes fraudulent use of the client's investment funds;
- provides personal advice which was not based on a reasonable inquiry into the client's needs and financial objectives or lacked a reasonable basis;

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9 *Financial Services Reform Bill 2001*, Explanatory Memorandum, para 2.27.

10 Section 761G(6)(b) and (c) and ASIC QFS 150 available at www.asic.gov.au..

11 Section 761G distinguishes retail client and wholesale client by reference to the financial products the client is dealing with and according to certain monetary and other tests. Essentially, a client of financial services will be regarded as a retail client if they are an individual:
- who contributes to a superannuation fund or purchases certain forms of general insurance (such as motor vehicle, home building, home contents or travel insurance);
- who acquires a financial product for less than $500,000;
- whose wealth is less than $2.5 million of net assets or has had less than $250,000 per annum in gross income for the last two years; and
- who is not a professional investor.

12 *Wholesale and Retail Clients-Future of Financial Advice Options Paper,* The Treasury, January 2011. Available at http://futureofadvice.treasury.gov.au/content/Content.aspx?doc=consultation.htm.

- provides defective product information including in a product disclosure statement or does not adequately disclose information to the client;
- engages in misleading, deceptive or unconscionable conduct; or
- makes an unauthorised transfer of securities.

Financial loss in absence of misconduct

1.26 Consistent with the current regulatory approach, the review is not concerned with compensation for investors who suffer loss in value of their investment in the absence of misconduct by a licensee with whom they have dealt. In the absence of a breach by a licensee of its obligations under Chapter 7 of the Corporations Act, the review does not address compensation in relation to:

- product failure or investment losses;
- the financial failure of a financial product issuer; or
- poor performance by an investment.

A retail client whose investments perform poorly will not have a claim for compensation against a financial adviser unless the investment can be attributed to inappropriate advice or other relevant misconduct by the financial service provider.

Basis of financial services regulation

1.27 The current regulatory approach grew out of the recommendations of the 1997 report of the Financial System Inquiry (commonly referred to as the Wallis Report).[13]

1.28 The Wallis Report was based on the premise that the financial system relies on maintaining free and competitive markets. However regulation is needed where markets fail and where the benefits of regulation outweigh the costs.

1.29 The Wallis Report considered the philosophy behind financial regulation, and concluded that specialised regulation was required to ensure that market participants acted with integrity and that consumers were protected. This was due to the complexity of financial products, the adverse consequences of breaching financial promises and the need for low-cost means to resolve disputes. Potential areas of market failure related to information asymmetry and systemic risk.

1.30 The report noted the case for specialised regulation in the areas of:

- financial market integrity — to ensure markets are sound, orderly and transparent;
- consumer protection — to ensure consumers are treated fairly, have adequate information and avenues for redress; and
- competition– to ensure markets are competitive.

13 *The Final Report of the Financial System Inquiry*, March 1997.

1.31 The report discussed the different types of financial promises and how those differences influence the approach to financial regulation. Promises can be distinguished according to three main characteristics:

- the inherent difficulty of honouring the promise;
- the difficulty in assessing the creditworthiness of the promisor; and
- the harm caused by breach of the promise.

Those promises that rank highly on all three characteristics of risk are regarded as having a high intensity.

1.32 The report considered the case for regulation which arises from the risks attached to financial promises. One of the vital economic functions of the financial system is to manage, allocate and price risk. To eliminate risk might make consumers complacent about the risks of dealing in the market and induce riskier behaviour by financial sector providers — that is, result in the risk of moral hazard. However there are some areas of the financial system where the higher intensity of a promise creates a stronger case for regulation and leads to government intervention.

1.33 The report noted that only some areas require financial safety regulation, which generally takes the form of prudential regulation. Regulatory intervention for financial safety should be proportional to the intensity of potential market failure and the promise made. Governments should not seek to impose financial safety regulation across the entire financial system and the assurance provided by prudential regulation should not extend to a government guarantee of any financial promise.

1.34 The report considered that the most intense financial promises are those which underlie payments services and therefore the most intense safety regulation should apply to the provision of the means of payment. This includes, for example, institutions offering payment services or conducting the general business of deposit taking. Beyond this the extent of regulatory assurance is a matter for judgment. Where systemic risk and information asymmetry are greatest, regulation should at least strive to minimise risk of promises being dishonoured.

1.35 It followed that those parts of the financial system which make the most intensive financial promises (primarily deposit taking, insurance and superannuation) require the most intensive regulation — that is prudential regulation.

1.36 Participants in those parts of the financial system which make less intensive financial promises are required to be licensed and to comply with stipulated standards in their conduct towards their clients and in the disclosure of information to their clients.

1.37 The Wallis Report led to the introduction of a dual regulatory model for the financial sector. It applies capital adequacy and other prudential requirements to deposit-takers, insurers and superannuation funds because of the intensity of the financial promises provided in their services to consumers. More broadly, it applies a consistent set of requirements for the conduct of, and the information disclosed, by all providers of financial services.

1.38 The dual regulatory model is supervised by two regulators:

- the Australian Prudential Regulation Authority (APRA) — the prudential regulator; and

- the Australian Securities and Investments Commission (ASIC) — the consumer protection and market integrity regulator for the financial sector.

1.39 Many recommendations of the Wallis Report were implemented through the *Financial Services Reform Act 2001* (FSR Act) which provided a uniform regulatory framework for the provision of financial services. Providers of financial services are required to be licensed and to comply with stipulated standards in their conduct towards their clients and in the disclosure of information to their clients.

Licensing regime for financial service providers

1.40 The FSR Act introduced a single licensing regime for providers of financial services, whether wholesale or retail. The licensing regime sets a threshold for entry into the financial services industry, and provides a basic screening process to facilitate investor confidence that financial service providers have appropriate skills, experience and qualifications, are of good character and are subject to service standards.

1.41 Additional obligations apply to licensees who provide services to retail clients. These obligations are directed to consumer protection.

1.42 A person who carries on a financial services business is required to hold a licence.[14] A licensee is required to meet the standards of conduct and for the disclosure of information provided in Chapter 7 of the Corporations Act. Upon the introduction of the Financial Services Reform Bill 2001, the policy intent of the disclosure obligations was described as:

> the financial service provider disclosure obligations ... will ensure that retail clients receive sufficient information to make informed decisions about whether to take up a financial service and whether to act on the advice they receive.[15]

1.43 Licensees are subject to a general obligation to have available adequate financial and other resources to provide their financial services business and to carry out supervisory arrangements.[16] This obligation does not apply to a licensee who is regulated by APRA given that they are subject to higher level prudential requirements. ASIC applies its financial requirements by way of licence conditions and its approach is set out in a regulatory guide (RG). ASIC puts the onus on a licensee to comply with the requirements and says the guide is not intended to ensure licensees meet their financial commitments.

1.44 In its regulatory guide, ASIC notes that it has not set financial standards with a view to ensuring that the licensee is able to compensate clients for a breach of their statutory obligation. This is because there is a separate requirement in regard to compensation arrangements. ASIC notes that a licensee's compliance with the financial requirements will contribute to its capacity to meet financial obligations to

14 See generally Chapter 7 and specifically section 911A.
15 Financial Services Reform Bill 2001, second reading speech to the House of Representatives Hansard, 4 December 2003.
16 Section 912A(1)(d).

clients. It adds however that it is not the focus of its guide to protect clients against credit risk.

1.45 In setting licence conditions ASIC sets minimum standards for financial requirements, which vary according to the financial products and services the licensee provides.[17] The minimum standards for providers of financial advice are to:

- have positive net assets;
- remain solvent at all times;
- have sufficient cash resources to cover the next three months' expenses with adequate cover for contingencies; and
- have an audit at least annually and additionally if required by ASIC.

Additional requirements apply to licensees who provide custodial services, are direct participants in a licensed financial market such as the ASX or operate a managed investment scheme.

1.46 ASIC provides licensees with several options to meet their financial requirements having regard to the nature of their business and their corporate relationships:

- Option 1 requires the licensee to prepare a projection of likely cash flows over at least 3 months and to be confident that they will have sufficient cash to meet likely liabilities. ASIC expects that this option would be more suited to larger businesses or those that have external sources of support. It requires the licensee to hold a cash buffer, though not to have at any one time *all* the cash needed to meet the liabilities that might arise over the quarter.
- Option 2 also requires the licensee to prepare a projection of likely cash flows over at least the next three months that takes into account a range of commercial contingencies that could impact on the licensee's cash position. ASIC expects this option to be potentially suited to all licensees but especially those operating small businesses who do not always maintain cash or commitments of support from others. It is sufficient for the licensee to show, based on projected cash flows, that it will have access as needed to enough financial resources to meet its liabilities, including through financial support from a parent company or other entity.
- Option 3 allows a licensee that is not itself prudentially regulated by APRA to access an enforceable and unqualified commitment from a deposit taking institution.
- Option 4 allows a licensee that is a subsidiary of an Australian authorised deposit-taking institution (ADI) or foreign deposit-taking institution (that is comparably regulated) to rely on a commitment of support or a guarantee from its parent company.
- Option 5 allows a licensee within a corporate group to access an enforceable and unqualified commitment from its parent or group resources to meet its cash needs.

17 ASIC RG 166 *Licensing: Financial requirements*, and specifically *section B – Base level financial requirements*.

Accordingly, although licensees are required to meet financial requirements some licensees, particularly those operating smaller businesses, do not need to hold cash or a commitment of support for this purpose.

1.47 The licensing regime enables a licensee to operate through representatives, including employees and authorised representatives. The licensee is liable to a client in respect of any loss of damage suffered by the client as a result of the representative's conduct.[18]

1.48 The conduct of a licensee (and its representatives) in dealing with retail clients is governed in two ways:

- by requiring conduct in the interests of the client (for example, before offering personal advice, by making reasonable inquiries into the client's personal circumstances and having a reasonable basis for the advice provided); and

- by prohibiting conduct that is detrimental to the interests of the client (such as misleading or deceptive conduct).

1.49 The requirements for the disclosure of information to a retail client arise at different stages of the relationship:

- before a financial service is provided — a client must be given a Financial Services Guide (FSG) that sets out the terms and kinds of services that may be provided;

- if personal advice (advice that is specific to the client's needs) is provided — a client must be given a written Statement of Advice that sets out the basis of the advice, and how the licensee or authorised representative is remunerated;

- when selling a financial product — a client must be given a Product Disclosure Statement (PDS) or prospectus; and

- for most products — ongoing disclosure is required.

1.50 Licensees who provide services to retail clients are also required to have in place a system for the resolution of disputes with those clients as well as arrangements to compensate their clients for loss or damage arising from breaches of Chapter 7 obligations.

18 Section 917E.

Context of compensation arrangements

1.51 Our legislation has for many years included provisions directed to the risk that financial service providers may not in practice be able to meet claims by clients who have sustained loss or damage as a result of misconduct by the provider of those services.

1.52 Compensation arrangements can be traced as far back as 1937 when the Sydney Stock Exchange established a guarantee fund to reimburse clients of failed brokers. Prior to the FSR Act, various legislative and regulatory arrangements were in place for compensation of consumers of financial services. The arrangements differed between segments of the financial services sector. Securities dealers and advisers were required to provide a security bond of $20,000 to ASIC. Insurance brokers and responsible entities of registered managed investment schemes were required to have appropriate professional indemnity insurance.

1.53 As part of the introduction of a uniform licensing regime in the FSR Act, harmonised compensation arrangements were introduced in the Corporations Act. Section 912B requires financial service licensees who provide services to retail clients to have arrangements in place for compensating those clients for loss or damage suffered as a result of a breach by a licensee or its representative of its obligations under Chapter 7.

1.54 There has been public consultation and discussion over a period of years on the appropriate content of those compensation arrangements.

1.55 Following the introduction of the FSR Bill in 2001, the then Minister for Financial Services and Regulation asked the Companies and Securities Advisory Committee (now the Companies and Markets Advisory Committee (CAMAC)) to consider issues relating to compensation in the financial services sector.

1.56 In September 2001, CAMAC released a consultation paper, *Retail Client Compensation in Financial Markets,* which proposed a scheme to compensate retail clients of licensed financial service providers who became insolvent.[19] The scheme would cover the return of client property held by the licensee or losses to retail clients arising from improper conduct by the licensee. The proposed scheme would:

- be operated by an independent body;
- apply to retail clients of licensees;
- compensate retail clients of licensees who are insolvent or are unable to pay;
- use the same eligibility criteria as apply in disputes with solvent licensees;
- be subject to compensation caps and time limits in making claims;
- be funded by levies on licensees dealing in investments on behalf of retail clients; and
- include transitional arrangements to deal with funds already held by the NGF and the Sydney Futures Exchange.

19 Available at www.camac.gov.au.

1.57 CAMAC conveyed its preliminary thinking to the Treasurer in December 2001 including a summary of submissions received on the consultation paper to that time.

1.58 In 2002, the Parliamentary Secretary to the Treasurer announced that he would release an issues paper for consultation on a framework for compensation arrangements in the financial services sector. The paper would include matters canvassed in the CAMAC paper. The Issues Paper, *Compensation for Loss in the Financial Services Sector, Issues and Options, September 2002*, was prepared by the Treasury. It noted that the objective of government action in relation to compensation arrangements was 'to ensure that consumers, particularly retail consumers, of financial services have appropriate remedies so that they maintain confidence in the financial marketplace and continue to participate in it'.

1.59 The Issues Paper considered whether compensation arrangements were justified and concluded that there appeared to be justification for such arrangements where the losses are suffered as a consequence of the conduct of financial services licensees. The stated reasons for this conclusion were that:

- consumers are not always in a position to assess the information provided by a licensee or the worth of the service provided;
- consumers can incur severe financial hardship through losses resulting from the licensee's conduct;
- consumers' confidence in obtaining financial advice and undertaking transactions in financial products is affected; and
- consumers expect the level of comfort provided by a compensation regime.

1.60 In recognising the case for compensation arrangements, the Issues Paper also noted that such arrangements need to reach a balance between financial risk and consumer protection, and the costs and benefits of any solution.

1.61 Following consideration of submissions received in response to that paper, a Position Paper was released in December 2003.[20] The then Government expressed a preference in that paper for arrangements based on professional indemnity insurance, and proposed that regulations should specify professional indemnity insurance as the primary type of arrangement for the purposes of compensation arrangements required under s912B of the Corporations Act. The Government concluded that the approach of specifying professional indemnity insurance as the primary arrangement reached a balance between consumer protection and the cost to business.

1.62 Under the approach that was adopted licensees can satisfy the requirement to have compensation arrangements by taking out professional indemnity insurance. This approach has been in place since 1 July 2008, following a one year transitional period. Licensees who are subject to prudential regulation are not required to have professional indemnity insurance on the basis that they can in effect self insure.

1.63 It is important to note that the requirement for licensees to hold professional indemnity insurance is not the only compensation arrangement in the financial

20 *Compensation for loss in the financial services sector*, Position Paper, The Treasury, December 2003.

service sector. Other arrangements have been established over time in particular areas:

- Operators of financial markets, such as a stock exchange, are required to have compensation arrangements to cover losses by clients who entrust property to market participants, such as stockbrokers, for the purpose of transactions through their market. The National Guarantee Fund (NGF) of the Australian Securities Exchange (ASX) is an example of such an arrangement. It provides compensation in circumstances where a client suffers loss by reason of the defalcation of, or unauthorised dealing with, the client's funds or property.

- The Financial Claims Scheme (FCS), introduced in October 2008, covers loss by depositors or policyholders due to insolvency of an authorised deposit-taking institution (ADI) or general insurer. The FCS guarantees bank deposits up to the specified cap, and also protects insurance policyholders who have an insurance claim.

- The *Superannuation Industry (Supervision) Act 1993* enables the Minister to make grants of financial assistance for loss incurred by a superannuation fund trustee from fraud or theft.

These specific compensation arrangements which cover some critical areas of financial services need to be kept in mind when considering the adequacy of professional indemnity insurance as the default arrangement. Further detail on these schemes is provided in Chapter 2.

Future of Financial Advice reforms

1.64 In considering the adequacy of current compensation arrangements, regard should also be had to the possible implications of proposed changes in the law relevant to the provision of financial advice to retail customers.

1.65 On 26 April 2010, the then Minister for Financial Services, Superannuation and Corporate Law announced a package of proposed changes in relation to the provision of financial advice under the heading of *Future of Financial Advice* reforms. The announcement was in response to the Ripoll Report. The Government is aiming to have most of the changes in place by 1 July 2012.

1.66 The key proposals in relation to financial advice to retail customers include a ban on conflicted remuneration structures (including commissions), the imposition of a statutory best interests duty on financial advisers, and the introduction of a requirement for advisers to secure agreement from clients for any ongoing fees relating to advice.

1.67 The proposed ban on conflicted remuneration involves the prohibition of commissions and volume-based payments in relation to advice and distribution of retail investment products, including managed investments, superannuation and margin loans. Margin loans in relation to retail financial advice were the subject of scrutiny by the Ripoll Report in the context of the collapse of Storm Financial.

1.68 The changes also aim to expand the provision of simple low-cost advice, both within and outside of intra-fund advice (advice about a member's existing interest in a

superannuation fund), with the aim of improving access to financial advice in the general community.

1.69 It is proposed to confer enhanced powers on ASIC in relation to the licensing and banning of individuals from the financial services industry. An expert advisory panel has been established to review professional standards within the advice industry.[21]

1.70 A review is also underway, as mentioned above, on the appropriateness of the current tests by which a client is classified as wholesale or retail (that is, the proxy for a sophisticated investor).[22]

1.71 In outlining the proposed changes, the Government said that it would be guided by two key principles: first, that financial advice must be in the client's best interests and, secondly, that financial advice should not be put out of reach of those who would benefit from it. In relation to the first principle, the proposed changes are aimed at aligning the interests of advisers with clients, while reducing remuneration based conflicts that can lead to sub-optimal advice.

1.72 Possible implications of the proposed changes for the matters under review in this paper are noted in Chapter 5.

21 *Government announces Financial Advice Advisory Panel Membership*, Media Release by the Hon Bill Shorten MP, Assistant Treasurer and Minister for Financial Services, Superannuation and Corporate Law, 24 November 2010 available at http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/015.htm&pageID=003&min=brs&Year=&DocType=0.

22 See footnote 10.

Chapter 2: Current compensation arrangements

This chapter describes in more detail the approach under the Corporations Act to the protection of retail clients who deal with providers of financial services. It covers the compensation arrangements required of licensed providers of financial services, the place of professional indemnity insurance in those arrangements, the administration of the compensation arrangements, the grounds for compensation claims, the avenues for consumer redress, and the more concrete compensation arrangements available in particular segments of the financial services sector:

- Compensation arrangements required of licensees are intended to reduce the risk that claims by retail clients cannot be met by licensees due to their lack of available financial resources.
- A retail client who suffers loss or damage because of a breach of a licensee's statutory obligations in regard to conduct or the disclosure of information may claim compensation from that licensee.
- Retail clients may seek such redress by legal action through the courts or by using the dispute resolution process a licensee has to make available.
- The compensation arrangement required of most licensees is to hold professional indemnity insurance. Certain licensees are exempted from this requirement on the basis of their relative financial strength.
- Professional indemnity insurance is an indirect means for compensating clients. Where a licensee's policy responds to a claim it assists the licensee to pay any compensation awarded to a client. Where this is not the case, the client's prospects of recovering will depend on the available financial resources of the licensee.
- Separate more direct statutory compensation arrangements cover some critical elements of the financial services sector. These include:
  - the National Guarantee Fund (and similar arrangements) to protect clients of stockbrokers;
  - the Financial Claims Scheme covering loss by depositors or policyholders due to insolvency of an authorised deposit-taking institution or general insurer; and
  - a scheme of financial assistance to compensate for loss incurred by a superannuation fund trustee from fraud or theft.

Arrangements under s912B of the Corporations Act

2.1 Licensed providers of financial services who deal with retail clients are required to have in place:

- a dispute resolution system that meets specified standards (s912A); and
- arrangements for compensating clients for loss or damage suffered because of a breach by the licensee of its statutory obligations (s912B).

2.2 The policy intent of s912B was to 'reduce the risk that compensation claims to retail clients cannot be met by the relevant licensees due to the lack of available financial resources'.[1] The rationale was described as follows in a Treasury paper:[2]

> Retail clients of financial services licensees are exposed to the risk of suffering losses arising from misconduct of the licensee or its representatives. This can result in claims for compensation against licensees. There is a risk that some financial services licensees could be faced with a situation in which they are unable to meet all such claims against them, unless some arrangements were made in advance ... the losses under consideration do not include losses arising from sources such as market fluctuations or the collapse of an issuer of a financial product.

2.3 Section 912B declares that a licensee who has retail clients must have arrangements for compensating those clients for loss or damage suffered because of a breach by the licensee of its relevant statutory obligations. It provides as follows:

> 912B(1) If a financial services licensee provides a financial service to persons as retail clients, the licensee must have arrangements for compensating those persons for loss or damage suffered because of breaches of the relevant obligations under this Chapter by the licensee or its representative. The arrangements must meet the requirements of subsection (2).
>
> 912B(2) The arrangements must:
>
> (a) if the regulations specify requirements that are applicable to all arrangements, or to arrangements of that kind satisfy those requirements; or
>
> (b) be approved in writing by ASIC.
>
> 912B(3) Before approving arrangements under paragraph (2)(b), ASIC must have regard to:
>
> (a) the financial services covered by the licence; and
>
> (b) whether the arrangements will continue to cover persons after the licensee ceases carrying on the business of providing financial services, and the length of time for which that cover will continue; and
>
> (c) any other matters that are prescribed by regulation made for the purposes of this paragraph.

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1 *Compensation Arrangements for Financial Services Licensees*, Regulation Impact Statement, April 2007

2 Commentary released with draft regulations: *Compensation Arrangements if Financial Services are provided to Retail Client under section 912B of the Corporations Act, Commentary on Draft Regulations*, the Treasury, 2006. Available at http://www.treasury.gov.au/documents/1181/RTF/Explanatory_commentary_Compensation_arrangements.rtf.

912B(4) Regulations made for the purposes of paragraph (3)(c) may, in particular, prescribe additional details in relation to the matters to which ASIC must have regard under paragraphs (3)(a) and (b).

2.4 Although s912B commenced on 11 March 2002, its practical operation was deferred until 2008 to allow for consultation to be undertaken on the content of the required arrangements.[3] In the intervening period, regulations and an ASIC class order allowed licensees to continue to comply with the pre-existing requirements for compensation:

- for securities dealers and advisers — a $20,000 security bond provided to ASIC to compensate a person who suffered a pecuniary loss due to failure to carry on the business adequately and properly; and

- for insurance brokers, operators of managed investment schemes and of investor directed portfolio services — professional indemnity insurance and in certain cases insurance against fraud.

2.5 Following consultation the then Government expressed a preference for compensation arrangements to be based on professional indemnity insurance.[4] The use of professional indemnity insurance as the default arrangement for compensation is embodied in the regulations. Corporations Regulation 7.6.02AA requires a licensee to hold professional indemnity insurance which is adequate having regard to specified considerations that relate to the licensee's business, clients and exposure to claims. These considerations include:

(a) the licensee's membership of a scheme (or schemes) mentioned in paragraph 912A(2)(b) of the Act, taking account of the maximum liability that has, realistically, some potential to arise in connection with:

  (i) any particular claim against the licensee; and

  (ii) all claims in respect of which the licensee could be found to have liability; and

(b) relevant considerations in relation to the financial services business carried on by the licensee, including

  (i) the volume of business; and

  (ii) the number and kind of clients; and

  (iii) the kind, or kinds, of business; and

  (iv) the number of representatives of the licensee.

2.6 Attachment A sets out the relevant regulation in full as well as the regulation covering the disclosure of information on compensation arrangements by a licensee.

3 Regulation 7.6.02AA made on 28 June 2007 imposed obligations under s912B for new licensees from 1 January 2008 and for existing licensees from 1 July 2008.

4 *Compensation for Loss in the Financial Services Sector*, Position Paper, December 2003. This followed an Issues Paper of the same name issued in September 2002. These papers are available at www.treasury.gov.au.

Exemptions from compensation arrangements

2.7 The regulation provides an exemption from the need for compensation arrangements for a licensee who is:[5]

- an 'exempt licensee' — a general insurance company, life insurance company and ADI regulated by APRA;
- a 'related licensee' — a licensee related to an exempt licensee and which holds a guarantee from the exempt licensee that is approved by ASIC.

2.8 The apparent rationale for the exemption of a licensee who is also regulated by APRA is that those licensees have to meet APRA's capital adequacy and other prudential requirements. The expectation is that prudential oversight of these entities means they are less likely to fail and more likely to have the financial capacity to meet claims for compensation from their own funds.[6] Such licensees are effectively able to self insure against the risk of compensation claims that might arise from their clients.

2.9 An entity that is related to an APRA regulated entity may be able to secure a guarantee that ensures payment of its obligations for compensation of retail clients. As such a guarantee would have capital implications for the APRA-regulated entity there have been only a few arrangements of this type to date.

Alternative arrangements

2.10 ASIC is empowered by s912B(2)(b) to approve in writing compensation arrangements other than professional indemnity insurance. In approving alternative arrangements, ASIC is required to have regard to a number of factors prescribed in s912B(3)(c) and by regulation. The regulation requires ASIC to have regard to whether those alternative compensation arrangements provide coverage that is adequate having regard to matters of the kind referred to in regulation 7.6.02AA(1). That is, the adequacy of the compensation arrangements must have regard to the licensee's volume of business, the number of clients, the kinds of business undertaken and the number of representatives.

Coverage of representatives

2.11 A licensee's insurance policy is expected to cover possible breaches committed by its representatives as well as breaches by the licensee itself.[7] A representative includes:[8]

- an employee or director of the licensee;
- an employee or director of a related body corporate of the licensee;
- an authorised representative appointed in writing by the licensee;[9] or
- any other person who acts on the licensee's behalf.

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5 Corporations Regulation 7.6.02AAA(4).
6 *Compensation Arrangements for Financial Services Licensees*, Regulation Impact Statement, April 2007.
7 Part 7.6, Division 6.
8 Section 910A.
9 Sections 916A or 916B.

Authorised representatives are not required to have separate compensation arrangements of their own because they are covered by their licensee's compensation arrangements.

Disclosure of compensation arrangements

2.12 The regulations require licensees to include in the FSG they provide to their clients a statement about the kind of compensation arrangements they have in place and whether those arrangements satisfy the requirements under s912B.[10] For licensees who hold professional indemnity insurance, ASIC requires a statement that they have such insurance in place and whether it will cover claims in relation to the conduct of employees and authorised representatives who no longer work for them.[11] Other licensees have to state that they have alternative arrangements approved by ASIC or that they are exempt from the requirement for compensation arrangements.

Insurance as a basis for compensation

2.13 Professional indemnity insurance is a commercial product available to financial services providers to protect them against liabilities incurred in the course of operating their business. It has been described as:

> a product that indemnifies professional people ... for their legal liability to their clients and others who relied on their advice or services. It provides indemnity cover if a client suffers a loss, material, financial or physical, that is directly attributed to negligent acts of the professional.[12]

A licensee's liabilities in this context would include compensation awarded to a retail client for loss or damage incurred as a result of the licensee's breach of statutory obligations.

2.14 Professional indemnity insurance is not itself a compensation mechanism for retail clients. It plays an indirect role in facilitating the payment of compensation to a client. Where a retail client is awarded compensation for a loss arising from the licensee's breach of a statutory obligation, the licensee may be able to claim against the insurance policy to help meet the costs of the award.

2.15 In this way a licensee's professional indemnity insurance cover reduces the risk to a client that the licensee will not have the financial resources to meet an award of compensation. However, it does not guarantee that a retail client will in fact be compensated (see Chapter 3).

2.16 ASIC's approach to the administration of the compensation arrangements for licensees is set out in Regulatory Guide (RG) 126 *Compensation and insurance arrangements for AFS licensees.* The Guide says ASIC's objective in administering the compensation requirements is to:

> reduce the risk that a retail client's losses (due to breaches of Chapter 7) for which a licensee is responsible) cannot be compensated by a licensee because of a lack of financial resources.[13]

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10 Regulation 7.7.03.

11 ASIC RG 126: Compensation and insurance arrangements for AFS licensees, October 2009, Part G – Disclosure in FSGs.

12 *Available and affordable – Improvements in liability insurance following tort law reform in Australia*, the Treasury, December 2006.

2.17 The Guide adds that ASIC will 'aim to raise the standard of available professional indemnity insurance cover for licensees' but notes that 'professional indemnity insurance is not a guarantee that compensation will be paid if there is a claim'.

2.18 The Guide also indicates that:

- licensees are responsible for assessing what is adequate cover in their circumstances;
- in determining whether an insurance policy is adequate it must be fit for providing compensation to retail clients and practically available.

2.19 The Guide sets out ASIC's view on the features a professional indemnity insurance policy should have in order for it to be 'adequate' in terms of:

- minimum requirements and features of the insurance policy; and
- factors that licensees should consider when determining what is adequate for them including the nature, scale and complexity of the business and the licensee's financial resources, as well as the maximum liability that might be incurred.

2.20 ASIC took a staged approach in introducing its administrative requirements for compensation arrangements.

- In the transitional period (1 January 2008 to 31 December 2009), licensees were to hold professional indemnity insurance that met the minimum policy features that were regarded as being commercially available in the insurance market:
  - a limit of indemnity of at least $2 million and up to $20 million depending on the licensee's annual revenue from financial services provided to retail clients;
  - cover for breaches of obligations under Chapter 7 including liability:
    - under external dispute resolution (EDR) scheme awards;
    - for fraud or dishonesty by directors, employees or representatives;
  - no exclusions for EDR scheme awards, losses caused by the conduct of representatives generally, fraud and dishonesty by directors, employees or representatives, claims for misrepresentation about services or for claims arising from incidents notified to ASIC;
  - inclusion of defence costs in addition to the minimum limit or an increased level of cover to take defence costs into account;
  - inclusion of an automatic reinstatement clause (if the limit of the policy is exhausted before the end of the policy period, the limit of indemnity is reinstated for the balance of the period to cover any new claims that arise);[14]

13 ASIC RG 126, para 5.
14 This is not necessary where the limit is at least twice the minimum amount of cover.

- inclusion of retroactive cover if the licensee had an immediately previous professional indemnity insurance policy (a retroactive clause is designed to cover past unknown claims); and

- excess amounts to be met by the licensee limited to a level that the licensee can confidently sustain as an uninsured loss.

- Since 1 January 2010, ASIC expects the licensee's policy to cover legitimate switching from funds or products that are not on an approved product list to another fund or product on the approved product list. Licensees are also expected to consider a more detailed list of factors in determining the level of indemnity that is adequate for their business and individual circumstances.

Run-off cover

2.21 In introducing its administrative guidance, ASIC initially proposed to require professional indemnity insurance to provide automatic run-off cover. Run-off cover is cover for claims made after an insurance policy has ended but which have arisen from acts or omissions of the insured during the period the policy was in force. However, following consultation with industry, ASIC concluded that insurers were generally not willing to provide this risk feature for licensees. ASIC did not proceed with the proposed requirement for run-off cover but has indicated that it will continue to monitor the availability of automatic run-off cover and may reassess its position in the future.

Insurance provider

2.22 ASIC generally calls for licensees to obtain insurance cover from an insurer regulated by APRA or operating under an exemption under the *Insurance Act 1973*.

ASIC administration of insurance requirement

2.23 ASIC's general approach is to look to licensees to self-assess the adequacy of their professional indemnity cover, taking account of the guidance in RG 126. ASIC regards the requirements as self-executing with the onus on a licensee to comply as part of its overall risk management processes. ASIC does not vet the terms of a licensee's insurance cover. It is up to the licensee to form the view that its policy is adequate.

2.24 An applicant for a licence is not required to provide ASIC with a copy of its insurance policy but has to provide information about its insurance cover and a certificate of currency of that insurance. This information is generally sought on a 'yes/no' basis and includes:

- name of the insurer;

- period of the policy;

- amount of cover;

- provision for defence costs;

- amount of excess and whether it is at a level that the licensee can confidently sustain as an uninsured loss;
- number of reinstatements allowed;
- indication of whether individual or group cover is provided;
- indication that cover is provided for all financial services and products that the licensee seeks to offer;
- indication that cover is available for breaches of Chapter 7 by both the licensee and the authorised representative;
- indication that the policy covers EDR scheme awards;
- indication that the policy covers fraud by representatives, employees and agents;
- indication that retroactive cover is provided;
- indication of exclusions in the policy; and
- estimated gross revenue for next financial year.

In addition, the licensee must confirm in writing to ASIC that the policy covers standard margin lending.

2.25 ASIC does conduct some risk-based surveillance of licensees through which it can check whether a licensee is complying with a range of statutory obligations including the adequacy of its professional indemnity insurance. It does not however conduct systematic or periodic compliance checks on the insurance held by a licensee.

2.26 Once a licence is granted it is not subject to annual or other periodic renewal. However, a licensee is expected to notify ASIC if it is unable to meet its licence obligations, including the requirement to have adequate professional indemnity insurance.

2.27 If ASIC becomes aware that a licensee does not have professional indemnity insurance, it could take action to suspend or ultimately cancel the licence.

Grounds for compensation claims

2.28 The compensation arrangements in s912B are directed to support the recovery of compensation awarded to a retail client who suffers loss or damage because a licensee has breached its obligations under Chapter 7. The licensee's relevant statutory obligations can be categorised as requirements directed to its conduct towards retail clients and to the information disclosed to clients.

2.29 A licensee will be in breach of the conduct rules if it engages in any of the following conduct, or fails to exhibit the professional conduct required under Chapter 7:

- fails to comply with the principal duties of a licensee (for example, to carry on a financial services business efficiently, honestly and fairly and comply with the financial services laws);

- provides personal advice without:

  – making reasonable inquiries into the client's personal circumstances and having a reasonable basis for the advice (advice that takes into account the person's needs, objectives or financial situation); or

  – warning the client if the advice is based on incomplete or inaccurate information;[15]

- provides general advice but fails to warn the client that it does not take account of the client's objectives, financial situation or needs;[16]

- fails to assess the client's suitability before issuing or increasing the limit on a margin loan;

- refuses to comply with a client's right to return a product in accordance with 'cooling off' provisions; or

- fails to deal as required with money provided by the client for the purchase of a financial product or service (for example, by payment into a specified account).

2.30 A licensee will also be in breach of the conduct rules if it engages in conduct that is prohibited under Chapter 7. This includes unconscionable, misleading or deceptive conduct, such as the making of false and misleading statements, market manipulation, false trading, or inducing people to deal using false or misleading information.[17]

2.31 A licensee will be in breach of the disclosure rules if it:

- does not provide a relevant disclosure document (a Statement of Advice, Financial Services Guide or Product Disclosure Statement) within the required timeframe; or

- provides documents which are defective (for example, contain a misleading or deceptive statement or omit material that is specifically required, such as information on remuneration and commissions).[18]

2.32 A licensee is also required to comply with the financial services laws.[19] These are defined in s761A to include, apart from specified provisions of the corporations law, other Commonwealth, State or Territory laws dealing with conduct in the provision of financial services, certain parts of the ASIC Act, and for a licensed trustee company, rules of common law or equity relevant to trustee company services.

15 Sections 945A and 945B.
16 Section 949A.
17 Section 1041I.
18 Sections 953B.
19 Section 912A(1)(c).

2.33 A recent study provides some insights into the most common forms of inappropriate advice by a financial adviser.[20] The study shows that the most common form of inappropriate advice is a 'misleading statement as to performance, product features or security, business reputations' (around 15 per cent of cases in the review), followed closely by 'using client funds for own purposes' (13 per cent) and the provision of 'advice [which] did not meet client objectives or circumstances and had no reasonable basis' (12 per cent). The study also found problems in the disclosure of information by the financial adviser to the consumer, with failures both to disclose 'remuneration benefits and conflicts of interest' and 'information relevant to client decision'. Consumer complaints in the period studied were also based on dissatisfaction with the advice provided, in terms of the adequacy or tailoring of the written advice received or the adequacy of the explanation and examination of the risks associated with the investment or financial product.

Avenues for consumer redress

2.34 A client of a financial services licensee who suffers a loss or damage arising from misconduct can seek redress through private legal action:

- by pursuing an action for a breach of contract or in tort, or through class action with other clients who have had similar experiences with the licensee;
- by utilising avenues for redress available under the Corporations Act which enable a court to make an order for compensation for damage:
  - that results from the licensee's contravention of a financial services civil penalty provision;[21]
  - that follows from the licensee's failure to provide a disclosure document;[22] or
  - that is consequential upon a breach of a provision relating to false and misleading statements, inducing a person to deal, dishonest conduct or misleading or deceptive conduct.[23] and
- by utilising the power of the courts to make orders relating to the payment of money. [24]

2.35 ASIC is also able to take action on behalf of investors who have suffered a loss if it appears to be in the public interest to do so. ASIC can take action under s50 of the *Australian Securities and Investment Commission Act 2001* to recover:

- damages for fraud, negligence, default, breach of duty, or other misconduct committed in connection with a matter which ASIC is investigating; or
- property on behalf of investors.

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20 *Ethics and Financial Advice: The Final Frontier*, Dr June Smith, 2010 which is available at http://www.businessandlaw.vu.edu.au/The The study was based on a review of 225 consumer complaints of inappropriate financial advice determined by the courts, FOS and ASIC between 2006 and 2007.
21 Section 1317HA.
22 Section 953B or 1022B.
23 Section 1041I.
24 Section 983E.

ASIC has succeeded in obtaining compensation for retail clients in a number of cases (see Chapter 3).

2.36 Compensation may also be secured as an outcome of an ASIC investigation of a licensee's conduct. In a recent investigation ASIC concluded that a financial adviser potentially breached various sections of the Corporations Act by providing inappropriate financial advice to a large number of clients. According to ASIC, the financial adviser subsequently agreed to identify those affected, assess liability and provide appropriate compensation.

Alternative dispute resolution mechanisms

2.37 It is also open to retail clients to seek redress through the less formal alternative dispute resolution processes that licensees are required to have in place under the Corporations Act. As these processes are the conduit through which many of the claims for compensation by retail clients flow they are outlined below.

The dispute resolution system

2.38 A licensee is required, under s912A(2), to have in place a dispute resolution system that consists of:

- an internal dispute resolution (IDR) procedure that meets ASIC's approved standards and requirements; and
- membership of at least one external dispute resolution (EDR) scheme that is approved by ASIC and covers complaints relating to the types of financial services provided by the licensee;
  - a licensee who only deals with superannuation products and services does not need to join an EDR scheme if all complaints can be handled by the Superannuation Complaints Tribunal.[25]

2.39 ASIC provides regulatory guidance on the standards for its approval of a dispute resolution system.[26]

2.40 The aim is to encourage the direct resolution of disputes between retail clients and financial service providers and to provide a less costly and more expeditious alternative to formal court processes.

2.41 In most cases, retail clients first seek to resolve their complaint directly with the licensee through its IDR process. If the complaint remains unresolved it may then be taken to the licensee's EDR scheme.

2.42 In deciding whether to approve an EDR scheme, ASIC has regard to the principles of accessibility, independence, fairness, accountability, efficiency, effectiveness and any other matter it considers relevant.[27] In practice, ASIC looks to an EDR scheme to provide free access for consumers, to actively promote its

25 Established under the *Superannuation (Resolution of Complaints) Act 1993.*
26 ASIC RG 165: *Licensing: internal and external dispute resolution* and RG 139: *Approval and oversight of external dispute resolution schemes*.
27 ASIC RG 139 in particular section B: Guidelines for initial and ongoing approval. The Corporations Regulations and the National Credit Regulations state that ASIC must take those principles into account when considering whether to approve an EDR scheme.

services, to be independent of its members and overseen by an independent body, and to apply principles of natural justice.

2.43 Under its guidelines ASIC has regard to the following matters in considering the approval of an EDR scheme:

- the adequacy of the scheme's coverage in terms of the types of complaints and complainants who may access the scheme;
- its ability to handle claims up to the value of $500,000 (consistent with a test for 'retail client' in the Corporations Act) and to make non-monetary orders, such as releasing a complainant from a contract;[28]
- its ability to award compensation up to a specified capped amount;
  - from 1 January 2010 to 31 December 2011, the upper limit of an award will be the limit each scheme used to operate in the immediately prior period;[29]
  - from 1 January 2012, the upper limit of an award will be $150,000 if made for a claim against a general insurance broker and $280,000 for other claims, and these caps will be subject to indexation;
- its ability to award interest on a loss;[30]
- the means by which the scheme will ensure compliance with its decisions; and
- the types of complaints a scheme can legitimately exclude from jurisdiction under its terms of reference, including those which were not brought in time.[31]

2.44 Following a recent change to the regulatory requirements, EDR schemes have a discretion to handle complaints against a member that has ceased to carry on business or ceased to have a licence.[32] Previously a scheme was not able to handle such complaints owing to the expulsion of a member from the scheme once it ceased to carry on business or lost its licence.

Approved EDRs

2.45 ASIC has approved eight EDR schemes for financial services over the years and, following amalgamations, two of these remain in operation:

- Financial Ombudsman Service Limited (FOS);
  - formed on 1 July 2008 by the merger of three EDR schemes previously approved by ASIC — the Banking and Financial Ombudsman Service, the Insurance Ombudsman Service and the Financial Industry Complaints Service.

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28 ASIC is currently consulting on whether a higher compensation cap should apply to beneficiaries of traditional trustee services complaints - ASIC Consultation Paper 138 *Dispute resolution requirements for trustee companies providing traditional services* (September 2010).

29 See para 2.45 which sets out the current caps for each EDR scheme.

30 An interest-inclusive award may exceed the capped amount by the amount of that interest.

31 Generally, a claim must be lodged by the earlier of six years from the date the complainant becomes aware of the loss or two years from the date a final response is given by an IDR scheme.

32 ASIC RG139, paras 139.196 to 200, para 3.10 of the FOS Constitution and para 10.1 of the COSL Constitution.

The Credit Union Dispute Resolution Centre Pty Limited and the Insurance Brokers Dispute Resolution Limited joined on 1 January 2009;

- had almost 5,400 members at the end of 2009-10;
- has a compensation cap of $150,000 for awards in investment related complaints (claims against a stockbroker, financial planner, managed investment scheme or in relation to securities and derivatives), $100,000 for awards in insurance broking complaints and $280,000 for awards in all other complaints (general insurance, deposit taking and credit); and
- received 23,790 new complaints and more than 200,000 inquiries in 2009-10.[33]

- Credit Ombudsman Services Limited (COSL);
  - had more than 12,700 members at the end of 2009-2010;
  - members are generally loan writers and mortgage brokers, and some financial planners;[34]
  - has a compensation cap of $250,000 for all complaints; and
  - received 1,153 new complaints and 19,147 inquiries in 2009-10.[35]

Financial Ombudman Service

2.46 FOS is the largest provider of dispute resolution services for disputes with financial advisers and its operations are dealt with in more detail below.

2.47 A retail client can seek redress through FOS if a dispute is within its terms of reference. There is no cost to the applicant to use the dispute resolution service provided by FOS.

2.48 The cost of providing the service is borne by the member licensees. FOS is funded by an annual membership base levy for which the maximum charge is $10,000 and the minimum is $250. There is also an annual user charge based on the number and complexity of disputes and the stage in the process at which they were closed in the previous year. A licensee who had no more than one dispute in the previous year does not pay the user charge. In addition member licensees are charged case fees which are charged at the closure of a dispute and depend on the complexity of the dispute and the stage in the process at which it is closed. The fees are payable by the licensee irrespective of the outcome of the dispute.

2.49 Where FOS finds in favour of a consumer it makes an award that reflects the loss incurred up to the compensation cap. Where the amount in dispute is higher than the cap the complainant can either:

- waive the excess and accept the scheme outcome in full and final settlement; or
- reject the scheme outcome and pursue the complaint in a court.

33 FOS Annual Review 2009-10.
34 COSL Annual Report on Operations 2008-2009.
35 COSL Annual Review of Operations 2009-10.

2.50 A member of FOS (the licensee) is contractually bound to honour a decision in favour of its client if accepted by the applicant in full and final settlement of the dispute[36]. The licensee is required to pay the amount of compensation awarded and comply with any term of a decision, such as a variation of its contract with the client.

2.51 While a licensee is contractually bound to honour an award it does not follow in practice that it will always have the financial capacity to do so. A licensee who fails to comply with a FOS determination could be reported to ASIC for serious misconduct and as a result ASIC could take steps to cancel its licence or impose conditions on the licence.

Grounds for EDR scheme awards

2.52 As noted in paragraph 2.42, in approving an EDR scheme ASIC looks to the scheme to reflect the principles of accessibility, independence, fairness, accountability, efficiency and effectiveness. In regard to fairness, ASIC says it believes a scheme's dispute handing should accord with the principles of natural justice. ASIC does not otherwise seek to limit the scope of the standard by which disputes may be resolved.[37]

2.53 In practice EDR schemes are not limited to handling disputes involving a breach of a licensee's obligations under Chapter 7. An EDR scheme may have jurisdiction to award compensation on grounds that go beyond breaches of Chapter 7.

2.54 ASIC's regulatory guidance also calls for EDR schemes to offer remedies that are 'consistent with the remedies available under the relevant laws that apply to the arrangements between the scheme member and its customers'.[38] In determining the extent of loss or damage suffered by a complainant, the scheme should have regard not only to the relevant legal principles but also to the concept of fairness and to industry best practice.

2.55 FOS, for example, in dealing with a dispute '... must do what in its opinion is appropriate with a view to resolving disputes in a cooperative efficient, timely and fair manner' and in resolving a dispute it will 'do what in its opinion is fair in all the circumstances, having regard to ...legal principles; applicable industry codes or guidance as to practice; good industry practice; and previous relevant decisions of FOS or a predecessor ...'. The types of disputes that can be considered by FOS are those '... that arise from a contract or obligation arising under Australian law' where it relates to the provision of a financial service.[39]

36 *Financial Industry Complaints Service Ltd v Deakin Financial Services Pty Ltd* [2006] FCA 1805.
37 ASIC RG139, paras 102 to 107.
38 ASIC RG, para 211.
39 FOS Terms of Reference, clauses 1.2, 8.2 and 4.2.

Complaints regarding investment services

2.56 Only a small proportion of the total disputes received by FOS in 2009-10 were investment disputes (1,639 of the 23,790 complaints received). In its Annual Review, FOS says that the:

> bulk of investment disputes were about problems ... with a financial service provider's (FSP) advice (38 per cent), disclosure (18 per cent) or service (17 per cent). Advice-related complaints included claims that an FSP gave inappropriate advice or failed to provide advice. Disclosure related complaints included claims that an FSP provided insufficient, misleading or incorrect information about a product or service.[40]

FOS also says that 'more than half (58 per cent) of the investment disputes it handled were about products or services provided by financial advisers or planners'.[41]

2.57 The proportion of claims regarding investment services which were decided in favour of claimants was around 16 per cent and in favour of members was 11 per cent.[42]

2.58 The apparently low proportion of claims resolved in favour of the consumer may be attributable in part to:

- settlement of claims by the parties before a determination is made;
- resolution of claims by members outside of FOS; and
- claims that fall outside FOS's jurisdiction (for example, claims that exceed the monetary cap), are inappropriate and dismissed by FOS or are withdrawn by the claimant.

2.59 Table 2.1 shows the composition of claims against members that offer investment services, the aggregate amounts claimed and the amounts awarded. The average amount awarded was 12 per cent of the total amount claimed.[43]

Table 2.1: Claims against FOS members who provide investment services — 2006 to 2009

Activity	Aggregate claims	Aggregate outcomes
	$million	$million
Financial planning	124.4	17.8
Managed investments	37.1	1.3
Stockbroking	22.9	2.4
Other Claims	5.4	0.4
Total	**189.9**	**21.9**
Average proportion awarded		**12 per cent**

Source: FOS data

40 FOS Annual Review 2009-10, section on Investment Disputes.
41 Ibid.
42 FOS data provided to the review relating to the four year period to December 2009.
43 FOS may not record the outcome amount for some claims so the value of claims settled in favour of the claimant may be understated.

2.60 Awards made in favour of a claimant are commonly for an amount less than the amount claimed. This may occur because FOS was not persuaded that the claimant was entitled to the full amount claimed.

2.61 In assessing the amount payable as a result of a breach, FOS indicates that it 'may consider whether there was any contributory negligence ...' by the applicant, but it will not consider the liability of financial service providers other than the licensee member against whom the claim has been made.[44] In the case of *Wealthcare Financial Planning Pty Ltd v Financial Industry Complaints Service Ltd [2009] VSC*, the Supreme Court of Victoria concluded, on several grounds, that FICS was not obliged to, and in many cases was not able to apply the principle of proportional liability by considering the liability of parties other than the financial adviser in question, such as the contribution to that loss of the finance company, directors, the product provider, auditors or the investment research firm. It was also noted that some of these parties would not have been subject to an EDR scheme's jurisdiction.

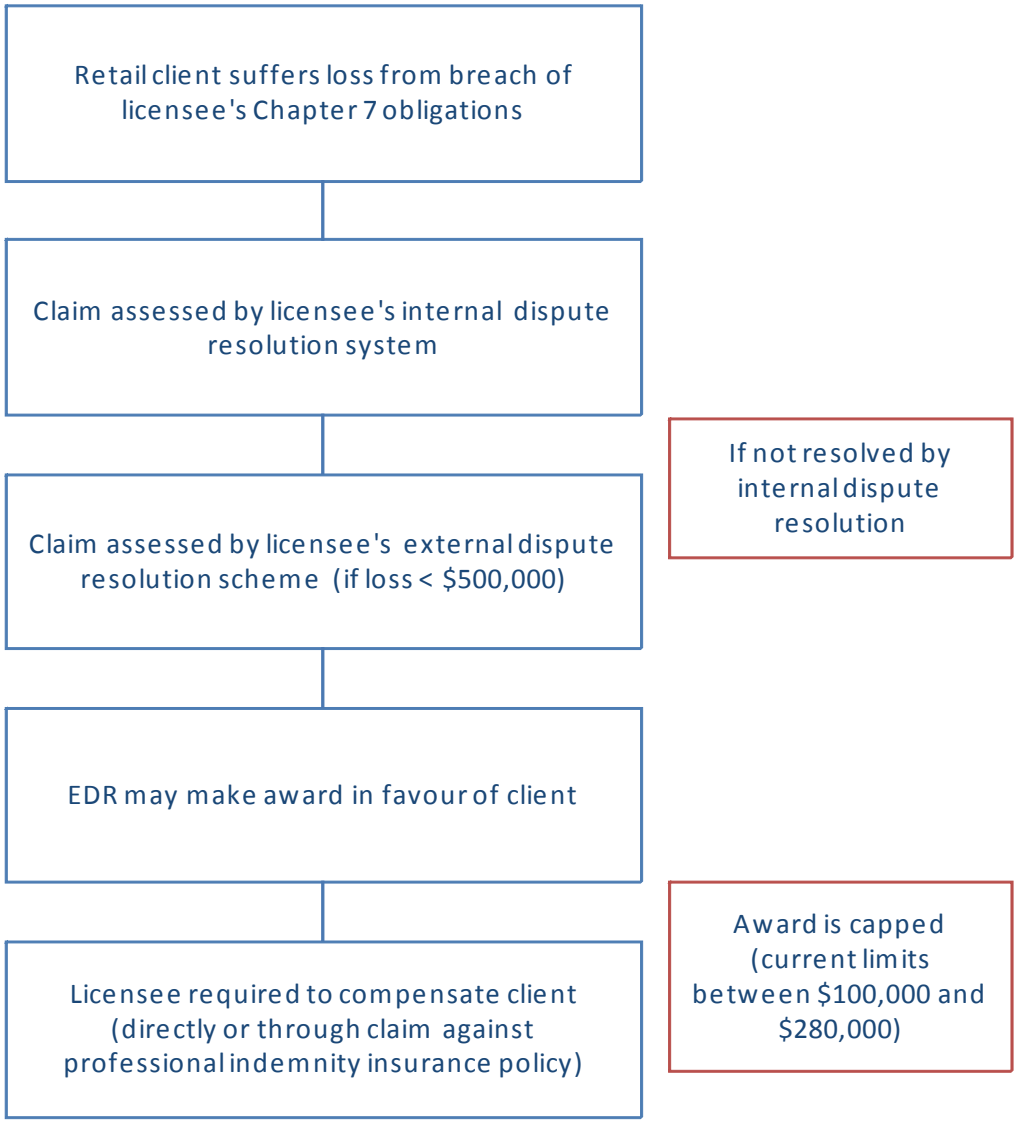
2.62 The effect is that the consumer can obtain an award of compensation from a member licensee with whom the consumer has dealt. The licensee in such circumstances might have a legal right to seek proportional recovery from other responsible parties.

EDR scheme awards and professional indemnity insurance

2.63 A licensee is contractually bound to honour an award of an EDR scheme made in favour of its client and could be expected to look to its professional indemnity insurer to meet this liability. The interaction between an EDR scheme award and professional indemnity insurance is shown in Diagram 2.1.

44 FOS Circular, 4 December 2010.

Diagram 2.1 — Interaction of EDRs and professional indemnity insurance



2.64 Licensees are expected by ASIC to have insurance that covers liability arising under an award made by an EDR scheme. ASIC states that the insurance policy 'must have the effect of providing cover for breaches of the relevant obligations under Chapter 7 and EDR scheme awards and that that policy must be a contract of professional indemnity insurance (meaning) ...it must cover negligence, fraud and other misconduct (relating to retail clients) ordinarily covered by a contract of professional indemnity insurance'.[45] It is noted that ASIC in this regard goes beyond requiring a licensee to have insurance covering breaches of Chapter 7.

2.65 In practice, a licensee's claim for payment of such an award under its professional indemnity insurance policy may not be straightforward. The insurer is likely to look at the basis for the award and whether the specific circumstances are covered, and not excluded, by the policy. The fact that an EDR scheme has made an award in favour of a retail client may not be enough to satisfy the insurer in this regard.

45 ASC RG 126, para 54, *Scope of cover,* Notes 1 and 2, p 17.

2.66 Difficulties may arise where an EDR scheme has based an award on a notion of fairness or breach of an industry code of practice or legal obligation other than those arising from Chapter 7. An example might be an EDR scheme award based on a breach of the licensee's contractual obligations to a client, or on its negligent conduct in breach of a common law duty of care to the client or on a licensee's breach of the broad principle of fairness and good practice.

2.67 A licensee who is not covered for such a liability under its insurance policy will have to meet it from its own financial resources. In some circumstances a licensee might also decide to meet the liability itself where it is less costly to do so than to pay an amount of excess required under the policy.

Other financial sector compensation arrangements

2.68 Apart from the s912B arrangements, separate statutory compensation arrangements are already in place covering significant segments of the financial services sector. These arrangements have developed over the years in a somewhat piecemeal fashion.

Compensation regime for financial markets

2.69 The Corporations Act regulates the operation of financial markets such as securities and futures markets. Under Chapter 7 a person licensed to operate a market is generally required to establish a compensation regime if its participants provide financial services for retail clients that involve the participants holding money or property on behalf of those clients.[46]

2.70 The purpose of these compensation arrangements is to promote confidence for retail investors in the handling of money or property provided to intermediaries for investment purposes. When the NGF was established, it was hoped that it would instil confidence and encourage participation in the share market, given the low level of participation at that time.[47]

2.71 Providers of financial markets are required to comply with one of two compensation regimes established respectively in Part 7.5. Members of the Securities Exchange Guarantee Corporation (SEGC) must comply with the compensation arrangements in Division 4 of Part 7.5. Other providers of financial markets must comply with the compensation arrangements in Division 3 of Part 7.5 of the Corporations Act.

2.72 In addition to the requirement that market operators establish compensation arrangements, participants in those markets, such as stockbrokers and futures traders, are required to have the financial capacity to meet claims for compensation from their clients. Under ASX operating rules, participants are required to meet capital adequacy requirements and core liquid asset ratios. Stockbrokers and other participants are required to hold professional indemnity insurance against a breach of

46 Section 881A.

47 *Australian Stock Exchange and National Guarantee Fund Bill 1987,* Second reading speech to the House of Representatives, Hansard, 18 February 1987.

duty owed in a professional capacity, whether in contract or at law.[48] Failure to meet the obligation to have insurance attracts a maximum penalty of $100,000.

2.73 In practice it is understood that stockbrokers take out professional indemnity insurance that meets their dual obligations as financial service licensees and as participants in the securities market. The latter requirement is broader in respect to cover 'against a breach of duty the market participant owes in a professional capacity whether owed in contract or otherwise at law'. Another distinction is that the market participant must advise ASIC within 10 business days of the renewal of its insurance policy, including the amount and nature of cover, and to advise ASIC immediately of any notification to its insurer of a claim.[49] Failure to meet these obligations attracts a maximum penalty of $20,000.

National Guarantee Fund

2.74 SEGC administers the NGF as the compensation regime for the ASX which currently is its only member.

2.75 NGF was established in 1987 from the amalgamation of state and territory fidelity funds following a long history of stock exchanges operating their own fidelity funds.[50]

2.76 NGF provides compensation for clients who incur a loss in their dealings with stockbrokers on the ASX in the following circumstances:[51]

- where a stockbroker has failed to complete a sale or purchase of securities entered into on the ASX's equities and debt market and where those transactions are required to be reported to the ASX by the stockbroker (that is, a contract guarantee);
- where a stockbroker makes an unauthorised transfer of securities;
- where a stockbroker cancels or fails to cancel a certificate of title to quoted securities contrary to the operating rules of the Australian Securities Exchange Settlement and Transfer Corporation Pty Limited; and
- where a person has entrusted property to a stockbroker who subsequently becomes insolvent and cannot meet its obligations to that person.

2.77 In the first three of those circumstances, there is no cap on the amount that can be claimed under NGF. In respect to a loss arising from a stockbroker's insolvency,

48 ASIC Market Integrity Rules (ASX Market) 2010, February 2011, rule 2.2.1.
49 ibid, rules 2.2.3 and 2.2.4.
50 NGF was established by *the Australian Stock Exchange and National Guarantee Fund Act 1987*. The Sydney Stock Exchange established a fund in 1937, and funds were subsequently established by the Perth Stock Exchange in 1968, by the Melbourne Stock Exchange in 1970 and by the Brisbane Stock Exchange in 1971. The *Securities Industry Act 1980* required all stock exchanges to establish and keep a fidelity fund and required a contribution to the fund of at least $500 from all members, with additional levies imposed if the fund became insufficient.
51 Part 7.5, Division 4 of the Corporations Regulations, subdivisions 4.4, 4.7, 4.8 and 4.9.

compensation is limited to 15 per cent of the minimum size of NGF — which is currently required to be a minimum of $80 million.[52]

2.78 While only required by law to provide compensation for retail clients, NGF in practice covers claims by wholesale clients as well.

2.79 Compensation is not available from NGF:

- for a loss arising from investment decisions or from relying on investment advice given by a participant;
- for a loss if a participant fails to act on instructions to buy or sell;
- for money lent to a participant which has not been repaid;
- in respect of conduct by an entity other than the specific entity which is the participant; and
- in respect of alleged unauthorised withdrawal or misappropriation by the participant of money in a client's account or held on a client's behalf (unless covered by one of the four circumstances noted above).

2.80 SEGC may impose a levy on operators or participants in their market if the amount in NGF falls below the minimum prescribed. SEGC has not found it necessary to impose any levies to date given the availability of assets rolled over from the pre-existing funds and subsequent investment earnings. NGF had $111 million in assets as at June 2010.

2.81 Where a retail client of a stockbroker is unable to receive compensation through NGF the client could still bring a claim under the broker's s912B compensation arrangements if the broker failed to meet its obligations under Chapter 7. An example might be where a client relied on a broker's investment advice and the broker did not have a reasonable basis for the advice provided.

Compensation regimes for other market operators

2.82 Market licensees who are not members of SEGC must obtain approval from the Minister for compensation arrangements to deal with losses in the following circumstances:[53]

- where a retail client gives money or other property to a participant in connection with a transaction covered by the operating rules of that market and there is a defalcation or fraudulent misuse of that money or property by the participant; or
- where the retail client gives the participant authority over the property and the participant fraudulently misuses that authority.

2.83 The market operator must have 'an adequate source of funds available to cover claims' which arise from the losses described above.[54] Examples of arrangements that have been accepted include a fidelity fund, insurance arrangements, an

52 Section 889I.
53 Sections 881B, 882A and 885C, and Corporations Regulation 7.5.15.
54 Section 885H.

irrevocable letter of credit or a combination of these.[55] The following market licensees have established compensation arrangements:

- SIM Venture Securities Exchange and the National Stock Exchange of Australia;
- Asia Pacific Exchange (formerly the Australia Pacific Exchange) — which has a fidelity fund with minimum cover of $750,000;
- IMB — which has an irrevocable undertaking by an ADI with minimum cover of $1 million;
- Australian Securities Exchange Supplemental Compensation Fund; and
- Sydney Futures Exchange Fidelity Fund.

Financial Claims Scheme for depositors and policyholders

2.84 FCS was established in October 2008 to provide depositors of ADIs and general insurance policyholders with timely access to funds in the event of the failure of such a financial institution. [56] In December 2010, FCS was confirmed as a permanent feature of the financial system.[57]

2.85 The introduction of FCS follows consideration by the Council of Financial Regulators dating from 2005, and also follows recommendations made by the HIH Royal Commission in 2003 and the global Financial Stability Forum in 2008. The Council of Financial Regulators, which includes the heads of APRA, ASIC, the Reserve Bank of Australia and the Treasury, examined Australia's crisis management arrangements and found there was a strong case for introducing a mechanism to provide both depositors in an ADI and policyholders in an APRA regulated general insurer with access to some of their funds or funds due to them in a timely manner should a financial institution fail.

2.86 The *Banking Act 1959* provides a mechanism for making payments to depositors under the Government's guarantee of deposits to ADIs up to a nominated cap (currently $1 million per depositor per institution).[58]

2.87 The *Insurance Act 1973* protects certain policyholders and other claimants who make valid claims on a general insurance company where the insurer is insolvent.

2.88 FCS is administered by APRA with its day to day costs met through the APRA levy on prudentially regulated financial institutions.

2.89 In the event of a payout to depositors or policyholders, the Government meets the cost of the payments in the first place, but recovers these costs when the failed ADI or general insurer is wound up. Should the available assets be insufficient, the Government can levy ADIs or general insurers as the case may be to recover the remainder.

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55 Notes to s885H.
56 *Financial System Legislation Amendment (Financial Claims Scheme and Other Measures) Act 2008*.
57 *A Competitive and Sustainable Banking System*, Media Release by Deputy Prime Minister and Treasurer, the Hon Wayne Swan MP, 12 December 2010.
58 The *Banking Act 1959* and the *Insurance Act 1973* were amended by the *Financial System Legislation Amendment (Financial Claims Scheme and Other Measures) Act 2008.*

Compensation arrangements for superannuation funds

2.90 The superannuation industry is subject to a prudential regulatory system. APRA supervises trustees of superannuation funds but allows trustees a degree of freedom to operate their funds. This regulatory approach aims to minimise rather than prevent failure of the superannuation funds.

2.91 In 1993, the then Government introduced legislation which aimed to strengthen the security of superannuation savings and protect the rights of superannuation fund members. [59] The Explanatory Memorandum stated that one of the most important elements of this package of measures was 'for financial assistance to be provided to funds that have suffered a loss due to fraudulent conduct or theft'.[60] This policy intent was the basis for Part 23 of the *Superannuation Industry (Supervision) Act 1993*.

2.92 Under Part 23 of that Act a trustee of an APRA-regulated superannuation fund (or approved deposit fund) can apply to the Minister for a grant of financial assistance if the superannuation fund incurs a loss as result of fraudulent conduct or theft.[61] The Minister is required to seek advice from APRA and must be satisfied that the loss has caused a substantial diminution of the fund leading to difficulties in the payment of benefits, and that the public interest requires a grant to be made.

2.93 The Minister has discretion over the payment of financial assistance and the amount of that assistance.

2.94 The financial assistance granted in this way is funded initially from the Consolidated Revenue Fund and then recouped through an industry levy on APRA-regulated superannuation funds and approved deposit funds.[62]The effect is that a loss in one superannuation fund is borne by the members of other funds that contribute to the levy. Levies are based primarily on the asset size of the contributing fund.

2.95 The Minister has a discretion to impose conditions on the grant of financial assistance and has used this discretion to impose a requirement that any monies recovered from the perpetrator of the fraud or theft against the superannuation fund be refunded to the Commonwealth up to the amount of the grant.

2.96 Part 23 specifically excludes self-managed superannuation funds (SMSF) from being able to apply for financial assistance under Part 23. This is on the basis that SMSF members, as trustees of their SMSF, have direct control over their superannuation savings and are in a position to protect their own interests. The trustees of an SMSF, in circumstances where they qualify as retail clients under the Corporations Act, will have rights to compensation on a par with other retail clients.

Compensation arrangements for credit providers

2.97 A provider of consumer credit and credit-related brokering services and advice must hold an Australian Credit License under the *National Consumer Credit*

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59 *Superannuation Industry (Supervision) Act 1993.*
60 Superannuation Industry (Supervision) Bill 1993, Explanatory Memorandum.
61 Part 23 applies to a regulated superannuation fund or an approved deposit fund but not a self managed superannuation fund.
62 *Superannuation (Financial Assistance Funding) Levy Act 1993* and the *Superannuation (Financial Assistance Funding) Levy and Collection Regulations 2005.*

Protection Act 2009.[63] In some instances, an Australian Financial Services Licensee may also hold a credit licence. A financial planner who also advises on mortgages, for example, will be subject to a dual regulatory regime, including compensation arrangements imposed under both the financial services and credit regimes (see Table 2.2).

2.98 Credit providers are required to have an IDR process, to be a member of an EDR scheme and to have adequate compensation arrangements for loss or damage to the consumer as a result of a breach of an obligation of the credit licensee, such as the obligation to ensure they do not provide a credit contract that is unsuitable for the consumer. These consumer protection mechanisms are broadly similar to those that apply to Australian Financial Services Licensees.

2.99 Under the regulations for credit providers, the obligation of the licensee to have compensation arrangements can be met by holding professional indemnity insurance cover that is adequate.[64] Licensees who are APRA-regulated insurers or ADIs are exempt from the requirement to hold professional indemnity insurance. In assessing the adequacy of the cover, the licensee is to have regard to:

- the maximum claim likely to be made against the licensee should a dispute be taken to an EDR scheme; and
- the credit activity undertaken by the licensee.

2.100 An overview of the compensation arrangements that apply to financial services licensees is provided in Table 2.2.

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63 Generally commenced on 1 July 2010, or 1 January 2011 for ADIs and Registered Financial Corporations.
64 *National Consumer Credit Protection Regulations 2010.*

Table 2.2: Compensation arrangements applicable to financial services licensees

Financial services licensees								
Financial services providers requiring a License	Financial advisers	Insurance brokerage	Securities, futures or derivatives brokers	Superannuation funds	Provision of managed investments	Provision of insurance	Provision of banking services	Provision of credit
Default compensation requirements	**Section 912B compensation requirements apply to all licensees**							Additional requirement for compensation under the National Consumer Credit Protection Act 2009
Nature of compensation arrangements	**Professional indemnity insurance (or alternative approved by ASIC)**					Self insurance (as prudentially regulated entities)		Professional indemnity insurance, self insurance (for prudentially regulated entities) or alternative approved by ASIC
Grounds for and resolution of claims	**Breach of conduct and disclosure requirements Determined by court, internal dispute resolution or external dispute resolution processes**							Additional grounds under National credit code for breach of responsible credit conduct
Other arrangements			National guarantee fund and other regimes set up by providers of financial markets	Ministerial grant of financial assistance to superannuation fund trustee for loss from fraud or theft		Financial Claims Scheme for loss by depositors or policyholders due to insolvency of ADI or general insurer		

Issues of interest

Insurance market

ASIC concluded, on the basis of research in 2006, that the market for professional indemnity insurance was well supplied and competitive on price at that time. There appears to have been a tightening in this market in more recent years, in particular in the availability and cost of cover for financial advisers. Information and comment are sought on the current conditions in and prospects for the market in the supply of professional indemnity insurance to licensees. In particular, the following aspects are of interest:

2.1 The capacity of the insurance market to supply licensees with professional indemnity insurance cover that is adequate to the needs of licensees considering the specific features ASIC requires the licensee to take into account such as minimum levels of cover, excess amounts the licensee can confidently sustain, and coverage of EDR scheme awards.

2.2 The circumstances in which the market has been able to supply run-off cover to a financial services licensee.

2.3 The conditions, in terms of access and price, for reinsuring the risk of professional indemnity insurance provided to financial service licensees.

2.4 Changes in the availability of professional indemnity insurance for licensees since 2008 when s912B arrangements came into full operation, in terms of premiums, excess amounts, cost of including specific policy features, factors that have impacted on pricing this product, and the impact on licensees of any changes, particularly on those who provide financial advice.

2.5 The longer term outlook for the insurance market in terms of the supply, cost and coverage of professional indemnity insurance for financial service licensees in accordance with the requirements of s912B, associated regulations and guidance from ASIC.

2.6 The circumstances in which licensees have found it difficult to acquire professional indemnity insurance cover that meets their needs.

ASIC requirements for professional indemnity insurance

In administering the requirement that licensees who deal with retail clients have in place compensation arrangements, ASIC provides formal guidance on the factors to be taken into account by licensees in assessing the adequacy of their professional indemnity insurance. ASIC is able to approve in writing compensation arrangements other than professional indemnity insurance. Information and comment are sought on the experience of insurers, licensees and consumers with this approach. In particular, the following aspects are of interest:

2.7 The utility and effectiveness of the guidance provided by ASIC to licensees in enabling them to assess the adequacy of their professional indemnity insurance.

2.8 The adequacy of the current administrative approach in providing assurance that licensees meet their requirements to have adequate insurance cover.

2.9 The appropriateness of the current exemptions from the need to hold professional indemnity insurance cover.

2.10 The scope for a licensee in practice to make alternative compensation arrangements with the approval of ASIC.

Process for claiming compensation

Information and comment are sought on the experience of respective parties with the process for claiming and recovering compensation for loss or damage arising from a breach of a statutory obligation by a licensee. In particular, the following aspects are of interest:

2.11 Awareness by retail clients of the available dispute resolution schemes and compensation arrangements, and the degree of clarity to consumers about using those processes.

2.12 Any issues arising from the existence of separate compensation schemes and arrangements in various segments of the financial services sector (for example, NGF and FCS).

2.13 The possible scope for bringing together some of these schemes and arrangements or moving towards some form of common administration.

2.14 The experience of respective parties in making and responding to claims for compensation in terms of time, cost and outcomes, including claims pursued through an internal or external dispute resolution scheme or the courts.

2.15 Circumstances in which retail clients have been unable to recover compensation awarded to them, or have not pursued claims because of the low probability of being able to recover any award in practice.

2.16 Circumstances in which retail clients have found it difficult to pursue a claim for loss or damage against a provider of financial services, including where the provider is no longer carrying on business, has become financially stressed or insolvent.

2.17 Any experience in pursuing compensation from financial services providers who are not in fact licensed as required.

2.18 Any practical difficulties arising from differences between the standards of liability for licensees under Chapter 7 of the Corporations Act, the general law and under EDR schemes, and the ambit of liability covered in professional indemnity insurance policies obtainable by licensees.

2.19 Any issues in practice with compensation claims against licensees by retail clients in regard to the distinction between inappropriate advice or misconduct by a licensee on the one hand and investment losses in the absence of such misconduct on the other.

2.20 Ability of clients to pursue claims through EDR schemes against parties, other than licensees with whom they have dealt, who may bear some responsibility for loss or damage (for example directors or auditors).

2.21 Ability of licensees to seek recourse against other licensees or parties, who may bear some responsibility for the loss or damage suffered by a retail client, in relation to an award of compensation in favour of that client under an EDR scheme.

Chapter 3: Compensation arrangements in practice

This chapter reviews the practical operation of the compensation arrangements for retail clients of financial service licensees. It draws on available data and preliminary input from licensees, insurers, regulators and a dispute resolution scheme that deals with providers of financial services. It discusses the market for professional indemnity insurance for financial services; access to and costs associated with professional indemnity insurance for licensees; the role and limitations of professional indemnity insurance in assuring the provision of compensation; and circumstances in which retail clients may be unable to recover awards of compensation against licensees:

- Given the reliance on professional indemnity insurance as a basis for compensation, the availability and cost of appropriate cover in the market is a relevant consideration.
- There appears to have been a hardening in the professional indemnity insurance market for some, but not all, financial services providers in recent years. On the supply side, the number of insurers providing cover for financial advisers has contracted.
- The need to maintain insurance cover has an impact on the cost of services such as the provision of financial advice. While there does not appear to have been an increase in the premiums for professional indemnity insurance across the whole financial sector, anecdotal evidence suggests that premiums for some licensees, such as financial advisers, have increased substantially in recent years.
- Claims lodged by financial service providers under professional indemnity insurance policies appear to have increased significantly, particularly from 2008 onwards.
- Professional indemnity insurance assists licensees to meet claims by clients in many cases, but has some limitations in ensuring clients receive compensation to which they are entitled. Insolvency issues, policy exclusions and gaps in the cover that the market will provide, as well as caps on the amount of cover taken out, limit the extent to which professional indemnity insurance can ensure that clients are in fact compensated where they succeed in a claim against a licensee.

- Where a licensee does not have a policy that responds to a successful claim, the licensee remains under an obligation to meet that claim. A client's prospects of recovering compensation will depend on the available financial resources of the licensee. The client is exposed to the risk that the licensee may no longer be trading, have become insolvent or is otherwise unable to pay.

- While precise data is hard to come by, there are cases where retail clients succeed in obtaining awards of compensation but are not able to recover that compensation. There could well be other cases where clients do not pursue claims because the chances of achieving payment of any award are remote.

Market for professional indemnity insurance

3.1 Ahead of the introduction of the requirement for professional indemnity insurance, ASIC undertook research into the Australian market for such insurance, including the availability and affordability of cover for licensees.[1] The report on this market research concluded that:

> ... the market for professional indemnity insurance is well supplied with a wide choice of providers, policies and special schemes. It is highly competitive on price with few concerns about affordability or premium levels. It is not expected that licensees, who are not presently insured, will experience difficulty in obtaining [professional indemnity insurance] unless they have a poor track record or present unusually high risk exposure ...
>
> the immediate outlook for the market is positive, with predictions that the present favourable market conditions for licensees will continue. It is also expected that there will be a market correction within three years. Developments further into the future will be largely determined by the economic outlook and the re-insurance market ...
>
> if the insurance market is the preferred solution, then it must be accepted that the market is dynamic and that affordability and availability of [professional indemnity] cover is subject to change. There is a risk that licensees are unable to purchase comprehensive or adequate professional indemnity and that retail clients may not be able to recover their losses against licensees.[2]

3.2 As noted in the report, insurance markets are dynamic and the affordability and availability of professional indemnity cover is subject to change over time. In the market for professional indemnity insurance overall, there is little evidence of a cyclical change in the period since that report. A report by Finity consultants found that average professional indemnity premiums peaked in 2004 and were quite stable until the end of 2008 (the period for which data was available).[3] This trend is supported by available data from APRA's National Claims and Policies Database (NCPD), which is assessed further below.

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1 ASIC Report 107. *Compensation arrangements for financial services licensees – Research into the professional indemnity insurance market*, prepared by Melzan Pty Ltd, December 2006.
2 ibid – at pp 4-5.
3 *Professional Indemnity & Directors' and Officers'– The Market & Challenges*, Finity Consultants, January 2009.

3.3 The professional indemnity insurance market appears to be competitive and affordable overall. However, for providers of certain financial services, particularly financial advice, anecdotal evidence points to a hardening of the professional indemnity insurance market in the last few years. The recent high profile collapses of domestic financial product and service providers, such as Westpoint and Storm Financial, have probably contributed to the tightening in the insurance market for some licensees. It appears that providers of certain financial services, in particular financial advice, are more affected than others.

3.4 In its submission to the PJC Inquiry, ASIC referred to a hardening of the market for financial advisers. ASIC indicated that, in spite of that hardening, its inquiries indicated that the professional indemnity insurance market was still functioning appropriately for licensees overall.[4] Financial advisers were able to acquire cover, albeit at increased premiums.

3.5 In the same submission, ASIC expressed concern that a further hardening of the market was possible in the short term, potentially making it more difficult for some licensees to obtain adequate cover. In the medium to longer term, there was a question whether the market for professional indemnity insurance for financial advisers would return to the level of competitiveness that prevailed when the regulatory requirement commenced.

3.6 It appears that licensees are still able to obtain insurance, but with a trend towards higher premiums for some licensees.

Supply of professional indemnity insurance

3.7 While the precise number is hard to determine, discussions with industry indicate there are at least ten insurers providing professional indemnity insurance for licensees. However, not all underwriters provide cover for a full spectrum of financial services.

3.8 As discussed, there appears to have been a hardening of the professional indemnity insurance market for licensees providing financial advice. It is understood that there are four mainstream underwriters for financial advice, and that at least two insurers have ceased providing cover for financial advisers in recent years. One of the largest providers of professional indemnity insurance in the financial services sector ceased providing cover for financial advisers in 2009.

Demand for professional indemnity insurance

3.9 As noted in Chapter 1, there are close to 5,000 licensed providers of financial services, with around three-quarters authorised to deal with retail clients. ASIC estimates that currently some 3,400 licensees are required to hold professional indemnity insurance.

Access to insurance cover by licensees

3.10 In its submission to the PJC Inquiry, ASIC said that, based on its inquiries, the professional indemnity insurance market was functioning adequately for providers of

4 ASIC submission to PJC Inquiry, August 2009, pp 83-84.

financial services. Licensees were able to obtain cover, but it had become more difficult and expensive for some licensees, including financial advisers, to secure cover that adequately met ASIC's standards.[5] ASIC concluded that licensees, particularly those providing financial advice, faced:

- an increase in premium costs;
- a reduction in policy limits;
  - new policies might have tighter limits on some items, such as for dishonest conduct or an award under an EDR scheme;
- an increase in excluded activities;
  - new policies were unlikely to cover advice on margin lending or for run-off of claims following the end of a policy period (though some licensees are able to negotiate these if they can satisfy the requirements of the insurer);
- an increase in general exclusions;
  - for example, some policies exclude cover for failure by the licensee or its representatives to disclose conflicts of interest in advice documents;
- greater scrutiny of the activities of licensees;
  - insurers may review a licensee's approved product lists and specify those financial products they will or will not cover.

3.11 Licensees and insurance brokers have confirmed these general findings, particularly in relation to cover for financial advisers. A common message to this review from licensees is that they are negotiating with insurers in a less competitive market and it is harder for them to acquire cover that meets ASIC requirements.

3.12 Licensees have expressed concerns about:

- reluctance of insurers to provide the full cover sought by the licensee;
  - where the cover sought is in the upper range indicated by ASIC (say $20 million) the licensee may need to acquire a layered policy from two insurers who share the risk. Licensees are finding it more difficult to find an insurer willing to accept the primary layer of cover;
- difficulty in acquiring a policy that covers all of a licensee's activities;
- the added cost of acquiring cover for defence costs;[6]
  - ASIC requires cover for defence costs in addition to the minimum level of cover, or an increase in the level of cover to take into account those costs. It is said that licensees often meet this requirement by adding the expected cost of

5 ASIC submission to PJC Inquiry, August 2009, pp 82-84.

6 Defence costs are intended to cover legal costs associated with handling a claim. ASIC Report 107 (see footnote 1), suggests that legal costs for a court action were generally between 30-50 per cent of a claim in 2006.

defence to their policy cap, which can be a more expensive way of meeting that requirement.

- difficulty in acquiring cover for EDR scheme awards up to the compensation caps;
  - including to meet the increase in the compensation cap from $150,000 to $280,000 for investment related disputes which takes effect from the commencement of 2012;
- difficulty in acquiring cover for fraud and dishonesty by directors; and
- difficulty in acquiring cover for financial advice relating to particular products on a licensee's approved product list. If an insurer is unwilling to cover particular products due to the risk involved, licensees may be less willing to offer those products.

3.13 While the concerns flagged by licensees do not mean that they are ultimately unable to obtain cover, changes in the terms called for by ASIC may require further negotiation with insurers.

Cost of professional indemnity insurance

3.14 APRA collects data from insurers on premiums and claims for professional indemnity insurance. The data in Table 3.1 for financial occupations relates to an aggregated group which includes accountants and others who do not necessarily require a licence.

Table 3.1: Average written premiums for PII by underwriting year ($)[(a)]

Occupation	2005	2006	2007	2008	2009
Financial occupations(b)	8,922	7,681	6,874	6,300	6,459
All occupations(c)	4,106	3,430	3,152	3,071	2,829

(a) Excludes medical indemnity and malpractice insurance or directors' and officers' liability and employment practices insurance.
(b) Covers a number of financial occupations including brokers and financial planners.
(c) All occupations, including the financial occupations shown separately.
Source: APRA National Claims and Policies Database (NCPD).

3.15 Average professional indemnity insurance premiums for financial occupations have decreased since 2005, and have remained fairly stable from 2007 to 2009. Premiums for financial occupations are consistently more than twice as high as premiums for all occupations as a group. This could reflect higher levels of cover, as well as insurers' views on the risk associated with this group of policyholders.

3.16 Owing to limited available data, it is difficult to identify trends in premiums for specific occupations and sub-sectors of the financial services industry. However, licensees and insurance brokers have referred to an upward trend in premiums, with increases differing significantly according to the activities of the licensee. Insurance brokers have indicated that their own premiums have remained relatively stable in recent years. On the other hand, financial advisers and property fund managers appear to have experienced larger cost increases, with examples of annual premium increases up to 30 per cent. ASIC's submission to the PJC Inquiry also stated that financial advisers faced increased premiums.[7] Some licensees have said that professional indemnity insurance is becoming a relatively larger operating expense

7 ASIC submission to PJC Inquiry, August 2009, pp 82-84.

for their business. The experience of financial advisers appears to belie the position indicated by the aggregate APRA data which includes non-AFSL holders and 'financial occupations' other than financial advisers

3.17 Cost pressures for professional indemnity insurance may create an incentive for licensees to trade off some of their premium cost for a higher excess. A licensee who reduces its business costs by making this trade off would increase its financial exposure to future claims for compensation.

3.18 In its regulatory guidance, ASIC addresses the trade-off between the amount of excess under a policy and the cost of premiums and makes it clear it is the responsibility of the licensee to consider how they will cover the insurance excess if a claim is made. They are required to assess the financial resources required (to cover the excess and gaps in cover due to various exclusions) and to ensure they have such financial resources available. ASIC says that a licensee should be able to demonstrate to itself, as well as to ASIC, if necessary, that it has financial resources available to cover the excess and gaps in cover due to exclusions.[8]

Trends in insurance claims

3.19 Due to confidentiality provisions, publicly available data on professional indemnity insurance claims is limited. However, the Insurance Council of Australia (ICA) says there has been a significant increase in claims paid to financial advisers. It provided the following statement to the review:

> Data made available to the Insurance Council by its Members shows that professional indemnity insurance claims paid in relation to financial planners have climbed significantly over the past five years, increasing around fourfold. The data typically has a time lag between claims paid spikes and financial collapses. It can be expected with recent collapses such as Storm and the fallout of the GFC that the steeply upward trend of professional indemnity insurance claims paid will continue.

3.20 The ICA added that:

> The data demonstrates the significant role that professional indemnity insurance plays in ensuring that money is available to pay compensation for most breaches of the financial services law.

The upward trend in claims described by the ICA is supported by APRA data. Table 3.2 shows gross claims incurred for financial occupations according to the year in which the loss occurred. For example, a claim lodged in 2009 in respect of a breach, such as inappropriate advice, that occurred in 2007 would be recorded in the 2007 accident year. For some policies, the date of the loss may be recorded by insurers as the date that the claim was notified to the insurer.

3.21 Due to the nature of financial services, it may take several years for a breach to be identified and for a claim to be made. It follows that claims figures recorded for more recent accident years may understate the emerging experience. Table 3.2 shows a large spike in claims due to events that occurred in 2008. This may reflect the onset of the global financial crisis and collapses of various financial service and product providers.

8 ASIC RG 126, paras 47-49.

Table 3.2: Gross claims incurred for PII (by accident year) by occupation ($ million)[(a)]

	2005	2006	2007	2008	2009
Financial Occupations(b)	53.5	72.3	59.7	176.4	63.8

(a) Excludes medical indemnity and malpractice insurance or directors' and officers' liability and employment practices insurance.
(b) Covers a number of financial occupations including brokers and financial planners.
Source: APRA's NCPD.

3.22 Table 3.3 shows gross claims incurred for financial occupations according to the year the claim was paid, or that a change was made to the provision for a claim on the books of the insurer. These claims may relate to events and claims that date back some years and have taken time to settle.

Table 3.3: Gross claims incurred for PII (by calendar year) by occupation ($ million)[(a)]

	2005	2006	2007	2008	2009
Financial occupations(b)	26.3	58.9	67.8	77.3	224.1

(a) Excludes medical indemnity and malpractice insurance or directors' and officers' liability and employment practices insurance.
(b) Covers a number of financial occupations including brokers and financial planners.
Source: APRA NCPD.

3.23 Table 3.3 indicates a significant increase in claims incurred from the 2005 calendar year onwards and a very large jump (almost 300 per cent) in claims incurred from 2008 to 2009. This is likely to reflect the significant rise in claims incurred due to events that occurred in the 2008 accident year (shown in Table 3.2). It should be noted that data from the 2005 and 2006 calendar years have incomplete occupation information, some of which would have related to financial occupations.

3.24 Table 3.4 shows total professional indemnity insurance premiums written for financial occupations by underwriting year. A comparison of Table 3.4 with Table 3.3 shows that the value of claims incurred in 2009 was $224 million while the total amount of premiums written for the 2009 underwriting year was $178 million. One potential outcome of the disparity between these figures could be a flow-on impact on insurance premiums.

Table 3.4: Gross written premiums for PII by occupation and underwriting year ($ million)[(a)]

	2005	2006	2007	2008	2009
Financial occupations(b)	163.3	155.0	161.3	171.2	178.2

(a) Excludes medical indemnity and malpractice insurance or directors' and officers' liability and employment practices insurance.
(b) Covers a number of financial occupations including brokers and financial planners.
Source: APRA NCPD.

Insurance as a means of compensation

Benefits of professional indemnity insurance

3.25 It seems clear that professional indemnity insurance plays a large part in assisting licensees to compensate complainants. It provides a measure of assurance that a claim will be met. The insurance mechanism serves this purpose to the extent that claims are covered by the terms of a licensee's policy. However, as discussed below, this will not always be the case and there are also circumstances in which no policy will be in place to respond to a claim.

3.26 The use of a commercial insurance product as the basis for compensation may have an indirect benefit so far as insurers play a role in assessing the risk worthiness of licensees. Insurers typically have regard to a range of criteria in determining their underwriting risk, including a licensee's risk management processes and controls, the professional training of staff and audit processes, and the licensee's compliance record. Weaknesses may be identified through this process. Cover for high risk products may be declined, thereby encouraging the licensee to avoid such products.

3.27 In this way, the annual process of policy renewal provides an indirect check of the operating systems of licensees. A licensee who is unable to satisfy an insurer's process in order to obtain or renew cover, and who cannot obtain adequate cover from another insurer, is required to file a breach report with ASIC. A breach report will act as a red flag for ASIC and should attract attention and scrutiny of the licensee in question.

Limitations of professional indemnity insurance

3.28 There are some limits to the effectiveness of professional indemnity insurance as a mechanism for compensating retail clients who suffer a loss as a result of a licensee's misconduct. As stated in RG 126, ASIC intends to administer the professional indemnity insurance framework to reduce the risk, as far as possible, that retail clients go uncompensated where a licensee has insufficient financial resources to meet claims by retail clients.[9] However, professional indemnity insurance is an imperfect mechanism to achieve this protection for consumers.

3.29 In evidence to the PJC Inquiry, ICA noted that it is problematic to try to make a commercial product into a compensation mechanism.[10] ASIC is also of the view that

9 ASIC RG 126, p 4.
10 Ripoll Report, p 92.

there are inherent limitations on the effectiveness of professional indemnity insurance as a compensation mechanism for retail investors who suffer loss.[11]

3.30 The obligation to meet a successful compensation claim rests with the licensee in question. If, for whatever reason, the licensee's professional indemnity insurance policy does not respond to such a claim, the licensee is left to meet the liability from its own resources.

3.31 The gap in the current compensation arrangements arises where an insurance policy does not respond to a claim and the licensee is not otherwise in a position to meet the liability.

3.32 The PJC Inquiry received a substantial amount of evidence on compensation arrangements for retail investors, with a particular focus on the shortcomings of professional indemnity insurance. The Ripoll Report notes that:

> ... professional indemnity insurance is not intended to be a catch-all scheme designed to compensate investors whenever they have a successful claim against an adviser. It merely ensures that advisers can meet their obligations if a finding is made against them, if occurring in circumstances covered by the relevant insurance policy. Investors are not protected in a number of important situations, notably where the licensee has become insolvent, disappeared or behaved fraudulently ...

3.33 There are many reasons why a professional indemnity policy may not respond to a claim.

3.34 Some of the limitations flow from the 'long tail' nature of liabilities associated with providing financial services, combined with the 'claims made' basis of professional indemnity insurance policies. 'Long-tail' liability means that claims may be notified several years after the service is provided or the breach occurs. According to APRA, for professional indemnity insurance:

> ... the majority of payments being made are in respect of claims from accident years of between two and seven years before the current year.[12]

3.35 Where a claim is made after a policy expires, it will not be considered under the policy unless the policyholder has run-off cover. Given the difficulties many licensees face in obtaining run-off cover, this presents a particular problem for claims made after a licensee ceases to trade. By the time a loss is identified and a claim lodged, there may no longer be a policy in force to respond to the claim.

3.36 The limitations of professional indemnity insurance, and circumstances whereby a policy may not react to a claim, are described further below including where:

- there is no run-off cover available and the licensee has ceased to operate;
- the licensee becomes insolvent and the policy is subsequently cancelled;
- a licensee is in breach of its contractual obligations under the policy;
- the claim falls within an exclusion in the policy;

11 ASIC submission to PJC Inquiry, August 2009, p 83.
12 ASIC Report 107 p 23.

- a licensee faces multiple or large excess payments; and
- the claim exceeds a cap on the cover provided by the policy.

Run-off cover

3.37 Run-off cover provides cover for claims made after an insurance policy has ended with respect to loss or damage arising earlier while the policy was in place. As run-off cover is not generally available to licensees, it follows that professional indemnity insurance is of limited value in underpinning the payment of compensation claims after an insurance policy has ended.

3.38 In the absence of run-off cover, claims arising from events occurring during a period where the insurance policy was in place, but not made until after that policy has ended, will not be covered. It follows that a licensee who retires, or otherwise exits the market, may be exposed to claims without recourse to insurance cover. This increases the risk for claimants of not being able to recover compensation awarded to them.

3.39 As discussed in Chapter 2, ASIC proposed earlier to require licensees to hold run-off cover for a period of at least one year. However, ASIC found the insurance market was generally unwilling to provide run-off cover for financial services providers, and did not proceed with the proposed requirement.

3.40 It is noted that individual licensees may be able to secure run-off cover in some circumstances on the basis of their insurance history or other circumstances. Some professional bodies in the financial services sector have been able to secure run-off cover through master policies which are available to their members. Run-off cover, where it is available, can be relatively expensive.

3.41 Given the absence of generally available run-off cover, it is relevant to note that a significant number of licensees cease to carry on business each year. Table 3.5 shows the number of licences that have been cancelled, voluntarily or by ASIC, over the past five years.

Table 3.5: Australian Financial Services Licence cancellations

	2005 -2006	2006-2007	2007-2008	2008-2009	2009-2010
Voluntary cancellations	152	141	168	227	250
ASIC initiated cancellations	0	5	20	22	19

Source: ASIC database

Insolvency leading to cancellation of an insurance policy

3.42 ASIC and FOS have drawn attention to the limitations of professional indemnity insurance as a compensation mechanism in situations where a licensee becomes insolvent.

3.43 Some of the difficulties relate to the timing of a claim following insolvency. Where a claim is made while the licensee's insurance policy is in force, the claim can be dealt with even if the licensee has become insolvent. However, where the claim is made after the licensee's insurance policy has lapsed or been cancelled, the policy will not respond.

3.44 The settlement of an insurance claim after a licensee becomes insolvent is likely to involve the liquidator of the licensee's business. The liquidator may pay any excess provided under the policy in order to facilitate the claim and then pass on the amount recovered to the claimant net of the excess, or the insurance company may make a payment (net of the excess) to the claimant direct.[13]

3.45 A licensee will generally be required to notify its insurer if it becomes insolvent, and in many cases an insurer who is so notified will cancel the policy with effect within seven to thirty days. An insurance contract cannot be cancelled retrospectively, and any claims made prior to cancellation have to be dealt with under the policy.

3.46 In any event, the liquidator of an insolvent licensee may well discontinue the licensee's insurance policy on the basis that further premium payments would only be for the benefit of certain claimants.

3.47 Where a claim is made in circumstances where a licensee has become insolvent and professional indemnity insurance policy is no longer in force, the claimant will only have rights as an unsecured creditor in the winding up of the licensee's business. A claimant is unlikely in those circumstances to recover all, if any, of the compensation to which it may be entitled.

Breach of insurance contract

3.48 An insured party normally has a number of obligations under an insurance contract such as to inform the insurer about a claim or loss as soon as possible, and to take reasonable steps to lessen liability in relation to a claim.

3.49 If a licensee fails to meet such an obligation, the insurer may be entitled to deny payment of a claim.[14] Further, an insurer who can demonstrate that the breach has a material impact on the risk associated with the policy may be entitled to cancel the contract. [15] Non-payment of claims or cancellation of a contract can lead to protracted disputes between the licensee and insurer and any delay could add to the financial pressure on a licensee.

Caps in insurance contracts

3.50 Professional indemnity insurance contracts generally provide cover up to a capped amount. As stated in RG 126, ASIC considers that, to be adequate, a licensee's professional indemnity insurance policy should have a limit of at least $2 million and up to $20 million, depending on the total revenue the licensee derives from retail clients.[16]

13 Section 562 provides that the proceeds of an insurance contract should be paid to the third party that has incurred the liability in priority to the payments of the company's debt (though there may be exceptions).
14 Section 54 of the *Insurance Contracts Act 1984* provides that the insurer is not automatically entitled to deny payment of a claim in the case of breach of a contract. In the case of relatively minor breaches, the insurer may be entitled to reduce the insurance payout to the extent the breach of contract had a material impact on the claim.
15 Cancellation of insurance contracts is dealt with in Part 7 of the *Insurance Contracts Act 1984.*
16 ASIC RG 126, p 24.

3.51 ASIC also calls for a policy to include at least one automatic reinstatement.[17] ASIC believes that automatic reinstatement is generally available in the market, but acknowledges that it may come at a higher cost than for prior premiums.

3.52 Where a licensee is faced with a large number of claims, or several large claims, the amount awarded to claimants in aggregate may exceed the capped amount of its cover. To the extent that the claims exceed the cover provided by its insurance policy, the licensee will have to meet them from its own financial resources if reinstatement is not available.

Excess payments

It is common for insurance policies to require the policy holder to bear an excess or deductible amount when a claim is made. To the extent that an excess or deductible is payable, the licensee is self-insuring. The larger the excess or deductible, the more financial pressure a licensee may come under when faced with a claim. Where a licensee is faced with a large number of claims, this pressure will be exacerbated.

Policy exclusions

3.53 Professional indemnity insurance contracts commonly include a number of exclusions or circumstances under which the policy will not cover a claim. For example, some insurers will not cover certain products on a licensee's approved product list (APL).[18] The excluded products may be higher risk or more complex products. Losses arising from the fraudulent or dishonest conduct of a licensee are also typically excluded. Where a claim falls within a policy exclusion, the insurance contract will not respond and the licensee will have to meet the claim from its own resources.

Consequences where insurance not available

3.54 As indicated above, there are various circumstances in which a licensee will not be able to claim against a professional indemnity policy, or claim the full amount, in order to meet its liability to a retail client. In those circumstances, the licensee remains liable to meet that claim from its own resources.

3.55 The claimant is then exposed to the risk that the licensee will not be in a position to meet the claim owing to the closure of its business, insolvency or other reason. Where the licensee has become insolvent in the absence of insurance, the claimant's only avenue for compensation is through the liquidation process. As an unsecured creditor the claimant is unlikely to recover all, if any, of its claim.

3.56 The essence of the problem for a claimant, where a licensee is not able to look to an insurer to cover a claim, is that the licensee may be insolvent (or become insolvent as a result of claims against it), is no longer trading or in a position to provide compensation.

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17 Automatic reinstatement means that if the limit of the policy is exhausted before the end of the policy period, the limit of indemnity is reinstated for the balance of the period to cover any new claims that might arise.

18 An APL is a list of financial products which a licensee is comfortable recommending to clients. Licensees would typically perform due diligence and research when determining whether a product will be included on their APL. Many though not all licensees use an APL, and some licensees only permit their authorised representatives to recommend products that are on the approved list.

Inability of retail clients to recover compensation

3.57 It seems clear that cases do arise where retail clients are unable in practice to recover compensation awarded in their favour. However, it is not easy to gauge the magnitude of the problem. Information provided by ASIC and FOS sheds some light on the problem but precise data is limited. For example, it may not capture the outcome of all claims, such as where they are settled, or fully reflect instances where claims are not pursued owing to the limited prospect of recovering any award made against the licensee.

3.58 Part of the problem lies in distinguishing between investment losses, such as may follow the collapse of a product provider, and losses that can be attributed to a financial services provider breaching its legal obligations, for example by providing inappropriate advice.

3.59 It should be noted too that it is not clear from the available information whether, in the cases where retail clients are unable to recover compensation to which they are entitled, the licensees had in fact taken out and maintained insurance cover as required, or whether such cover had lapsed following the winding up of the licensee's business or was still in force but did not respond to the claim.

3.60 FOS has provided some information about cases in which clients were not able to receive compensation where one of its members became insolvent. The data covers 78 claims for compensation which involved members (licensees) at the point of insolvency in the five years to December 2009.[19] In aggregate, a total of almost $4.6 million was awarded in compensation, but claimants only recovered $2.7 million of that amount.

3.61 Further information provided by FOS indicates that in the period September 2007 to September 2010, it handled 69 complaints where the member became insolvent. Table 3.6 shows the outcomes of those claims. In almost 60 per cent of cases, the claim was withdrawn by the complainant.

Table 3.6: Outcome of complaints to FOS against insolvent financial advisers

Outcome	Number of Claims
Withdrawn by complainant	41
Found in favour of complainant	10
Found in favour of member	4
Yet to be finalised	3
Resolved by member without FOS involvement	2
Outside jurisdiction	9
Total	**69**

Source: FOS.

FOS is aware that, in at least 6 of the10 cases where it found in favour of the complainant client, the complainant received no payment of compensation. In at least two of these cases, the reason for non-payment of compensation was lack of funds available for unsecured creditors and lack of available professional indemnity insurance.

19 FOS says this data is not exhaustive of all cases involving insolvent licensees during this period and it is likely there were other cases involving insolvent licensees.

3.62 FOS believes that the figures are likely to under-represent the number of claims relating to insolvent licensees. This is because many claims, or initial approaches to FOS, are withdrawn by the complainant or not pursued once the licensee becomes insolvent as the complainant considers the chances of recovery to be low.

3.63 Other clients with grievances against an insolvent licensee (or a licensee on the verge of insolvency) may not take their complaint to an EDR scheme for the same reason.

3.64 Apart from the aggregate FOS data referred to above, reference has been made to some specific cases, discussed below, where claimants have been unable to recover compensation that has been awarded to them.

Westpoint

3.65 In early 2006, the Federal Court ordered the winding up of Westpoint Corporation Pty Ltd (Westpoint) following an application by ASIC on the grounds of insolvency. Investors had outstanding capital of $388 million invested in Westpoint financial products at that time.

3.66 Westpoint's difficulties related to a number of projects for which part of the funding was raised through the issue of promissory notes, a form of debenture, to retail investors. Retail clients generally made their investments in a Westpoint financial product following advice from a financial adviser. Retail clients have claimed losses, at least in part, because of the poor or misleading advice received. ASIC has brought successful actions against seven financial adviser groups as well as other parties. These actions involved the use of ASIC's section 50 powers on behalf of investors.[20] It is noted that Westpoint was found in the legal proceedings to have been operating an unregistered managed investment scheme and had not held a license.

3.67 Table 3.7 provides some information about ASIC's actions against financial advice groups in relation to Westpoint.

20 For a description of these powers see para 2.35.

Table 3.7: Compensation recovered by Westpoint investors as a result of ASIC action

Defendant Financial service provider	Subsequent insolvency of the business	Investors for whom ASIC sort compensation	Total damages claimed	Amount determined through settlements
Masu Financial Management Pty Ltd	No	85 (25 other investors took separate legal proceedings).	$12.6 million	Settlement details not disclosed
Professional Investment Services Pty Ltd (PIS)	No	247	$22.8 million	$5.9 million
Bongiorno Financial Advisers Pty Ltd/Bongiorno Financial Advisers (Aust) Ltd	Bongiorno Financial Advisers (Aust) Pty Ltd is no longer licensed. Bongiorno Financial Advisers Pty Ltd is currently licensed.	125	$8.5 million	$2.6 million
Glenhurst Corporation Pty Ltd	Yes	90	$7.1 million	$2.5 million
Brighton Hall Securities Pty Ltd	Yes	200	$14 million	Not yet resolved
Dukes Financial Services Pty Ltd (now known as Barzan Pty Ltd)	No	159	$12.2 million	$1 million
Strategic Joint Partners Pty Ltd	No	80	$6.5 million	Not yet resolved

Source: ASIC FIDO and Westpoint investor website pages

3.68 Drawing from data in Table 3.7, for cases where the settlement amount is publicly known, the average claim against adviser groups was approximately $81,000 and the average settlement amount was approximately $19,000 per investor.

3.69 As far as ASIC is aware, all amounts of compensation agreed in settlements in Table 3.7 have been paid, or will be paid, to affected clients. In the case of Glenhurst Corporation Pty Ltd, the settlement was reached with its professional indemnity insurer. It should be noted that Westpoint investors who benefited from the settlements in Table 3.7 may also have benefited from other ASIC actions and FOS determinations described below.

3.70 ASIC has pursued, or is in the process of pursuing other actions against auditors, directors, and a trustee in relation to Westpoint. On 1 February 2011, ASIC announced it had reached agreements to settle the actions it brought against certain directors and the former auditors of Westpoint.[21] Those settlements will result in the recovery for the benefit of investors through the liquidation process of up to an additional $67.45 million. Overall, over the five years since the company collapsed, investors in Westpoint have recovered an average of approximately 43 cents for each dollar invested.

3.71 Separate from the actions pursued by ASIC, according to a report prepared by Professional Financial Solutions Pty Limited (PFS) over 400 Westpoint investors pursued complaints against licensees, largely adviser groups, through FOS over the period 1 January 2006 to 30 June 2008. Of these claimants, 37 had awards made in their favour by FOS but did not receive any compensation because of the insolvency of the respondent licensee. The unpaid amount was in the order of $2.4 million. [22]

21 *ASIC settles Westpoint compensation litigation,* ASIC media release 11-17, 1 February 2011.

22 *Proposal to Establish a Financial Services Compensation Scheme*, prepared by Professional Financial Solutions Pty Limited for Financial Ombudsman Service, October 2009.

Further claims made to FOS were deemed to be outside its jurisdiction. It should be noted that the cases in which claimants did not receive any compensation because of insolvency may also be referred to in the FOS cases referred to in paragraph 3.59.

3.72 FOS has informed the review that any apparent inconsistency between the number of Westpoint awards described in the PFS report and the data in Table 3.6 is due to the timing of the determination of those cases. FOS says many Westpoint cases were determined before September 2007.

3.73 In addition to the data in the PFS report, FOS has provided information about some further cases involving Westpoint investors determined since that time in which claimants did not receive full payment of amounts awarded to them. In nine separate cases, a total amount of $540,000 was awarded to complainants. As far as FOS is aware, in four of those nine awards, no compensation was received by the complainant. In the remaining five awards, the claimants recovered something through the liquidation process, but less than the amounts awarded to them. For all Westpoint cases it has considered to date, FOS indicates it has awarded a total of $8.5 million to complainants. Therefore, combining the available data on unpaid awards, it appears that somewhere in the vicinity of 30 per cent of the total amount awarded by FOS has not been paid.

Storm Financial

3.74 Another collapse of a financial services provider causing large scale loss to retail clients was Storm Financial (Storm) which had approximately 14,000 clients, about 3,000 of whom held margin loans for share market investments. Storm went into administration in December 2009 after receiving notice from the Commonwealth Bank of Australia (CBA) to repay its corporate debt facilities within 24 hours.

3.75 ASIC is currently investigating a range of issues relating to Storm and its collapse, including investments in home lending and margin lending as well as related advice. These investigations formally began on 12 December 2008 and are ongoing.[23]

3.76 ASIC has begun penalty proceedings against the directors of Storm, and has also decided to commence compensation proceedings against the CBA, Bank of Queensland Limited and Macquarie Bank Limited on behalf of Storm investors. There are also lawsuits brought by law firms on behalf of Storm investors.

3.77 It is not yet clear whether ASIC will bring actions relating to inappropriate advice or other breaches of Chapter 7of the Act, or the extent to which claims by retail investors relate to such breaches. It also remains to be seen whether any compensation which may be awarded to affected investors in respect of such breaches will ultimately be recovered by them.

Other corporate collapses

3.78 According to ASIC and FOS, a handful of small and medium sized licensees are generally wound up each year with outstanding claims against them by retail clients. ASIC says that such a case might involve a licensee with a number of outstanding claims amounting to several million dollars.

23 ASIC Storm Investor website including AD08-09 of 24 December 2008.

3.79 As already noted, the ability of the claimant to recover compensation in such cases will depend on the licensee's available financial resources or its success in claiming under its professional indemnity policy.

3.80 FOS has referred by way of example to a recent case in which approximately $1.2 million has been awarded in favour of complainants, with an average award of about $91,000. None of the awarded amount has been received by complainants at this time. FOS is still to consider further claims against the same licensee amounting to approximately $2.9 million.

Issues of interest

Premium and payout experience

Information and comment are sought on trends in premiums for professional indemnity insurance borne by licensees, and on claims experience under those policies, from 2008 when the requirement for professional indemnity insurance was applied broadly to licensees. In particular, the following aspects are of interest:

3.1 The trend in premiums for professional indemnity insurance taken out by financial services licensees, and the factors behind that trend.

3.2 The trend in claims paid under professional indemnity insurance held by those licensees and the value of claims made under those policies which are still outstanding.

3.3 As a subset of the above, the proportion of the premiums received from, and claims paid out to, licensees who provide financial advice.

3.4 The typical grounds upon which claims under professional indemnity insurance policies are not met.

Experience with compensation arrangements

Comment and perspectives are sought on the effectiveness of current compensation arrangements, including the costs and benefits for consumers and industry of the reliance on professional indemnity insurance as the default arrangement for compensation. In particular, the following aspects are of interest:

3.5 The costs and benefits of professional indemnity insurance for licensees and the financial services industry more broadly.

3.6 The level of assurance to retail clients that claims for loss or damage will be dealt with and awards for compensation paid.

3.7 The contribution of the current compensation arrangements in maintaining confidence by retail clients in dealing with financial services providers, including financial advisers, and in underpinning responsible behaviour by licensees.

Chapter 4: Comparison with other arrangements

This chapter outlines the compensation arrangements for consumers in some other countries in relation to their dealings with financial intermediaries. It also refers to arrangements in other industry sectors. In brief:

- The United Kingdom has a two-tiered approach to the protection of retail consumers and small businesses with claims against financial intermediaries:
  - depending on their size and risk profile, investment firms have to meet a capital requirement as well as hold professional indemnity cover;
  - the Financial Services Compensation Scheme provides last resort protection where a firm becomes insolvent or is otherwise unable to meet a claim.
- Other members of the European Union, Canada and the United States have narrower compensation arrangements to protect clients against losses of funds held by investment firms on their behalf.
- Within Australia, compensation schemes are in place in some industry sectors apart from the financial sector.

4.1 A number of other countries have compensation arrangements to provide some protection for consumers who suffer losses as a result of their dealings with providers of financial services. Most of these arrangements are limited to the provision of compensation to investors in securities, derivatives or futures markets who suffer losses due to the insolvency of intermediaries holding funds or securities on their behalf.

4.2 Arrangements of this kind are required in the European Union and are found also in the United States and Canada. They apply to losses arising from failures in undertaking financial transactions through a financial services provider rather than losses arising from financial advice. These regimes more closely resemble the market compensation regimes under Part 7.5 rather than the compensation arrangements for licensees under Part 7.6 of the Corporations Act.

4.3 In the United Kingdom, on the other hand, there is a more comprehensive compensation scheme that covers the activities of all financial service providers and is not limited to client losses of money or financial instruments held by an investment firm on a client's behalf.

4.4 The scheme includes a fund of last resort (the Financial Services Compensation Scheme (FSCS)) which pays compensation in specific circumstances if an investment firm is unable to meet a claim by a client.

4.5 The compensation arrangements described above have all of the following features in common:

- a claim can only be made on the fund where the financial services provider is unable to meet a claim (for some schemes the provider has to be insolvent);
- a capping of the compensation payout;
- the funding of compensation from industry levies; and
- operation through a scheme which is independent of the regulator (although some schemes are accountable to the regulator).

Table 4.1 provides a high level comparison of the schemes found in other countries.

Table 4.1: Summary of overseas compensation schemes

	United Kingdom	European Union	Canada	USA
Scope	Firms offering financial services are required to hold minimum capital, professional indemnity insurance, or a combination of both to meet certain liabilities, including liabilities arising from compensation payments to their clients. In addition a scheme of last resort applies to client losses from services of deposit taking, insurance, home finance, investments, pensions and endowments.	Client losses of money or financial instruments held by an investment firm on their behalf	Client losses of money or financial instruments held by an investment firm on their behalf	Client losses of money or financial instruments held by an investment firm on their behalf
Grounds for claim	Financial services firm unable to pay a client because it has stopped trading, is insolvent or has insufficient assets	Investment firm unable to return client's money or securities	Insolvent investment firm unable to return client's money or securities	Insolvent investment firm unable to return client's money or securities
Applicant	Retail clients and small business	Normally retail clients	All investors	All investors
Compensation	For investments, the maximum compensation is 100 per cent of the first £50,000	Minimum compensation per investor of at least 90 per cent of the first €20,000	Maximum compensation of $1 million	Maximum compensation of $500,000
Funding	Industry funding	Industry funding	Industry funding	Industry funding
Governance	Independent scheme accountable to regulator	Independent schemes accountable to regulators	Independent scheme	Independent scheme

UK compensation arrangements

4.6 In the United Kingdom, there is a two-tiered compensation regime for losses arising from activities of financial services providers. Depending on their size and risk profile, investment firms have to meet a capital requirement as well as hold professional indemnity cover (first tier). There is also a fund of last resort, the FSCS, for certain consumer claims (second tier).

4.7 Under the first tier, the minimum capital requirements for investment firms are risk-based and are dependent on the type of activity being undertaken (for example, an investment firm dealing as principal will be subject to more demanding requirements than one advising or dealing as an agent) as well as the nature of the assets on the balance sheet.

4.8 Professional indemnity insurance is another component of the first tier arrangements. Under an EU directive, insurance intermediaries (which include those arranging life assurance) must hold a minimum level of professional indemnity cover. It is also regarded as best practice in the UK for all investment intermediaries to have adequate professional indemnity insurance. Some categories of firms can choose to hold additional capital as an alternative to the prescribed levels of insurance cover.

4.9 Investment firms are required to meet the capital and professional indemnity insurance requirements set out in the relevant Prudential Sourcebook. The requirements are generally less onerous than those imposed on deposit-taking institutions such as banks and building societies, but can still be substantial as they are intended to reduce the impact of insolvency.

4.10 The second tier is FSCS which operates as a fund of last resort for certain customers of firms authorised by the Financial Services Authority (FSA) to operate services of deposit taking, insurance, home finance, investments, and pensions and endowments. An individual or small business customer can look to FSCS for compensation in circumstances where a firm against which it has a claim is insolvent or is otherwise unable to meet the claim, being a claim arising from bad investment advice, poor investment management, misrepresentation, fraud, or failure to return the invested funds of the claimant.

4.11 Where a claimant is compensated under FSCS, its rights against the firm with which it dealt are assigned to FSCS which can pursue recovery. If FSCS recovers more from the firm than it paid out under the scheme it returns the excess to the claimant.

4.12 The scheme is funded by levies on firms authorised by FSA. The levy model covers five broad classes of financial services providers, each with its own annual levy limit. When a financial provider defaults, a levy is made first against that firm's class up to the levy limit. If the pool of compensation required exceeds that levy limit, other classes of providers are asked to contribute up to their own annual levy limits. This cross subsidisation from other classes provides a general pool which is currently over £4 billion. The levies are collected on a 'pay as you go' basis to meet the amounts known or likely to be required each year.

4.13 Further details of FSCS are provided in Table 4.2.

Table 4.2: UK compensation scheme

Financial Services Compensation Scheme

Scope

FSCS works as a fund of last resort for certain customers of firms, authorised by FSA, which provide deposit taking, insurance, home finance, investment, pension and endowment services.

Claims may be brought by retail and small business customers.

Grounds for compensation

A customer can look to the scheme for compensation where a financial services provider is unable to pay claims against it because it has stopped trading, has insufficient assets or is insolvent. Claims against a firm that is still trading must be dealt with by the firm or the Financial Ombudsman Service.

For investment claims, FSCS provides protection where:

- an investor suffers a loss arising from bad investment advice, poor investment management, misrepresentation or fraud; or
- an authorised firm cannot return investments or money owed to a customer.

For claims based on inappropriate advice, FSCS only pays compensation for actual (or direct) financial loss that is essential and fair (to put the consumer back in the position they would have been in but for the advice). The Financial Ombudsman Service, on the other hand, may also order a firm to pay for 'distress and inconvenience' (or indirect or consequential loss).

Compensation not available

Compensation is not available where:

- the claimant has not suffered financial loss;
- an investment has not performed well;
- the financial services firm did not cause the financial loss;
- the financial services firm is still trading and has sufficient resources to meet a claim itself; or
- the firm is no longer in business but it (or its owners) are still able to pay the claim.

Conditions

Claimants may be asked to assign their rights against the financial services firm to FSCS. Any recoveries by FSCS through the exercise of those rights, in excess of the compensation paid, are returned to the claimant.

Assessment of claims

FSCS considers the eligibility of a claim for compensation under its rules. FSCS has regard to guidance from the regulator where relevant and discusses approaches with the Financial Ombudsman Service and relevant trade bodies.

In considering a claim based on inappropriate advice, FSCS gathers and examines evidence (from the consumer, as well as client files and information from the product provider) and looks at the consumer's attitude to risk and investments to establish whether:

- the advice to invest in the product was suitable for the needs of the consumer at the time; and
- the consumer was advised of the risks associated with the product.

To proceed with the claim, FSCS must be satisfied that there is a financial loss for which the firm is liable.

Financial Services Compensation Scheme

This assessment process is followed whether or not a court or the Financial Ombudsman Service has made a decision in favour of the claimant. While FSCS's rules do not specifically recognise court decisions and ombudsman determinations, FSCS is not precluded from having regard to a decision or determination in its assessment of the merits of claim.

Compensation payable

The maximum recovery in relation to firms declared in default on investments is 100 per cent of the claim and not more than £50,000 in the aggregate for all types of claims (per investor, per defaulting firm).

Funding

The scheme is funded by levies on firms authorised by FSA. It also receives recoveries and has access to borrowing facilities.

Separate levies apply to each of five broad classes (deposits, life and pensions, general insurance, investments and home finance). The latter four classes have two sub-classes made up of firms which are either providers or intermediaries and:

- engage in similar styles of business with similar types of customers; and
- share a common interest in protecting their collective good name.

(A firm could belong to more than one sub-class according to the activities it undertakes.)

A firm's contribution reflects the levy applicable to its sub-class and the level of the firm's activity (for advisers, the basis is commission and fee income).

The model operates on the basis that a sub-class will meet the compensation claims from defaults in that sub-class up to its levy threshold. Once a sub-class reaches its threshold the other sub-class within the class will be required to contribute to any further compensation costs up to its own threshold for the class.

The levy limits for each class are:

- deposit — £1,840 million;
- general insurance — £970 million (£775 million for providers and £195 million for intermediaries);
- life and pensions — £790 million (£690 million for providers and £100 million for intermediaries)
- investment — £370 million (£270 million for fund management and £100 million for intermediaries); and
- home finance — £130 million (£70 million for providers and £60 million for intermediaries).

A final layer of cross-subsidy is available from the general retail pool, through which all other classes support any class which has reached its threshold. The general retail pool has an aggregate capacity of approximately £4.03 billion.

Firms pay a Management Expenses Levy which comprises base costs (not dependent on levels of activity) and specific costs (the costs of assessing claims and making payments). The overall management expenses levy limit (that is, the limit amount that FSCS can levy without further consultation) for 2010-11 has been set at £1 billion.

Levies are collected on a pay as you go basis to reflect the amounts known, or likely, to be required each year to provide liquidity for timely payment of compensation claims. In 2009-10, the levies from investment fund management were £3 million and compensation of £0.92 million was paid.

Financial Services Compensation Scheme

Governance

The compensation scheme is operated by FSCS, a company limited by guarantee and established by FSA under the *Financial Services and Markets Act 2000*. FSCS is independent of the government and the financial industry. It is independent of FSA in decision-making but is accountable to it as FSCS's rules are made by FSA and included in the compensation section of its Handbook.[1]

Board appointments are made by FSA with the appointment of the Chairman also approved by HM Treasury.

Operation of UK arrangements

4.14 The effectiveness of the first tier requirements in protecting consumers is hard to gauge. Professional indemnity cover is not a product which is intended to protect consumers directly. It is designed to cover the liability risk of the insured (the investment firm) and in so doing may enable consumers to recover from the firm.

4.15 FSCS began operation in 2001 following the amalgamation of six existing compensation schemes. Its effectiveness appears to have been more robustly tested following the global financial crisis and global downturn.

4.16 FSCS received 24,301 claims in the investment sub-class in 2009-10 compared with around 4,000 in the previous year. This class of claims represented by far the largest proportion of the total of 31,592 claims across all classes. The significant increase in investment claims is attributable in large part to the number of claims received following the failure of Keydata Investment Services Limited, Pacific Continental Securities (UK) Limited and Square Mile Securities Limited. FSCS processed around 15,000 claims in the same period and 90 per cent resulted in payout offers. The average compensation payment was £10,799.[2] According to FSCS's annual report, most of the claims were in relation to the mis-selling of investment products such as pensions, 'penny' shares and endowment policies.

New prudential requirements

4.17 Investment firms in the United Kingdom are in the process of implementing new prudential rules that require them to hold more capital resources by December 2013. The new rules require all investment firms to hold capital resources worth at least three months of their annual fixed expenditure (the amount of expenditure a firm is committed to pay regardless of its income level) with a minimum holding of £20,000. As part of the changes, a separate requirement that investment firms hold own-funds of £10,000 will be removed.

4.18 The aim of the change, according to the prudential regulator, is to ensure that investment firms are better capitalised to withstand any future financial shocks.[3] FSA has estimated that, as a result of the capital resources proposal, investment firms collectively will hold an additional £600 -- £850 million of capital. FSA assesses that

1 http://fsahandbook.info/FSA/html/handbook/COMP.
2 FSCS Annual Report 2009-10 available at http://www.fscs.org.uk/industry/publications/annual-reports/ .
3 *FSA sets out new prudential regime for personal investment firms*, Press Release issued by the Financial Services Authority, 6 November 2009.

the requirement for higher capital resources will increase the incentive of investment firms to 'reduce the incidence of unsuitable advice' and will enable firms to provide redress for consumers with less reliance on FSCS.[4]

4.19 Investment firms are currently required to hold sufficient additional capital resources to cover the exposure created by exclusions in their professional indemnity insurance. FSA has stated that it does not object to the practice of firms using 'policy exclusions to improve the cost effectiveness of professional indemnity insurance', and has noted the practice of investment firms to use exclusions to reduce their premiums or gain access to a policy, especially when the insurance market hardens.[5] However, FSA has clarified its rules on the minimum level of additional capital required to cover an investment firm's likely liabilities arising from exclusions in its insurance cover. (Policy exclusions that are not relevant to the business conducted by a particular investment firm are not caught by the requirement.) FSA has calculated that this change will result in around 2 per cent of investment firms having to hold additional capital resources to cover exclusions in their policies.

4.20 FSA has also recently considered mechanisms to deal with claims for compensation made against an investment firm after it has ceased to trade. FSA's aim is to have departing firms bear more of the costs of subsequent claims made against them, with less of the burden falling on operating investment firms through claims on FSCS. FSA has explored in its consultation paper options for requiring departing firms to 'leave resources behind'. These include creating a trust that holds run-off cover, or allowing departing firms to make their own arrangements, for example by arranging to transfer responsibility to another investment firm for compensation claims received in respect to past business.[6]

4.21 FSA has noted a number of practical issues that would need to be resolved to apply a mechanism to have firms 'leave resources behind'. FSA has not yet made a policy decision on this issue.

Proposed changes to UK regulatory architecture

4.22 The UK Government announced changes to its financial sector regulatory architecture in June 2010, with draft legislation expected in mid 2011 and proposed commencement at the end of 2012. The proposals are for a dual regulatory model for the financial sector (together with a new Economic Crime Agency). That is:

- a new Financial Conduct Authority (FCA) which will have the role of consumer protection and market conduct for financial markets and will supervise all retail and wholesale services firms. FCA will also have oversight of the Financial Ombudsman Service, the Consumer Financial Education Body, and FSCS; and

- the Prudential Regulation Authority (PRA) which will continue in its role of monitoring financial institutions but will operate as a full subsidiary of the Bank of England.

Under the proposed changes, FSA will cease to exist in its current form.

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4 *Review of the Prudential Rules for Personal Investment Firms*, Consultation Paper 08/20, FSA, November 2008, and the subsequent Policy Statement 09/19 issued in November 2009.
5 ibid.
6 FSA Consultation Paper 08/20, FSA (see footnote 4), chapter 4

4.23 There is no suggestion at this stage of any change in coverage for the compensation arrangements operated by FSCS. A discussion paper issued in February 2011 proposed an operating model whereby FCA and PRA will jointly take on the FSA's powers and responsibilities in relation to FSCS. The proposal would involve each regulator having distinct rule-making powers in relation to FSCS: [7]

- PRA to have responsibility for making compensation and fee rules on deposits and insurance; and
- FCA to have responsibility for making compensation and fee rules relating to all other types of financial activity covered by the compensation scheme.

Schemes in other countries

4.24 The investor compensation schemes in other EU member countries, the Investor Protection Fund in Canada and the Securities Investor Protection Corporation in the United States are more akin to Australia's market-based National Guarantee Fund (NGF). The rationale for these schemes appears to be to enhance trust, confidence and integrity in intermediary firms that hold funds on behalf of clients.

4.25 Within the EU, the investment compensation scheme directive requires member states to establish compensation schemes in relation to authorised investment firms supplying investment services.[8] The measures aim to protect investors against the risk of losses should an investment firm be unable to repay money or return financial instruments held on a client's behalf. The schemes protect investors against the risk of loss of their assets through theft and fraud, unintentional errors, negligence or system breakdowns. They do not protect consumers for losses arising from inappropriate investment advice.

4.26 The directive establishes principles, provisions and definitions but member states can implement the Directive to suit their domestic situations (including going beyond recommended standards). In practice, the schemes operating in member states vary considerably.

4.27 Following a 2005 survey of the operation of the compensation schemes, and in the wake of the global financial crisis, the EU is undertaking a review of the operation of the directive. The review is intended to consider the implications of changes in the regulatory framework for the provision of investment services across Europe and to increase the coverage levels required under the deposit guarantee schemes directive. Proposals under consideration include increasing the compensation cap, requiring schemes to have some pre-funding and to have the capacity to borrow between national schemes, and to reduce delays in payouts to consumers.

4.28 Additional information on the EU, Canadian and US compensation schemes is set out in Attachment B.

4.29 In the US, regulators in most states also require investment advisers to be bonded or to maintain minimum net capital requirements, with the level of

7 *A New Approach to Financial Regulation: building a stronger system*, Her Majesty's Treasury, February 2011.

8 Directive 97/9/EC: The Investment Compensation Scheme Directive.

requirement dependant on whether the adviser has custody of client funds or securities. Investment advisers are licensed with state regulators, rather than the federal securities regulator, if their assets under management are below $25 million.[9]

Operation of schemes in Canada, USA and EU

Canadian Investor Protection Fund

4.30 Since the inception of CIPF in 1969 there have been 17 member insolvencies. CIPF has made payments of $36 million, net of recoveries, and no eligible customers have suffered a loss of property.[10]

Securities Investor Protection Corporation (USA)

4.31 From 1970 to 2009, SIPC advanced $1.2 billion in order to make possible the recovery of assets for an estimated 763,000 investors.[11]

EU

4.32 It appears that some countries have had significant claims experience, while others have had very little or no call on their schemes. There is limited information to hand in relation to the experience of individual member countries, but by way of example:

- In Ireland, an Irish stockbroking firm ceased trading in April 2001 following the discovery of financial irregularities and the misappropriation of assets from clients' accounts. The scheme received 2,606 claims, verified 2,235 for payment and rejected 371. The scheme paid more than €7.5 million to claimants in respect of verified claims.

- In Spain, there have been more than 8,000 claims with almost 7,000 from the insolvency of one broker. Compensation funds of €31.8 million were made available.

Compensation schemes in other industry sectors

4.33 Last resort compensation schemes have been established by State and Territory legislation for particular industry sectors other than financial services.

4.34 Solicitors and law firms have to contribute to a fidelity fund in the jurisdiction in which they practice to cover the circumstance where a client has lost money held in a solicitor's trust account due to a failure to pay or deliver trust money or trust property that was received in the course of legal practice.[12] These funds do not cover all client losses, but they respond to claims where clients have lost money or property held for them in their solicitor's trust account because of the dishonesty of a solicitor

9 From July 2011, this threshold will increase to $100 million.
10 CIPF Annual Report 2009 and www.cipf.ca.
11 SIPC Annual Report 2009.
12 The failure to deliver trust money or trust property must be caused by dishonesty or fraudulent conduct by someone in the law practice.

or law firm. While there are differences between these schemes, all perform substantially the same function.

4.35 These fidelity funds operate in addition to professional indemnity insurance held by solicitors. For example, solicitors practising in New South Wales are required to hold compulsory professional indemnity insurance arranged through LawCover Insurance which currently provides cover of up to $2 million per claim and run off cover for former principals and employees and for practices that have ceased to operate.

4.36 State and Territory based home warranty insurance schemes provide compensation arrangements in relation to certain building work. Most of the schemes now operate as schemes of last resort. Builders are required to take out insurance to cover client losses due to a builder's insolvency, death or disappearance. In Queensland alone client losses can be compensated where the builder is still operating. Tasmania abolished its mandatory last resort scheme in 2008.

4.37 Some States and Territories have also established a motor dealers compensation fund to protect consumers when buying or selling a vehicle through a licensed motor dealer. For example, a consumer can seek compensation from the fund if they have suffered a loss arising from a dealer's failure to meet warranty obligations, to repay a deposit or to pass on the proceeds of a vehicle sold on the consumer's behalf. A claim can generally be made against a dealer who is no longer operating. The compensation funds are funded through the licensing fees paid by motor vehicle dealers.

4.38 There are also compensation arrangements in place for the travel industry. The Travellers Compensation Fund is used to compensate travellers who suffer loss as a result of a financial collapse of a participating travel agency business.

Professional indemnity insurance schemes

4.39 Apart from industry compensation arrangements in the legal and building sectors (which by their nature are focussed on compensating clients), government schemes in other sectors aim to make professional indemnity insurance more affordable for professionals or service providers. These schemes were developed in response to perceived market failures in various segments of the professional indemnity insurance market in 2002.

4.40 Initiatives to improve the availability and affordability of professional indemnity insurance include the Government's medical indemnity assistance package (aimed at making medical indemnity insurance more available and affordable for doctors), as well as State and Territory professional standards schemes (which allow members of professional schemes to have their civil liability limited in certain circumstances).

4.41 These initiatives were introduced in response to a perceived market failure in various professional indemnity insurance markets, rather than as primary mechanisms to repay client losses.

Issues of interest

Given the compensation arrangements for financial services in other countries, and in respect to other professions and occupations domestically, views and comments are sought on:

4.1 The practical operation of those other arrangements including their costs, benefits and scope, and their effectiveness in contributing to consumer protection and the underpinning of consumer confidence in relevant markets.

4.2 The possible relevance of those arrangements as models for the compensation of consumers of financial services in Australia.

Chapter 5: Observations and issues

This chapter provides preliminary observations and comments based on information gathered so far and initial consultation with a number of interested parties. These observations and comments are put forward with a view to drawing out the questions that seem to arise and providing shape to emerging issues as a basis for further consultation. They do not represent concluded views in any way. Respondents are encouraged to correct or supplement any of the information provided, to comment on issues raised or suggest other relevant avenues of inquiry. In brief:

- There is a relatively well developed regime for the protection of consumers in the financial services sector including a licensing regime for providers of those services, the imposition of statutory conduct and disclosure obligations upon licensed providers and rights of redress for consumers.
- Retail clients of financial services have additional protection in the form of a low cost alternative system for dispute resolution and arrangements to provide them with some assurance about recovery of compensation for loss or damage attributable to licensee misconduct.
- There are already statutory compensation schemes in place to provide consumers with last resort protection in sensitive areas such as in certain dealings with stockbrokers, authorised deposit-taking institutions and general insurers.
- The focus of the review is on the adequacy of the default arrangements for the protection of consumers in circumstances where they do not have recourse to those existing last resort arrangements.
- The default arrangements stem from a legislative declaration that financial service licensees who deal with retail clients should have arrangements for compensating those clients for loss or damage attributable to a licensee's breach of its statutory obligations.
- Following the implementation of the default arrangements, most licensees are required to hold professional indemnity insurance cover that is adequate for their business. Other licensees are exempt from any such requirement on the basis of their apparent financial strength and ability to meet claims for compensation from their own resources.
- The current default arrangements provide a measure of assurance but no guarantee that retail clients will be able to recover compensation to which they may be entitled.
- Professional indemnity insurance assists licensees in paying compensation that may be awarded to a client, but it is not a direct mechanism for the compensation of clients. It provides a valuable buffer but, under current arrangements, limited assurance that a licensee will be able to compensate a client. In some cases a policy will no longer be in force or it may not respond to a particular claim or provide sufficient cover.

- The risk for a client, where a licensee does not have recourse to insurance to cover the client's claim, is that the licensee may have stopped trading, become insolvent or have insufficient assets.

- There is an apparent shortfall in the delivery of compensation under current arrangements. Cases have arisen where retail clients have not been able to recover compensation to which they are entitled. While it is not easy to quantify the problem, clients have missed out on substantial recoveries and in any case the consequences for individuals can be harsh.

- Any move to provide further protection for retail clients could include measures to reduce the incidence of cases where clients suffer loss or damage from inappropriate licensee advice or conduct. This might be through improvements in professional standards for financial advisers on the one hand, and efforts to improve the financial literacy of consumers on the other.

- Mechanisms to enhance the effectiveness of professional indemnity insurance in underpinning the compensation arrangements could also be considered. This might include:

  – a tighter approach to the administration of the requirement for professional indemnity insurance;

  – the promotion of standard professional indemnity insurance cover including to deal with claims after licensees cease to trade; and

  – improved disclosure of insurance arrangements and facilitation of third party rights.

- The ultimate risk for clients in recovering compensation stems from a licensee's creditworthiness. This raises the question whether more attention should be given to the adequacy of licensees' financial resources.

- Beyond measures of this kind, or in conjunction with them, a further option would be to introduce a scheme to provide retail clients with last resort recourse to compensation to which they are entitled. There is a model for a comprehensive scheme of this kind in the United Kingdom, but not it seems elsewhere.

- In designing such a scheme, key issues would include:

  – the liability standard for eligible claims;

  – circumstances in which a claim can be brought;

  – capping of claims;

  – relationship to current compensation arrangements including existing statutory schemes;

  – relationship to EDR schemes and legal system;

  - funding arrangements;
  - authority for scheme;
  - governance arrangements; and
  - process for systemic improvements.
- In assessing the costs and benefits of such a scheme, or other measures to strengthen compensation arrangements, it is relevant to consider:
  - the degree of harm suffered by retail clients under current arrangements;
  - the impact of that harm on confidence in financial markets and consumer participation in those markets;
  - the effects on wider regulatory settings and market impacts; and
  - the effects on barriers to entry in the financial services sector and on the cost of provision of those services.
- Current compensation arrangements do not purport to deal with loss or damage suffered by consumers from investment failures other than as a result of licensee misconduct. In practice this line may be somewhat blurred in dealing with loss from the failure of a product issuer for example. The line between non-compensable investment loss and compensable loss from licensee misconduct, and the implications of any cross-over between the two in practice, need to be kept in mind in considering possible new measures.
- A balance will have to be made between the effectiveness of any enhanced compensation arrangements in protecting consumers and promoting confidence in the financial services sector, and their impact on the cost and supply of financial services to retail clients and the overall efficiency of the sector.

Introduction

5.1 The review is directed to the adequacy of compensation arrangements for the protection of consumers in the financial services sector. The arrangements in question aim to provide some assurance that retail clients will be able to obtain compensation to which they may become entitled from financial service providers with whom they deal.

5.2 The assumption and management of risk and trade-offs between risk and reward are inherent for those who participate or invest in financial markets, services or products. The regulatory framework imposes standards of conduct and disclosure on the providers of financial services and offers remedies for those who suffer loss or damage where those standards are not met. It does not however generally seek to eliminate risk for those participants.

5.3 The regulatory regime already provides an additional level of protection for retail participants on the basis presumably that they are likely to be less well informed or able to take care of their own interests than wholesale participants. The high cost — in economic, social and human terms — that can ensue for individuals who suffer loss in the financial markets becomes readily apparent in the aftermath of the failure of financial products or institutions. There is a heavy toll on individual lives and families where for example they lose their life savings or retirement nest egg through unwise or inappropriate investment.

5.4 These issues are pronounced in circumstances where, as has been the case for some years now, individuals are encouraged to participate in the financial markets and, through superannuation, to take more responsibility for their own future financial security. The experience of such investors, and any sense of grievance where they feel let down by participants on whom they rely, can be expected to affect overall confidence in the financial services sector.

5.5 The case for a statutory compensation scheme needs to be considered within the existing framework of measures for the protection of consumers and the overall regulatory scheme for financial services.

5.6 The challenge is to strike a balance between measures for the protection of retail participants, weighing the benefits and costs of those measures including their impact on the costs of and supply of financial services, and the overall efficiency and effectiveness of the relevant markets.

Consumer protection relatively well developed

5.7 There is already a fairly well developed regime for the protection of consumers in the financial services sector. The provision of a low cost alternative dispute resolution system, and arrangements to provide some assurance that consumers will be able to obtain compensation for loss or damage to which they may be entitled, go beyond the level of protection generally available to consumers of goods and services in other sectors.

5.8 The regulatory framework includes significant components directed to the protection of consumers and, in particular, of retail clients who deal with providers of financial services. Consideration of these components, their rationale and the way they fit together provides a starting point.

5.9 Providers of financial services are required to be licensed and are subjected to standards that govern their conduct towards clients and their disclosure of information to clients. Those licensees who provide financial services to retail clients are also required to have in place:

- a system for the resolution of disputes with those clients — in effect a less formal alternative to redress through the courts — funded by licensees and made available at no cost to the client, and

- arrangements for compensating those clients for loss or damage suffered by reason of a licensee's breach of its statutory obligations.

The regulatory regime is overseen by a consumer protection and market integrity regulator and a prudential regulator.

Focus on fallback compensation arrangements

5.10 Moreover, there are already in place statutory compensation schemes providing consumers with last resort protection in specific areas of the financial services sector.

5.11 These arrangements have been developed in a somewhat piecemeal fashion over the years. They include:

- long-standing arrangements, now represented in NGF and like schemes, which in essence provide investors in markets such as the ASX with recourse to compensation for loss of funds or securities on the insolvency of a broking firm;

- more recent arrangements, through FCS, by which consumers can be compensated in certain circumstances for losses following the failure of an ADI or general insurer.

These arrangements constitute schemes of last resort in particular areas where institutional insolvency could give rise to systemic risk. Their adequacy in providing protection in those areas is not addressed in the review.

5.12 The focus of the review is on the default or fallback arrangements for the protection of consumers of financial services in circumstances where they do not have recourse to those existing last resort compensation arrangements.

Mandate for fallback arrangements

5.13 There is a legislative acknowledgement — in s912B of the Corporations Act — of a place for compensation arrangements to protect retail clients of financial services licensees. This acknowledgement is noteworthy as an expression of general intent although its substance is somewhat open-ended as indicated below. The legislation goes beyond the imposition of standards of conduct on licensees and the conferral on clients of rights of redress. It includes access to dispute resolution processes as an alternative to legal redress through the courts and addresses the issue whether any compensation awarded will be recoverable.

5.14 Section 912B declares that a licensee who has retail clients 'must have arrangements for compensating those [clients] for loss or damage suffered because of breaches of the relevant obligations under this Chapter by the licensee or its representative'. It goes on to provide that those arrangements must satisfy any requirements specified in the regulations or else be approved in writing by ASIC. It also provides, interestingly, that in exercising its power to approve alternative arrangements ASIC must have regard to whether those arrangements will continue to cover clients after the licensee ceases carrying on business and for what period. Otherwise the provision gives little guidance on the content of any regulations or on the exercise by ASIC of its power of approval.

5.15 The nature of the compensation arrangements required of licensees is left to be specified in regulations or by ASIC.

Implementation of fallback arrangements

5.16 The nature of the compensation arrangements required of licensees has been spelled out in regulations which, after a period of consultation and transition, became fully operative in 2008. The regulations call for a licensee to hold professional indemnity insurance which is adequate having regard to specified considerations that relate to its business, clients and exposure to claims.

5.17 While the legislation on its face appears to expect all licensees who deal with retail clients to have compensation arrangements, the regulations exempt from the requirement licensees who are general or life insurance companies or ADIs regulated by APRA. Furthermore, ASIC is authorised to exempt licensees who are related to such a prudentially regulated company where a guarantee is received that ensures payment of awards of compensation to retail clients of the licensee.

5.18 In practice most licensees are required to hold professional indemnity insurance in order to satisfy the need for compensation arrangements. According to ASIC, just under 3,700 of the almost 5,000 financial services licensees can give advice to retail clients. Of that number, all need professional indemnity insurance except for several hundred ADIs and insurers who are regulated by APRA, a handful of others who have been exempted by ASIC on the basis of relationship to an APRA-regulated company, and one other licensee for whom ASIC has approved alternative arrangements.

Eligible claims by retail clients

5.19 The compensation arrangements called for under the Corporations Act are to protect retail clients who have suffered loss or damage from a licensee's breach of obligations under Chapter 7 of that Act or under any other 'financial services law'.[1] This would include, for example, a claim based on breach of a licensee's duty in providing personal financial advice to inquire into a client's personal circumstances and to have a reasonable basis for the advice provided.

5.20 The legislative concern does not in its terms extend to claims such clients may have based on breach of other statutory or common law standards. A claim based on breach of contract would not be eligible. Nevertheless, EDR schemes have a broader jurisdiction and can take such matters into account in making an award for compensation. Any differences of this kind in liability standards can give rise to questions about the match between the cover provided under professional indemnity insurance and the claims to which licensees may in fact be exposed.

5.21 The definition of eligible claims has a bearing on the potential number and size of claims under any compensation arrangements or second tier scheme should one be introduced and on the costs of those arrangements or that scheme, as well as on the extent of protection afforded to retail clients.

1 Section 761A.

Compensation for licensee misconduct not investment losses

5.22 The dichotomy between loss or damage suffered by consumers as a result of licensee misconduct, and claims related to the failure of investment products or other investment losses in the absence of such misconduct is fundamental and needs to be kept in mind. The compensation arrangements referred to in the legislation are designed to provide retail clients with some assurance of recovery where they have a claim against a licensee based on advice in breach of the statutory standard or other misconduct in the provision of services.

5.23 The fallback arrangements stop short of trying to compensate for investment loss in the absence of inappropriate advice or other licensee misconduct. As explained in the Wallis Report, while regulation should strive to minimise risk in certain areas, it is not the role of regulation to eliminate risk in the financial services area. A judgment about risk and reward is inherent in any investment, and the spectrum of risk plays a part in economic efficiency. There is a risk of moral hazard to the extent that investors are cushioned from the financial consequences of their investment decisions.

5.24 It is not surprising however that in practice the line between loss arising from licensee misconduct and loss from investment failure or under-performance may become somewhat blurred. Product providers for example are subject to fallback compensation arrangements in circumstances where they are required to be licensed (where they operate a managed investment scheme for example, but not if they are a company in whose shares clients can invest) and they have direct dealings with retail clients. Where this is the case, a client might have a claim against the provider, following the failure of a financial product, based on misrepresentation of the product in question. The loss or damage attributable to that misrepresentation could equate to the loss in value of the investment. A product provider who does not deal direct with retail clients will not be subject to those compensation arrangements even if it contemplates that its products will be offered to retail clients by other licensees.

5.25 There is potential also for an expectation gap between the compensation sought by an aggrieved consumer and the amount of loss or damage that can be attributed to licensee misconduct. A consumer aggrieved following the failure of an investment product may understandably look to recover the amount lost through the investment and not feel satisfied by recovery of part only of that loss that may be attributable to a licensee upon whom the consumer relied.

5.26 Furthermore, an aggrieved consumer may see an adviser or other intermediary as a more attractive target than a product issuer, especially if the product issuer is insolvent, or a more accessible target than those product issuers, directors, auditors or other participants in the investment chain who are not licensed or subject to an EDR scheme. In circumstances such as these the separation between product and product selection may be tested.

5.27 Again, a client's prospects of recovery may hang upon the line drawn in particular circumstances between advice to follow an investment strategy that turns out to be unsuccessful and advice that fails the legal standard required of a licensed financial services provider. Advisers and other intermediaries play an important part in financial services and should bear an appropriate responsibility. It does not follow that they should be seen as guarantors of the financial products they recommend.

Insurance not a guarantee of compensation

5.28 As already noted licensees, other than those who are exempt by reason of their presumed financial strength, have to hold professional indemnity insurance in order to meet the licensing requirement for compensation arrangements.

5.29 It is generally acknowledged that such insurance does not constitute a direct mechanism for the compensation of retail clients. Rather it provides a measure of protection for the business of a licensee, providing the licensee with the means to pay compensation that may be awarded to a client. By providing funds which a licensee might not otherwise have available to meet a claim, it works as a proxy for a compensation arrangement. It is not however a guarantee that compensation will be paid.

5.30 Professional indemnity insurance is a commercial product available in the market. It is a product that prudent licensees might utilise regardless of the regulatory requirement in order to manage their business risk. The terms on which cover is offered by insurers, and the pricing of that cover, vary over time in accordance with overall market conditions and insurers' views on relevant risk.

5.31 There has been an apparent tightening in recent years in the availability of professional indemnity insurance for financial advisers in particular.

5.32 ASIC spells out in RG126 various considerations it sees as relevant for a licensee in assessing the adequacy of its professional indemnity insurance cover. It does not follow that terms or features that ASIC would like to see in licensees' insurance cover will be generally available in the market. ASIC pulled back, for example, from calling for licensees to have run-off cover when it became apparent, following industry consultation, that insurers were not prepared to make cover of that kind available to licensees on a general basis.

5.33 Professional indemnity insurance only assists a licensee in meeting a client's claim where the licensee's policy is still effective and responds to the claim in question. ASIC acknowledges that the insurance cover currently available in the market is unlikely to provide a source of funds where a licensee has become insolvent before the claim was brought. It also recognises 'that insurers may exclude some areas of cover in policies for risk management reasons'.[2]

5.34 Upon the introduction of the relevant regulation, the Government described the objective of the compensation arrangements as to:

> reduce the risk that compensation claims to retail clients cannot be met by the relevant licensees due to the lack of available financial resources.[3]

ASIC says its objective is to 'administer the compensation requirements to maximise their potential to meet this objective'.[4] ASIC adds that 'professional indemnity insurance is not designed to protect consumers directly and is not a guarantee that compensation will be paid'.[5]

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2 ASIC RG 126, para 10.
3 Regulation Impact Statement *Compensation arrangements for financial services licensees,* April 2007, page 7.
4 ASIC RG 126, para 20.
5 ASIC RG 126, para 8.

5.35 While setting out in RG126 what it sees as the minimum requirements for professional indemnity insurance cover, ASIC counsels licensees that 'it is up to [the licensee] to determine what is adequate professional indemnity insurance for [the licensee] to meet [its] obligations under s912B and obtain such professional indemnity insurance'.[6] ASIC says licensees should take into account 'all the facts and circumstances' of their business in determining what cover will be adequate for them, including 'the nature, scale and complexity' of their business, but also notes that 'one of the elements of adequacy is what is practically available at any given time'.[7]

5.36 In other words ASIC largely relies on licensees to maintain insurance cover and on their self-assessment of the adequacy of that cover. Apart from checking at the initial licensing stage that a licensee has insurance cover in place, ASIC does not monitor the terms of that cover or its continuation in force. In this respect ASIC's approach is relatively light touch.

5.37 There is a risk that a licensee, because of financial pressure or otherwise, may not maintain its insurance cover or may trade off the amount of cover or excess limits for lower premium. There is, of course, a further problem if a provider of financial services carries on a business without being licensed as required. There is no assurance in such a case that the business will hold professional indemnity insurance cover let alone satisfy other standards required of licensees.

Consequences where insurance does not respond

5.38 Professional indemnity insurance plays a large part in assisting licensees to meet claims brought against them by their clients. In so doing it provides a level of assurance, particularly where a licensee would otherwise be stretched for funds, that claims for compensation by retail clients will be met.

5.39 In some cases however there will no longer be an insurance policy in force, or the claim will fall outside the terms of the cover or will exceed the available limits of the cover. In such cases the licensee, notwithstanding its inability to claim from an insurer, still remains liable for any compensation payable to a client. The client's prospects of recovery will depend however on the continuation in business of the licensee and its financial resources.

Nub of the problem

5.40 There is an apparent shortfall in the delivery of compensation under current arrangements. In some cases retail clients, while entitled to compensation from licensees with whom they have dealt, are not in practice able to recover that compensation. The risk for a client, where the licensee in question does not have recourse to insurance to cover the claim, is that the licensee may have stopped trading, become insolvent or otherwise have insufficient assets. The client's prospects of recovering compensation will depend on a recovery in the licensee's business or the extent of any funds available to meet the claims of unsecured creditors.

6 ASIC RG, para 50.
7 ibid and para 33.

5.41 In other words retail clients who look to providers of financial services to compensate them for loss or damage are exposed ultimately to a licensee's creditworthiness.

5.42 The problem is not just a theoretical one. The review has been informed of cases where clients, while becoming entitled to awards of compensation from licensees with whom they have dealt, have been unable to recover substantial amounts awarded to them.

5.43 It is not easy to quantify the problem. There is a lack of comprehensive data, collected on a consistent basis, about relevant claims against licensees and their outcome let alone about the success of claimants in recovering compensation payments. Relevant claims for this purpose are claims by retail clients for loss or damage attributable to breach by licensees of obligations under Chapter 7.

5.44 Information about claims that are settled without a formal award is not always captured. Whether or not the licensees in question in fact held professional indemnity insurance cover, and cover that met ASIC's standards, is not always clear in cases where clients go wanting.

5.45 The number of cases reported may also understate the problem. Retail clients may not be aware that they have rights to pursue a claim, or have access to dispute resolution mechanisms. Other clients may decide not to make a claim where a licensee is insolvent and the prospects of recovery appear poor. In any event, regardless of the overall size of the problem, the consequences for an individual client may be harsh.

Possible remedial measures

5.46 As has been noted, professional indemnity insurance works by assisting licensees to meet claims by clients and reduces the risk that retail compensation claims will not be met due to a licensee's lack of financial resources. It provides a valuable buffer but, under current arrangements, limited assurance that a licensee will in the end be able to compensate a client. It was not designed to, and does not, provide a comprehensive safety net for consumers.

5.47 Any move to provide further protection for retail clients could include consideration of measures:

- to reduce the incidence of cases where clients suffer loss or damage from licensee misconduct such as through:
  - improvements in professional standards for financial advisers; and
  - efforts to improve the financial literacy of consumers;
- to enhance the utility of professional indemnity insurance as a mechanism to underpin the ability of licensees to meet compensation claims through:
  - more proactive administration of licensing requirements;
  - efforts to facilitate the availability of appropriate insurance cover;

- better disclosure of the insurance cover held by licensees and facilitation of third party rights;

- to focus more attention on the financial resources of licensees in order to reduce the risk of their becoming insolvent; and

- for a scheme of last resort to provide compensation where a licensee is unable to do so.

Protection of consumers at the outset

5.48 Consideration of the adequacy of compensation arrangements tends to focus on the problems arising after the event when a client suffers loss or damage attributable to licensee misconduct.

5.49 Regard should also be had to the possible relevance of measures to raise standards of licensee conduct, and to enhance the understanding of consumers and their ability to look out for their own interests in their financial dealings.

5.50 Measures of this kind are directed at reduction in the instances where consumers are adversely affected by the misconduct of licensees on whom they rely.

Standards of licensee conduct

5.51 The *Future of Financial Advice* reforms announced by the Government on 26 April 2010 are aimed at lifting the professional standards and conduct of financial advisers and confidence in and the quality of financial advice. To the extent they achieve their purpose these changes have the potential to reduce the incidence of claims for compensation against financial advisers. The proposals do not generally extend to other financial service licensees.

5.52 One element of the package is the proposed imposition of a statutory best interests duty on licensees who provide personal advice to retail clients. The objective is for advisers to have proper regard to the best interests of their clients and not merely consider their clients' interests when a conflict arises. It is proposed that licensees would meet this duty if they take reasonable steps to act in the best interests of their clients, but they would not be expected to consider every product on the market in giving personal advice on financial products. Other elements are directed to the removal of conflicted remuneration structures.

5.53 A newly established advisory panel on financial advice and professional standards will provide views to the Government aimed at lifting the level of professional standards of financial advisers, including by establishing competency requirements and training for licensees who provide financial product advice. The panel has been involved in ASIC's development of a framework for assessment and professional development of financial advisers designed to improve the quality of advice consistent with industry standards.[8]

5.54 To the extent that the proposed changes contribute to a clearer understanding by licensees of the standards expected of them, and to improved standards of

8 ASIC Consultation Paper 153, *Licensing: Training and assessment framework for financial advisers,* April 2011.

conduct, it is to be hoped there will be a decrease over time in the incidence of problems for retail clients.

5.55 Again, if improved standards of conduct result in a reduction over time in claims against insurers, the cost of insurance cover for financial advisers may be mitigated. On the other hand, any uncertainty about the implications of a new statutory best interests duty for the liability of licensees could work the other way, at least until any affect on claims experience can be assessed.

5.56 Any further assessment of the impact of the *Future of Financial Advice* proposals on adviser conduct or on the risk profile of advisers will have to await their final form and implementation.

Financial literacy

5.57 Programs and other efforts to improve the financial literacy of consumers are also relevant in empowering consumers to make investment and other decisions in their own interests, to better understand the trade-off between risk and potential reward, and in reducing the information asymmetry between them and advisers or other licensees with whom they deal. ASIC provides basic information through its new MoneySmart website to complement face-to-face advice services by helping consumers understand their financial issues and goals before they seek advice. ASIC's recently announced national financial literacy strategy also aims to deliver financial literacy education through schools and higher education institutions, the workplace and in the community, and is another example of efforts to this end.[9]

Enhancement of insurance cover

5.58 Given the reliance on professional indemnity insurance as a means of underpinning compensation for retail clients, it is relevant to consider possible ways to make that mechanism more effective.

Assurance that licensees have adequate cover

5.59 Most licensees are subject to the requirement for professional indemnity insurance. Current arrangements rely heavily on the self-assessment by licensees of the level of insurance adequate for their business and on their maintenance of such cover. The licensees who are exempt from this requirement — on the basis of their apparent financial soundness — do not appear to have had difficulty in meeting any compensation claims.

5.60 Licensees are provided with guidance by ASIC on the features a professional indemnity insurance policy should have and on their assessment of the adequacy of their cover. ASIC generally regards the requirements as self-executing with the onus on a licensee to comply. Apart from a check when a licence is first granted that an applicant holds insurance cover (or is exempt or has approved alternative arrangements), it does not conduct systematic or periodic checks on the insurance held by licensees. Instead, the arrangements appear to work on a self-compliance and self-reporting basis.

9 www.moneysmart.gov.au and ASIC *National Financial Literacy Strategy*, Report 229, March 2011.

5.61 An approach of this kind poses a degree of systems risk that licensees are either not insured at the point in time that cover is required, are underinsured or have cover that excludes the grounds on which compensation is awarded.

5.62 By way of comparison, stockbrokers and other market participants are required to advise ASIC within 10 days of the renewal of their insurance cover, as well as letting ASIC know of any notification to their insurer of a claim. Brokers that fail to do so are subject to penalties.[10]

5.63 Similarly, personal investment firms in the United Kingdom are required to notify the regulator that they have obtained professional indemnity insurance within 28 days from the expiry of their previous policy. If notification is not received, FSA contacts the firm and works with it to resolve the issue. While FSA does not consider it is in the interests of firms or consumers 'simply to close down firms on the day their cover runs out', nor does it consider it 'in the interests of consumers ...to allow firms to continue trading without [professional indemnity insurance] indefinitely'.[11] FSA will consider the following possible courses of action:

- the requirement for the firm to have professional indemnity insurance may be waived after taking into account factors such as its financial position, claims records and past business. A firm given such dispensation must comply with additional reporting requirements relating to customer complaints and have adequate financial resources to meet an increased financial resources requirement;

- the provision of individual guidance to the firm where it has professional indemnity insurance that does not comply with the rules; or

- enforcement action where a firm does not have adequate resources overall or is unwilling to consider and implement alternative solutions. This could lead to the cancellation of the firm's authorisation to operate as a personal investment firm.

5.64 FSA also states that it has:

> discovered that firms who are unable to obtain [professional indemnity insurance] often have other regulatory problems ..., and some of them do not, or are likely not to, meet our minimum capital requirements. When a [professional indemnity insurance] insurer assesses a personal investment firm it is performing a risk assessment, the results of which influence their decision to provide cover and the price of the policy. If the personal investment firm has unresolved regulatory or financial problems this inevitably causes concerns to the insurer and decreases the availability of cover for that firm.[12]

5.65 It is a matter for consideration whether a more proactive approach by ASIC would provide a worthwhile increase in assurance. One approach, akin to that in the United Kingdom, would be to require licensees to certify to ASIC on an annual basis that they have renewed their policies.

5.66 Licensees might be asked to report through their financial statements whether they hold a current policy of professional indemnity insurance, or have made alternative compensation arrangements, and on the adequacy of their cover for the

10 ASIC *Market Integrity Rules (ASX Market) 2010*, February 2011, rule 2.2.1.
11 Financial Services Authority, Professional Indemnity Insurance for personal investment firms: proposed rule changes, June 2003.
12 ibid.

needs of their business. This certification could be made subject to confirmation in the independent audit of those financial statements.

5.67 Another approach would be for ASIC to carry out checks on individual firms that may be financially vulnerable or otherwise to pose a risk.

5.68 Any closer engagement by ASIC with individual licensees on the details and adequacy of their insurance cover would have resource implications for the regulator and industry. A risk-based approach, targeted at licensees who appear more financially vulnerable or otherwise at risk, would have some attraction. There would seem to be scope for such an approach, given that the ultimate concern is with a licensee's creditworthiness and that financially stronger firms may find it easier to negotiate adequate insurance cover than are firms who are more marginally resourced.

5.69 In any move to a more proactive approach by ASIC it may be necessary to review the adequacy of ASIC's existing powers in relation to the granting of licences and sanctions for non-compliance including cancellation of a licence.

Promotion of standard insurance cover

5.70 There may be useful scope too for the development of standard policies to meet the basic needs of licensees, or particular classes of licensees such as financial advisers. The availability of standard policies would be expected to reduce the transaction costs of licensees in making insurance arrangements that meet regulatory requirements and may facilitate regulatory efforts in monitoring compliance with those requirements.

5.71 Current regulations and guidance require licensees to hold professional indemnity insurance cover that is adequate to their needs and sets out a range of factors to which the licensee should have regard to in assessing those needs, such as the maximum liability that might arise from their membership of an EDR scheme and the financial services they deliver.

5.72 As discussed in Chapter 3 some licensees appear to face difficulties in accessing cover that is adequate to their needs and meets ASIC's requirements.

5.73 In consultations with industry ahead of the commencement of the regulations, ASIC sought to encourage industry and professional bodies to 'consider what standard professional indemnity insurance policies and other measures they can develop to assist their members'.[13] ASIC also expressed an expectation that 'licensees will work actively (alone or collectively) to encourage insurers to meet the demand for professional indemnity insurance products that are consistent with the compensation requirements... [including by] exploring the possibility of developing standardised policies that can cover similarly situated licensees in the same industry, or industry sector'.[14]

5.74 While tripartite negotiations ensued between ASIC, the insurance industry and professional bodies representing licensees, they did not lead to agreement on a standard form of professional indemnity insurance policy.

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13 Compensation and insurance arrangements for AFS licensees, Consultation Paper 87, ASIC, July 2007, para 17.

14 ibid, para 18.

5.75 Some professional bodies in the financial services industry have subsequently negotiated master policies under which their members can acquire individual cover on the same terms and conditions as the master policy. Beyond this, efforts to produce standard policies appear to have had little success.

5.76 While the regulatory regime mandates insurance cover for several thousand licensees, insurers for their part are left to offer cover, if they so choose, on their own terms.

5.77 Given more experience with the operation of the regulatory framework, and the expectations of the regulator, it may be timely to explore further the development of a standard policy or policies for licensees generally or a class of licensees. The development of a standard policy would need to be market based and negotiated between professional bodies that represent licensees and the insurance industry. There may be a role for ASIC, or possibly the Government, in the coordination of such an initiative.

5.78 There are examples outside the financial services sector where professional industry associations have established professional indemnity insurance policies that suit the professional requirements of their members. The legal profession in NSW has established LawCover Insurance which issues both professional indemnity insurance policies and run-off policies to legal practitioners.

5.79 Consideration might also be given to the possibility of developing a standard policy on a group basis. That is, a policy might be provided by multiple insurers collectively covering the risk of a pool of insured licensees under a standard set of terms. Insurers might be prepared to provide certain terms in such a policy that they are not willing to offer on an individual risk basis. Consideration would need to be given to whether any industry wide arrangement would require authorisation from the competition regulator.

Coverage of claims after licensees cease to trade

5.80 A weak point in the current reliance on professional indemnity insurance is the general lack of run-off cover for licensees. This means that clients whose claims come to light after a licensee ceases to trade will have difficulty in receiving compensation where the licensee has wound up its business, has disappeared or is insolvent. The long-tail nature of claims against licensees exacerbates this problem.

5.81 The Corporations Act recognises the risk to which clients may be exposed after a licensee ceases trading. Section 912B(3)(b) requires ASIC, when considering approval of alternative compensation arrangements instead of insurance, to have regard to 'whether the arrangements will continue to cover persons after the licensee ceases carrying on the business of providing financial services, and the length of time for which that cover will continue'. [15]

5.82 ASIC sought in its administrative guidance to require the inclusion of automatic run-off cover in professional indemnity insurance policies. However, following consultation ASIC concluded that insurers were generally not willing to provide automatic run-off cover and did not proceed with its proposal.[16]

15 Section 912B(3).
16 ASIC RG 126, para 40.

5.83 It is understandable that insurers will only be prepared to make run-off cover available to licensees on a basis that is commercially viable. The scope for such cover could be examined further in any move to develop standard forms of insurance cover for licensees. Consideration might be given to the commerciality of a separate group policy that deals specifically with run-off and pools the risk of claims arising from multiple licensees that had ceased to trade. Such a group policy would not necessarily replicate the terms of prior policies held by the former licensees covered by the group policy, but would provide a basis for dealing with claims for compensation after a licensee ceases trading.

5.84 Consideration might also be given to alternative arrangements to deal with compensation claims for a period after a licensee ceases to trade. In the United Kingdom, FSA has been exploring the issue of requiring firms to 'leave resources behind' when they cease to trade, with proposals such as a trust to hold run-off cover, or the transfer of responsibility for future compensation claims to a firm that still operates. FSA has not yet concluded its position on this issue.[17]

Disclosure of insurance arrangements

5.85 It may be timely as well to look again at the disclosure by licensees of their compensation arrangements. Licensees are currently required to disclose to clients the kind of compensation arrangements they have in place and whether those arrangements satisfy the regulatory requirements. A licensee has to include in its Financial Services Guide a statement that it has in place professional indemnity insurance, alternative arrangements approved by ASIC or is exempt from the requirement. It does not have to go beyond such limited disclosure.

5.86 There is a question whether a minimal disclosure requirement of this kind achieves any useful purpose, and whether additional disclosure would better enable retail clients to protect themselves. It is arguable that a minimal disclosure pursuant to the current requirement could convey a sense of assurance that is not necessarily warranted.

5.87 Any further disclosure of insurance cover should provide consumers with simple yet meaningful information about the protection the licensee has without raising expectations that claims for compensation will necessarily be met in that way.

5.88 ASIC proposed earlier to require more detailed disclosure of insurance arrangements but did not proceed following a process of consultation with industry. Those proposals included disclosure of a number of aspects of a licensee's insurance cover that were intended to make more realistic the expectations of consumers about the level of protection afforded by that cover. It was proposed for example that the licensee include statements such as 'the policy will not necessarily be adequate to meet all possible claims ..' and 'cover might be less effective in the event of insolvency of the licensee...'.[18]

5.89 More meaningful disclosure of available insurance cover, and its limitations, or the basis on which a licensee was exempt from the need to have such cover, would put clients in a better position to assess the credit risk of a licensee.

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17 FSA, *Review of prudential rules for personal investment firms*, Consultation Paper 08/20, November 2008.

18 Compensation and insurance arrangements for AFS licensees, Consultation paper 87, ASIC, July 2007, at paras 98-99.

5.90 There may be a question however about the value to consumers, when deciding whether to deal with a particular licensee, of information relevant to their prospects of recovering compensation if they end up suffering loss or damage by reason of the licensee's subsequent misconduct. That question may not be foremost when an adviser is being engaged.

5.91 Any requirement for additional disclosure, if it is to be useful, should be as simple and meaningful as possible. Relevant aspects for disclosure would seem to include the monetary limits of the cover, the level of any excess, any significant exclusions and whether there is any run-off cover. There would need to be a process for keeping any such disclosures up to date.

5.92 Any additional disclosure requirements would need to weigh the benefit to consumers against the cost to licensees of making that information available. Reliance on online delivery, as permitted by the Corporations Act, would facilitate, and reduce the cost of, any additional disclosure.[19]

5.93 Disclosure of the name of the licensee's insurer in itself might be seen as relevant information and important, in particular, in the event that a licensee winds up its business or becomes insolvent and does not respond to a client's claim.

Third party rights

5.94 A third party such as a retail client already has the right, in limited circumstances, to lodge a claim directly with the insurer of a party from whom it is claiming compensation. Section 51 of the *Insurance Contracts Act 1984* enables a third party to recover directly from the insurer if the insured is liable to pay damages and has died or cannot be found after reasonable inquiry. Access to information about the insurer would assist a consumer in exercising its rights under this section in circumstances where the licensee has closed its business and cannot be found.

5.95 A review of the *Insurance Contracts Act 1984* considered, amongst other things, a broadening of s51 in ways that might have benefited retail clients in other circumstances such as when a licensee has become insolvent. An Exposure Draft issued in 2007 proposed an extension of the right to recover directly from an insurer in circumstances where a third party has obtained a judgment against an insured in respect of a liability and the execution of that judgment is unmet. In the event, following a process of consultation the Insurance Contracts Amendment Bill 2010 proposed limited changes to s51 which would not materially aid a retail client in relation to a failed licensee.[20] The Bill lapsed before enactment and has not yet been reintroduced.

5.96 The ability of consumers to pursue claims where an insured party has become insolvent might be looked at in any further consideration of s51.

More focus on financial adequacy of licensees

5.97 The root of the problem where retail clients are unable to recover compensation from a licensee lies in the licensee's lack of financial resources. While insurance cover, where held, provides licensees with a buffer in meeting compensation claims, it does not necessarily respond in all cases or to the full extent of a claim. Licensees

19 ASIC RG 221, *Facilitating online financial services disclosure,* December 2010.
20 Key documents in this review are available at www.icareview.treasury.gov.au.

may be financially exposed if they face multiple claims for compensation at any one time, if they have exhausted the capacity of their policy to meet further claims, or face claims that do not fall within their policy. The capacity of licensees to continue trading in such circumstances, and the capacity of consumers to recover compensation, will depend on the financial resources available to the licensee.

5.98 The relevance of financial resources in this context is reflected in the fact that the only licensees who are exempted from the requirement to hold professional indemnity insurance cover are certain licensees who, by reason of being subject to APRA's prudential regulation or like circumstances, can be regarded as relatively sound in financial terms. The exemption of such licensees does not appear to have led to problems with the ability of those licensees to meet compensation claims.

5.99 Under present arrangements however there is very limited scrutiny of the financial resources of licensees. The general obligation of licensees to have available adequate resources to carry on their business is limited in its purpose.[21] ASIC does not see the focus of its guidance on financial adequacy as the protection of clients against credit risk. It appears to regard the separate requirement on licensees to hold professional indemnity insurance as covering this issue.

5.100 In the context of the financial standards for licensees, ASIC's options for compliance do not require licensees operating small businesses to hold any cash or commitment of support for the purposes of compliance.

5.101 This raises the question whether there should be some higher level of comfort that a licensee has adequate resources, when considered in relation to the extent of its insurance cover, to meet compensation claims from clients. For example, licensees might be required to hold an additional form of financial security as a general condition of licence, such as a capital holding or a security bond or guarantee from a financial institution or related entity. The aim would be to give the licensee more capacity to meet awards of compensation that are not covered by professional indemnity insurance.

5.102 It is not suggested that licensees should be subject to anything approaching the capital adequacy standards required of financial institutions that are prudentially regulated by APRA. The question is whether some form of financial security, short of that kind of regulation, would in a practical way reduce the risk of a licensee being unable to meet a claim for compensation. Any such benefit would have to be weighed against the effects of a stricter requirement on barriers to entry and competition in financial services.

5.103 Arrangements of this type apply to investment firms in the United Kingdom who are required to meet capital adequacy requirements in conjunction with their holding of professional indemnity insurance cover. A change in the calculation of the financial requirement will require firms to hold resources worth at least three months of their annual fixed expenditure in realisable assets such as cash (with a minimum holding of £20,000) by December 2013. FSA states that the intended outcome of this change in the financial requirement on investment firms is 'to see a reduction in the level of consumer detriment and the costs to the levy payers contributing to the Financial Services Compensation Scheme (FSCS) from unsuitable advice on

21 ASIC RG 166, section B – Base level financial requirements.

investment products'. [22] In making this change, the UK regulator recognises that an increase in the formal adequacy requirement will have the effect of raising the barriers to entry to investment business.

5.104 There is a question to whether any additional financial security could be required to be preserved for a specified period after a licensee ceases to trade. Consideration would need to be given to how claims would be made and defended in this period, how the financial security would be held, how payments of awards would be made and how unused capital would be returned to the licensee once the specified period has lapsed. As noted above, consideration is currently being given to this issue in the United Kingdom.

A last resort scheme for compensation

5.105 A statutory compensation scheme, as adverted to in the terms of reference, could be designed to provide retail clients with recourse to payment in circumstances where they are unable to recover compensation to which they are entitled from a provider of financial services. Such a scheme would in effect extend or supplement the recourse already available to clients whose claims fall within the scope of schemes such as NGF or FCS.

5.106 There is a model for such a scheme in the United Kingdom where the Financial Services Compensation Scheme provides a fund of last resort for customers who suffer losses, including from poor investment advice, and are unable to recover compensation because the service provider in question has stopped trading, has become insolvent or has insufficient assets. The scheme offers 'second tier' protection for claims which slip through the 'first tier' protection which is based on a mix of professional indemnity insurance and minimum capital requirements.

Issues in relation to any scheme

5.107 Consideration of the appropriate scope and elements of such a scheme raises a number of questions including the following:

- **Eligible claims**: whether claims should be limited to circumstances where a licensee has ceased trading, is insolvent or otherwise unable to meet a claim by a retail client.

- **Capping of claims**: whether the amounts recoverable should be limited to a maximum amount, or a proportion of a claim up to such an amount, in order to limit the financial exposure of the scheme, and to mitigate any element of moral hazard, while affording worthwhile protection to consumers.

- **Liability standard for claims**: whether eligible claims should be confined to a breach by a licensee of Chapter 7 obligations, as is the case under current arrangements, and in any case whether there needs to be a closer alignment between those standards and the basis upon which compensation can be awarded under EDR schemes. While there may be an argument for including claims based on the general law of negligence or contract, claims based on

22 Review of the prudential rules for Personal Investment Firms (PIFs), Feedback to CP08/20 and CP09/20, Financial Services Authority, 09/19, November 2009, paragraph 1.4.

breach of more general notions of fairness or industry standards may be more problematic.

- **Relationship to current compensation arrangements**: whether mandatory professional indemnity insurance should be retained as a core element of protection. If it is, the statutory scheme would in effect provide a second level of protection behind the primary level pertaining to the licensing requirements for financial service providers. There is a question whether there would need to be any strengthening of the primary level (through financial adequacy standards for example) in order to mitigate the financial exposure of the scheme.

- **Relationship to EDR schemes and legal system**: whether a claim based on an EDR award or the outcome of a court case would be accepted for the purpose of the scheme or be subject to further review on the merits.

- **Relationship to existing statutory schemes**: in an ideal world any new scheme would probably be integrated in some way with schemes such as NGF and FCS which already provide last resort protection in segments of financial services. Issues such as the treatment of funds contributed to NGF by brokers in the past may make integration problematic. Consideration could still be given to possible ways to achieve efficiency through common administration and to measures to assist consumers in identifying and navigating between avenues of recourse that are open to them.

- **Funding of scheme**: it might be expected that a scheme of this kind would be funded by industry. There would be questions about the basis for assessing the contributions of individual licensees and any arrangements for pooling licensees to confine their obligations as far as possible to the funding of claims against licensees in a similar line of business. There is also a question whether contributions other than for regular outgoings should be levied on a pre- or post-event basis.

- **Authority for scheme**: statutory backing, through the licensing arrangements or otherwise, may be necessary in order to achieve mandatory participation and funding by licensees.

- **Governance**: appropriate arrangements for the governance of a scheme, including the extent of involvement by industry, consumer representatives or a regulatory authority would need to be addressed. If statutory backing is required in order to ensure mandatory participation, it is arguable that the governing body should be accountable to government in some way. This may also raise the question whether the governance of EDR schemes should similarly be made accountable to government given any link between EDR scheme awards and claims upon a statutory scheme.

- **Systemic improvements**: in designing a scheme there may be scope for processes to provide feedback to stakeholders on systemic problems with a view to identifying ways in which licensee standards can be raised, the incidence of harm to consumers can be mitigated and claims against the scheme can be contained.

PFS/FOS scheme proposal

5.108 A proposal to establish a compensation scheme has been prepared by Professional Financial Solutions Pty Limited on behalf of the Financial Ombudsman Service. The scheme is described as an industry-based scheme, which would be underpinned by legislative and possible financial support from the Government. The main features of this proposed fund of last resort are:

- the scheme would operate in addition to the current compensation arrangements, would have a statutory mandate and would specify a maximum time period for claims to be lodged;

- the scheme would operate where a retail client has received an award of compensation by an EDR scheme, a court or a liquidator and the licensee is unable or likely to be unable to satisfy at least one claim against it. This may occur where the licensee is insolvent or bankrupt or cannot be contacted after reasonable steps have been taken to do so;

- the scheme would cover loss arising from fraud or misappropriation of funds that involves dishonesty by the licensee;

- the amount of compensation payable to claimants would be subject to caps. For example, a cap of 90 per cent on the first $120,000 of the claim, a further 70 per cent on the excess up to $200,000 and a further 50 per cent up to an overall cap of $280,000, which would equate to a maximum payment of $204,000 on a claim of $280,000 or more;

- the scheme would be industry-based with mandatory membership by all licensees who provide financial services to retail clients;

- members would be expected to fund the establishment and operating costs of the scheme and compensation payments to retail clients on prescribed terms and conditions, such as:

  – a pre-funded component to cover anticipated management costs and compensation costs;

  – a post-funded levy if required to compensate retail clients for significant losses;

  with reference also made to a possible guarantee from government;

- members would be grouped into classes, according to the financial service activities they are licensed to provide, and each class would be subject to a maximum annual levy of one per cent of their revenue. Payments of compensation would be drawn first from the pre-funded component of the class to which the ‘defaulting’ member belonged, before funds were drawn against other classes or a post-funded levy was called upon;

- the scheme would have a borrowing facility, and would take an assignment of rights from claimants who accept compensation, entitling it to become a creditor in the winding-up of insolvent licensees;

- the scheme would be operated by an independent body governed by a constitution and with a board of directors comprising industry and consumer representatives;

- the scheme would be subject to approval by ASIC but would be independent from ASIC; and

- the interaction between the scheme and other compensation schemes, such as NGF, FCS and under the SIS Act, would need to be determined.

5.109 The proposal is said by its proponents to be a work in progress and is being further developed in consultation with stakeholders particularly in relation to the development of a new funding formula which more closely aligns the costs of the scheme to the class of financial services in which the consumer losses have arisen.

5.110 The proposal is referred to in this paper, given its relevance to the issues under consideration, and its possible assistance to respondents in considering elements of any model for a scheme, but without further comment or any endorsement.[23]

Other considerations

5.111 The question of a statutory compensation scheme needs to be considered in the context of existing regulatory arrangements for the financial services sector, including the extent and effectiveness of those elements directed to the protection of consumers. These include the existence of statutory last resort compensation schemes covering some critical, but not all, areas of financial services, as well as the default arrangements that rely on the holding by licensees of appropriate professional indemnity insurance cover.

5.112 There is a degree of interconnectedness in the present system and regard should be had in addressing particular problem areas to the effects of any new measures on wider regulatory settings and to market impacts.

5.113 The effects of any new measures, including on barriers to entry in the financial services sector, and on the cost of provision of those services, need to be weighed against the benefits to consumers who may be better protected and the consequential confidence of retail clients in the financial services sector.

5.114 There are shortcomings in the current arrangements. Cases arise where retail clients miss out on compensation to which they are entitled. This results in essence from their exposure to the credit risk of licensees against whom they have claims for compensation.

5.115 Cases of that kind can be very serious for the individuals who miss out on compensation. The size of the problem overall is less easy to gauge.

5.116 Responses to shortcomings in the current arrangements could include a more proactive approach to the administration of licensing arrangements for licensees, renewed efforts to improve the availability to licensees of appropriate insurance cover, and more attention to the adequacy of the financial resources of licensees at the outset, as well as a statutory scheme of last resort that would underpin the payment of compensation by financial advisers and other licensees. There is a precedent for a comprehensive last resort scheme in the United Kingdom,

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23 *Proposal to Establish a Financial Services Compensation Scheme*, prepared by Professional Financial Solutions Pty Limited for Financial Ombudsman Service, October 2009. Available at http://fos.org.au/centric/home_page/publications/submissions.jsp.

but there does not appear to be a comparable scheme elsewhere in Europe or in North America.

5.117 A key issue in any move to a statutory scheme of last resort will be the funding arrangements. Reliance on industry funding could well necessitate participation and potential contributions by all licensees including those who, under present arrangements, are exempt from the need to hold insurance cover by reason of their presumed relative financial strength. This raises questions of the extent to which more financially secure licensees should be expected to underwrite claims against licensees who are less well capitalised or do not have the backing of a corporate group. A relevant consideration may be the extent to which participants in the financial services industry share an interest in the maintenance of retail confidence in the integrity of relevant markets.

5.118 Another issue is the risk of exacerbating an expectation gap that may already exist for consumers in regard to compensable loss or damage. A move to a last resort scheme, while giving more assurance of some recovery of damages attributable to inappropriate financial advice or other licensee misconduct, will not in itself address losses and damage that flow from the collapse of a product issuer or other investment failures. Any move to widen the range of compensable claims to cover product failures more directly would raise substantial issues relating to moral hazard and comparability of treatment of other forms of investment such as shares.

5.119 In some instances also, such as where a product provider is licensed and deals with retail clients, the line between compensable damage by licensee misconduct, and losses from product failure, which ordinarily are not compensable, can become blurred. This may lead to apparent anomalies between the position of clients who can pursue last resort compensation, and those who cannot, following the failure of an investment product. A blurring of this line may also have implications for the funding of a last resort scheme, increasing its exposure to claims following a product failure as well as for moral risk on the part of consumers.

5.120 A somewhat related issue is the effect of any strengthening of compensation arrangements on the selection by aggrieved consumers of parties against whom to claim compensation. The licensees with whom retail clients have a direct relationship may already attract claims in circumstances where product issuers (who may not be licensed to deal direct with retail clients) or other parties such as directors or auditors share a responsibility. Those other parties will for example not be members of and subject to the jurisdiction of an EDR scheme. Changes to strengthen existing compensation arrangements might have the effect of skewing claims further in the direction of licensees whose liability to retail clients is underwritten by those enhanced compensation arrangements.

5.121 In the end, a balance will have to be made between the effectiveness of any enhanced compensation arrangements in protecting consumers and promoting confidence in the financial services sector, and their impact on the cost and supply of financial services to retail clients and the overall efficiency of the sector.

Information and comment is sought on the issues and possible remedial measures canvassed in this chapter, including on:

5.1 The nature and extent of any shortfall in the delivery of compensation under current arrangements.

5.2 The scope for further measures to lift the standards of licensee conduct or assist consumers in looking after their own interests.

5.3 The scope for a tighter approach to the administration of the current requirement to hold professional indemnity insurance.

5.4 The scope for more standardisation in the kind of professional indemnity insurance cover available for financial service licensees or classes of licensee.

5.5 The usefulness of improved disclosure about a licensee's professional indemnity insurance policy.

5.6 Possible arrangements to deal with claims for compensation after a licensee ceases to trade.

5.7 The case for additional requirements in regard to the financial security of licensees.

5.8 The merits, and key design components, of a last resort scheme to provide compensation for retail clients, including the approach to industry funding.

Attachment A:
Relevant Corporations Regulations

Compensation arrangements if financial services provided to persons as retail clients (Act s 912B)

7.6.02AAA(1) For paragraph 912B(2)(a) of the Act, arrangements mentioned in subsection 912B(1) of the Act are, unless the financial services licensee is an exempt licensee, subject to the requirement that the licensee hold professional indemnity insurance cover that is adequate, having regard to:

(a) the licensee's membership of a scheme (or schemes) mentioned in paragraph 912A(2)(b) of the Act, taking into account of the maximum liability that has, realistically, some potential to arise in connection with:

  (i) any particular claim against the licensee; and

  (ii) all claims in respect of which the licensee could be found to have liability; and

(b) relevant considerations in relation to the financial services business carried on by the licensee, including:

  (i) the volume of business; and

  (ii) the number and kind of clients; and

  (iii) the kind, or kinds, of business; and

  (iv) the number of representatives of the licensee.

7.6.02AAA(2) For paragraph 912B(3)(c) of the Act, a matter that ASIC must have regard to, before approving particular arrangements under paragraph 912B(2)(b) of the Act, is whether those arrangements provide coverage that is adequate, having regard to matters of the kind mentioned in subregulation (1).

7.6.02AAA(3) In this regulation, exempt licensee means:

(c) a company or institution of any of the following kinds:

  (i) a general insurance company regulated by APRA under the *Insurance Act 1973*;

  (ii) a life insurance company regulated by APRA under the *Life Insurance Act 1995*;

  (iii) an authorised deposit taking institution regulated by APRA under the *Banking Act 1959*; or

(d) a licensee (related licensee):

(i) that is related to a company or institution mentioned in paragraph (a); and

(ii) in respect of which the company or institution has provided a guarantee that:

A. ensures payment of the obligations of the related licensee to its retail clients; and

B. is approved in writing by ASIC.

Financial Services Guide given by financial services licensee: compensation arrangements

7.7.03A(1) For paragraph 942B(2)(k) of the Act, the Financial Services Guide given by the financial services licensee must include a statement about:

(a) the kind of compensation arrangements that the licensee has in place: and

(b) whether those arrangements satisfy the requirements for compensation arrangements under section 912B of the Act.

7.7.03A(2) This regulation commences, for a particular financial services licensee, on the date that subregulations 7.6.02AAA(1), (2) and (3) take effect for that licensee.

Attachment B:
Investor compensation arrangements in the European Union, Canada and the United States of America

Investor Compensation Schemes (EU)	Canadian Investor Protection Fund	Securities Investor Protection Corporation (USA)
Scope		
Member States of the EU are required to implement a compensation scheme in accordance with an EU Directive.[1] The scheme must provide for compensation where an authorised investment firm[2] fails to repay money or return financial instruments held on a client's behalf. Compensation is not available for other losses, such as from a decline in the value of the investment or negligent investment advice.	CIPF is designed to protect investors from the bankruptcy of an investment firm.[3] CIPF covers accounts used solely for the purpose of transacting in securities, cash balances, commodities, futures contracts, and segregated insurance funds received, acquired or held by the member in an account for the customer. The scheme is not restricted to retail investors.	SIPC protects funds or securities lodged with a firm which subsequently becomes insolvent. The scheme reimburses investors for stocks, notes, bonds, warrants and cash lodged for the purpose of security investment with a member firm that fails financially. All brokers and dealers registered with the Securities Exchange Commission must be members of the scheme.

1 Establishment dates for founding Member State Schemes: Austria –1999; Belgium –1999; Denmark –1998; Finland –1998; France –1999; Germany –1998; Greece –1998; Ireland –1998; Italy –1998; Luxembourg – 2000; Netherlands – 1998; Portugal – 2000; Spain – 2001; Sweden –1999; UK – 1988; Cyprus – 2004; Czech Republic – 2002; Estonia – 2002; Hungary – 1997; Latvia – 2002; Lithuania – 2002; Malta – 2003; Poland –2001; Slovakia – 2002; Slovenia – 2002.

2 An investment firm provides investment services for third parties, including reception and transmission, dealing, managing portfolios and underwriting of transferable securities, units in collective investment undertakings, money-market instruments, futures contracts, forward interest-rate agreements, interest-rate, currency and equity swaps, options to acquire or dispose of any of the above (including on currency and on interest rates).

3 CIPF's role in the Canadian regulatory system is shaped by, among other things, a Memorandum of Understanding with the Canadian Securities Administrators (CSA). CSA is comprised of Canada's 13 provincial and territorial securities regulators.

Investor Compensation Schemes (EU)	Canadian Investor Protection Fund	Securities Investor Protection Corporation (USA)
Grounds for compensation		
Compensation is available where: • an investment firm is unable to meet obligations arising out of investors' claims; or • a judicial authority suspends investors' ability to make claims against an investment firm. Cover has to be provided for claims arising out of an investment firm's inability to: • repay money owed/belonging to investors and held on their behalf in connection with investment business; or • return to investors any instruments belonging to them and held, administered or managed on their behalf in connection with investment business.	Claims can only be made when a CIFP member is insolvent. A claimant must be a customer of and have an account with a CIFP member, within which assets have not been returned to the customer by the (insolvent) CIFP member. Claims may be made by customers that are individuals, corporations, partnerships, unincorporated syndicates, unincorporated organisations, trusts, trustees, executors, administrators or other legal representatives. Non-citizens who have accounts with CIFP members are also covered.	Claims can only be made against broker-dealers who are in liquidation under the *Securities Investor Protection Act.* Claims can be made when a brokerage firm fails and cash and securities are missing from customer accounts. SIPC asks a federal court to appoint a trustee to liquidate the firm and protect its customers. With smaller brokerage firm failures, SIPC sometimes deals directly with customers.

Investor Compensation Schemes (EU)	Canadian Investor Protection Fund	Securities Investor Protection Corporation (USA)
Compensation not available		
Member States can exclude certain categories of investments or investors they consider do not need special protection. EU schemes generally do not extend to professional and institutional investors, including investment firms, credit institutions, pension, superannuation and retirement funds, directors, managers and members of investment firms, and large companies. Some members have chosen to extend compensation availability to large companies and professional and institutional investors[4].	Compensation is not available for the following customer losses: • changing market values of securities, unsuitable investments, or the default of an issuer of securities; • losses in accounts of customers related to business financing, such as securities lending and purchase/repurchase transactions; • losses where the customer has not filed a claim within 180 days of the date of insolvency; and • securities or segregated funds that are not held by a member, or recorded in a customer's account as being held by a member, for example, registered directly in the name of the customer with a mutual fund company.	Compensation does not extend to fraudulent sales practices, unsuitable investments, or failure to execute sell orders. Assets not covered include commodities, futures contracts, fixed annuity contracts, currency investments, as well as investment contracts (such as limited partnerships) that are not registered with the Securities and Exchange Commission.
Conditions		
Member State's may specify conditions on compensation provided they do not conflict with any EU Directive.	The Board of Directors may reduce the amount of a claim for financial loss by the amount of compensation the customer has received from any other source.	SIPC and court-appointed trustees assess compensation based on customer accounts as recorded in the books of the broker firm.

4 Countries that have extended compensation availability include: Denmark which allows claims from insurance companies, retirement funds and large companies; Finland which allows claims from any entity not formally recognised as a professional investor; France, Germany, Greece, Italy, Portugal and Spain which allow claims from large companies; Luxembourg which allows claims from auditors of the defaulting firm; Sweden which allows claims from all investors except firms that are themselves members of the scheme.

Investor Compensation Schemes (EU)	Canadian Investor Protection Fund	Securities Investor Protection Corporation (USA)
Access to compensation		
The directive leaves this to member states.	CIPF has developed a claims procedure which sets out timeframes and steps to be followed. CIFP or the trustee of the insolvent member will circulate a notice of insolvency to the member's customers. Customers must initiate the claim by lodging a proof of claim. CIPF reviews all claims to ensure they are eligible for compensation. Customers who are not satisfied with CIPF's decision may ask for the decision to be reviewed by a panel of CIPF Directors.	Customers of a failed brokerage firm get back all securities that are registered in their name or are in the process of being registered. The firm's remaining customer assets are divided on a pro rata basis with funds shared in proportion to the size of claims. If sufficient funds are not available in the firm's customer accounts to satisfy claims within these limits, the reserve funds of SIPC are used to supplement the distribution up to the defined claim ceilings. Additional funds may be available to go towards the remainder of customer claims after meeting the cost of liquidating the brokerage firm. Recovered funds are used to replenish the reserve where that reserve has been drawn on earlier in a liquidation proceeding.
Eligibility		
There are few rules on how compensation schemes should process claims from investors. In many cases, the establishment of eligible claims and calculation of compensation is a matter of judgment and the responsibility of the scheme operator, subject to the general criteria laid down in law and regulation.	The Board of Directors of CIPF has discretion to determine the customer's eligibility for protection and the financial loss suffered.	Compensation is only available to arms-length customers of brokers. It does not extend to brokers themselves or entities associated with a brokerage firm.

Investor Compensation Schemes (EU)	Canadian Investor Protection Fund	Securities Investor Protection Corporation (USA)
Assessment of claims		
The EU Directive requires compensation schemes to take appropriate measures to inform investors once a participating firm has defaulted and a compensation event is established. Assessment for compensation from a scheme is largely left to national law.	CIPF uses 'fair and reasonable policies' for assessing claims, to pay eligible claims and to review claims that are not accepted for coverage. The Board of Directors or a review panel will review the outcome if requested by the customer or CIPF staff.	Aggrieved customers submit a claim which describes the form of cash and securities that are owed to them. The court-appointed trustee will compare what the customer claims against the books and records of the brokerage firm. Frequently, a customer's entire account is transferred to another brokerage firm.
Compensation limits		
The EU Directive sets a minimum level of compensation per investor of at least 90 per cent of the first €20 000, though Member States are allowed to provide for a higher level of compensation.	Each customer's coverage is limited to a $1 million shortfall for any combination of cash and securities held at CIPF members. When a member becomes insolvent, the CIPF will move the customer' account, within the limits of coverage, to another investment dealer where the customer can access it.	The financial worth of a customer's account is calculated as of the 'filing date.' Wherever possible, the actual stocks and other securities owned by a customer are returned to them. Once the defaulting firm's assets are exhausted, funds from SIPC's reserve are available to satisfy the remaining claims of each customer up to a maximum of $500,000. This figure includes a maximum of $250,000 on claims for cash.

Investor Compensation Schemes (EU)	Canadian Investor Protection Fund	Securities Investor Protection Corporation (USA)
Funding of scheme		
The EU Directive calls for compensation schemes to be funded from contributions of participating firms proportionate to their liabilities. There are differences between States with regard to when contributions are collected, the management of the schemes, the degree to which funds are pooled across participating firms, the way contributions are calculated, and the existence of different funding arrangements.	The CIPF is funded by CIPF members. The size of the fund's resources is close to $300 million. CIPF determines the size of the fund based on the customer assets held by each of its approximately 200 members and also determines the amount that each Member has to contribute. For liquidity purposes the Fund has two lines of credit provided by two Canadian chartered banks totalling $100 million. The Fund has also arranged insurance of $70 million for any one loss and in the annual aggregate in respect of losses to be paid by CIPF between $100 million and $200 million, in the event of Member insolvency.	The scheme is funded from member assessments and income from investments in government bonds. The levy imposed on participants' ranges from a minimum of $150 per annum to a maximum of 1 per cent of their annual revenue.
Scheme governance		
Operation of schemes is left to national law, with some schemes under the responsibility of professional organisations and others regulated on a statutory basis. Although independent, the schemes generally maintain close relationships with the financial services regulator.	The CIPF is a non profit corporation created by the Canadian investment industry in 1969. The CIPF works with several sponsors: the Investment Industry Regulatory Organization of Canada, Bourse de Montréal Inc., and the TSX Group of Companies.	The SIPC was established by the *Securities Investor Protection Act 1970* and is a non profit, membership corporation, funded by its member securities broker-dealers.

Glossary

AFS licence	Australian financial services licence
APL	Approved Product List
APRA	Australian Prudential Regulation Authority
ASX	Australian Securities Exchange
ASIC	*Australian Securities and Investments Commission*
CIPF	Canadian Investor Protection Fund
COSL	Credit Ombudsman Services Limited
Corporations Act	*Corporations Act 2001*
EDR scheme	External dispute resolution scheme
FCS	Financial Claims Scheme
FSCS	Financial Services Compensation Scheme (UK)
FOS	Financial Ombudsman Service Limited
FSA	Financial Services Authority (UK)
IDR	Internal dispute resolution
NGF	National Guarantee Fund
PJC Inquiry	*Parliamentary Joint Committee on Corporations and Financial Services, Inquiry into financial products and services in Australia*
SEGC	Securities Exchange Guarantee Corporation
SCT	Superannuation Complaints Tribunal
SIPC	Securities Investor Protection Corporation (USA)
RG	ASIC Regulatory Guide
Ripoll Report	The final report of the PJC Inquiry, November 2009
Wallis Report	The final report of the Financial System Inquiry, March 1997