# 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;

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.