Chapter 2: Consumer protection in financial services

This chapter describes the current approach to the protection of retail clients who deal with providers of financial services. The grounds upon which clients can seek compensation for losses attributable to misconduct on the part of providers are described together with the avenues for redress. It covers the compensation arrangements required of licensees and the way in which the compensation arrangements are administered in practice. The focus is on areas where clients do not have access to the statutory last resort schemes already in place in some parts of the financial services sector.

Reference is made to the role of professional indemnity insurance in providing the compensation arrangements, the availability of such insurance in the market and the limitations of insurance in assuring that clients will be able to recover compensation to which they are entitled. The circumstances in which retail clients may not be able to recover compensation from licensees, and the extent of that shortfall, are addressed.

Regulatory approach

2.1 The current regulatory approach grew out of the recommendations of the report of the Financial System Inquiry in 1997 (referred to as the Wallis Report).[1]

2.2 The Wallis Report sought a balance between competitive outcomes in the financial system and consumer confidence in the integrity and safety of the system. It 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.

2.3 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.

2.4 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;

1 Financial System Inquiry, *Financial System Inquiry Final Report (Wallis Inquiry),* 1997.

- 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.

2.5 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, give rise to moral hazard. However there are some areas of the financial system where the high intensity of a promise creates a strong case for regulation and leads to greater government intervention.

2.6 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.

2.7 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 the risk of promises being dishonoured.

2.8 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.

2.9 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.

2.10 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.

2.11 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.

2.12 Some of the 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.

Licensing regime for financial service providers

2.13 The FSR Act introduced a single licensing regime for providers of financial services, whether to wholesale or retail clients. 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.

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

2.15 A person who carries on a financial services business is required to hold a licence.[2] 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.[3]

There does not appear to have been a statement at the time on the intent of the conduct obligations on licensees.

Adequacy of financial resources

2.16 Licensees are subject to a general obligation to have adequate financial and other resources to provide their financial services business and to carry out supervisory arrangements.[4] This obligation does not apply to licensees who are regulated by APRA given that they are subject to higher level prudential requirements. ASIC applies the financial requirements by way of licence conditions and its approach is set out in a regulatory guide.[5] The onus remains on a licensee to comply with the requirements and ASIC says the guide is not intended to ensure licensees meet their financial commitments.

2.17 In its regulatory guide, ASIC notes that it has not set financial standards with a view to ensuring that a licensee is able to compensate clients for a breach of its statutory obligations. In other words ASIC is not looking to have licensees hold sufficient capital to protect clients against credit risk as such, though it acknowledges that any capital held may contribute to a licensee's capacity to meet compensation claims by clients. ASIC appears to rely upon the requirement on licensees to hold

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2 Section 911A *Corporations Act 2001*.
3 *Financial Services Reform Bill 2001,* second reading speech to the House of Representatives, 4 December 2003.
4 Paragraph 912A(1)(d) *Corporations Act 2001*.
5 ASIC Regulatory Guide 166, *Licensing: Financial requirements,* May 2010.

professional indemnity insurance to mitigate the risk that they will be unable to meet claims that may arise.

2.18 In setting licence conditions ASIC sets minimum financial requirements, which vary according to the financial products and services the licensee provides.[6] The minimum standards for providers of financial advice (who do not also provide other financial services) 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
- lodge with ASIC an audit report each year which amongst other things contains information about the licensee's compliance with ASIC's financial requirements.

Additional requirements apply to other licensees including those who provide custodial services, are direct participants in a licensed financial market such as the Australian Securities Exchange (ASX) or operate a managed investment scheme.

2.19 ASIC provides licensees with several options to meet the base level 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 three 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. ASIC says that the licensee's projection of likely cash flows should 'demonstrate the effect of the combination of eventualities that makes it most difficult [for the licensee] to show it will have sufficient cash' but that in doing so the licensee can 'disregard highly unlikely contingencies or combinations of contingencies'. In other words the licensee is supposed to satisfy itself that it will have sufficient cash available to meet its liabilities including in the circumstances described above.
- Option 3 allows a licensee to rely on 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

6 ibid, *Section B – Base level financial requirements*.

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 if on a group basis the requirements of option 1 and 2 are satisfied.

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.

Conduct and disclosure requirements

2.20 The conduct of a licensee in dealing with retail clients is governed in two ways:

- by requiring conduct in the interests of the client (for example, in providing personal advice to a client); and

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

2.21 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 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

- ongoing disclosure is required for most products.

2.22 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.[7]

2.23 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.

Grounds for compensation claims

2.24 The compensation arrangements in Chapter 7 of the Corporations Act are intended to support the recovery of compensation awarded to a retail client who suffers loss or damage because a licensee has breached its obligations under that

7 Section 917E *Corporations Act 2001.*

chapter. As noted above, a licensee's statutory obligations are directed at conduct and disclosure.

2.25 Circumstances in which a licensee will be in breach of the conduct rules in Chapter 7 include where it:

- fails to comply with the principal duties of a licensee (for example, to do all things necessary to ensure that it carries on its financial services business efficiently, honestly and fairly and complies 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 (by taking into account the person's needs, objectives or financial situation); or
  - warning the client if the advice is based on incomplete or inaccurate information;[8]
- provides general advice but fails to warn the client that it does not take account of the client's objectives, financial situation or needs;[9]
- fails to assess the client's suitability before issuing or increasing the limit on a margin loan;[10]
- refuses to comply with a client's right to return a product in accordance with 'cooling off' provisions;[11] 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).[12]

2.26 A licensee will breach the conduct rules by engaging in conduct that is prohibited under Chapter 7. This includes dishonest conduct, and 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.[13]

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

- does not provide a relevant disclosure document 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).[14]

2.28 A licensee is also required to comply with *financial services laws* more broadly, including other Commonwealth, State or Territory laws dealing with conduct in the provision of financial services, certain parts of the *Australian Securities and*

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8 Sections 945A and 945B *Corporations Act 2001*.
9 Section 949A *Corporations Act 2001*.
10 Section 985K *Corporations Act 2001*.
11 Section 1019B *Corporations Act 2001*.
12 Section 981B *Corporations Act 2001*.
13 Sections 1041E – 1041H *Corporations Act 2001*.
14 Section 953B *Corporations Act 2001*.

Investments Commission Act 2001 (ASIC Act) and, for a licensed trustee company, rules of common law or equity relevant to trustee company services.[15]

2.29 According to a Treasury paper in 2002:

> it was not the intention that section 912B be read as requiring the compensation arrangements to cover compliance with other *financial services laws*, one of the obligations included in section 912A.[16]

This appears to be saying that the compensation arrangements were intended to cover the liability of licensees for losses resulting from a breach of the statutory obligations set out in Chapter 7 of the Corporations Act but not for a breach of other *financial services laws*. If that was the intention it does not appear to have been reflected in the language of the statute.

2.30 It should be remembered that in the absence of misconduct on its part, a licensee is not responsible to compensate a consumer for loss in the value of investments following on from:

- product failure or general investment losses;
- the financial failure of a financial product issuer; or
- performance by an investment that has not met expectations.

2.31 According to a recent study based on a review of about 229 consumer complaints of inappropriate financial advice determined by the courts, FOS and ASIC between 2006 and 2007, misconduct by financial advisers related to:

- the appropriateness or completeness of advice provided (57 per cent of the cases) and in particular:
  - failure to disclose information relevant to the client decision or remuneration benefits and conflicts of interest (20 per cent);
  - inadequate explanation of risks of investment or financial product (15 per cent);
  - advice which did not meet client objectives or circumstances and had no reasonable basis (12 per cent);
  - inadequate understanding of the financial product recommended (10 per cent);
- inadequate written advice or tailoring of advice to the client (9 per cent);
- misleading statements, including as to performance, product features or riskiness (around 15 per cent);
- use of client funds for own purposes (13 per cent); and
- failure to follow licensee compliance procedures (6 per cent).[17]

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15 Paragraph 912A(1)(c) and the definition of financial services laws in section 761A *Corporations Act 2001*.
16 The Treasury, *Compensation for loss in the financial services sector: issues and options*, September 2002 p 50.
17 June Smith, *Ethics and Financial Advice: The Final Frontier,* Victoria University, 2010.

Avenues for consumer redress

2.32 A client who suffers a loss or damage arising from licensee misconduct can seek redress through private legal action including:

- by pursuing an action for a breach of contract, breach of trust 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;[18]
  - for a failure by a responsible entity of a registered managed investment scheme to meet its obligations;[19]
  - that follows from the licensee's failure to provide a disclosure document;[20] 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;[21]
- by utilising the power of the courts to make orders relating to the payment of money.[22]

2.33 ASIC is 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 has succeeded in obtaining compensation for retail clients in a number of cases brought under s50 of the ASIC Act. Such action can be taken 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.

2.34 Compensation may also be secured as an outcome of an ASIC investigation of a licensee's conduct, as in the following cases:

- ASIC secured the return of client funds and compensation of their financial loss (around $50,000) following action taken against a financial adviser (who operated as an authorised representative for those licensees) for deception and dishonest dealings with documents.[23]
- ASIC accepted an Enforceable Undertaking (EU) from a licensee following concerns that it failed to comply with its licensing obligations. As part of the EU the

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18 Section 1317HA *Corporations Act 2001.*
19 Section 601MA *Corporations Act 2001.*
20 Section 953B or 1022B *Corporations Act 2001.*
21 Section 1041I *Corporations Act 2001.*
22 Section 983E *Corporations Act 2001.*
23 ASIC Media Release, 11 - 210AD, 27 September 2011.

licensee is to rectify any deficiencies identified by the appointed independent expert including compensation for clients for loss suffered by them.[24]

- ASIC took action against an authorised representative of a financial adviser for inappropriate advice and other misconduct. The licensee agreed to a compensation program that would return affected clients to investment positions they would have held had they received appropriate advice. An independent expert was appointed to review the compensation offers.[25]

Alternative dispute resolution

2.35 It is also open to retail clients to seek redress through the less formal alternative dispute resolution processes, comprising both internal and external processes. External dispute resolution schemes provide a less costly and relatively expeditious alternative to formal court processes and they are commonly utilised by retail clients with compensation claims.

2.36 A licensee is required by section 912A to be a member of at least one external dispute resolution (EDR) scheme approved by ASIC.[26]

2.37 In approving schemes, ASIC looks to an EDR scheme to provide free access for consumers, to actively promote its services, to be independent of its members, to be overseen by an independent body, and to apply principles of natural justice.[27]

2.38 The two EDR schemes currently approved by ASIC are Financial Ombudsman Service Limited (FOS) and Credit Ombudsman Services Limited (COSL).

2.39 Whilst FOS has half as many members as COSL, its membership base generally comprises larger financial service providers as well as a broad range of financial services sectors. The membership base of:

- FOS generally comprises insurers, deposit takers, some authorised credit providers, stockbrokers, responsible entities of managed investment schemes, trustees of superannuation funds, financial advisers and insurance brokers;

- COSL generally comprises non-bank lenders, finance brokers, credit unions, building societies, debt collection firms, some financial advisers and mortgage managers.

The revenue base of FOS is ten times larger than that of COSL.

2.40 The upper limit of an award is currently $150,000 for a claim against a general insurance broker and $280,000 for other claims (with the caps adjusted for indexation). The schemes are required to deal with consumer complaints involving monetary amounts up to the value of the retail client test in the Corporations Act (currently $500,000).

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24 ASIC Media Release, 10 - 275AD, 20 December 2010.
25 ASIC Media Release, 11 - 42AD, 10 March 2011.
26 ASIC Regulatory Guide 165: *Licensing: internal and external dispute resolution,* April 2011, and Regulatory Guide 139: *Approval and oversight of external dispute resolution schemes,* April 2011.
27 ASIC Regulatory Guide 139, *Section B: Guidelines for initial and ongoing approval,* April 2011. 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.

2.41 Following recent changes, EDR schemes now have a discretion to handle complaints against a member that has ceased to carry on business or ceased to have a licence.[28]

2.42 The cost of operating EDR schemes is borne by member licensees. FOS is funded by an annual membership levy, an annual user charge, and case fees (based on complexity and the stage reached in the process).[29] Case fees are payable by the member even if the scheme finds in its favour.

2.43 A member of an EDR scheme is contractually bound to pay an award once accepted by the applicant in full and final settlement of a dispute.[30] It does not follow in practice that the licensee will always have adequate insurance or the financial capacity to pay. A licensee who fails to pay could be reported to ASIC for serious misconduct and, as a result, it would be open to ASIC to take steps to cancel its licence or impose conditions on the licence. In practice, in circumstances where a licensee is likely to be insolvent, or has disappeared, such action is not likely to result in the award being paid.

Grounds for EDR scheme awards

2.44 In approving an EDR scheme ASIC looks to see whether it reflects the principles of accessibility, independence, fairness, accountability, efficiency and effectiveness. In regard to fairness, ASIC says it believes a scheme's dispute handling should accord with the principles of natural justice. This has been supported by the courts.[31] ASIC does not otherwise seek to limit the scope of the standard by which disputes may be resolved.[32]

2.45 ASIC's regulatory guidance 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'.[33] In determining the extent of loss or damage suffered by a complainant that should be compensated, the scheme should have regard not only to the relevant legal principles but also to the concept of fairness and to industry best practice.

2.46 In practice EDR schemes are not limited to handling disputes involving a breach of a licensee's obligations under Chapter 7. They have jurisdiction to award compensation on grounds that go beyond breaches of Chapter 7 or indeed breaches of the law at all. Schemes may have regard to laws of tort, contract, the concept of fairness and to industry best practice. FOS for example in resolving 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 ... 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.[34]

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28 ASIC Regulatory Guide 139, April 2011, paragraphs 139 and 196 to 200, FOS Constitution paragraph 3.10, and COSL Constitution paragraph 10.1.
29 User charges do not apply to members who had no more than one dispute in the prior year.
30 *Financial Industry Complaints Service (FICS) Ltd v Deakin Financial Services Pty Ltd* [2006] FCA 1805.
31 ibid.
32 ASIC Regulatory Guide 139, April 2011, paragraphs 102 to 107.
33 ASIC Regulatory Guide 139, April 2011, paragraph 211.
34 FOS Terms of Reference, clauses 1.2 and 8.2.

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.[35]

EDR scheme awards and professional indemnity insurance

2.47 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.

2.48 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 ... it must cover negligence, fraud and other misconduct (relating to retail clients) ordinarily covered by a contract of professional indemnity insurance.[36]

It is noted that ASIC in this regard goes beyond requiring a licensee to have insurance covering breaches of Chapter 7.

2.49 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.

2.50 Only a small proportion of the total disputes received by FOS in 2010-11 were investment disputes (2,235 of the 30,283 complaints received).[37] In its previous annual report, FOS said 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.

2.51 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’.[38] In other words, those disputes were about inappropriate advice from a financial adviser.

2.52 While FOS says that it can deal with a dispute about non-disclosure or misrepresentation by a product issuer, in practice very few disputes alleging misrepresentation or mis-selling more broadly by the product issuer appear to have been brought or considered (see further Chapter 5).

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35 FOS Terms of Reference, clause 4.2.

36 ASIC Regulatory Guide 126, *Compensation and insurance arrangements for AFS licensees, Scope of cover,* Notes 1 and 2, p 17, December 2010.

37 FOS characterises investment disputes as those relating to managed investments, superannuation, securities, derivatives and hedging, and real property.

38 FOS Annual Review 2009-10, section on Investment Disputes.

2.53 In its handling of claims regarding investment services FOS found in favour of claimants in 16 per cent of cases and in favour of members in 11 per cent.[39] The remaining cases were resolved by members outside FOS, or by agreement, or were dismissed by FOS or withdrawn by the claimants.

2.54 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.[40]

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

Activity	Aggregate claims $million	Aggregate outcomes $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

2.55 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.[41] 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 (a predecessor ombudsman service to FOS) was not obliged to, and in many cases was not able to apply the principle of proportionate 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 noted that some of these parties were not members and thus not subject to an EDR scheme's jurisdiction.

Scope of compensation arrangements

2.56 There have been for many years legislative 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 in the provision of those services.

2.57 Compensation arrangements can be traced back to 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

39 FOS data provided to the review relating to the four year period to December 2009.
40 FOS may not record the outcome amount for some claims so the value of claims settled in favour of the claimant may be understated.
41 FOS Circular, 4 December 2010.

responsible entities of registered managed investment schemes were required to have appropriate professional indemnity insurance.

2.58 As part of the introduction of a uniform licensing regime by the FSR Act, harmonised compensation arrangements were introduced in the Corporations Act. These include a requirement for 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 statutory obligations.

2.59 There was public consultation and discussion over a period of years on the appropriate content of those compensation arrangements.

2.60 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.

2.61 CAMAC released a consultation paper which proposed a scheme to compensate retail clients of licensed financial service providers who became insolvent.[42] 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 NGF and the Sydney Futures Exchange.

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

2.62 In 2002, the then 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 resulting issues paper would include matters canvassed by CAMAC and he noted that the objective of the compensation arrangements was:

42 CAMAC, *Retail Client Compensation in Financial Markets*. September 2001.

> 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.[43]

2.63 The issues paper concluded that there appeared to be justification for compensation 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;
- consumer 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.

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.

2.64 Following consideration of submissions received in response to that paper, a position paper was released in December 2003.[44] The then Government expressed a preference for compensation arrangements based on professional indemnity insurance, and proposed that regulations specify professional indemnity insurance as the default arrangement to meet the section 912B requirement. The Government concluded that the use of professional indemnity insurance appropriately balanced consumer protection and the cost to business.

2.65 Under the adopted approach 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. Prudentially regulated ADIs and insurers are not required to have professional indemnity insurance on the basis that they can in effect self insure.

Specific schemes of last resort

2.66 It is important to note that the requirement for licensees to hold professional indemnity insurance is not the only compensation arrangement in the financial service sector. Other arrangements have been established over time to provide additional, last resort, protection in particular areas:

- Operators of financial markets, such as a securities exchange, are required to have compensation arrangements to cover losses by clients who entrust property to stockbrokers and other market participants to transact through their market. The National Guarantee Fund (NGF) of the ASX for example provides compensation where a client suffers loss by reason of the defalcation of, or unauthorised dealing with, its funds or property.

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43 The Treasury, *Compensation for loss in the financial services sector: issues and options*, September 2002.
44 The Treasury, *Position Paper Compensation for loss in the financial services sector.* December 2003.

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

- The SIS Act enables the Minister to make grants of financial assistance for loss incurred by a superannuation fund trustee from fraud or theft.

2.67 These specific last resort arrangements which cover critical areas of financial services need to be kept in mind when considering the adequacy of current compensation arrangements overall. Licensees operating in those areas are subject to more intensive regulation than applies to financial service licensees in general. A more detailed description of these statutory arrangements is provided in Appendix C. An overview of the compensation arrangements that apply to financial services licensees is provided in Table 2.2.

International comparisons

2.68 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. Members of the European Union, the United States of America and Canada have established compensation arrangements for investors in securities, derivatives or futures markets who suffer losses due to the insolvency of intermediaries holding funds or securities on their behalf. These arrangements correspond broadly to the protection available to clients of stockbrokers in Australia under NGF.

2.69 In the United Kingdom a comprehensive two-tiered compensation regime requires investment firms to hold professional indemnity cover and capital appropriate to their risks and activities. The UK regulator appears to play a relatively active role in administering these tier one arrangements, with firms required for example to notify the regulator that they have renewed their insurance policies and follow up action by the regulator where no confirmation is received. The second tier arrangement in the UK is a last resort compensation scheme (the Financial Services Compensation Scheme) which provides some recompense for consumer loss arising from poor advice or investment management, fraud or failure to return investment funds where the firm is insolvent or otherwise unable to meet the claim. These arrangements provide broader protection than is generally available in Australia or elsewhere. A more detailed description of the UK arrangements is provided in Chapter 6 and Appendix D.

Table 2.2: Compensation arrangements applicable to financial services licensees

Financial services providers requiring a license	Financial advisers	Insurance brokers and agents	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 (prudentially regulated entities)		Professional indemnity insurance, self insurance 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 under SIS Act 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		

Nature of compensation arrangements

2.70 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);[45] and
- arrangements for compensating clients for loss or damage suffered because of a breach by the licensee of its statutory obligations (s912B).

2.71 The stated policy intent of section 912B is to 'reduce the risk that compensation claims [by] retail clients cannot be met by the relevant licensees due to the lack of available financial resources'.[46] The rationale is described in a Treasury paper as follows:

> 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.[47]

2.72 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

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45 The dispute resolution system must consist of both:
- 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.

46 Regulation Impact Statement, *Compensation Arrangements for Financial Services Licensees,* October 2006.

47 The Treasury, *Compensation Arrangements if Financial Services are provided to Retail Client under section 912B of the Corporations Act, Commentary on Draft Regulations*, 2006.

(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.

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).

2.73 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.

2.74 Appendix E sets out the relevant regulation in full as well as the regulation covering the disclosure of information on compensation arrangements by a licensee.

Exemptions and alternatives

2.75 The regulation provides an exemption from the need for compensation arrangements for a licensee who is:

- 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.[48]

2.76 The rationale for the exemptions is that licensees who meet APRA's capital adequacy and other prudential requirements are less likely to fail and more likely to

48 Regulation 7.6.02AAA(4) *Corporations Act 2001.*

have the financial capacity to meet claims for compensation from their own funds.[49] Such licensees are able in effect to self insure against the risk of compensation claims that might arise from their clients.

2.77 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. Such a guarantee would have capital implications for the APRA-regulated entity and there have been only a few arrangements of this type to date.

2.78 Those licensees who are exempt from the need to hold professional indemnity insurance (largely APRA-regulated licensees) are not exempt from the requirement to pay any compensation liabilities they incur.

2.79 ASIC is empowered by paragraph 912B(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 paragraph 912B(3)(c) and by regulation, including the licensee's volume of business, the number of clients, the kinds of business undertaken and the number of representatives as set out in sub regulation 7.6.02AA(1). The legislation 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. It is understood that only one such arrangement has been approved.

Coverage of representatives

2.80 A licensee's insurance policy is expected to cover possible breaches committed by its representatives as well as breaches by the licensee itself.[50] A representative includes:[51]

- 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;[52] or
- any other person who acts on the licensee's behalf.

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

2.81 The regulations require licensees to include in their Financial Services Guide a statement about the kind of compensation arrangements they have in place and whether those arrangements satisfy the requirements under s912B.[53] In particular:

49 Regulation Impact Statement, *Compensation Arrangements for Financial Services Licensees,* April 2007.
50 Part 7.6, Division 6 *Corporations Act 2001.*
51 Section 910A *Corporations Act 2001.*
52 Sections 916A or 916B *Corporations Act 2001.*
53 Regulation 7.7.03 *Corporations Act 2001.*

- licensees who hold professional indemnity insurance are required to state 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;[54] and

- other licensees have to state that they have alternative arrangements approved by ASIC or that they are exempt from the requirement for compensation arrangements.

As noted in Chapter 4, there is a question about the utility of such bare disclosures.

Insurance as a basis for compensation

2.82 Professional indemnity insurance is a commercial product available to financial services providers (amongst other professionals) 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.[55]

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.

2.83 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.

2.84 In Regulatory Guide 126*,* ASIC says its objective in administering the compensation arrangements 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.[56]

ASIC goes on to say that professional indemnity insurance is not a guarantee that compensation will be paid if there is a claim.

2.85 The Guide 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 be practically available.

2.86 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:

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54 ASIC Regulatory Guide 126, Part G – Disclosure in FSGs.
55 The Treasury, *Available and affordable – Improvements in liability insurance following tort law reform in Australia*, December 2006.
56 ASIC Regulatory Guide 126, paras 5 and 8.

- minimum requirements and features;
- 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.

2.87 In brief, a policy should include:

- a limit of indemnity of at least $2 million and up to $20 million (based on revenue);
- cover (and no exclusions) 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;
- excess amounts at a level that the licensee can confidently sustain;
- cover of legitimate switching from funds or products that are not on an approved product list to another fund or product on the approved product list;
- defence costs;
- automatic reinstatements; and
- retroactive cover.[57]

Licensees are expected to consider a more detailed list of factors in determining the level of indemnity that is adequate for their business.

2.88 In introducing its administrative guidance, ASIC initially proposed to require professional indemnity insurance to provide automatic run-off cover (that 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 but has indicated that it will continue to monitor the availability of automatic run-off cover and may reassess its position in the future.

ASIC administration of insurance requirement

2.89 ASIC's general approach is to look to licensees to assess for themselves the adequacy of their professional indemnity cover, taking account of the guidance in Regulatory Guide 126. The onus is on a licensee to comply as part of its overall licensing obligations and 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.

2.90 An applicant for a licence is not required to provide ASIC with a copy of its insurance policy but has to provide some information about its insurance cover and a

57 A retroactive clause is designed to cover past unknown claims arising in a period covered by the immediately previous policy.

certificate of currency of that insurance. The information sought in summary form 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, a licensee dealing in margin loans must confirm in writing to ASIC that the policy covers standard margin lending.

2.91 Once a licence is granted the licensee is not subject to annual or other periodic renewal. There is a requirement upon the licensee under section 912D to notify ASIC of certain breaches, or likely breaches, of its obligations under section 912A or section 912B. The requirement only applies if the breach is significant, having regard to various considerations including the actual or potential financial loss to clients that might arise from the breach. Whether or not a breach should be reported to ASIC depends on the licensee's own judgment of its seriousness.

2.92 ASIC does conduct some risk-based surveillance of licensees through which it could 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 licensees.

2.93 If ASIC becomes aware that a licensee does not have professional indemnity insurance, it could take action to suspend or ultimately cancel the licence. That said, the basis upon which ASIC could take such action is not straightforward. ASIC's guidance to licensees on assessing the adequacy of their professional indemnity insurance goes beyond the considerations referred to in the Corporations Regulation. It remains to be seen whether, if ASIC took proceedings against a licensee based on the inadequacy of its insurance cover, a court or the Administrative Appeals Tribunal would accept ASIC's view of the considerations bearing on that question. This issue is considered further in Chapter 4.

Limitations of professional indemnity insurance

2.94 There are some limits to the effectiveness of professional indemnity insurance as a mechanism for compensating retail clients who suffer loss as a result of a licensee's misconduct. As stated in Regulatory Guide 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.[58] However, professional indemnity insurance is an imperfect mechanism to achieve this protection for consumers. In its submission, ICA says that it:

> ... has consistently argued that professional indemnity insurance cannot be made to operate as a guarantee that compensation will be paid and if the Government adopts this as a policy goal, there should be serious consideration given to the merits of a last resort compensation scheme.[59]

2.95 There are limits to the extent to which professional indemnity insurance cover will respond to claims against a licensee by retail clients. In circumstances where there is no available cover or the policy does not cover the claim, the licensee's ability to meet claims will depend upon its available financial resources.

2.96 Some of the limitations of professional indemnity insurance 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.[60]

2.97 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 there may no longer be a policy in force to respond to a claim.

2.98 There are other reasons why a professional indemnity policy may not respond to a claim. As discussed below these include circumstances where:

- a licensee is in breach of its contractual obligations under the policy;
- the claim falls within an exclusion in the policy;

58 ASIC Regulatory Guide 126, Part G – Disclosure in FSGs, p 4, December 2010.
59 ICA submission, page 1.
60 ASIC Report 107, *Compensation arrangements for financial services licensees - Research into the professional indemnity insurance market*, December 2006, page 23.

- a licensee faces claims that fall within the level of excess it has to bear;
- the claim exceeds a cap on the cover provided by the policy;
- the claim is made after the cancellation of an insolvent licensee's policy.

Breach of insurance contract

2.99 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.

2.100 If a licensee fails to meet such an obligation, the insurer may be entitled to deny payment of a claim.[61] 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.[62] 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.

Policy exclusions

2.101 Professional indemnity insurance contracts commonly include a number of exclusions or circumstances under which the policy will not cover a claim. 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.

2.102 Licensees will face a problem if offered policies that exclude activities or products that they provide. The review has been told of instances where policies have been renewed with more limited coverage than before. In a recent survey ASIC says that some licensees are finding new or renewed policies to have significant exclusions for more risky products and services. ASIC says it expects licensees:

> ... to refrain from providing some more risky services or products for which they are unable to obtain adequate insurance cover.[63]

It is not clear whether licensees are in fact limiting their services in this way.

2.103 In practice, policies often limit indemnity to financial advice provided in relation to products that are on the licensee's approved products list (APL).[64] It is understood that in some cases insurers exclude certain products on a licensee's APL that they consider to be higher risk or more complex.

2.104 Although ASIC says in RG 126 that it requires insurance policies to cover liabilities that might arise 'for fraud or dishonesty by directors, employees or

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61 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.

62 Part 7 of the *Insurance Contracts Act 1984* deals with cancellation of insurance contracts.

63 ASIC Report 251, *Review of financial advice industry practice,* September 2011, page 32.

64 Slater and Gordon submission, page 3. 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.

representatives', both FOS and Slater and Gordon say that, in their experience, professional indemnity insurance policies do not always cover fraud or dishonesty by directors.[65]

Excess payments

2.105 Insurance policies commonly require the policyholder to bear an excess (or deductible) amount when a claim is made. To the extent that an excess is payable, the licensee is in effect self-insuring. The larger the excess, the more financial pressure a licensee may come under when faced with a claim. Where a licensee is faced with a number of claims, this pressure will be exacerbated.

2.106 The cost of 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.

2.107 In its regulatory guidance, ASIC says it is the responsibility of the licensee to consider how they will cover the insurance excess if a claim is made. Licensees are told to assess the financial resources required (to cover the excess and gaps in cover due to exclusions) and to ensure they have such financial resources available. ASIC says 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.[66]

2.108 NIBA in its submission refers to a move by insurers to increase excess levels, especially in relation to claims that would fall within the jurisdiction of an EDR scheme.

Caps in insurance contracts

2.109 Professional indemnity insurance contracts generally provide cover up to a capped amount. 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.[67]

2.110 ASIC also calls for a policy to include at least one automatic reinstatement.[68] ASIC believes that automatic reinstatement is generally available in the market, but acknowledges that it may come at a higher cost than the previous cover.

2.111 Where a licensee is faced with a large number of claims, or a number of 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.

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65 FOS submission and Slater and Gordon submission.
66 ASIC Regulatory Guide 126, December 2010, paragraphs 59 – 60.
67 ASIC Regulatory Guide 126, December 2010 page 24.
68 ASIC Regulatory Guide 126, December 2010 page 18. Automatic reinstatement applies where the limit of the policy is exhausted before the end of the policy period and the limit of indemnity is reinstated for the balance of the period to cover any new claims that might arise. This is not required where the limit is at least twice the minimum amount of cover.

2.112 The cap may also be reached more quickly if claims made against a licensee's policy relate not just to losses by retail clients but to non-financial services parts of its business, its obligations towards wholesale clients or costs incurred in defending claims.

2.113 It is understood that associated licensees, such as related managed investment schemes, sometimes acquire a group policy which provides collective cover for their professional liabilities but with a single cap which can be exhausted through claims made by any one of the group policyholders.

Insolvency leading to cancellation of an insurance policy

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

2.115 Where a licensee is in financial distress a client's chances of recovering compensation may depend on when its loss was realised and a claim lodged. If the licensee's policy operates on a claims made basis, a claim made:

- while the licensee's insurance policy is in force can be dealt with even if the licensee has become insolvent;
- after the licensee's insurance policy has lapsed or been cancelled will not be covered.

Clients who realise their loss and claim compensation early will have a better chance of recovering compensation than later claimants.

2.116 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 to the claimant the amount recovered net of the excess, or the insurance company may make a payment net of excess to the claimant direct.[69]

2.117 A licensee will generally be required to notify its insurer if it becomes insolvent, and in many cases an insurer will then cancel the policy 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.

2.118 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.

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69 Section 562 of the *Insurance Contracts Act 1984* provides that the proceeds of an insurance contract should be paid to the third party to which a company has incurred the liability in priority to the payments of the company's debt (though there may be exceptions).

Compensation arrangements in practice

Access to professional indemnity insurance

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

2.120 The professional indemnity insurance market appears to be functioning adequately for licensees overall. However, there appears to have been a hardening in the market for financial advisers with only three or four underwriters now providing cover (two providers including one of the largest withdrew from this market recently).[70] By its nature the insurance market is cyclical and changes in the availability and cost of cover can be expected over time reflecting both experience in the relevant market (including the incidence of claims and uncertainties about future trends) and the wider impact of underwriting and other factors.

2.121 ICA comments in its submission on the reasons for the tight supply of professional indemnity insurance for financial advisers:

> The global financial crisis in 2008 increased the cost of capital and with it the price of reinsurance cover generally. In relation to PII, it resulted in reinsurers being more selective in the risks they were willing to cover. This was particularly the case for a sector such as financial planning where there had been considerable losses in Australia due to several large scale financial collapses. These developments have been reflected in the pricing of PII.

2.122 ASIC for its part has expressed the view that the professional indemnity insurance market overall is functioning adequately for providers of 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 meets ASIC's standards.[71] 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 were able to negotiate these if they could satisfy 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;

70 FPA submission, page 26.
71 ASIC Submission to the PJCCFS, *Inquiry into the collapse of Trio Limited*, August 2009, pages 82-84.

- 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.

2.123 Financial advisors and insurance brokers have confirmed the difficulty for advisers of acquiring professional indemnity insurance that meets ASIC requirements of adequacy. FPA says in its submission:

> There is an extreme inadequacy and unavailability of professional indemnity insurance for financial advisers and licensees in Australia ... there are three to four underwriters in (the financial planning space) offering policies with multiple exclusions and inadequate cover to meet the RG 126 requirements.

NIBA for its part says:

> ... the PI market is harder given the recent adverse claims/dispute experience. NIBA understands that whilst aggregated adviser groups can still obtain compliant PI at reasonable cost given the numbers of participants, smaller advisers may face difficulty, dependant on their claims experience.

2.124 Licensees have also expressed concerns about the reluctance of insurers to provide the full cover sought. Where for example $20 million of cover is required, 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. It may be particularly difficult and expensive for smaller advisers and sole traders to obtain the cover sought as risk is not spread between group participants.[72]

2.125 These market conditions have an impact on the cost of insurance for some licensees as well as access to cover. Some submissions have made the point that the cost of premiums appears to vary according to the activities of the licensee in question, with financial advisers facing larger increases. NIBA states that:

> In relation to insurance brokers, as the risk has remained relatively stable along with the PI requirements that applied before the Corporations Act 2001 (Cth), so too has the premium and availability of insurance.
>
> In relation to investment advisers the trend has generally been towards a lessening of capacity as insurers withdraw from this specific PI market as a result of the increasing claims experience trends. NIBA understands that the costs have been increasing and the flexibility of terms decreasing.

ICA made a similar point in its submission.

2.126 FPA in its submission compares the cost of premiums for advisers in Australia and those operating in the United Kingdom:

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

72 NIBA submission, paragraph 21.

It is understood that the figure quoted by FPA for the cost to advisers of insurance in Australia is based on anecdotal evidence from a limited number of its members. While it has not been verified, it suggests that the cost of premiums for Australian advisers (at least those of the profile surveyed by FPA) is high compared to what is understood to be the average for licensees overall. The figures quoted by FPA also suggest a marked difference in the average cost of premiums paid by advisers in the United Kingdom and Australia. A disparity of that kind could reflect differences in supply between the two insurance markets as well other factors such as insurers' perspectives of the relative risk of covering advisers in those markets.

Role of professional indemnity insurance

2.127 Professional indemnity insurance provides licensees with a useful mechanism to assist in managing their risk of incurring claims for compensation from clients. In practice it appears to play a large part in assisting licensees to compensate complainants. Overall it provides a measure of assurance that claims will be met.

2.128 It does this to the extent that a licensee in fact has insurance cover as required and that any 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 there is no policy in place to respond to a claim.

2.129 FOS has indicated that in most cases consumers who are awarded compensation are able to recover it under current arrangements. Drawing on experience in dealing with a large number of disputes FOS has stated that:

> Usually either the financial planning firm will have the resources to meet any award made against them or they will have a PI insurer involved ... the vast majority of disputes at FOS against whatever type of financial services provider, if they end up with a decision in favour of the consumer, will get paid.[73]

2.130 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 profile 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.

2.131 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 expected to file a breach report with ASIC. A breach report should act as a red flag for ASIC and attract attention and scrutiny of the licensee in question.

2.132 The requirement on most licensees to hold adequate professional indemnity insurance for compensation purposes is not of course without cost. The cost to licensees of their compensation arrangements would be expected to flow through to the cost of the financial services provided.

73 Alison Maynard, Ombudsman, Financial Ombudsman Service, testimony to the PJC Inquiry into the collapse of Trio Limited, Hansard, 30 August 2011, page 8.

Costs and benefits

2.133 Owing to the limited information available, it has not been possible to conduct a satisfactory cost benefit analysis of the current compensation arrangements. However with the assistance of APRA an effort has been made to calculate the direct cost to licensees of professional indemnity insurance together with benefits derived by consumers from those arrangements. While this information is set out for what it is worth, the analysis, given the limitations noted below, needs to be used be with some care.

2.134 APRA has provided data on professional indemnity insurance (by underwriting year) for a subset of the category 'financial occupations' that is generally reported on by APRA.[74] While this subset does not equate with licensed financial product and service providers who are the subject of this review it appears to provide a fairly good proxy for them.

2.135 The data for this subset relates more closely to the compensation arrangements of licensees than the data referred to in Chapter 3 of the Consultation Paper which related to the broader set of 'financial occupations'.[75] Given the limitations noted below however it is not possible to derive from this data a complete estimate of the costs and benefits of the current compensation arrangements.

2.136 The data relates to the underwriting years 2005-2008 for a subset of 'financial occupations' that covers financial planners, stockbrokers, finance brokers, insurance companies, insurance related services, banks and building societies, superannuation funds and managed investment schemes. As it also includes some accounting services it is likely to be a somewhat broader group than licensed financial services occupations. However, for the sake of simplicity, the subset of occupations to which the data relates is referred to as 'licensees'.

2.137 Some of the data for this subset did not fit with the expected profiles of claims and policies relevant to the review. In particular there were a small number of policies which reported unusually high excess payments. These were removed from the analysis.

2.138 The cost to 'licensees' of meeting their obligations to compensate consumers for misconduct is estimated on average to be at least $160 million per annum representing:

- the cost of professional indemnity insurance arrangements (gross written professional indemnity insurance premiums and excess payments made under those policies);
- membership and case fees under EDR schemes; and
- a proportion of FOS awards treated as paid by licensees direct to clients from their own funds rather than under insurance policies where the value of the award was below the average excess payable under the policy.

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74 Unpublished data provided by APRA from its National Claims and Policies Database (NCPD).

75 The data set used in this report excludes the following occupations which are generally included in APRA data on 'financial occupations': aspects of accounting services (insolvency and acquisition, management services and audit), bookkeeping services, IT business services, hardware engineering, computer consultants, computer systems auditors, computer programmers, computer service bureaus, IT education and training, and web design. The data in Tables 3.1 to 3.4 of the Consultation Paper used APRA data for all financial occupations including those listed in this footnote.

The estimate does not include other compensation payments made direct to consumers, including where a claim is settled at the internal dispute resolution stage, or on the basis of a court award or ASIC compliance or deterrence action. Nor does it include the cost to 'licensees' of complying with other obligations under Chapter 7, such as in providing internal dispute resolution processes, or compliance with other financial services laws. The estimate does not include the costs to licensees or consumers of defending or making claims for compensation or the cost to licensees of complying with prudential standards where applicable.

2.139 The benefit derived by consumers from the compensation arrangements is estimated on average to be at least $66 million per annum representing:

- gross claims incurred against professional indemnity insurance policies held by 'licensees.' Gross claims incurred includes both amounts paid by insurers and estimates of remaining payments to be made on reported claims (case estimates);[76] and

- a proportion of FOS awards assumed to be paid by licensees direct to clients from their own funds rather than through insurance policies where the award was below the average excess payment.

The estimate does not include other compensation payments made direct to consumers as described in the previous paragraph, or the benefit to consumers of having access to a dispute resolution scheme that is free of charge.

2.140 An imbalance between estimated costs and benefits of the magnitude indicated would call into question the cost effectiveness of current arrangements. The limitations of the analysis that has been possible to undertake should be kept in mind. It should be noted that additional claims are likely to be reported for the periods considered (due to the long tail nature of claims made against policies held by 'licensees'), and will result in increases to the benefits to consumers as measured by the gross claims incurred against professional indemnity insurance policies held by 'licensees'. For example, some of the failures referred to in Chapter 3 might give rise to additional claims. In other words, the gap between costs and benefits is expected to decrease over time as more claims are reported.

2.141 Furthermore, some imbalance is consistent with expectations for an insurance market that is profitable over the long term.[77] That is, in aggregate, the costs of insurance should exceed the benefits paid out across a class of policyholders. This is because insurers need to cover operating costs (including underwriting and claim processing costs), as well as providing an acceptable return on the level of capital required by APRA for this type of business. The costs of insurance may vary depending upon recent industry experience and competitive pressures.

2.142 There are of course other costs and benefits that cannot be quantified in monetary terms. One benefit is the confidence provided to consumers of financial products where there is some assurance of compensation for licensee misconduct. There are also the social and individual costs borne by consumers, their families and

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76 The claims data used does not include provisions made by insurers for claims they estimate to be 'incurred but not reported'.

77 This explanation of the operation of an insurance market is relevant even though in the costs and benefits analysis some of the costs and benefits are not attributable to the insurance cover.

communities in circumstances where they suffer uncompensated loss through licensee mis-selling or other misconduct.

2.143 It is noted too that the APRA data shows there has been an overall increase in gross written professional indemnity insurance premiums collected by insurers from 'licensees' of 15 per cent over the underwriting years 2005 to 2009, despite a temporary decline in the premiums collected in the initial two years of that period.

Consequences where insurance not available

2.144 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 compensate the client from its own resources.

2.145 Notwithstanding the regulatory requirement for professional indemnity insurance cover, there could well be other cases where licensees do not in fact maintain adequate, if any, cover.

2.146 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 to pay the compensation.

2.147 Where a licensee becomes insolvent and its insurance policy is no longer in force, clients with outstanding awards of compensation 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.

Shortfall for consumers

2.148 Generally speaking it seems that retail clients are able to recover compensation for losses attributable to licensee misconduct. However, in a limited number of cases they are not able to do so. In these cases clients are unable to recover awards of compensation owing to a licensee's lack of available financial resources. Particular instances of consumers remaining uncompensated involve misrepresentation or mis-selling of products associated with the collapse and failure of a managed investment scheme (discussed further in subsequent chapters).

2.149 It is not always clear in such cases whether the licensee 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. In some cases licensees leave their compensation liabilities behind and re-emerge to carry on business in a new guise.

2.150 The cases in which consumers are unable to recover compensation mostly appear to involve claims against financial advisers, such as for inappropriate advice, and are associated with investments in a financial product that fails.

2.151 The review has had limited success in quantifying the magnitude of the problem either in terms of the losses from licensee misconduct that are not able to be recovered or the number of consumers affected. ASIC and FOS have provided assistance, but information relevant to this review has not generally been collected on a systematic basis. Care is needed to avoid equating the often large scale of consumer losses where an investment product fails, and the generally more limited claims based on licensee misconduct that may be associated with or follow such a failure.

2.152 The information available does not capture the outcome of all claims (such as where they are settled), and generally does not capture losses suffered by consumers who do not pursue claims owing to the limited prospect of recovery following the failure of a licensee. Little is known about whether licensees who fail in fact held insurance cover of the kind required up until the failure of their business.

2.153 According to ASIC, a small number of licensees are wound up involuntarily each year including through ASIC enforcement action. ASIC says the number of such cases is increasing, with 44 licensees having their licence cancelled in 2010-11 at least twice as many as in each of the previous three years.

2.154 All that ASIC and FOS can say definitively is that a handful of small and medium sized licensees are likely to be 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. It has referred by way of example to a current case of a licensee with some $7 million of compensation claims from around 12 clients in regard to inappropriate advice. It is too early to say whether those clients can substantiate their claims or the extent of compensation that might be paid to them either through any available professional indemnity insurance or the insolvency proceedings which have commenced. ASIC expects that total claims may exceed $20 million.

2.155 FOS has provided two examples of claims for compensation that led to awards that the licensee has been unable to pay:

- in the first case there were 78 claims against a member licensee that became insolvent. In aggregate, a total of almost $4.6 million was awarded in compensation, but claimants only recovered $2.7 million of that amount;
- a recent case in which approximately $1.2 million was awarded to complainants, with an average award of about $91,000. None of the awarded amount has been recovered by complainants at this time. FOS is still to consider further claims against the same licensee amounting to approximately $2.9 million.

2.156 Further, in the period September 2007 to September 2010 FOS handled 69 complaints where the member became insolvent. Table 2.3 shows the outcome of those claims.

Table 2.3: 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 data.

FOS is aware that in at least six of the ten cases where it found in favour of the complainant client the complainant received no payment of compensation. In at least two of those cases, non-payment was due to lack of funds available for unsecured creditors and lack of available insurance cover.

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

2.158 In advocating a last resort scheme, FOS has tried to estimate the size of uncompensated losses based on the cases of licensee insolvency that it has dealt with in recent years (including the first example described in paragraph 2.155). In its first submission to this review FOS provided an estimate of the value of uncompensated losses that might be handled by a last resort scheme on such a basis.[78] The estimate, undertaken for FOS by the actuarial firm Professional Financial Solutions Pty Limited (PFS), was that in an average year 'the scheme would receive claims of $12 million per annum and claim numbers of 180 per annum'.

2.159 It is understood that the estimate was based on FOS experience in managing 148 claims over the period 1 January 2006 to 30 June 2008 where member licensees entered insolvency. In more than half of those claims, FOS made awards which averaged $65,000 per claim. In estimating the value of 'uncompensated losses', FOS and PFS assume that their sample of 148 equals a third of the possible consumer claims of this type. They base this assumption on their assessment that FOS dealt with a third of Westpoint claims (with the majority of Westpoint affected consumers participating in ASIC action referred to in Table 3.1). Therefore, FOS's estimate of number of claims that would be 'uncompensated' in an average year is calculated on the following basis:

adjustment to base for claims assumed not lodged with FOS = 148 x 3 = 444 claims;

conversion to per annum basis = 444 ÷ 2.5 = 180 claims per annum; and

calculation of value of claims for average year = 180 x $65,000 = $12 million per annum.

2.160 While this estimate provides a sense of the scale of the problem it needs to be treated with some caution. In particular:

- the data is drawn from disputes brought to FOS and assumes that FOS deals with a third of all claims. This uplift factor appears to be based on experience in one significant case, Westpoint, which is not necessarily typical. In that case, ASIC brought action on behalf of investors under section 50 which is not done as a matter of course;
- it is noted that the average amount of the award used in the estimate ($65,000) differs from the average amount awarded by FOS in a more recent case of insolvency ($91,000)(see paragraph 2.155);

78 FOS, *Proposal to Establish a Financial Services Compensation Scheme,* October 2009.

- the base does not account for consumer losses that are not claimed because consumers believe they are unlikely to recover anything due to licensee insolvency. The introduction of a last resort scheme to underwrite the liabilities of insolvent licensees could result in more claims coming forward;

- the estimate assumes that consumers who received FOS awards recovered nothing from insurance or through insolvency proceedings. FOS does not know whether the claimants they dealt with received any compensation through other means. As a practical matter, consumers are unlikely to have recovered more than a small proportion of their compensable loss through insolvency proceedings.

2.161 Overall therefore it is difficult to quantify the shortfall suffered by retail clients under the current compensation arrangements. The case studies and other information provided by ASIC and FOS indicate that the value of compensation claims that cannot be recovered following the failure of licensees is significant, probably running into some millions of dollars each year, but not large when compared for example with the scale of losses suffered by consumers following the failure of financial products in which they have invested.

2.162 While the shortfall may be limited in aggregate terms there is no denying the seriousness of the potential impact on individuals who do not receive compensation to which they are entitled.

2.163 ASIC recently released the findings of research undertaken by its Consumer Advisory Panel into the social impacts of investors suffering losses due to licensee misconduct.[79]

2.164 Investors who participated in the study reported initial losses ranging from $2,000 to $200,000, with most reporting losses of around $50,000.[80] The study found that the participants received limited if any compensation and no more than a few cents in the dollar. It found that some consumers did not make claims to recover their loss because they:

- were unable to make contact with licensees who were in administration and did not know about other avenues of redress;

- felt too ashamed to seek assistance and blamed themselves for the loss; or

- were unwilling to risk more money on private legal action.

2.165 For consumers who lost all their money and/or incurred debt, the financial impact of the loss was 'immediate and critical' and even 'catastrophic' and 'so significant their life will never be the same'. The impact on affected individuals included the loss of the family home, illness, strain in family relationships, and frugal spending on essentials. The study found the emotional wellbeing of affected consumers deteriorated with 'prolonged anger, uncertainty, worry and depression'. The study also found a subsequent lack of confidence in the financial system by those experiencing the loss.

2.166 There is also a flow on cost to the community as a whole, with some cost transferred to governments, the financial system, the charitable sector, and the

79 ASIC Media Release 11-102MR, May 2011 and ASIC Report 240, *Compensation for retail investors: the social impact of monetary loss,* May 2011.
80 ASIC Report 240, page 20.

corporate sector more broadly. For example, individuals who had invested to fund their retirement may have to turn to the age pension following their loss.[81]

Phoenix activity by some licensees

2.167 There appears to be a disturbing incidence of cases in which, following the winding up of licensed firms with outstanding compensation claims, the principals of those firms emerge in another firm.

2.168 It is a serious matter of concern if licensees, faced with compensation liabilities they may have difficulty in meeting, can be wound up and then re-emerge with no responsibility for those prior compensation liabilities. In some cases a new licensed entity emerges with the same or similar principals or the principals re-enter the industry as representatives for another licensee. Through such conduct, the new entity or former principals are able to continue in business free of the liabilities in the former licensed entity.

2.169 The principals of a licensed firm may re-emerge by forming a new company and being granted a new financial services licence before it becomes apparent that the misconduct of the prior licensee has resulted in large scale client loss. Retail clients who suffer loss from licensee misconduct where the licensee ceases to trade, disappears or becomes insolvent, will struggle to obtain payment for awards made in their favour.

2.170 It is understood that phoenix companies are often set up in the same premises or close to those of their predecessor entity with similar staff and directors and sometimes trade under a similar name. Consumers are unlikely to be aware that much the same financial services business is being run under a different licence. It is difficult for consumers to protect themselves in those circumstances by avoiding dealing with providers who have engaged in prior misconduct.

2.171 In other instances, directors of an insolvent company move on to become authorised representatives or employees of other licensees.

2.172 One submission provided a case study of phoenix activity involving a licensee who faced 'scores of inquiries' for client loss from misconduct in the period 2008-10.[82] The submission states that:

> The licensee went into liquidation and the liquidator informed unsecured creditors, including those with legal proceedings on foot, that there were no assets and no professional indemnity insurance cover left to meet claims.
>
> The liquidator ... informed Maurice Blackburn that the following year (2009-10), the licensee continued to provide financial advice but had no professional indemnity insurance at all.
>
> The licensee went into liquidation and a new company was formed by at least one of the directors. This company continues to provide financial advice from the same office.

81 Joint Consumer Submission (prepared in association with a number of consumer organisations and individuals) expands on these points, page 3.
82 Maurice Blackburn submission, page 1.

2.173 ASIC for its part has informed the review that it is seeing a concerning level of phoenix activity in the financial advice sector. ASIC has provided the review with some case studies and these are summarised in Table 2.4.

Table 2.4: Case studies of phoenix activity in providing licensed financial services

Case Study 1 - Operating under a new licence
Company A was a mid-sized financial advisory business that held a professional indemnity insurance policy with a limit of $2 million. Under the policy, Company A's insurer accepted several claims for monetary loss due to inappropriate financial advice. When Company A went into liquidation, the liquidator informed unsecured creditors, including consumers with legal proceedings against the licensee on foot, that there were no assets or professional indemnity insurance cover left to meet any outstanding claims. According to the liquidator's report unsecured creditors, including consumers with unpaid compensation claims, were owed $1-5 million, but would receive back zero cents in the dollar. Around the same time Company A went into liquidation, a new company was formed, similar in name: Company A2. Company A2 operates out of the same office as Company A. The authorised representatives of Company A2 appear to have been authorised representatives of Company A. Some of the directors of Company A also became directors of Company A2. One of the directors subsequently became an authorised representative once they became bankrupt and could no longer be a director. Many investors in the original Company A appear to have suffered 'catastrophic loss'.[a] Individuals who suffered loss have expressed concern to ASIC that new investors in Company A2 will suffer similar detriment to them.
Case Study 2 - Operating under a new licence
Company B was a mid-sized licensee with approximately 40 representatives. The director of Company B incorporated Company B2 and within 6 months obtained a financial services licence for Company B2. Company B cancelled its licence and revoked authorisation for its 40 representatives, and the Director resigned and appointed his wife. Company B entered voluntary administration. Company B2 operated in exactly the same manner, in the same premises, with the same business name and same representatives as the former Company B. FOS made determinations for 18 clients of Company B totalling around $5 million in respect to licensee breaches such as failing to provide a written statement of advice and proper risk disclosure. Company B had a professional indemnity insurance policy with a limit of $2 million, but the policy may not respond to awards because the insurer has not been notified of the claims made.
Case Study 3 - Operating as an authorised representative of another licensee
Company C was a small licensee associated with a number of accountancy and finance practices and was licensed to provide financial advice to retail clients. ASIC became aware that Company C had growing debt and increasing losses. Company C also had a history of moving between professional indemnity insurers. Company C formed a new company, Company C2, with the same directors. Company C2 became a corporate authorised representative of an unrelated licensee, Company X. Company D, had directors in common with Companies C and C2, also became a corporate authorised representative of Company X. Voluntary administrators were appointed to Company C and creditors voted in favour of a Deed of Company Arrangement. Unpaid investor claims against Company C range from $8 - 10 million. Company C2 has already switched its authorised representative relationship from Company X to Company Y, another small licensee. It may be that Company C2 was also causing liabilities for Company X, which is why it moved to become the authorised representative of Company Y.

Source: ASIC.

(a) 'Catastrophic loss' is defined in ASIC Report 240 *Compensation for retail investors: the social impact of monetary loss*, May 2011.

2.174 Phoenix activity of this kind calls into question the efficacy of the consumer protection regime for financial services.

2.175 Licensees with a track record of misconduct giving rise to uncompensated consumer loss present a real threat to other consumers if they re-emerge in the financial services industry. Their ability to remain in business also affects consumer confidence in the financial services sector. There is likely to be an expectation by consumers who have suffered uncompensated loss in dealing with a licensee that the regulator will be able to prevent other consumers from being put at risk in dealing with a re-emerged entity or key individuals from that licensee. In case study A in Table 2.4, individuals who suffered loss from the licensee in question expressed concern to ASIC that new investors in the re-emerged licensee were also at risk. Regulatory intervention is required to protect consumers and preserve consumer confidence in such circumstances.

2.176 It is noted that recent legislative amendments address the cost to the community of phoenix activity by companies that liquidate to avoid paying liabilities such as employee superannuation entitlements and taxes.[83]

Operation of EDR schemes

2.177 While not the focus of this review, EDR schemes such as FOS play a key role in the regime for the protection of consumers of financial services. EDRs provide a facility through which consumers can pursue complaints against a licensee at no cost to themselves and a consumer friendly and relatively informal forum for the resolution of disputes. Some 25,000 new cases were brought to FOS and COSL in 2009-10.

2.178 EDRs clearly play an important role in providing consumers with ready access to a process for the resolution of disputes with providers of financial services. It is timely however to reflect on the way in which they have developed and on underlying issues which seem to be becoming more pronounced as the jurisdiction of EDRs is extended to include claims for substantial damages.

2.179 While industry has been involved in and generally supportive of the development of EDRs, there appears to be some disquiet about aspects of their working in practice. The concerns go to issues of fairness, touching on the rule of law, and of cost. These concerns are of lesser significance in the context of the handling of run of the mill complaints by consumers about the administration of their accounts or policies, which constitute a large proportion of EDR business, and may be accepted in the interest of a ready means for the resolution of consumer disputes. The concerns are more serious however when considered in the context of the recently expanded jurisdiction of EDRs to consider claims up to $500,000 and to award compensation up to $280,000.

2.180 The concerns relate to matters such as:

- the lack of effective rights of review from decisions;
- the limited transparency of dispute resolution processes including the grounds for awards;
- the inability of a licensee member to join in a proceeding other licensees who may share responsibility for the loss or damage in question (looking to proportionate liability). While in theory a respondent licensee might be able to institute separate proceedings in a court to recover a proportion of an award from another responsible licensee this may not be a practical option in terms of the additional time, cost and effort (see further Chapter 5);
- while complaints can be brought to an EDR scheme without cost to a consumer, the EDR process is not cost free to member licensees against whom complaints are brought. Member licensees bear all the cost of a proceeding even where there

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83 *Tax Laws Amendment* (2011 Measures No. 7) Act 2011.

is a finding in their favour. Moreover, a consumer who succeeds in obtaining an award in his or her favour has the option of walking away from the EDR process and pursuing legal rights, by joining a class action for example. While free access to complaint handling processes for consumers is generally an admirable feature, there is a case for imposing some kind of fee on the applicant at the outset of a claim for substantial monetary compensation. Payment of a fee, even if relatively limited in amount, would be consistent with the seriousness and demands of the process as well as providing at least some disincentive for claims of limited substance;

- the fact that the liability standard for EDR awards is not confined to breaches of legal rights but may include broader notions such as fairness or industry practice;
- concerns from licensees about apparent inconsistency between an EDR scheme's interpretation of licensee obligations and regulatory guidance issued by ASIC;
- operational issues about the management of disputes including the role of insurers and their legal representatives in the EDR processes.

It is understood too that insurers have concerns about aspects of the EDR process and their uncertainties in this regard may have contributed to the tightening of the professional indemnity insurance market for financial advisers. NIBA in its submission refers to a move by insurers to increase excess levels, especially in relation to claims that would fall within the jurisdiction of an EDR scheme.

2.181 It appears that more attention needs to be given to underlying issues of due process and transparency in the context of the expanded jurisdiction of EDRs in order to maintain confidence in the system and contain any undue cost burden on the provision of financial services.

2.182 There will always be some trade-off between the provision of low cost, flexible dispute resolution services for consumers and ordinary procedural and due process safeguards. The answer may lie in the provision of somewhat more rigorous and transparent processes for claims for compensation in excess of a reasonable monetary threshold. I suggest that issues of the kind noted above call for further consideration including by EDR schemes themselves and ASIC in its overview role.

Assessment

The following considerations are relevant in assessing the adequacy of the current arrangements to provide consumers with assurance about their ability to recover compensation following licensee misconduct:

Regulatory approach

(a) The Corporations Act declares that financial services 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.

(b) As those arrangements have been implemented, most licensees are required to submit to a dispute resolution system and hold professional indemnity insurance cover that is adequate for their business. Such arrangements are not without cost. That cost would be expected to flow through to the consumers of financial services, with a potential to affect access to those services.

(c) Certain licensees (particularly those regulated by APRA) are exempt from any requirement to hold insurance on the basis of their apparent financial strength and ability to meet claims for compensation from their own resources. The basis for this exemption is clear and the exemption does not appear to have given rise to difficulties for consumers.

Insurance as a basis for compensation

(d) Professional indemnity insurance is a commercial product that assists licensees to pay compensation awarded to a client. It is not a direct mechanism for the compensation of clients. While the requirement for many licensees to take out professional indemnity insurance has provided insurers with a captive market for that sector, they provide the product on their own terms which do not necessarily include terms which ASIC would like to see (run-off cover for example).

(e) The professional indemnity insurance market appears to be functioning adequately for licensees overall. In the case of financial advisers however only a small number of insurers are willing to offer cover, the cost of that cover is increasing, and there has been a tightening in the terms on which it is made available. By its nature the insurance market is cyclical and changes in the availability and cost of cover can be expected over time reflecting both experience in the relevant market (including the incidence of claims and uncertainties about future trends) and the wider impact of underwriting and other factors.

(f) A licensee remains liable to make a compensation payment itself where it does not have insurance cover or its cover proves inadequate.

Protection for consumers

(g) Overall, it seems that retail clients are able to recover compensation awarded to them in most cases. In some cases however there is a shortfall and retail clients remain uncompensated.

(h) There are inherent limitations in the assurance provided by professional indemnity insurance, including policy exclusions, gaps in the cover, caps on the amount of cover taken out and the application of the policy once a licensee becomes insolvent.

(i) There is a question about the extent to which licensees in practice are maintaining professional indemnity insurance that is adequate to their needs. Licensees are expected to self assess the adequacy of their professional indemnity cover taking into account guidance from the regulator. There is limited pressure on licensees or attention by ASIC to ensure that licensees in fact hold adequate insurance. There is a risk that some licensees do not maintain insurance cover, are underinsured or have cover that excludes aspects of the services they provide.

(j) Where a licensee does not have recourse to insurance, a client pursuing a claim for compensation is exposed to the licensee's creditworthiness. Where the licensee has stopped trading or become insolvent, or does not have available resources, a client may be left without compensation.

(k) Under present arrangements the requirements on licensees to have adequate financial resources to carry on their business are limited, as is the scrutiny of those resources.

(l) It is a matter of real concern that some licensees, faced with compensation liabilities they may have difficulty in meeting, appear able to be wound up and then re-emerge with no liability for prior compensation liabilities.

(m) The default arrangements where consumers do not have recourse to schemes of last resort provide a measure but no guarantee that retail clients will be able to recover compensation to which they may be entitled.

(n) It has not proved possible satisfactorily to quantify the number and size of claims for loss that remain uncompensated. All that can be said is that a relatively small number of small and medium sized licensees are likely to be wound up each year with outstanding compensation liabilities running to several million dollars.

(o) In many cases where consumers go uncompensated their claims involve misrepresentation or mis-selling of products associated with the collapse and failure of a managed investment scheme.

(p) While the shortfall may not appear great overall there is no denying the potential seriousness of the consequences for individual consumers who miss out on compensation to which they are entitled. There could be a consequential impact on the confidence of those consumers in financial services.

Specific schemes of last resort

(q) In key areas of financial services statutory last resort compensation arrangements are already in place through NGF, FCS and arrangements under Part 23 of the SIS Act. Licensees operating in those areas are subject to more intensive regulation than applies to financial service licensees in general.

(r) On a comparative basis, our regime for the protection of consumers in the financial service sector is relatively well developed. The confining of last resort arrangements to particularly sensitive areas is broadly in line with approaches in other countries. The United Kingdom however goes further than other countries in providing last resort protection for consumers where a licensed firm is insolvent or otherwise unable to meet a claim against it.

Operation of EDR schemes

(s) While not the focus of this review, it is noted that EDRs such as FOS play a key role in the regime for the protection of consumers of financial services. They provide a relatively informal process through which consumers can bring complaints against licensees at no cost to themselves. They play a valuable role in this regard. At the same time, EDRs are not cost free to member licensees or to the provision of financial services to consumers. A note of caution is sounded about elements of their operation and processes as they grow beyond their origins as forums for resolving small claims. Issues of the kind noted in paragraph 2.180 call for further consideration including by EDR schemes themselves and ASIC in its overview role.