Chapter 4: Comparison with other arrangements

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

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

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

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

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

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

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

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

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

Table 4.1: Summary of overseas compensation schemes

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

UK compensation arrangements

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

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

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

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

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

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

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

4.13 Further details of FSCS are provided in Table 4.2.

Table 4.2: UK compensation scheme

Financial Services Compensation Scheme

Scope

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

Claims may be brought by retail and small business customers.

Grounds for compensation

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

For investment claims, FSCS provides protection where:

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

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

Compensation not available

Compensation is not available where:

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

Conditions

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

Assessment of claims

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

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

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

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

Financial Services Compensation Scheme

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

Compensation payable

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

Funding

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

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

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

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

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

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

The levy limits for each class are:

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

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

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

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

Financial Services Compensation Scheme

Governance

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

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

Operation of UK arrangements

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

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

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

New prudential requirements

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

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

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

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

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

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

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

Proposed changes to UK regulatory architecture

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

- a new Financial Conduct Authority (FCA) which will have the role of consumer protection and market conduct for financial markets and will supervise all retail and wholesale services firms. FCA will also have oversight of the Financial Ombudsman Service, the Consumer Financial Education Body, and FSCS; and
- the Prudential Regulation Authority (PRA) which will continue in its role of monitoring financial institutions but will operate as a full subsidiary of the Bank of England.

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

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

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

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

Schemes in other countries

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

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

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

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

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

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

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

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

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

Operation of schemes in Canada, USA and EU

Canadian Investor Protection Fund

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

Securities Investor Protection Corporation (USA)

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

EU

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

- In Ireland, an Irish stockbroking firm ceased trading in April 2001 following the discovery of financial irregularities and the misappropriation of assets from clients' accounts. The scheme received 2,606 claims, verified 2,235 for payment and rejected 371. The scheme paid more than €7.5 million to claimants in respect of verified claims.
- In Spain, there have been more than 8,000 claims with almost 7,000 from the insolvency of one broker. Compensation funds of €31.8 million were made available.

Compensation schemes in other industry sectors

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

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

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

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

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

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

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

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

Professional indemnity insurance schemes

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

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

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

Issues of interest

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

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

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