

## Chapter 4: Strengthening current arrangements

This chapter looks at ways in which the default arrangements for compensation could be made more effective. A first step in bolstering the protection of consumers would be to implement a more robust system to put licensees in a position to meet any compensation claims based on their own misconduct.

Proposals are put forward for:

- more onus on licensees to verify that they have adequate insurance cover;
- more attention by ASIC to the adequacy of licensees' financial resources as viewed in conjunction with their insurance cover;
- a more pro-active stance by ASIC in administering compliance by licensees with their obligation to hold adequate professional indemnity insurance or other financial resources;
- strengthening ASIC's ability to police the licensing system.

There is a need to strengthen the regulator's hand to deal effectively with licensees and key individuals who, having left the industry with outstanding compensation obligations to consumers, re-emerge in another guise.

The ability of consumers to obtain access to a licensee's insurer and to pursue claims direct in circumstances where a licensee has disappeared or has become insolvent is also considered, as are the requirements on licensees who voluntarily cease to trade.

The importance of concerted efforts by the regulator to police the boundaries of financial services and target firms or individuals who operate outside the licensing system in ignorance or defiance of its requirements is also noted.

### Introduction

4.1 The current regulatory approach to assurance of the availability of compensation to retail clients is a light handed one. As noted below, this approach:

- entrusts licensees to self assess the level of professional indemnity insurance that is adequate to their needs and to maintain such cover;
- does not require any confirmation by licensees to ASIC as a matter of course that they have such cover in place;
- requires little in the way of financial resources on the part of licensees in general;
- is administered by the regulator on a reactive basis; and

- provides the regulator with limited powers to enforce standards or sanction non-compliant licensees.

4.2 Built on the licensing regime for the providers of financial services, it calls for those licensees who deal with retail clients to hold professional indemnity insurance cover that is adequate for the needs of their business. ASIC has published guidance on considerations it sees as relevant to adequacy for this purpose, but the judgment of the adequacy of cover is largely left to the licensee.

4.3 Again, while the licensee has to certify, when first applying for a licence, that it holds appropriate cover there is no obligation upon it to confirm that its cover is maintained from year to year thereafter. ASIC for its part does not check whether licensees in fact hold appropriate cover on a regular or systematic basis. Even where a licensee fails, and consumers are left with outstanding claims, not much attention seems to be paid to whether the licensee had in fact maintained appropriate insurance cover during the course of its business.

4.4 In other words the insurance obligation rests very much on self assessment by licensees of the cover called for in their circumstances and their own sense of responsibility in maintaining that cover.

4.5 Some financial service licensees, such as advisers, by the nature of their business do not require much in the way of capitalisation. However, apart from recent initiatives by ASIC in respect to certain sectors, there are only limited requirements on the adequacy of financial resources of licensees apart from the insurance cover that is available to them.

4.6 ASIC's approach to the administration of the relevant requirements tends to be reactive and, where breaches of a licensee's obligations do come to light, its position and powers in terms of revoking a provider's licence or applying other sanctions are limited.

4.7 It appears that consumers are able in most cases to recover compensation for loss or damages they suffer by reason of licensee misconduct. This may well be a reflection of the fact that most licensees take a responsible approach to their obligations and are in a position to meet claims against them.

4.8 Nevertheless in some cases consumers are not able to recover compensation to which they are entitled because the licensee had no or inadequate insurance cover and lacked other financial resources.

4.9 Any effort to bolster the protection of consumers should be directed in the first place at those less responsible licensees who do not maintain adequate insurance cover, or a reasonable buffer of financial resources, to meet claims for compensation that may arise in the course of their business.

4.10 It is suggested that a more robust approach could involve:

- putting more onus on licensees to establish that in fact they have adequate insurance cover;
- requiring licensees to demonstrate they have capital resources at risk from consumer claims, with trade-off possible between available insurance cover and capital resources;

- a more pro-active approach by ASIC;
- a strengthening of ASIC's position to police the licensing system.

The aim would not be to increase the regulatory burden on licensees overall, but to enable a tighter approach to be taken to licensees who present more of a risk.

### **Current regulatory arrangements**

4.11 Under the existing regulatory framework, the onus is on licensees to assess for themselves the adequacy of their professional indemnity insurance cover, taking into account the minimum requirements in Regulatory Guide (RG) 126. ASIC does not take an active role in the monitoring of compliance.

4.12 The requirements are self-executing with the onus on a licensee to comply as part of its overall risk management processes. ASIC does not vet the terms of a licensee's insurance cover. It is up to the licensee to form the view that its cover is adequate.

4.13 Licensees who deal with retail clients are required to have in place arrangements for compensating clients for loss or damage suffered because of the breach by the licensee or its representatives of its statutory obligations. The regulations require licensees to hold adequate professional indemnity insurance as the default arrangement for compensation. Some categories of licensees are exempt from this arrangement on the basis of their presumed relative financial strength.

4.14 For most licensees therefore regulatory reliance is placed on professional indemnity insurance to provide assurance of the licensee's capacity to meet compensation liabilities. No significant regard is had to the extent to which the licensee's financial resources (apart from insurance cover) might enable it to meet compensation liabilities.

4.15 An approach of this kind poses a degree of systems risk that a licensee may be:

- uninsured at a point in time when cover is required;
- underinsured;
- covered by a professional indemnity insurance policy that excludes certain products or services provided by the licensee and in relation to which it is exposed to potential future claims of compensation; or
- under-resourced financially.

4.16 In the course of the consultation process the review has heard anecdotal accounts of licensee under-insurance, including a licensee that operated for up to 18 months with no insurance.<sup>1</sup>

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1 ACTek Superannuation Fund, Maurice Blackburn and Slater and Gordon submissions.

## Administration of insurance requirement

4.17 An applicant for a licence has to provide ASIC with information about its insurance cover and a certificate of currency of that insurance. The information, which is largely sought on a yes/no basis, covers matters such as:

- name of the insurer;
- period of the policy cover;
- total amount of cover;
- the amount of excess and whether it is at a level that the licensee can confidently sustain as an uninsured loss;
- whether all financial services and products offered are covered;
- whether breaches of Chapter 7 of the Corporations Act by both the licensee and its representatives are covered;
- whether ASIC-approved EDR scheme awards are covered;
- whether fraud by representatives, employees and agents is covered; and
- an indication of policy exclusions.

The licensee does not have to provide ASIC with a copy of its policy.

4.18 Once a licence is granted by the regulator it is not subject to any annual or other periodic renewal. A licensee is not required to confirm the renewal of professional indemnity insurance cover from year to year. ASIC proceeds on the basis of a representation by a firm at the point when it is first licensed that it has cover which the firm believes is adequate for its circumstances.

4.19 The onus remains on a licensee to form the view upon renewal that its professional indemnity insurance policy is adequate taking into account the minimum requirements in RG 126. ASIC does not take an active role in the monitoring of compliance nor does it vet the terms of a licensee's insurance cover.

4.20 A licensee is expected to notify ASIC if it is likely to breach its licence obligations to a significant extent.<sup>2</sup> The failure of a licensee to have adequate professional indemnity insurance could constitute such a breach, but it is understood that ASIC has only received a handful of notifications in regard to insurance cover.

4.21 ASIC generally does not conduct systematic or periodic compliance checks on the professional indemnity insurance policy held by licensees, although insurance cover may be looked at as part of ASIC's broader surveillance activities.

4.22 ASIC says it generally takes a pro-active and reactive risk-based approach with licensees, and targets its activity based on the identification, analysis and evaluation of risks that licensees are, or likely to be, operating in breach of obligations. For example, complaints against a licensee, breach reports from licensees, and

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2 Section 912D *Corporations Act 2001* and ASIC Regulatory Guide 78 *Breach reporting by AFS licensees*.

complaints, serious misconduct and systemic issues raised by EDR schemes may prompt a check as to whether a licensee is complying with its licensing obligations.

4.23 ASIC recently surveyed the top twenty financial product adviser licensees to examine their compliance systems.<sup>3</sup> One of its findings was that:

all firms reported that their PI insurance covered all of their products and services. We understand that some licensees are finding that new or renewed policies have significant exclusions for more risky products and services. We expect licensees to carefully consider the terms of their policy, including any exclusions, and ensure that they are able to demonstrate that they are in a position to compensate clients for potential losses that may occur anywhere in their business operations. In practice, licensees may need to refrain from providing some more risky services or products for which they are unable to obtain adequate insurance cover.<sup>4</sup>

ASIC says the survey will inform its analysis of the risks facing the financial advice industry and will assist it to focus attention on licensees who do not address risks and whose compliance frameworks are weaker. ASIC proposes to follow up with a more targeted survey of the next 30 largest licensed financial advisers.

4.24 ASIC could potentially take action to suspend or ultimately cancel a licence if it becomes aware that a licensee does not have professional indemnity insurance, or that its cover is inadequate. As indicated below its ability to do this is not straightforward and its relevant powers may need strengthening.

4.25 A compensation system that relies in large part on the holding of professional indemnity insurance is at risk particularly in circumstances where the professional indemnity insurance market hardens and there are minimal checks and balances to ensure that licensees in fact hold insurance adequate to their business needs.

4.26 A licensee who is under severe financial pressure may not maintain its insurance cover. The review has heard reports of cases where licensees continued to trade without insurance cover.<sup>5</sup> This might occur when the number of consumer claims against the licensee becomes so significant, in number and value, that the insurer refuses to renew the policy and no other insurer will provide cover.

4.27 Licensees might trade off the amount of cover or excess limits for lower premiums, thereby saving money by under-insuring. A trade off might also occur in the coverage of the policy, with the insurer excluding products and services it regards as riskier. Questions would arise about the adequacy of such policies. As noted above, in its Report 251 ASIC says 'licensees may need to refrain from providing some more risky services or products for which they are unable to obtain adequate insurance cover'. That would certainly seem to be the case, but whether or not licensees in such circumstances do in fact curtail the products or services they provide is not known.

4.28 A number of industry and consumer submissions were in favour of tighter administrative procedures around the adequacy and currency of professional indemnity insurance policies for licensees. One submission noted that:

In our opinion, the current professional indemnity insurance arrangements are only partially

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3 ASIC Report 251, *Review of financial advice advisory practice*, September 2011.

4 *ibid*, paragraph 93.

5 Maurice Blackburn and ACTek Superannuation Fund submissions.

effective. All too often, consumers with strong claims against financial service providers, either are unable to recoup their losses due to inadequate insurance being maintained; or do not proceed with litigation due to the uncertainty about whether there will be sufficient funds available at the end of the proceeding to satisfy their claim.<sup>6</sup>

4.29 On the face of it there is scope for a more pro-active approach by ASIC in monitoring licensee compliance with the requirement to hold adequate insurance cover.

4.30 Any closer engagement by ASIC with individual licensees on the details and adequacy of their insurance cover would of course have resource implications for the regulator and licensees. What is needed is a risk-based approach, targeting licensees who may appear to be more financially vulnerable or otherwise at risk. It is not expected that a large proportion of the 3,400 licensees who are required to hold professional indemnity insurance would be subject to close surveillance.

4.31 Recent announcements in the United Kingdom refer to a regulatory approach that more actively collects and assesses market intelligence and undertakes risk analysis. They suggest that the newly formed Financial Conduct Authority (FCA) will undertake continued intelligence gathering - covering the operation of markets, industry trends, new products and the like - to identify potential and emerging conduct risks and poor consumer outcomes.<sup>7</sup> The information will be gathered systematically through enhanced firm-specific and thematic work, sector and cross-sector analysis, market and consumer intelligence, and regular engagement with external stakeholders to gain early insights into potential conduct problems. FCA is developing a comprehensive risk model to help it respond to the market intelligence.

4.32 Given the inevitable pressure on resources for ASIC and the resource intensive demands of any close checking of insurance cover, more onus should also be placed on licensees to inform the regulator on an ongoing basis of their insurance cover and place ASIC in a better position to assess target areas.

4.33 Reference is also made below to the legislative backing for ASIC's approach on adequate insurance cover and to a need to broaden the sanctions available to ASIC where licensees fail to meet their obligations.

## **Assurance from licensees**

4.34 A more pro-active stance is called for from ASIC in monitoring compliance by licensees with the requirement to maintain adequate professional indemnity insurance cover. It is recognised however that regulatory effort of this kind is onerous, especially where large numbers of licensees are involved, and that resources will always be limited. It is appropriate therefore to place more onus on licensees to provide assurance about their insurance cover, thereby providing ASIC with a firmer basis for its monitoring activities.

4.35 To provide more assurance that they hold adequate professional indemnity insurance licensees should be required to confirm to ASIC on a regular basis that their policies are current and adequate to their needs.

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<sup>6</sup> Slater and Gordon submission, page 2.

<sup>7</sup> Financial Services Authority (UK), *The Financial Conduct Authority – Approach to Regulation*, June 2011.



4.36 Stockbrokers are already subject to a requirement of this kind. They are required to renew their cover no later than the expiry of the insurance policy, to give ASIC a copy of the certificate and to notify ASIC in writing within ten days of:

- the amount and nature of cover;
- the date the cover became effective; and
- the date the cover will expire.<sup>8</sup>

They are also required to advise ASIC of any notification of a claim to their insurer. Brokers who fail to do so may be subject to penalties of up to \$20,000.

4.37 The adequacy of professional indemnity insurance for a licensee will depend on its particular business circumstances in the insured period and may change over time. Any ambiguity as to what is 'adequate cover' is generally resolved at the licensee's discretion.

4.38 Given the degree of reliance on professional indemnity insurance as a compensation arrangement, licensees who have to hold such cover should be required:

- to submit to ASIC an annual certificate of currency for their policy including such relevant factual information as ASIC requires about the policy;
- to provide an annual declaration, signed by senior management, that in the process of renewing their insurance cover they have satisfied themselves that it meets established standards of adequacy;
- to include in their annual report to ASIC a statement by their auditor that it has reviewed and signed-off on the currency of the insurance policy and its adequacy in covering the risks of the licensee's business.

It should also be a requirement of a compliant policy that the insurer will advise ASIC if a policy is downgraded or cancelled during the course of its term and if a policy is exhausted by claims and is not reinstated. Consideration should also be given to requiring the nomination of ASIC as an interested party in any compliant insurance policy.<sup>9</sup>

4.39 Further, the notification requirement should be designed to elicit whether there is any gap between the products and services covered by the policy and those provided by the licensee.

4.40 The annual certification requirement would be an extension of the licensee's obligation to provide audited financial statements to ASIC.<sup>10</sup> It would be more efficient and cost effective for both licensees and ASIC for all required information to be submitted at the same time.

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8 ASIC Market Integrity Rules (ASX Market) 2010, February 2011, rule 2.2.1.

9 A requirement to nominate the regulator as an interested party in an insurance policy was in WA legislation for the regulation of finance brokers prior to the transfer of the credit licensing regime to the Commonwealth. It required the insurer to inform the Consumer Protection Commissioner in the event of a cancellation and/or lapse of the policy, non-renewal of the policy, and/or claims made under the policy. In the event of the insured ceasing to be licensed as a finance broker, the Commissioner had the ability to effect a run-off cover policy on the insured's behalf.

10 Section 989B, *Corporations Act 2001*.

4.41 NIBA suggested in its submission that licensees may find themselves in breach of their insurance policy if they disclose information about their policy where this is explicitly prohibited. It is understood that policies generally allow disclosure where it is permitted by the law. ASIC may need to ensure through its regulatory guidance (or if necessary through legislative action) that a compliant policy must so provide.

4.42 It is proposed therefore that additional assurance should be obtained from licensees that they continue to hold professional indemnity insurance cover that is adequate to their needs. An obligation of this kind will assist ASIC in taking a more pro-active approach in monitoring compliance by licensees. It will also expose the management of licensees to sanctions where they do not meet the notification requirements.

### **Financial adequacy of licensees**

4.43 The root of the problem where retail clients are unable to recover compensation from a licensee lies in the licensee's lack of financial resources. While insurance cover, where held, provides licensees with some assurance of ability to meet compensation claims, it does not necessarily respond in all cases or to the full extent of a claim. Licensees may be financially exposed if they face multiple claims for compensation at one time, if they exhaust the capacity of their policy to meet further claims, or face claims that are excluded by their policy. The capacity of licensees to continue trading in such circumstances, and the capacity of consumers to recover compensation, will depend on the extent to which additional financial resources are available to the licensee. These matters are discussed further in Chapter 2.

4.44 The relevance of financial resources in this context is reflected in the fact that the only licensees who are exempted from the requirement to hold professional indemnity insurance cover are certain licensees who, by reason of being subject to APRA's prudential regulation or like circumstances, can be regarded as relatively sound in financial terms.

4.45 More attention needs to be given to the financial resources of licensees in conjunction with the requirement to hold insurance cover. The aim would be to see that they have some additional capacity to meet claims that may arise, and in so doing ensure that they have some of their own resources at risk.

4.46 In considering the adequacy of the financial resources of licensees, account should be taken of the specific needs and/or risk of the different types of activities undertaken by various classes of licensees. To some extent, financial adequacy requirements in other areas already take this approach and ASIC is revising these requirements with respect to two financial industry sectors as discussed below.

4.47 It is recognised that any move directed to the financial adequacy of licensees, in order to strengthen their operating positions and capacity to meet compensation liabilities should they arise, has the potential to raise a barrier to entry for new firms and even a hurdle for some already in the industry. While a balance needs to be struck it is timely, almost a decade after the introduction of the financial services regime, to reassess how the general licensing obligation to have 'adequate financial resources' should be applied in practice.

4.48 More attention to the financial resources of licensees should contribute to their capacity to meet liabilities but will not guarantee that compensation liabilities will be



fully paid. Reference is made in this regard to the case of a stockbroker who met the liquid capital requirements set by ASIC but still failed to provide for all client losses.<sup>11</sup>

4.49 It is not the intention to emulate the greater level of assurance that is expected of prudentially regulated licensees. Further the question of financial adequacy should be considered in conjunction with a licensee's professional indemnity insurance cover with trade-offs possible between the two.

### Current requirements on financial adequacy

4.50 The general obligations of a licensee include having:

... adequate resources (including financial ... ) to provide the financial services covered by the licence and to carry out supervisory arrangements.<sup>12</sup>

This general obligation is supplemented through more detailed licensing conditions and ASIC's Regulatory Guide 166.<sup>13</sup> In providing guidance on this matter, ASIC says that the objective of financial requirements on licensees is to ensure that:

[licensees] have sufficient financial resources to conduct...financial services business in compliance with the Corporations Act;

there is a financial buffer that decreases the risk of a disorderly or non-compliant wind-up if the business fails; and

there are incentives for owners to comply through risk of financial loss.<sup>14</sup>

Given the separate requirement for professional indemnity insurance, ASIC does not see the role of the financial requirements on licensees as to protect clients from loss from licensee misconduct.

4.51 Pursuant to RG 166, ASIC provides licensees with several options to meet their base level financial requirements having regard to the nature of their business and their corporate relationships. As discussed in Chapter 2, the financial requirements expected of licensees, especially those operating smaller businesses, are minimal. They do not need to hold cash or a commitment of support for the purpose. The relevant option requires the licensee to prepare a projection of likely cash flows over at least the next three months that takes into account a range of commercial contingencies that could impact on the licensee's cash position. ASIC expects this option to be potentially suited to all licensees but especially those operating small businesses who do not always maintain cash or commitments of support from others. It is sufficient for the licensee to show, based on projected cash flows, that it will have access as needed to enough financial resources to meet its liabilities, including through financial support from a parent company or other entity.

4.52 It seems somewhat counter-intuitive that smaller businesses that may have limited financial resources are allowed to operate with their principals having little 'skin in the game'.

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11 ASIC Media Release 09-120AD, 10 July 2009.

12 Paragraph 912A(1)(d) *Corporations Act 2001*.

13 ASIC Regulatory Guide 166, May 2010, *Licensing: Financial requirements* and Pro Forma 209 *Australian Financial Services Licenses Conditions*.

14 ASIC Regulatory Guide 166, May 2010, *section B – Base level financial requirements*.

4.53 It is noted that the current requirements of RG 166 provide stricter requirements for certain types of financial services including responsible entities of managed investment schemes, investor directed portfolio services, custodians, market participants and providers of OTC derivatives. ASIC is currently reviewing the financial requirements of both OTC derivative issuers and responsible entities for managed investment schemes.<sup>15</sup> ASIC says it is undertaking these reviews because it wants to ensure that the financial requirements are adequate for entities managing financial investments that are growing in significance. It also notes that its proposed approach would align the financial requirements for Australian providers with those applied to providers in peer jurisdictions.

4.54 The relevant ASIC consultation papers suggest it is seeking to scale up the financial requirements of entities in those two sectors. The new financial adequacy requirements are aimed at:

Ensuring issuers are appropriately capitalised so that equity owners of the business have a sufficient financial interest in the health of the business and its compliance with the law, and so that the business has the financial strength to cope with anticipated expenses and with costs and losses arising from unexpected operating risks.<sup>16</sup>

For OTC derivatives issuers it is proposed to require rolling 12 month cash flow projections and a change in the quantum and liquidity of the financial resources requirement. Under the new net tangible asset test this would require a provider to hold the greater of \$1 million or 10 per cent of average revenue (with half held as cash and half in liquid assets). ASIC proposes to support these changes with regular reporting of an issuer's financial resources to ASIC and investors. If introduced, these changes would require an update of all licensing conditions for relevant licensees, following procedural fairness processes, and subject to possible review by the AAT.

4.55 The current approach, by which insurance cover is relied upon for assurance of compensation seems somewhat narrow. By contrast, in the United Kingdom insurance cover and other financial resources are considered in conjunction with each other. The UK regulator is proposing changes in the capital requirements for personal investment firms to ensure they are better capitalised and able to provide redress for consumers. This is in addition to their need to hold professional indemnity insurance. FSA says the intended outcome of this change in the financial requirement on investment firms is:

to see a reduction in the level of consumer detriment and the costs to the levy payers contributing to the Financial Services Compensation Scheme (FSCS) from unsuitable advice on investment products.<sup>17</sup>

4.56 The proposed change will require UK personal investment firms to hold resources worth at least three months of their annual fixed expenditure in realisable assets such as cash (with a minimum holding of £20,000). These measures were to have been phased in over two years with the full requirements in place by the end of 2013 (a one year extension on earlier announcements). In August 2011, FSA advised firms it would allow them more time to build up their capital resources to the

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15 ASIC Consultation Paper 140, *Responsible entities: Financial requirements*, September 2010 and ASIC Consultation Paper 156: *Retail OTC derivative issuers – Financial requirements*, May 2011.

16 *ibid* and ASIC Consultation Paper 156: *Retail OTC derivative issuers – Financial requirements*, May 2011.

17 Financial Services Authority (UK), *Review of the prudential rules for Personal Investment Firms (PIFs)*, Feedback to Consultation Paper 08/20 and Consultation Paper 09/20, 09/19, paragraph 1.4, November 2009.

required levels. The phasing in of the new rules will now commence on 31 December 2013 with the full requirements in place by the end of 2015.

### **Enhanced requirements on financial adequacy**

4.57 More attention should be given to the adequacy of financial resources of financial advisers and other licensees to manage expected expenses and operational risks that could lead to unexpected losses or expenses such as compensation liabilities. The exposure of the equity owners of a licensee to more financial risk should encourage them to be vigilant in complying with the law and in protecting clients from loss from misconduct by the licensee or its representatives.

4.58 The aim in proposing more attention to financial adequacy is to ensure licensees have some sort of financial buffer, without going further in an attempt to put them in a position to meet all claims that might be brought against them by clients.

4.59 The financial resources of a licensee are relevant in supplementing the insurance arrangements made by the licensee such as in meeting excess payments required under a policy as well as going towards meeting liabilities not covered by the policy. In its consideration of the adequacy of a licensee's financial resources ASIC should pay particular regard to whether the licensee's insurance policy includes run-off cover, that is cover that will continue after the licensee ceases to carry on business. This would be in accord with the legislative policy reflected in paragraph 912B(3)(b) in regard to the approval of alternative compensation arrangements.

4.60 Further, the level of financial resources held could be treated as a swing factor in considering the adequacy of a licensee's insurance cover.<sup>18</sup> It is understood that the UK regulator allowed some trade-off between insurance and capital during the last tightening in the insurance market.

4.61 It is envisaged that ASIC, in reviewing the capital adequacy requirements of licensees beyond those being addressed in its current reviews, would adopt a tailored approach that takes into account the nature of the services and products provided. This might have regard to the relative riskiness of the financial services or products offered by a licensee, for example the complexity or otherwise of financial products issued or advised on. Little if any change may be called for in the requirements for categories of licensees, such as insurance brokers, who incur limited claims for compensation from retail clients.

4.62 There would need to be a consultation process to assess the regulatory and financial impact of changes on licensees. Such a process would aim to reach an appropriate balance between protecting consumers and implementing financial requirements that provide a buffer without being overly burdensome on licensees. The consultation process would also be expected to explore an appropriate timeframe for implementation of new measures to allow licensees where necessary to build up their capital over a period.

4.63 In summary it is proposed that the financial requirements for licensees and financial advisers in particular should be reviewed with a view to complementing and supporting the reliance on professional indemnity insurance as a compensation arrangement. The proposal would not extend to licensees who are already subject to

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18 Financial Services Authority (UK), *Review of the Prudential Rules for Personal Investment Firms (PIFs)*, Consultation Paper 08/20, November 2008, and Policy Statement 09/19, November 2009.

prudential regulation. Similarly, there may not be a need to change the requirements for stockbrokers who are already subject to additional requirements, or to re-examine new rules proposed for OTC providers and responsible entities of managed investment schemes.

## **Enforcement powers**

4.64 Under the current light-handed regulatory regime for licensees, the powers of the regulator to take away the licence or otherwise discipline providers of financial services are quite limited. Much of the regulatory framework for the protection of consumers is tied to conditions attached to licences and to regulatory guidance published by ASIC. Consideration needs to be given to ASIC's ability to hold licensees to the expected standards of behaviour.

4.65 If ASIC is to play a more pro-active and effective role in administering the licensing regime it needs clear powers to enforce standards required of licensees and to sanction firms that do not comply.

4.66 Attention should be given in particular to:

- the enforceability of standards on adequacy of insurance cover and adequacy of financial resources;
- powers to deal with phoenix activity, both through licensees establishing new entities or by former directors who re-emerge in the industry as authorised representatives;
- the ability to deal with disreputable industry participants; and
- the extension of an infringement notice regime to deal with more minor breaches of financial services licensing conditions.

4.67 The aim is to ensure that ASIC can hold licensees to account for the adequacy of their compensation arrangements and that it has an appropriate range of sanctions to deal with the breach of licensing obligations.

4.68 These proposals would complement measures to enhance ASIC's licensing and banning powers provided for in legislation before the Parliament pursuant to the *Future of Financial Advice* program.<sup>19</sup>

## **ASIC's current licensing powers**

4.69 As discussed in Chapter 2, under the current licensing system a person or entity who carries on a financial services business must obtain from ASIC a licence covering the provision of the relevant financial services. Some officers with decision-making responsibilities for the licensee are subject to tests of good fame and character when a licence is granted (police checks for example). However, the representatives of a licensee (including employees, directors, corporate or other authorised representatives) are exempt from the need to hold a licence. ASIC does not approve the representatives of a licensee.

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<sup>19</sup> Corporations Amendment (Future of Financial Advice) Bill 2011.

4.70 The focus of the law is on a licensee's obligations rather than those of its directors, employees or agents. This focus limits the regulator's ability to restrain individual participants who may have engaged in questionable activity with another licensee from continuing to operate in the financial services sector.

4.71 While authorised representatives must be registered with the regulator there is no vetting of those entities or individuals by the regulator.<sup>20</sup> ASIC keeps a register of authorised representatives notified to it by licensees.<sup>21</sup> The regulator has limited information about employee representatives and has to rely on licensees to ensure the competency and integrity of their representatives. This can cause problems for the regulator in dealing with representative misconduct as discussed below in relation to so called 'bad apples'.

4.72 There is a relatively low threshold for applicants wanting to obtain a licence. ASIC must grant an AFS licence to an applicant if:

- the application is made properly;
- ASIC has no reason to believe that the applicant will not comply with the licensee obligations;
- ASIC is satisfied that there is no reason to believe that the applicant or its responsible officers are not of good fame or character; and
- the applicant has provided ASIC with any additional information requested for the purposes of assessing the application.<sup>22</sup>

4.73 Once a licence is granted, ASIC's powers to suspend or cancel it are limited. Immediate suspension or cancellation is possible on application by the licensee or where the licensee is insolvent, ceases to carry on business, is convicted of serious fraud or is incapacitated.<sup>23</sup> Following a hearing at which time the licensee can put views and submissions before an independent ASIC delegate, ASIC can suspend or cancel a licence when:

- the licensee has not complied with its general licensing obligations or ASIC has reason to believe the licensee will not comply with those obligations;
- ASIC is no longer satisfied that the licensee or its representatives are of good fame or character;
- a banning order is made against the licensee or a key representative; or
- the licence application was materially false, misleading or omitted a material matter.<sup>24</sup>

Decisions to suspend or cancel a licence can be appealed to the Administrative Appeals Tribunal (AAT). In practice, the regulator reports that it:

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20 Section 916F *Corporations Act 2001*.

21 Section 922A *Corporations Act 2001* and Corporations Regulation 7.6.05(2).

22 Section 913B *Corporations Act 2001*.

23 Section 915B *Corporations Act 2001*.

24 Section 915C *Corporations Act 2001*.

... has found it very difficult to establish before the AAT that a licensee will not comply with obligations in the future. This makes it difficult to remove licensees who may potentially cause investor losses in advance of an actual breach.<sup>25</sup>

4.74 As noted below, some tightening of the tests for when the regulator may grant, suspend or cancel a financial services licence is proposed as part of the legislative amendments resulting from the *Future of Financial Advice* package.

### **Enforceability of adequacy standard on insurance**

4.75 There is a need to provide licensees with some certainty on how they should assess the adequacy of their professional indemnity insurance. ASIC also needs a clear mandate to take action against a licensee for failure to comply with its obligation to hold professional indemnity insurance cover that is adequate.

4.76 ASIC sets forth in RG 126 its expectations in regard to the adequacy of professional indemnity insurance cover. However, in order to impose sanctions on a licensee for failure to meet its standard ASIC's views on adequacy need to prevail in legal proceedings.

4.77 The guidance provided by ASIC to licensees in assessing the adequacy of their professional indemnity insurance goes into much more detail than the considerations set out in Corporations Regulation 7.6.02AAA. If ASIC took legal action against a licensee for inadequate insurance cover, a court would not necessarily accept ASIC's formulation in RG 126 of a standard by which the legislative requirement for adequate insurance cover should be tested. Nevertheless, given ASIC's critical role in promulgating guidance to the financial services industry on the content of these and other licensing requirements, it needs to have the courage of its convictions in being prepared to enforce its own published standards.

4.78 If ASIC's efforts to enforce its view of adequate insurance cover were not upheld, the matter would need to be considered further. Some legislative backing might be required in order to ensure that the standards of adequacy, which are a critical element of current compensation arrangements, have real value.

4.79 If it became necessary to strengthen ASIC's position in taking a more pro-active approach in its administration of the compensation arrangements, one way would be to provide more legislative prescription of what is called for to satisfy the test of adequate professional indemnity insurance cover.

4.80 Corporations Regulation 7.6.02AAA is in broad terms and provides limited basis for objective assessment of the adequacy of a licensee's insurance cover. Some amplification of the considerations listed in the regulation might be required to give meaningful substance to the legislative requirement.

4.81 This could be done by stipulating in legislation that regard is to be had in assessing the adequacy of insurance cover to any standards published by ASIC. Any concerns about conferring on ASIC delegated legislative powers could be met by requiring it to publish its standards in a disallowable instrument. It is noted, by way of comparison, that APRA is to be given power to make prudential standards for prudentially regulated superannuation entities. Alternatively, the regulation could be

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25 ASIC Submission to the PJCCFS, *Inquiry into the collapse of Trio Limited*, paragraph 59.



amended to include some of the more prescriptive elements of ASIC's regulatory guidance.

4.82 As indicated above, ASIC has an important responsibility in promulgating what it sees as the considerations that give substance to the licensing requirement for adequate professional indemnity insurance cover. Having published its views, it needs to stand behind them and be prepared to take action against licensees that it considers fall short of the expected standard. In the event that it became apparent that the current legal framework provided insufficient support for effective enforcement action, consideration would need to be given to the introduction of clear legislative backing.

### **Enforceability of adequacy standard on financial resources**

4.83 Similar issues could arise for consideration in relation to ASIC's position in its administration of the compensation arrangements in regard to the adequacy of a licensee's financial resources. At present the law provides little guidance on the required levels of financial resources. It is left to ASIC guidance to elaborate on this topic. ASIC should be prepared to take action where appropriate to back up its published views.

### **Phoenix activity by licensees**

4.84 As discussed in Chapter 2, there is a disturbing incidence of cases in which, following the winding up of licensed firms with outstanding compensation liabilities, the principals re-emerge and carry on business in another form.

4.85 ASIC does not have clear powers that would enable it to intervene in appropriate cases to prevent directors or managers of a failed licensed financial services business from re-entering the industry:

- as directors of a newly created licensee; or
- as an employee or representative of another or new licensee.

4.86 Consideration should be given to additional enforcement powers to deal with cases of this kind. In the first scenario, there may not be sufficient basis at the time the new licence is sought for a belief by ASIC that the applicant will not meet the licensing tests or is not of good fame or character. Under s913B as it stands:

ASIC must grant an applicant an Australian financial services licence if ... ASIC has no reason to believe that the applicant will not comply with the obligations that will apply under section 912A if the licence is granted; and

if the applicant is a natural person, ASIC must be satisfied that there is no reason to believe that the applicant is not of good fame or character.<sup>26</sup>

4.87 Involvement with a failed licensee does not necessarily mean that a former director or manager of a failed licensee is not of good fame and character. Even where ASIC is able to call into question the character of an individual who was involved with a failed licensee, ASIC can only review the status of the licensee itself.

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<sup>26</sup> Subsections 913B (1) and (2) *Corporations Act 2001*.

It does not have the power to ban individuals from participating in the provision of financial services by reason of their involvement with a failed licensee.

4.88 ASIC has the power to ban from being the director of a company a person involved in the mismanagement of two companies that have failed.<sup>27</sup> ASIC is unable however to ban such a person from participating in the industry as an authorised representative or manager of a licensee.

4.89 The proposed legislation to provide broader licensing and banning powers, if enacted, will give ASIC the right to refuse, cancel or suspend a licence, where an applicant is 'likely to contravene its obligations'.<sup>28</sup> While this change will strengthen ASIC's hand in declining a licence, the amendments are not designed to help ASIC address the problem of phoenix activity by licensees. Where a new legal entity applies for a licence (perhaps with a slightly different directorship), it may still be difficult for ASIC to conclude that the licensee is 'likely to contravene its obligations'.

4.90 Where a director of a failed licensed company applies for a new licence in an individual capacity, there may be a stronger basis for ASIC to deny a licence. Under the proposed legislative amendments, ASIC would be able deny the licence if it has reason to believe the applicant is 'not of good fame or character'. The Explanatory Memorandum says this would include whether:

the individual has engaged in conduct causing serious detriment or financial loss to consumers, so that there is a need to protect the public [or has been a manager of a licensee that has had its licence suspended or cancelled].<sup>29</sup>

How far ASIC's hand will be strengthened, in circumstances where the individual was involved in the governance of a licensee that failed leaving unmet compensation liabilities, remains to be seen. More might be required to found a negative belief about the applicant's fame or character.

4.91 Once a licence is granted, and ASIC becomes aware of prior misconduct and unpaid compensation, the grounds on which the licence can be revoked are limited.<sup>30</sup> Unpaid compensation liabilities of a predecessor licensee are not grounds for cancelling the new licence, even if the directors of the old and re-emerged entity are one and the same. The proposed legislative amendments will not alter this position.

4.92 Given the way phoenix activity can undermine confidence in the financial system, and put consumers at further risk, attention should be given to enforcement strategies and the possibility of additional powers to counter such activity.

4.93 Consideration may need to be given to powers that would enable ASIC in an appropriate case to:

- refuse to grant a licence if a director or manager of a new company applying for the licence was formerly a director or manager of a licensed company that ceased to trade without meeting awards of compensation ;
- cancel a licence if a director or manager of the licensee was involved in phoenix activity; and

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27 Sections 206A and 206B *Corporations Act 2001*.

28 Corporations Amendment (Future of Financial Advice) Bill 2011, para 2.

29 Corporations Amendment (Future of Financial Advice) Bill 2011, Explanatory Memorandum.

30 Section 915C, *Corporations Act 2001*.

- prevent a person involved in phoenix activity becoming an authorised representative, director or manager of another licensee.

ASIC might also be given additional powers to ban a director or manager of a licensed financial service provider which becomes insolvent with significant unpaid liabilities for compensation, from being able to take up or hold the position as a director, manager or authorised representative of another licensee.

4.94 Where ASIC takes action under its general power to ban individuals from being company directors, it adds details to a public database. If it gained powers to ban individuals on the basis of phoenix activity it could use a similar process to publish details of the individuals concerned. Such transparency would help consumers and prospective employing licensees to make informed decisions, and to avoid dealing with individuals with a questionable record.

### **Managing movement of disreputable industry participants**

4.95 In 2007 ASIC commenced a project aimed at tracking the movement of financial advisers who have a dubious employment history in the sector. As part of this project, ASIC released a guide to assist employers with a reference checking framework which could be applied to all financial advisers.<sup>31</sup>

4.96 ASIC has found that nearly all the top 20 licensees conducted police checks on new advisers, but noted an inconsistency between licensees in their approach to reference checking of new advisers.<sup>32</sup> A number of licensees said they had difficulty in obtaining references from other licensees while others did not check references.

4.97 This is an area where the regulator and the industry share an interest in effective action against individuals who have a history of causing problems for clients or licensees through their employment in the industry. If the capacity or willingness of licensees to undertake reference checks as a matter of course remains patchy, some strengthening of the regulatory requirements (licensing conditions for example) might need to be considered.

### **Infringement notice regime**

4.98 There is also a case for empowering ASIC to deal appropriately with regulatory breaches at the more modest end of the scale. A broader range of regulatory tools would enable ASIC to take enforcement action that is appropriate to the severity of the breach. Where the only real option open to ASIC is to cancel a licence it has little scope for effective enforcement action in circumstances where such a heavy sanction may not be appropriate.

4.99 Consideration should be given to introducing an infringement notice regime to expand ASIC's regulatory tools in dealing with financial service licensees. Infringement notices are a first point regulatory tool that can be used efficiently and quickly in response to less serious contraventions. Such actions send a message to licensees on the standard of conduct they are expected to abide by without imposing the full force of the law. The regulator has commented that the ability to issue infringement notices can be helpful as:

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31 ASIC Media Release 07-267AD, 11 October 2011.

32 ASIC Report 251, September 2011, paragraph 64.

They allow the individual or firm to accept a modest sanction for minor breaches and continue in business, without fear of drawn-out and costly litigation, and the damaging impact this can have on reputations and livelihood.<sup>33</sup>

4.100 Such tools are available to ASIC in dealing with other regulated entities such as licensed credit providers and market participants and in relation to the continuous disclosure obligations of listed companies.<sup>34</sup> For example, under the credit regime, ASIC may issue an infringement notice if it has reason to believe that a person has committed an offence or contravened a civil penalty provision under the *National Consumer Credit Protection Act 2009*. The infringement notice is to be issued within 12 months of the alleged offence and imposes a monetary penalty. If the penalty is paid, it will discharge the liability. Otherwise ASIC can commence civil proceedings. ASIC has already issued an infringement notice and penalty under this regime against a mortgage broker that allegedly promoted itself as providing credit services despite being unlicensed to do so and having been warned by the regulator that it would be in breach.<sup>35</sup>

4.101 The conferral of such powers upon ASIC in the financial services area would assist it in policing the compensation arrangements as well as other aspects of licensee conduct. Infringement notices could be issued as a first point response for example where it comes to ASIC's attention that a licensee has failed to renew its professional indemnity insurance policy.

4.102 It is proposed that ASIC should be given access to an infringement notice regime to enable it to deal proportionately with breaches of licensee obligations.

## Other issues

### Compensation where a licensee ceases to trade

4.103 Where the business of a licensee is wound up, retail clients with claims against the licensee, or which emerge later, may be at risk. According to ASIC, 280 licensees voluntarily ceased to trade in 2010-11 and 44 licensees were wound up involuntarily including through ASIC enforcement action. The difficult issues that arise for retail clients in pursuing compensation claims when a licensee becomes insolvent are discussed in Chapter 2.

4.104 This section canvasses possible additional measures that might be taken where a licensee voluntarily ceases to trade whether it is leaving the industry, merging with another licensee or is taken over by another business.

4.105 In developing its position for RG 126, ASIC sought to require the inclusion in professional indemnity insurance policies of automatic run-off cover which continues to cover the insured's risks once they cease to trade. However, following consultation ASIC concluded that insurers were generally not willing to provide such cover and did not proceed with its proposal.

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33 ASIC Submission to the PJC, *Inquiry into the collapse of Trio Limited*, paragraph 96.

34 Section 331, *National Consumer Credit Protection Act 2009*, Part 6-2 (regulations 37-49) of the National Consumer Credit Protection regulations and section 798H, *Corporations Act 2001*, Division D of Part 7.2A and Corporations Regulations 7.2A.02-7.2A.15.

35 ASIC Media release 11-126AD, 28 June 2011.

4.106 The Corporations Act itself recognises, in a particular context, the need to deal with a licensee who ceases to trade. In approving alternative compensation arrangements for a licensee, paragraph 912B(3)(b) requires ASIC to consider:

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.

4.107 The question of the compensation arrangements that apply after a licensee ceases to trade are of relevance because professional indemnity insurance policies operate on a 'claims made' basis. This means that the insurer will only deal with claims that are notified in the period the policy is in force.

4.108 It follows that a retail client who identifies a loss from licensee misconduct after the licensee ceases to trade may have difficulty getting redress unless the licensee made some provision for compensation when it ceased to trade. Some, but not all, licensees may be able to arrange for run-off cover or otherwise make provision for possible later claims.

4.109 Run-off cover is designed to provide cover for compensation liabilities that arise following a trading period. Insurers are prepared to supply such cover in some circumstances to licensees they assess as risk worthy but not on a general basis.<sup>36</sup>

4.110 The position of licensees who cease to trade is a weakness in the application of compensation arrangements.

4.111 In dealing with licensees who give up their licence or reduce the scope of their licensed activities, ASIC seems to be moving towards imposing conditions on licensees to leave behind some capacity to meet compensation liabilities that may arise. In the past ASIC allowed licensees to cancel their licence without imposing any conditions upon them. In one such case where a licence was cancelled, clients could not recover awards of compensation of around \$88,000. More recently ASIC has required certain licensees to extend their EDR scheme membership and professional indemnity insurance policy for a further 12 months. However, in one of these cases the insurance provider is disputing liability for compensation awards of \$98,000.

4.112 This is an area where ASIC needs to continue to explore ways to secure some ongoing protection for retail clients, whether through conditions imposed in relation to the voluntary termination of a licence or upon amalgamation or takeover of a licensed business.

4.113 Where for example an existing licensee's business is amalgamated with another licensee's business, the acquiring licensee might be required to cover claims arising from the conduct of the licensee that it has merged with or taken over.

4.114 A requirement for a licensee to make compensation arrangements to cover claims of compensation beyond the trading period will provide some assurance to that licensee's clients should they need to claim compensation. While such an approach may be open where a licensee ceases to trade voluntarily, that is not likely to be the case where a licensee becomes insolvent.

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<sup>36</sup> NIBA submission, paragraph 5.6.

4.115 In the United Kingdom, FSA has consulted on the need to require firms to 'leave resources behind' when they cease to trade.<sup>37</sup> Its Consultation Paper raises possibilities such as setting up a trust to hold run-off cover, or the transfer of responsibility for future compensation claims to a firm that still operates. It is understood that this issue is still to be resolved.

4.116 In the absence of other steps that may be open to it, ASIC should as proposed above (paragraph 4.111) have regard to the availability of run-off cover when considering the adequacy of a licensee's resources.

### **Protection from unlicensed providers**

4.117 Whilst licensed providers of financial services are required to have arrangements in place for compensating retail clients for loss suffered from a breach of Chapter 7 obligations, some financial services providers operate with no or limited compensation arrangements. Such providers might operate legitimately but be exempt from the need to be licensed or to have compensation arrangements.

4.118 Of more concern to consumers are those providers who operate outside the licensing regime either because they operate without a licence or because they operate beyond their licence conditions. Retail clients who deal with such providers will be at risk and not have the benefits of the consumer protection and compensation arrangements attached to licensed providers. They would not have access to an EDR scheme process or most likely to professional indemnity insurance in respect to claims against the provider.

4.119 In dealing with a licensed industry of the scale of the financial service sector (that is almost 5,000 licensees and 40,000 authorised representatives) there is always the potential for rogue activity at the edges. This is particularly so in a system which requires participants to assess their obligation to be licensed, to apply for a licence and to operate according to the licensing requirements.

4.120 The numerous exempt circumstances prescribed in the law might reduce the clarity as to whether a particular activity is a financial services business requiring a licence. Whether deliberately failing to meet the requirement to hold a licence or not, Westpoint is a case in point with hundreds of consumers found to have suffered large scale loss from their investments in an unregistered managed investment scheme.

4.121 It will always be a challenge for the regulator to identify and deal with outlaws operating in the financial services sector. That said, concerted effort by the regulator to police the boundaries of licensed financial services activities is important for consumer protection and confidence.

4.122 ASIC takes legal action against unlicensed providers of financial services, including prosecution where required, with affected consumers or licensees sometimes drawing ASIC's attention to rogue activity. It appears from cases reported by ASIC over the past three years that the nature of the unlicensed activity, and the risk to consumers, is broad ranging and can be summarised as follows:

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<sup>37</sup> Financial Services Authority (UK), *Review of the Prudential Rules for Personal Investment Firms (PIFs)*, Consultation Paper 08/20, November 2008.



- the offer of interests in a managed investment scheme by a provider that has neither registered those schemes with ASIC nor obtained a financial services licence;
  - in five separate cases of this type some 880 consumers invested around \$93 million.<sup>38</sup> The prospect that these consumers will recover their investments appears varied, with better prospects where the unlicensed provider has undertaken through ASIC or a court to return the funds, and less so where the provider becomes insolvent.
- the offer of interests in a managed investment scheme by a provider that is licensed but has not registered those particular schemes with ASIC;
  - in seven separate cases of this type around \$63 million was invested by at least 560 consumers, again with differing recovery outcomes expected for consumers.<sup>39</sup> In many of these cases the providers were wound up, with only some consumer investments appearing to be available for distribution through the insolvency proceedings.
- through use by an unlicensed provider of a trading name similar to that of a licensed provider to induce customers to acquire financial advice or other services from the unlicensed firm.<sup>40</sup>

4.123 The risk to consumers of dealing with unlicensed financial service providers is highlighted in a KPMG report which says that the incidence of fraud perpetrated against investors from ‘investment scams orchestrated by individuals purporting to be legitimate financial advisers or investment businesses’ amounted to around \$10 million in the six month period to June 2011.<sup>41</sup>

4.124 There appears to be no easy way to prevent the occurrence of some element of unlicensed provision of financial services. Nonetheless, given the risks to consumers of dealing with unlicensed providers, there should be a premium on efforts to mitigate those risks through early discovery of such activity. ASIC should consider ways to encourage consumers and licensees to bring forward information on unlawful industry activity. In this regard ASIC’s perceived responsiveness to informants about possible unlawful behaviour can affect confidence in ASIC and their willingness to assist.

4.125 A more transparent approach by ASIC to the handling of complaints, including those about licensee activity or the provision of financial services without a licence, might help to counter concerns about ASIC’s responsiveness to complaints. The more feedback ASIC can provide on action it takes following complaints, and about outcomes, the more complainants will be encouraged to lend it aid.

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38 ASIC Media Release 11-45AD, 11 March 2011; ASIC Media Release 10-188AD, 13 September 2010; ASIC Media Release 10-74MR, 8 April 2010; ASIC Media Release 09-154AD, 21 August 2009; and ASIC Media Release 08-94, 8 May 2008.

39 ASIC Media Release 11-249AD, 11 November 2011; ASIC Media Release 09-252AD, 15 December 2009; ASIC Media Release 09-165AD, 7 September 2009; ASIC Media Release 09-161MT, 3 September 2009; ASIC Media Release 08-120, 11 June 2008; ASIC Media Release 08-40, 3 March 2008; and ASIC Media Release 08-38, 29 February 2008.

40 ASIC Media release 11-177MR, 18 August 2011 and ASIC Media release 11-207AD, 21 September 2011.

41 KPMG *Fraud Barometer*, edition 5 June 2011 which analyses serious fraud cases before Australian courts. Earlier editions do not provide comparable information on fraud undertaken by unlicensed providers of financial services.

4.126 Apart from the handling of one-off complaints, there may also be scope for a more formal and transparent approach to bringing systemic problems in the financial system to the regulator's attention. This would encourage stakeholders to provide ASIC with information on activity which appears inappropriate and risky to consumers. It is noted that EDR schemes are already required to inform ASIC of 'systemic issues and serious misconduct'.

4.127 In the United Kingdom, HM Treasury's blueprint for financial reforms states that:

... the Government is considering giving other parties a clear, statutory role in [this] process by enabling them formally to bring issues to the [regulator's] attention. For example, the FOS, with its evidence base of complaints, would be well-placed to raise an issue to the [regulator], as would consumer groups which also see and gather evidence of consumer detriment. Under this approach, once an issue has been raised by a party, the regulator may be required to state publicly whether the issue is causing mass detriment, along with its rationale for reaching this judgment and the action it intends to take to address the issue. The regulator's statement would have to be made within a set period of time.<sup>42</sup>

These proposals are at a relatively early stage of development and views have been sought on them through a consultation process.

### Third party rights under licensee's insurance policy

#### Disclosure of insurance details

4.128 Licensees are required to disclose in their Financial Services Guide (FSG) the type of compensation arrangements they have in place and whether those arrangements satisfy the regulatory requirements.<sup>43</sup> A licensee has to include in its FSG a statement that it has in place professional indemnity insurance, alternative arrangements approved by ASIC, or is exempt from the requirement. The current requirements do not go beyond such limited disclosure and could convey a false sense of assurance on compensation.

4.129 The Consultation Paper put forward the proposition that more meaningful disclosure of available insurance cover would put clients in a better position to assess the credit risk of a licensee. It sought comment on the usefulness of improved disclosure about a licensee's professional indemnity insurance policy.

4.130 Some submissions make the point that additional detail about a licensee's professional indemnity insurance policy may not be very meaningful to consumers.<sup>44</sup> For example:

The relevance of and consequences that flow from the nature of compensation arrangements would not be understood by many members of the general public and in particular vulnerable investors with little understanding of law or insurance ...

Moreover, these disclosure requirements are not sufficient to ascertain whether insurance exists at the time of an investor wanting to make a claim. Financial Services Guides are often outdated

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42 HM Treasury, *A new approach for financial regulation: the blueprint for reform*, June 2011.

43 Corporations Regulation 7.7.03A.

44 Law Council of Australia, FOS, NIBA and Maurice Blackburn submissions.

and in any event licensees are not required to disclose, for example, whether or not it's a 'claims made and notified' policy or if run-off exists, therefore it is impossible to even determine whether or not the claim would come under the period of insurance.<sup>45</sup>

4.131 Submissions also note that consumers face difficulty in determining whether the licensee they have dealt with, and at whose hands they have incurred a loss, has an active insurance policy from which an award of compensation might ultimately be paid. For example:

In practice, consumers with a claim, their legal advisers and even EDR schemes all face difficulties in identifying whether or not relevant insurance exists, the name of the insurer and the type of insurance coverage in place. Considerable effort and expense is wasted in attempting to locate this basic information. ... This information ... should be disclosed immediately when a complaint or claim is received by the licensee. This uncertainty makes it very difficult for consumers to judge the benefit of pursuing compensation in order to balance it against the cost. It also results in money and time being spent in the pursuit of compensation when the exercise is pointless ... some [clients] could have saved themselves thousands of dollars and two years of work and emotional hardship if they had been informed at the outset that there was no insurance or that the insurance had been exhausted.<sup>46</sup>

4.132 As a practical matter, some submissions note that insurance contracts may preclude the insured from disclosing information about the policy and a risk that a licensee would breach its contract if required to disclose information about its insurance policy.

4.133 The existing disclosure requirements, which only require licensees to disclose to clients the barest information about the category of compensation arrangements they have in place and that those arrangements satisfy the regulatory requirements, are of questionable value. It is however doubtful that additional information about insurance arrangements would be useful to consumers, due to the complex nature of policies. Also, when investments are being considered, or other financial services are sought, compensation arrangements are unlikely to be the focus of a consumer's attention.

4.134 It is suggested that consumers would benefit from additional information about a licensee's insurance policy at a point when it is required rather than through disclosure at the outset. Some additional information about a licensee's professional indemnity insurance policy could be made available to a retail client who is considering whether to pursue a claim for compensation.

4.135 This should be the case where the licensee is no longer carrying on business, has disappeared or fails to acknowledge the consumer's complaint. A retail client may have difficulty in such circumstances in ascertaining whether an insurance policy is still in place, whether it will respond to the claim and whether it has reached its limit.

4.136 It is proposed earlier in this chapter that licensees should be obliged to confirm with ASIC, on annual basis, details of their insurance cover. It would be reasonable for ASIC to draw on this information, and exercise a discretion to pass it on to a retail client who is pursuing a claim against a licensee that is no longer available or fails to respond.

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45 Maurice Blackburn submission, page 4.

46 Joint Consumer Submission, page 5.

4.137 ASIC should be able to provide information about a licensee's insurer and insurance policy if requested by a retail client, its authorised agent or representative, or an EDR scheme where:

- the licensee (or its administrator or liquidator) does not respond to the consumer's dispute; or
- the licensee cannot be contacted after reasonable inquiry.

4.138 It would be reasonable in these circumstances for the client be able to obtain basic information about the insurance policy such as the name of the insurer and policy number. This will enable clients to contact the insurer to check whether the licensee's policy is current and whether it has reached its limits. It will help the consumer to decide whether there is a prospect of recovering compensation should the claim proceed and be successful.

4.139 It is understood that an EDR scheme, in dealing with a dispute with a member licensee that is insolvent, will commonly try to ascertain from an administrator or receiver the capacity of the licensee's insurance policy to deal with further awards. This is an informal process and is only of benefit if the consumer has sought to progress a claim for compensation through an EDR scheme.

4.140 Access to information about the insurer would also enable the client, or an EDR scheme on its behalf, to notify the insurer of a claim made against the insured licensee. Prompt notification of a claim is important for policies that operate on a 'claims made' basis. It would be necessary to ensure, perhaps through a licensing requirement, that policies permitted such disclosure.

#### Third party rights

4.141 A retail client should be entitled to make a claim directly against its licensee's insurer in some circumstances where it obtains an award of compensation and the licensee does not pay the award.

4.142 Section 51 of the *Insurance Contracts Act 1984* (Insurance Contracts Act) provides direct recourse for third parties against an insurance policy held by an insured where the licensee has died or cannot, after reasonable enquiry, be found. The section could be used by a retail client in those circumstances.

4.143 Those circumstances are however limited and do not cover a case where the licensee is unresponsive to a retail client's award of compensation for other reasons. For example, a licensee who is insolvent or in financial difficulty may have an active insurance policy but no incentive to claim against the policy to benefit the client.

4.144 Section 6 of the *Law Reform (Miscellaneous Provisions) Act 1946* (NSW) is broader than the Insurance Contracts Act in its application to third parties. It provides for:

- funds payable under indemnity policies to be subject to a statutory charge; and
- third party claimants to enforce the charge directly against insurers.

In practice, a consumer is generally able to obtain leave to enforce the statutory charge if he or she can show that there is some likelihood of a claim against the licensee being ineffective. This is commonly done where the consumer shows that the licensee is of doubtful solvency, and may therefore be unable to meet a judgment made against it.

4.145 A review of the Insurance Contracts Act in 2004 recommended changes to section 51 amongst other changes to that Act.<sup>47</sup> In response, an Exposure Draft issued in 2007 proposed an extension of the right to recover directly from an insurer in circumstances where a third party has obtained a judgment against an insured in respect of a liability and the execution of that judgment is unmet. Following a process of consultation, the *Insurance Contracts Amendment Bill 2010* proposed more limited changes to section 51 which would not materially aid a retail client in relation to a failed licensee.<sup>48</sup> The Bill lapsed before enactment.

4.146 There appears to be a case for an amendment to section 51 of the Insurance Contracts Act in similar terms to those proposed in the Exposure Draft. Such an amendment would assist a retail client where it cannot recover compensation awarded against the insured.

4.147 Such changes would enable a retail client to claim directly against a licensee's insurer in circumstances where the licensee cannot meet a judgment by reason of insolvency or financial distress. The retail client would deal with the insurer as a third party to the licensee's professional indemnity insurance contract. This would be appropriate where the licensee's insurance policy is still in force when the dispute commences but the insured licensee does not respond to an award of compensation.

## Developments in insurance

4.148 There may be scope in the insurance market for the development of products or arrangements that address some of the difficulties licensees face in accessing adequate professional indemnity cover, and limitations with current compensation arrangements.

4.149 Some industry bodies in the financial sector are working with insurers and brokers to facilitate the availability of professional indemnity insurance to their members. These efforts assist in the development of policies that meet the needs of licensees and comply with ASIC's standards.

4.150 Some licensees, advisers in particular, appear to face difficulties in accessing affordable cover that is adequate to their needs and which meets ASIC's requirements. The Consultation Paper noted that:

there may be useful scope for the development of standard policies to meet the basic needs of licensees, or particular classes of licensees such as financial advisers. The availability of standard policies would be expected to reduce the transaction costs of licensees in making

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47 Review of the *Insurance Contracts Act 1984*, *Final report on second stage: provisions other than 54*, June 2004.

48 Key documents from this review are available at [www.icareview.treasury.gov.au](http://www.icareview.treasury.gov.au)

insurance arrangements that meet regulatory requirements and may facilitate regulatory efforts in monitoring compliance with those requirements.<sup>49</sup>

4.151 Insurers and industry bodies pointed out in their responses that the diversity between sectors of the industry made it impractical to develop a standard policy for the financial services industry as a whole. Tripartite negotiations between ASIC, the insurance industry and industry bodies in 2007 failed to come up with a standard form of professional indemnity insurance policy.

4.152 However, several industry bodies are working with insurers and brokers to make available professional indemnity insurance cover that is adequate to the needs of their members. Their efforts also encourage greater competition in the supply of such insurance.

4.153 These arrangements vary and continue to be developed and modified as needs change. They include arrangements made by industry bodies for a master policy with a standard set of policy terms which are offered in individual policies that members can take out through the providing insurer or broker.

4.154 There is scope in such arrangements for industry bodies to gain recognition by insurers of the lower risk of misconduct by members who are bound by the professional and ethical standards of an industry body. FPA for example has set up an insurance service for its members, through an insurance broker and underwriters, which recognises the regulatory and professional standards and obligations adhered to by its members.<sup>50</sup>

4.155 There would seem to be further scope for industry bodies to take initiatives with brokers and insurers in developing insurance solutions that respond to the specific obligations on licensees to hold adequate professional indemnity insurance.

#### Run off cover

4.156 Run-off cover is cover for claims made after an insurance policy has ended, but arising from acts or omissions of the insured during the period the policy was in force.

4.157 In developing and consulting on its draft regulatory guide on compensation and insurance arrangements for licensees in 2007, ASIC considered requiring automatic run-off cover as a term of a licensee's professional indemnity insurance policy. ASIC concluded that insurers were generally not willing to provide this risk feature on an automatic basis and did not proceed with the proposed requirement.

4.158 The reluctance of insurers to provide such cover on a regular basis is understandable, particularly in circumstances of a tight market and concerns about the exposure of some licensees to liability claims.

4.159 In practice insurers offer run-off cover on an individual basis where they regard the risk profile of the licensee they are dealing with to be acceptable. It is understood that some master policies arranged by industry bodies have included scope for run-off cover for their members.

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49 Richard St. John, Consultation Paper, *Review of compensation arrangements for consumers of financial services*, April 2011, paragraph 5.70.

50 FPA's Pro PI service.



4.160 ASIC has indicated that it will continue to monitor the availability of automatic run-off cover and may re-assess its position in the future.

4.161 It is possible that insurers will revisit the supply of run-off in softer market conditions or where they become more comfortable with the exposure to liability of licensees or certain categories of licensees. The prospects of obtaining such cover may be better for members of an industry body that can point to the improved risk credentials of its members by virtue of their professional standards and claims record.

#### Insolvency insurance

4.162 Two submissions raised the possibility of a new insurance product to cover unmet awards of compensation for clients of insolvent licensees.<sup>51</sup> The submissions suggest that such cover would be required in addition to the professional indemnity insurance policies held by licensees.

4.163 The proposal in those submissions was to develop a group insolvency insurance policy that would cover awards of compensation that an insured licensee cannot pay upon becoming insolvent. Possible features of a group policy were suggested as follows:

- policy to be negotiated and administered by a group policy administrator, for example an industry body;
- all licensees that hold professional indemnity insurance to participate and pay premiums (to establish an adequate pool for a group policy);
- overall cap on the total amount payable from the policy each year and possibly on a per claimant basis; and
- policy administrator would deal with a liquidator to manage an insolvent licensee's compensation liabilities.

4.164 The viability of such an idea remains untested and extensive work would be required to progress it. For example, the capacity to access the reinsurance market for such a product is uncertain. In commenting on this idea, ICA concluded that:

while theoretically possible, the appetite of the private sector to provide such cover at a level of premium that would be affordable is uncertain.<sup>52</sup>

The proposal is at a preliminary stage and would require a good deal of further work to test its feasibility. In essence, the proposal would seem to involve a spreading among all licensees of the cost of unmet liabilities of less responsible licensees. In this way it would seem to raise policy considerations similar to those posed by a last resort compensation scheme.

4.165 Over the longer term, innovative insurance solutions could provide responses to some of the problems with the current professional indemnity insurance arrangements described in this report. The proposed *Future of Financial Advice*

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51 FSC and ICA submissions.

52 ICA submission, page 7.

changes, by requiring financial advisers to meet higher standards, may facilitate opportunities for the development of innovative approaches.

4.166 There is scope for further initiatives by industry bodies in working with insurers to find processes and products to fulfil the compensation obligations of licensees. Any such efforts, which might be linked to the development of professional standards in financial services, should be encouraged.

### **Defence costs**

4.167 Professional indemnity insurance normally covers legal costs a licensee would incur in defending claims for compensation. In RG 126, ASIC sets out its expectation that:

defence costs must be 'in addition' to the minimum limit or the level of cover must be sufficiently increased to take into account these costs.

4.168 This requirement can be met through an increase in the minimum limit of the policy to meet defence costs, with no internal limit on the proportion or dollar value of the policy that can be used on such costs.

4.169 Concerns have been expressed that a policy could be drawn down substantially in meeting the insured's legal costs.<sup>53</sup> For example, an insurer and/or licensee might see benefit in mounting a test case where there is high exposure from other claims against the licensee. If the licensee fails in the test case, the net value of the policy after defence costs are met may be insufficient to pay the awards of compensation made against the insured licensee. One submission notes that even where a defence is unmeritorious, the plaintiffs have no real recourse against the insurer for the depletion of the funds available under the policy.<sup>54</sup> If third party consumers could seek remedies against insurers for unreasonable defence costs, insurers might be less likely to defend an action with limited or no prospect of success.

4.170 While it has not been possible to give close attention to this issue in the review it is a matter of understandable concern. It warrants further consideration by ASIC in relation to its administration of the compensation arrangements.

## **Recommendations**

The recommendations put forward in this chapter for changes to strengthen the current compensation arrangements, together with other matters that may call for further consideration in relation to the professional indemnity insurance cover required of licensees, are summarised below.

### **Licensees to demonstrate adequacy of their insurance**

- (a) Require licensees to provide ASIC with additional assurance that their professional indemnity insurance cover is current and is adequate to their business needs.

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<sup>53</sup> Slater and Gordon submission, page 2.

<sup>54</sup> *ibid.*

## Licensees to hold appropriate capital resources

- (b) More attention should be given, on a risk targeted basis and in conjunction with the level of their insurance cover, to the adequacy of licensees' financial resources to enable better management of risks and unexpected costs such as compensation liabilities.

## A more pro-active stance by ASIC

ASIC should take a more pro-active approach in monitoring licensee compliance with the requirement to hold adequate professional indemnity insurance cover and any new requirement in regard to financial resources, and in targeting licensees who are most at risk.

## Policing the licensing system in regard to compensation

- (c) To assist ASIC in playing a more pro-active role in administering the licensing regime with respect to compensation arrangements, consideration should be given to clearer powers to enforce standards and to sanction firms that do not comply through:
  - : powers to deal with phoenix activity, both through licensees establishing new entities or by former directors who re-emerge in the industry as authorised representatives;
  - : ability to deal with disreputable industry participants; and
  - : access to an infringement notice regime.

It is important that ASIC for its part be prepared to take action in appropriate cases to enforce its published views of what is required by the licensing conditions on insurance cover or financial resources. In the event that it becomes apparent that the current legal framework provides insufficient basis for effective enforcement action, consideration should be given to clearer legislative backing.

## Other matters

Recommendations are also made for action or further efforts in relation to particular issues that bear on the compensation arrangements.

### Compensation where licensees cease to trade

- (a) In dealing with licensees who give up their licence or reduce the scope of their licensed activities, ASIC should seek where possible to secure ongoing protection for retail clients including by imposing appropriate conditions in relation to the termination of a licence or the amalgamation or takeover of a licensed business.

### Protection from unlicensed providers

- (b) There are risks to consumers where they deal with financial services providers that:

- : have a licence, but operate beyond the scope of that licence because they provide products or services that are not covered by the licence; or
  - : should be licensed under the Corporations Act but are not,
- and accordingly have limited or no compensation arrangements.

While acknowledging the difficulties in identifying outlaw activity, the importance of concerted enforcement effort by ASIC to police the boundaries of licensed financial service activities is emphasised. In its approach to the handling of complaints about outlaw activities ASIC is encouraged to be transparent and provide as much feedback to complainants as possible in order to encourage further assistance.

#### Third party rights under licensee's insurance policy

- (c) Where a licensee (or its administrator or liquidator) does not respond to claims from a consumer or the licensee cannot be contacted after reasonable inquiry, ASIC should be able to provide the consumer with information it has about the insurance policy including the name of the insurer and the policy number. This would assist the consumer to decide whether there is a prospect of recovering compensation should the claim proceed and be successful.
- (d) The third party rights provisions of the *Insurance Contracts Act 1984* should be extended, as was proposed by a review of that Act in 2004, to apply where a consumer cannot recover compensation awarded against the insured and there is capacity to meet that liability from the insured licensee's professional indemnity insurance policy.

#### Defence costs

- (e) ASIC should give further consideration, in its approach to the adequacy of professional indemnity insurance cover, to the treatment of defence costs with a view to striking a reasonable balance between the interests of licensees and insurers on the one hand, and consumers on the other.

Reference is also made in this Chapter to initiatives by industry bodies, brokers and insurers to develop insurance solutions that better cater for the specific obligations on licensees to hold adequate professional indemnity insurance. Initiatives of this kind are acknowledged and should be encouraged.