Australian Government

Compensation arrangements for consumers of financial services

Report by Richard St. John

April 2012

Future of **Financial Advice**

Compensation arrangements for consumers of financial services

Future of financial advice

ISBN 978-0-642-74797-6

Manager
Communications
The Treasury
Langton Crescent Parkes ACT 2600
Email: medialiaison@treasury.gov.au

Statutory Compensation Review
Future Of Financial Advice

Richard St. John

Email: futureofadvice@treasury.gov.au
http://futureofadvice.treasury.gov.au

5 April 2012

The Hon Bill Shorten MP
Minister for Financial Services and Superannuation
Parliament House
CANBERRA ACT 2600

Dear Minister

I present my report on compensation arrangements for consumers of financial services.

Those arrangements are designed to reduce the risk that compensation claims by retail clients cannot be met by licensed providers of financial services due to their lack of available financial resources. The current arrangements call for licensees, other than relatively well resourced categories such as APRA-regulated banks and insurers, to hold professional indemnity insurance cover as a means of enhancing their ability to meet claims.

Retail clients are generally able to recover compensation for losses attributable to misconduct by licensees with whom they have dealt. In some cases however this is not so as the licensees in question lack the resources to meet claims by clients. These cases mostly involve claims for inappropriate investment advice and are commonly associated with losses incurred by clients following the failure of a managed investment scheme. Uncompensated losses of this kind can have serious consequences for affected retail clients. They may also detract from confidence in the financial services sector.

I have considered the need for a statutory scheme to provide additional protection for retail clients in circumstances where they do not have recourse to the last resort arrangements which are already in place in key areas such as bank deposits and general insurance.

I have concluded that it would be inappropriate, and possibly counter-productive, to introduce a more comprehensive last resort compensation scheme to underpin the current relatively light compensation regime for financial advisers and other providers of financial services. Given the limited regulatory measures to protect retail clients from the risk of licensee insolvency, it would be inappropriate to require more responsible and financially secure licensees to underwrite the ability of other licensees to meet claims against them for compensation. There would also be an element of regulatory moral hazard should a last resort scheme be introduced without a greater effort first to put licensees in a position where they can meet compensation claims from retail clients. It would reduce the incentive for stringent regulation or rigorous administration of the compensation arrangements.

Priority should be given, in any move to bolster the protection of retail clients, to a more rigorous approach to compliance by licensees to provide greater assurance that they will be in a position to compensate their own clients through their insurance arrangements and the capital resources they have at risk.

To put it another way, the regulatory platform for financial advisers and other licensees needs to be made more robust and stable before a safety net, funded by all licensees, is suspended beneath it. I see this as a necessary step before further consideration is given to a scheme under which the cost of uncompensated claims against one firm would be passed on to other firms who are not so remiss. This would be consistent too with the more robust regulatory approach to the providers of services elsewhere in the financial system, including prudential regulation, where last resort protection is offered to consumers.

It needs to be recognised that a more stringent approach to licensing may itself have consequences for the cost of, and access to, the market for the provision of financial services. The proposed remedial measures are designed to give more substance to the compensation arrangements that are already in place. They would be focused on those licensees who are seen to pose most risk. They would not impose a significant regulatory burden across the board.

I point out also that as a practical matter there is some disparity between the obligations towards retail clients borne by issuers of financial products and by financial advisers, with consequential limits to the protection offered and recourse open to those clients who acquire products direct from issuers. As a matter of strategic approach, it would be timely to review the current relatively light-handed regulatory regime for the issue of certain financial products into the market, in particular managed investment schemes, and the possible need for some tightening of that regime.

If the current compensation arrangements are reinforced along the lines proposed it would be open to round them out in due course with a more comprehensive scheme of last resort. The report goes on to consider the scope for, design and limits of any such scheme.

Yours sincerely

Richard St. John

Contents

Outline of report

The report covers the following matters:

- Chapter 1 outlines the scope of the review and the review process, and provides background.
- Chapter 2 describes and assesses the current arrangements for the protection of retail clients who deal with providers of financial services.
- Chapter 3 looks at the scope for retail clients to obtain compensation for licensee misconduct in the context of recent collapses of financial services providers.
- Chapter 4 considers possible legislative and administrative measures to bolster the current compensation arrangements and make licensees responsible for the consequences of their own misconduct.
- Chapter 5 considers possible measures to redress an apparent imbalance between the responsibilities borne by financial advisers compared to the issuers of products given that financial product failure generally underlies claims against advisers.
- Chapter 6 addresses the possible design and governance of a scheme of last resort, if one were to be introduced, to provide compensation in circumstances where a licensee does not have the financial resources to meet a claim for compensation by a retail client.
- Chapter 7 provides an overview of the report and its findings and conclusions on the need to strengthen the current arrangements for compensation of retail clients. It sets out a number of recommendations for further action.

Chapter 1: Introduction

This chapter outlines the scope of the review and the review process, and provides background.

Terms of reference

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

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

1.3 The Parliamentary Joint Committee on Corporations and Financial Services (PJCCFS) conducted an *Inquiry into financial products and services in Australia* following a number of collapses in the financial sector which resulted in substantial financial losses and damage to a large number of investors. The Committee reported on its inquiry on 23 November 2009.

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

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

1.6 Recommendation 10 of the Committee's Report was:

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

1.7 In response to the Report, the Government announced the *Future of Financial Advice* reforms on 26 April 2010.[1] The response adopted most of the recommendations of the Report, including one for the examination of a statutory compensation scheme. The response also included some additional measures.

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

1.9 It is noted that, since the review was initiated, the collapse of Trio Capital has thrown up further issues about the ability of consumers to recover compensation

1 The Hon Chris Bowen MP (Minister for Financial Services, Superannuation and Corporate Law), Media Release No 036/2010, 26 April 2010.

following the failure of a financial product due to fraud. The circumstances of that case are also the subject of an inquiry by the PJCCFS.

Background and scope

1.10 The following concepts and issues are relevant to and bear on the review:

- The review is directed to the adequacy of arrangements by which investors may be compensated where they suffer loss as a result of misconduct by a provider of financial services. Those arrangements arise in the context of the regulatory regime for financial services and markets provided under Chapter 7 of the *Corporations Act 2001* (Corporations Act).
- Providers of financial services are required to be licensed under Chapter 7 and to have compensation arrangements in place in relation to their retail clients. The rationale for the focus on retail clients is that they are less likely to be able to look after their own interests than are wholesale clients.
- Licensed providers of financial services are subject to a range of obligations under Chapter 7. The review is concerned with the position of retail clients who incur a financial loss or damage as a result of a breach of such an obligation by a licensee or its representative.
- The review is concerned with the position of a retail client whose loss is attributable to the misconduct of a financial services licensee. It is not concerned with losses that result from failure of a financial product or poor investment performance in the absence of licensee misconduct.

Financial services

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

1.12 The financial services provided to clients by licensees generally relate to a financial product. The term ‘financial service’ includes, in relation to a financial product, providing advice, dealing, making a market, operating a registered managed investment scheme or providing a custodial or depository service. A ‘financial product’ includes a security, a derivative, an interest in a managed investment scheme, a superannuation interest, a general or life insurance policy, a deposit-taking facility or a margin lending facility.[2]

Financial services industry

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

2 Division 3 and 4, Chapter 7 *Corporations Act 2001*, with particular reference to section 764A.

products or margin lending. Table 1.1 provides more detail on the number of licensees authorised to undertake financial services.

1.14 Almost 93 per cent of licensees are licensed to undertake more than one financial services activity. More than 70 per cent of them are authorised both to provide financial product advice and to deal in a financial product.[3] Table 1.1 shows the number of licensees categorised according to the financial services activities they are authorised to undertake, whether a single or multiple activities.

Table 1.1 Number of licensed financial service providers by activity

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

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

1.15 The review is concerned with licensees who provide financial services to retail clients. Around three quarters of licensees, that is just under 3,700, are authorised to provide services to retail clients. Around 270 of those licensees, being deposit-takers or insurers, are also prudentially regulated by APRA and are not required to have professional indemnity insurance for compensation purposes.

1.16 Licensees may authorise representatives to carry out financial service activities for which they are authorised under their licence, and in so doing assume the responsibility that the representatives will conduct themselves in the manner required of a licensee.

1.17 A subcategory of the licensees who are authorised in broad terms to 'provide financial product advice' specialise in financial planning for their clients. ASIC estimates that there are '749 advisor groups operating over 8,000 practices and employing around 18,200 advisers'.[4] An advisor group is a financial advisory business or group of businesses which operate under a single licence. A group may have more than one practice and may use multiple trading names. Advisers can operate through their own licence, as authorised representatives, or as employees of a licensee or an authorised representative.

1.18 ASIC has characterised the financial advice industry as 'dominated by large dealer groups and financial institutions' with 'approximately 85 per cent of financial

3 These licensees are authorised to undertake only the specific activities mentioned.
4 ASIC, *Submission to the PJC Inquiry into financial products and services in Australia*, August 2009, pp 108-109, with information attributed to the Rainmaker Financial Planning Report, January 2009.

advisers ... associated with a product manufacturer'. ASIC added that 'most large financial planning firms (that is, dealer groups) are owned by diversified financial services groups that also include funds management entities (that is, product manufacturers)'.[5]

Retail clients

1.19 The review is concerned with compensation arrangements for retail clients of financial services providers. Those compensation arrangements are part of a package of consumer protection measures under the Corporations Act in favour of retail clients. Retail clients can include small businesses as well as individuals.[6]

1.20 The focus on retail clients reflects the view that, generally speaking, those clients are in greater need of protection than are wholesale clients who should be better informed and better able to assess the risks involved in financial transactions.[7]

1.21 An exception to this approach is the National Guarantee Fund (NGF) which is not limited to retail clients of a stockbroker. A wholesale client of a stockbroker with a claim could recover compensation from the NGF.

1.22 The classification of superannuation funds, including a self managed superannuation fund (SMSF), as wholesale or retail clients is complex and is discussed further in Chapter 3.

1.23 It is also noted that separate consideration is being given within the *Future of Financial Advice* reform process to the appropriateness of the current tests by which a client is classified as retail or wholesale. The Treasury released an options paper on this issue and is considering submissions.[8] Any ensuing change in the retail client test would have implications for the coverage of compensation arrangements under Chapter 7 of the Corporations Act.

Obligations on licensees

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

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

- misappropriates funds provided by a client for the purposes of investment;

---

5 ibid, p 110.

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

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

8 The Treasury, *Wholesale and Retail Clients - Future of Financial Advice Options Paper*, 24 January 2011.

- provides personal advice which was not appropriate to the client having regard to the adviser's inquiry into the client's personal circumstances and investigation of the subject matter of the advice;
- provides a product disclosure statement that does not make the required disclosures, for example on any significant risks of holding the product;
- engages in dishonest, misleading or deceptive conduct in relation to a financial product or service, or makes false or misleading statements that are likely to induce persons to acquire a financial product; or
- makes an unauthorised transfer of securities.

Financial loss in absence of misconduct

1.26 Consistent with the fundamental regulatory approach, the review is not concerned with compensation for investors who suffer loss in value of their investment through:

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

in the absence of inappropriate advice or other relevant misconduct by a licensee with whom they have dealt.

Review process

1.27 The review has been carried out in two stages: research, information gathering and preliminary consultation that led to the release of a Consultation Paper; and the consultative and deliberative stage that followed. The reviewer was assisted by a secretariat in the Treasury.

Initial information gathering

1.28 The reviewer had preliminary meetings with interested parties in July 2010 and, following the election caretaker period, from October to December 2010. Those parties included the Insurance Council of Australia (ICA), Financial Planning Association (FPA), Association of Financial Advisers (AFA), BT Financial Group, Financial Services Council (FSC), Australian Securities Exchange (ASX), CHOICE and John Morgan, partner, Allens Arthur Robinson.

1.29 Meetings were also held with the Australian Securities and Investments Commission (ASIC), Financial Ombudsman Service (FOS) and Professional Financial Solutions Pty Ltd (PFS) the firm engaged by FOS to prepare its proposal for a last resort compensation scheme. The reviewer discussed technical issues with the Australian Government Actuary (AGA).

1.30 The initial meetings were followed by dialogue between the secretariat and various industry bodies, Australian Prudential Regulatory Authority (APRA), ASIC, FOS and AGA in order to amplify information and clarify technical issues.

Consultation

1.31 A Consultation Paper was released for comment on 20 April 2011.[9] Submissions were sought by 1 June 2011 although several bodies sought and were given an extension to submit views after that date. A summary of the Consultation Paper is provided in Appendix A.

1.32 Following the release of the Consultation Paper, and before the receipt of formal submissions, the reviewer had further discussions with ICA, FSC, FPA, CHOICE, AFA and the National Insurance Brokers Association (NIBA). A meeting was also held with Dr June Smith who had earlier carried out academic research on the basis for consumer compensation.

1.33 The review received 28 submissions of which five were subject to a request for confidentiality.[10] The public submissions were received from:

- Consumer advocates - Joint consumer submission prepared for a number of consumer organisations including CHOICE.
- Investors - ACTek Superannuation Pty Ltd, ARP Unitholders Incorporated, RADE Provident Fund.
- Legal and accounting bodies - Deloitte, Law Council of Australia, Maurice Blackburn, Slater and Gordon.
- Industry bodies - ICA, Australian Bankers Association, Association of Superannuation Funds Australia, FPA, FSC, Liability Reform Steering Group, NIBA, National Information Centre on Retirement Investments, Stockbrokers Association of Australia.
- Research house - van Eyk.
- Licensees - Professional Investment Services, Hayden Financial Services, Bruce Keenan.
- Dispute resolution bodies - FOS, Superannuation Complaints Tribunal.

An overview of submissions received in response to the Consultation Paper is provided in Appendix B.

1.34 Following their submissions, the reviewer had further meetings with FPA, FSC and ICA. The reviewer also met representatives of Self-Managed Super Fund Professionals Association of Australia (SPAA) and received its views.

1.35 The reviewer had a series of meetings with ASIC including with the Chairman, Mr Greg Medcraft.

1.36 The reviewer also had several meetings with FOS including with the Chief Ombudsman, Mr Shane Tregillis and a meeting with Mr Peter Daly, the Chairman of Financial Services Compensation Scheme Pty Ltd (FSCS) - a FOS subsidiary established to promote a last resort compensation scheme, PFS and AGA.

---

9 Richard St. John, *Review of compensation arrangements for consumers of financial services*, April 2011, available at futureofadvice.treasury.gov.au.

10 Copies of all submissions made available for public release are available at futureofadvice.treasury.gov.au.

1.37 In addition the reviewer has had discussions with officers of the Treasury.

1.38 In July 2011, the reviewer conducted a week-long series of meetings in London in relation to the comprehensive compensation arrangements in place in the United Kingdom. He was supported by the Minister-Counsellor (Economic), Australian High Commission. The reviewer attended meetings with regulators and officials from Her Majesty's Treasury, the Financial Services Authority, the Financial Ombudsman Service and the Financial Services Compensation Scheme, and with:

- Association of British Insurers (John Breckenridge and Joel Lewis);
- Institute of Financial Planning (Phil Billingham and Susan Jordan);
- Investment Management Association (Richard Saunders and Susan Wright);
- Nigel Boardman, Jan Putnis and Charles Randell, partners of the law firm Slaughter and May;
- WHICH, a consumer advocacy organisation (Doug Taylor, Gareth Shaw and Vera Cottrell);
- Professor David Jackman, The Ethical Space; and
- Professor Paul Davies, University of Oxford.

1.39 In preparing the report, the reviewer has continued to draw, through the secretariat, on the knowledge and expertise of various industry bodies, APRA, ASIC, FOS, PFS, and AGA.

Acknowledgements

1.40 I acknowledge with appreciation the input and assistance of all those industry groups, consumers, regulators and other interested parties who have made submissions or have provided information, comments and assistance, some of them on a continuing and intensive basis. I include also the bodies and individuals consulted in the United Kingdom who were generous with their time and insights. Together they have illuminated the issues and filled out my understanding. I also express my thanks to the members of the Treasury secretariat for their support throughout.

Chapter 2: Consumer protection in financial services

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

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

Regulatory approach

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

2.2 The Wallis Report sought a balance between competitive outcomes in the financial system and consumer confidence in the integrity and safety of the system. It considered the philosophy behind financial regulation, and concluded that specialised regulation was required to ensure that market participants acted with integrity and that consumers were protected. This was due to the complexity of financial products, the adverse consequences of breaching financial promises and the need for low-cost means to resolve disputes. Potential areas of market failure related to information asymmetry and systemic risk.

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

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

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

- the inherent difficulty of honouring the promise;

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

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

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

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

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

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

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

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

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

2.11 The dual regulatory model is supervised by two regulators:

- the Australian Prudential Regulation Authority (APRA) - the prudential regulator; and
- the Australian Securities and Investments Commission (ASIC) - the consumer protection and market integrity regulator for the financial sector.

2.12 Some of the recommendations of the Wallis Report were implemented through the *Financial Services Reform Act 2001* (FSR Act) which provided a uniform regulatory framework for the provision of financial services.

Licensing regime for financial service providers

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

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

2.15 A person who carries on a financial services business is required to hold a licence.[2] A licensee is required to meet the standards of conduct and for the disclosure of information provided in Chapter 7 of the Corporations Act. Upon the introduction of the Financial Services Reform Bill 2001, the policy intent of the disclosure obligations was described as:

> the financial service provider disclosure obligations ... will ensure that retail clients receive sufficient information to make informed decisions about whether to take up a financial service and whether to act on the advice they receive.[3]

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

Adequacy of financial resources

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

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

---

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

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

2.18 In setting licence conditions ASIC sets minimum financial requirements, which vary according to the financial products and services the licensee provides.[6] The minimum standards for providers of financial advice (who do not also provide other financial services) are to:

- have positive net assets;
- remain solvent at all times;
- have sufficient cash resources to cover the next three months' expenses with adequate cover for contingencies; and
- lodge with ASIC an audit report each year which amongst other things contains information about the licensee's compliance with ASIC's financial requirements.

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

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

- Option 1 requires the licensee to prepare a projection of likely cash flows over at least three months and to be confident that they will have sufficient cash to meet likely liabilities. ASIC expects that this option would be more suited to larger businesses or those that have external sources of support. It requires the licensee to hold a cash buffer, though not to have at any one time all the cash needed to meet the liabilities that might arise over the quarter.
- Option 2 also requires the licensee to prepare a projection of likely cash flows over at least the next three months that takes into account a range of commercial contingencies that could impact on the licensee's cash position. ASIC expects this option to be potentially suited to all licensees but especially those operating small businesses who do not always maintain cash or commitments of support from others. ASIC says that the licensee's projection of likely cash flows should 'demonstrate the effect of the combination of eventualities that makes it most difficult [for the licensee] to show it will have sufficient cash' but that in doing so the licensee can 'disregard highly unlikely contingencies or combinations of contingencies'. In other words the licensee is supposed to satisfy itself that it will have sufficient cash available to meet its liabilities including in the circumstances described above.
- Option 3 allows a licensee to rely on an enforceable and unqualified commitment from a deposit taking institution.
- Option 4 allows a licensee that is a subsidiary of an Australian authorised deposit-taking institution (ADI) or foreign deposit-taking institution (that is

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

comparably regulated) to rely on a commitment of support or a guarantee from its parent company.

- Option 5 allows a licensee within a corporate group to access an enforceable and unqualified commitment from its parent or group resources to meet its cash needs if on a group basis the requirements of option 1 and 2 are satisfied.

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

Conduct and disclosure requirements

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

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

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

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

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

- if personal advice is provided - a client must be given a written Statement of Advice that sets out the basis of the advice, and how the licensee or authorised representative is remunerated;

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

- ongoing disclosure is required for most products.

2.22 The licensing regime enables a licensee to operate through representatives, including employees and authorised representatives. The licensee is liable to a client in respect of any loss of damage suffered by the client as a result of the representative's conduct.[7]

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

Grounds for compensation claims

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

7 Section 917E *Corporations Act 2001.*

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

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

- fails to comply with the principal duties of a licensee (for example, to do all things necessary to ensure that it carries on its financial services business efficiently, honestly and fairly and complies with the financial services laws);
- provides personal advice without:
  - making reasonable inquiries into the client's personal circumstances and having a reasonable basis for the advice (by taking into account the person's needs, objectives or financial situation); or
  - warning the client if the advice is based on incomplete or inaccurate information;[8]
- provides general advice but fails to warn the client that it does not take account of the client's objectives, financial situation or needs;[9]
- fails to assess the client's suitability before issuing or increasing the limit on a margin loan;[10]
- refuses to comply with a client's right to return a product in accordance with 'cooling off' provisions;[11] or
- fails to deal as required with money provided by the client for the purchase of a financial product or service (for example, by payment into a specified account).[12]

2.26 A licensee will breach the conduct rules by engaging in conduct that is prohibited under Chapter 7. This includes dishonest conduct, and misleading or deceptive conduct, such as the making of false and misleading statements, market manipulation, false trading, or inducing people to deal using false or misleading information.[13]

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

- does not provide a relevant disclosure document within the required timeframe; or
- provides documents which are defective (for example, contain a misleading or deceptive statement or omit material that is specifically required, such as information on remuneration and commissions).[14]

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

---

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

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

2.29 According to a Treasury paper in 2002:

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

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

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

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

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

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

---

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

Avenues for consumer redress

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

- by pursuing an action for a breach of contract, breach of trust or in tort, or through class action with other clients who have had similar experiences with the licensee;
- by utilising avenues for redress available under the Corporations Act which enable a court to make an order for compensation for damage:
  - that results from the licensee's contravention of a financial services civil penalty provision;[18]
  - for a failure by a responsible entity of a registered managed investment scheme to meet its obligations;[19]
  - that follows from the licensee's failure to provide a disclosure document;[20] or
  - that is consequential upon a breach of a provision relating to false and misleading statements, inducing a person to deal, dishonest conduct or misleading or deceptive conduct;[21]
- by utilising the power of the courts to make orders relating to the payment of money.[22]

2.33 ASIC is able to take action on behalf of investors who have suffered a loss if it appears to be in the public interest to do so. ASIC has succeeded in obtaining compensation for retail clients in a number of cases brought under s50 of the ASIC Act. Such action can be taken to recover:

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

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

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

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

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

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

Alternative dispute resolution

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

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

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

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

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

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

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

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

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

---

24 ASIC Media Release, 10 - 275AD, 20 December 2010.

25 ASIC Media Release, 11 - 42AD, 10 March 2011.

26 ASIC Regulatory Guide 165: *Licensing: internal and external dispute resolution,* April 2011, and Regulatory Guide 139: *Approval and oversight of external dispute resolution schemes,* April 2011.

27 ASIC Regulatory Guide 139, *Section B: Guidelines for initial and ongoing approval,* April 2011. The Corporations Regulations and the National Credit Regulations state that ASIC must take those principles into account when considering whether to approve an EDR scheme.

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

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

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

Grounds for EDR scheme awards

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

2.45 ASIC's regulatory guidance calls for EDR schemes to offer remedies that are 'consistent with the remedies available under the relevant laws that apply to the arrangements between the scheme member and its customers'.[33] In determining the extent of loss or damage suffered by a complainant that should be compensated, the scheme should have regard not only to the relevant legal principles but also to the concept of fairness and to industry best practice.

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

> ... must do what in its opinion is appropriate with a view to resolving disputes in a cooperative, efficient, timely and fair manner and ... do what in its opinion is fair in all the circumstances, having regard to ... legal principles; applicable industry codes or guidance as to practice; good industry practice; and previous relevant decisions of FOS or a predecessor.[34]

---

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

The types of disputes that can be considered by FOS are those ' ... that arise from a contract or obligation arising under Australian law' where it relates to the provision of a financial service.[35]

EDR scheme awards and professional indemnity insurance

2.47 A licensee is contractually bound to honour an award of an EDR scheme made in favour of its client and could be expected to look to its professional indemnity insurer to meet this liability.

2.48 Licensees are expected by ASIC to have insurance that covers liability arising under an award made by an EDR scheme. ASIC states that the insurance policy:

> must have the effect of providing cover for breaches of the relevant obligations under Chapter 7 and EDR scheme awards and that that policy must be a contract of professional indemnity insurance ... it must cover negligence, fraud and other misconduct (relating to retail clients) ordinarily covered by a contract of professional indemnity insurance.[36]

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

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

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

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

2.51 FOS also says that 'more than half (58 per cent) of the investment disputes it handled were about products or services provided by financial advisers or planners'.[38] In other words, those disputes were about inappropriate advice from a financial adviser.

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

---

35 FOS Terms of Reference, clause 4.2.

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

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

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

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

2.54 Table 2.1 shows the composition of claims against members that offer investment services, the aggregate amounts claimed and the amounts awarded. The average amount awarded was 12 per cent of the total amount claimed.[40]

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

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

Source: FOS data

2.55 In assessing the amount payable as a result of a breach, FOS indicates that it 'may consider whether there was any contributory negligence' by the applicant, but it will not consider the liability of financial service providers other than the licensee member against whom the claim has been made.[41] In the case of *Wealthcare Financial Planning Pty Ltd v Financial Industry Complaints Service Ltd [2009] VSC*, the Supreme Court of Victoria concluded, on several grounds, that FICS (a predecessor ombudsman service to FOS) was not obliged to, and in many cases was not able to apply the principle of proportionate liability by considering the liability of parties other than the financial adviser in question, such as the contribution to that loss of the finance company, directors, the product provider, auditors or the investment research firm. It was noted that some of these parties were not members and thus not subject to an EDR scheme's jurisdiction.

Scope of compensation arrangements

2.56 There have been for many years legislative provisions directed to the risk that financial service providers may not in practice be able to meet claims by clients who have sustained loss or damage as a result of misconduct in the provision of those services.

2.57 Compensation arrangements can be traced back to 1937 when the Sydney Stock Exchange established a guarantee fund to reimburse clients of failed brokers. Prior to the FSR Act, various legislative and regulatory arrangements were in place for compensation of consumers of financial services. The arrangements differed between segments of the financial services sector. Securities dealers and advisers were required to provide a security bond of $20,000 to ASIC. Insurance brokers and

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

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

2.58 As part of the introduction of a uniform licensing regime by the FSR Act, harmonised compensation arrangements were introduced in the Corporations Act. These include a requirement for licensees who provide services to retail clients to have arrangements in place for compensating those clients for loss or damage suffered as a result of a breach by a licensee or its representative of its statutory obligations.

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

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

2.61 CAMAC released a consultation paper which proposed a scheme to compensate retail clients of licensed financial service providers who became insolvent.[42] The scheme would cover the return of client property held by the licensee or losses to retail clients arising from improper conduct by the licensee. The proposed scheme would:

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

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

2.62 In 2002, the then Parliamentary Secretary to the Treasurer announced that he would release an issues paper for consultation on a framework for compensation arrangements in the financial services sector. The resulting issues paper would include matters canvassed by CAMAC and he noted that the objective of the compensation arrangements was:

---

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

> to ensure that consumers, particularly retail consumers, of financial services have appropriate remedies so that they maintain confidence in the financial marketplace and continue to participate in it.[43]

2.63 The issues paper concluded that there appeared to be justification for compensation arrangements where the losses are suffered as a consequence of the conduct of financial services licensees. The stated reasons for this conclusion were that:

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

The issues paper also noted that such arrangements need to reach a balance between financial risk and consumer protection, and the costs and benefits of any solution.

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

2.65 Under the adopted approach licensees can satisfy the requirement to have compensation arrangements by taking out professional indemnity insurance. This approach has been in place since 1 July 2008, following a one year transitional period. Prudentially regulated ADIs and insurers are not required to have professional indemnity insurance on the basis that they can in effect self insure.

Specific schemes of last resort

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

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

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

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

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

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

International comparisons

2.68 A number of other countries have compensation arrangements to provide some protection for consumers who suffer losses as a result of their dealings with providers of financial services. Members of the European Union, the United States of America and Canada have established compensation arrangements for investors in securities, derivatives or futures markets who suffer losses due to the insolvency of intermediaries holding funds or securities on their behalf. These arrangements correspond broadly to the protection available to clients of stockbrokers in Australia under NGF.

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

Table 2.2: Compensation arrangements applicable to financial services licensees

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

Nature of compensation arrangements

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

- a dispute resolution system that meets specified standards (s912A);[45] and
- arrangements for compensating clients for loss or damage suffered because of a breach by the licensee of its statutory obligations (s912B).

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

> Retail clients of financial services licensees are exposed to the risk of suffering losses arising from misconduct of the licensee or its representatives. This can result in claims for compensation against licensees. There is a risk that some financial services licensees could be faced with a situation in which they are unable to meet all such claims against them, unless some arrangements were made in advance ... the losses under consideration do not include losses arising from sources such as market fluctuations or the collapse of an issuer of a financial product.[47]

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

> 912B(1) If a financial services licensee provides a financial service to persons as retail clients, the licensee must have arrangements for compensating those persons for loss or damage suffered because of breaches of the relevant obligations under this Chapter by the licensee or its representative. The arrangements must meet the requirements of subsection (2).
>
> 912B(2) The arrangements must:
>
> (a) if the regulations specify requirements that are applicable to all arrangements, or to arrangements of that kind - satisfy those requirements; or
>
> (b) be approved in writing by ASIC.
>
> 912B(3) Before approving arrangements under paragraph (2)(b), ASIC must have regard to:
>
> (a) the financial services covered by the licence; and

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

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

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

(b) whether the arrangements will continue to cover persons after the licensee ceases carrying on the business of providing financial services, and the length of time for which that cover will continue; and

(c) any other matters that are prescribed by regulation made for the purposes of this paragraph.

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

2.73 The use of professional indemnity insurance as the default arrangement for compensation is embodied in the regulations. Corporations Regulation 7.6.02AA requires a licensee to hold professional indemnity insurance which is adequate having regard to specified considerations that relate to the licensee's business, clients and exposure to claims. These considerations include:

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

(i) any particular claim against the licensee; and

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

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

(i) the volume of business; and

(ii) the number and kind of clients; and

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

(iv) the number of representatives of the licensee.

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

Exemptions and alternatives

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

- an 'exempt licensee' - a general insurance company, life insurance company and ADI regulated by APRA;
- a 'related licensee' - a licensee related to an exempt licensee and which holds a guarantee from the exempt licensee that is approved by ASIC.[48]

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

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

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

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

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

2.79 ASIC is empowered by paragraph 912B(2)(b) to approve in writing compensation arrangements other than professional indemnity insurance. In approving alternative arrangements, ASIC is required to have regard to a number of factors prescribed in paragraph 912B(3)(c) and by regulation, including the licensee's volume of business, the number of clients, the kinds of business undertaken and the number of representatives as set out in sub regulation 7.6.02AA(1). The legislation provides, interestingly, that in exercising its power to approve alternative arrangements ASIC must have regard to whether those arrangements will continue to cover clients after the licensee ceases carrying on business and for what period. It is understood that only one such arrangement has been approved.

Coverage of representatives

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

- an employee or director of the licensee;
- an employee or director of a related body corporate of the licensee;
- an authorised representative appointed in writing by the licensee;[52] or
- any other person who acts on the licensee's behalf.

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

Disclosure of compensation arrangements

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

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

- licensees who hold professional indemnity insurance are required to state that they have such insurance in place and whether it will cover claims in relation to the conduct of employees and authorised representatives who no longer work for them;[54] and

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

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

Insurance as a basis for compensation

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

> a product that indemnifies professional people ... for their legal liability to their clients and others who relied on their advice or services. It provides indemnity cover if a client suffers a loss, material, financial or physical, that is directly attributed to negligent acts of the professional.[55]

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

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

2.84 In Regulatory Guide 126*,* ASIC says its objective in administering the compensation arrangements is to:

> reduce the risk that a retail client's losses (due to breaches of Chapter 7) for which a licensee is responsible cannot be compensated by a licensee because of a lack of financial resources.[56]

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

2.85 The Guide indicates that licensees are responsible for assessing what is adequate cover in their circumstances. In determining whether an insurance policy is adequate it must be fit for providing compensation to retail clients and be practically available.

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

---

54 ASIC Regulatory Guide 126, Part G – Disclosure in FSGs.

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

56 ASIC Regulatory Guide 126, paras 5 and 8.

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

2.87 In brief, a policy should include:

- a limit of indemnity of at least $2 million and up to $20 million (based on revenue);
- cover (and no exclusions) for breaches of obligations under Chapter 7 including liability:
  - under external dispute resolution (EDR) scheme awards;
  - for fraud or dishonesty by directors, employees or representatives;
- excess amounts at a level that the licensee can confidently sustain;
- cover of legitimate switching from funds or products that are not on an approved product list to another fund or product on the approved product list;
- defence costs;
- automatic reinstatements; and
- retroactive cover.[57]

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

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

ASIC administration of insurance requirement

2.89 ASIC's general approach is to look to licensees to assess for themselves the adequacy of their professional indemnity cover, taking account of the guidance in Regulatory Guide 126. The onus is on a licensee to comply as part of its overall licensing obligations and risk management processes. ASIC does not vet the terms of a licensee's insurance cover. It is up to the licensee to form the view that its policy is adequate.

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

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

certificate of currency of that insurance. The information sought in summary form includes:

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

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

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

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

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

Limitations of professional indemnity insurance

2.94 There are some limits to the effectiveness of professional indemnity insurance as a mechanism for compensating retail clients who suffer loss as a result of a licensee's misconduct. As stated in Regulatory Guide 126, ASIC intends to administer the professional indemnity insurance framework to reduce the risk, as far as possible, that retail clients go uncompensated where a licensee has insufficient financial resources to meet claims by retail clients.[58] However, professional indemnity insurance is an imperfect mechanism to achieve this protection for consumers. In its submission, ICA says that it:

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

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

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

> ... the majority of payments being made are in respect of claims from accident years of between two and seven years before the current year.[60]

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

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

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

---

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

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

Breach of insurance contract

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

2.100 If a licensee fails to meet such an obligation, the insurer may be entitled to deny payment of a claim.[61] Further, an insurer who can demonstrate that the breach has a material impact on the risk associated with the policy may be entitled to cancel the contract.[62] Non-payment of claims or cancellation of a contract can lead to protracted disputes between the licensee and insurer and any delay could add to the financial pressure on a licensee.

Policy exclusions

2.101 Professional indemnity insurance contracts commonly include a number of exclusions or circumstances under which the policy will not cover a claim. Where a claim falls within a policy exclusion, the insurance contract will not respond and the licensee will have to meet the claim from its own resources.

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

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

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

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

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

---

61 Section 54 of the *Insurance Contracts Act 1984* provides that the insurer is not automatically entitled to deny payment of a claim in the case of breach of a contract. In the case of relatively minor breaches, the insurer may be entitled to reduce the insurance payout to the extent the breach of contract had a material impact on the claim.
62 Part 7 of the *Insurance Contracts Act 1984* deals with cancellation of insurance contracts.
63 ASIC Report 251, *Review of financial advice industry practice,* September 2011, page 32.
64 Slater and Gordon submission, page 3. An APL is a list of financial products which a licensee is comfortable recommending to clients. Licensees would typically perform due diligence and research when determining whether a product will be included on their APL. Many, though not all, licensees use an APL, and some licensees only permit their authorised representatives to recommend products that are on the approved list.

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

Excess payments

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

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

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

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

Caps in insurance contracts

2.109 Professional indemnity insurance contracts generally provide cover up to a capped amount. ASIC considers that, to be adequate, a licensee's professional indemnity insurance policy should have a limit of at least $2 million and up to $20 million, depending on the total revenue the licensee derives from retail clients.[67]

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

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

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

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

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

Insolvency leading to cancellation of an insurance policy

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

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

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

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

2.116 The settlement of an insurance claim after a licensee becomes insolvent is likely to involve the liquidator of the licensee's business. The liquidator may pay any excess provided under the policy in order to facilitate the claim and then pass on to the claimant the amount recovered net of the excess, or the insurance company may make a payment net of excess to the claimant direct.[69]

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

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

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

Compensation arrangements in practice

Access to professional indemnity insurance

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

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

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

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

2.122 ASIC for its part has expressed the view that the professional indemnity insurance market overall is functioning adequately for providers of financial services. Licensees were able to obtain cover, but it had become more difficult and expensive for some licensees, including financial advisers, to secure cover that adequately meets ASIC's standards.[71] ASIC concluded that licensees, particularly those providing financial advice, faced:

- an increase in premium costs;
- a reduction in policy limits;
  - new policies might have tighter limits on some items, such as for dishonest conduct or an award under an EDR scheme;
- an increase in excluded activities;
  - new policies were unlikely to cover advice on margin lending or for run-off of claims following the end of a policy period (though some licensees were able to negotiate these if they could satisfy the insurer);
- an increase in general exclusions;
  - for example, some policies exclude cover for failure by the licensee or its representatives to disclose conflicts of interest in advice documents;

---

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

- greater scrutiny of the activities of licensees;
  - insurers may review a licensee's approved product lists and specify those financial products they will or will not cover.

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

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

NIBA for its part says:

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

2.124 Licensees have also expressed concerns about the reluctance of insurers to provide the full cover sought. Where for example $20 million of cover is required, the licensee may need to acquire a layered policy from two insurers who share the risk. Licensees are finding it more difficult to find an insurer willing to accept the primary layer of cover. It may be particularly difficult and expensive for smaller advisers and sole traders to obtain the cover sought as risk is not spread between group participants.[72]

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

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

ICA made a similar point in its submission.

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

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

---

72 NIBA submission, paragraph 21.

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

Role of professional indemnity insurance

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

2.128 It does this to the extent that a licensee in fact has insurance cover as required and that any claims are covered by the terms of a licensee's policy. However, as discussed below, this will not always be the case and there are also circumstances in which there is no policy in place to respond to a claim.

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

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

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

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

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

---

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

Costs and benefits

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

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

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

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

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

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

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

---

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

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

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

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

- gross claims incurred against professional indemnity insurance policies held by 'licensees.' Gross claims incurred includes both amounts paid by insurers and estimates of remaining payments to be made on reported claims (case estimates);[76] and
- a proportion of FOS awards assumed to be paid by licensees direct to clients from their own funds rather than through insurance policies where the award was below the average excess payment.

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

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

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

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

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

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

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

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

Consequences where insurance not available

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

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

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

2.147 Where a licensee becomes insolvent and its insurance policy is no longer in force, clients with outstanding awards of compensation will only have rights as an unsecured creditor in the winding up of the licensee's business. A claimant is unlikely in those circumstances to recover all, if any, of the compensation to which it may be entitled.

Shortfall for consumers

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

2.149 It is not always clear in such cases whether the licensee had in fact taken out and maintained insurance cover as required, or whether such cover had lapsed following the winding up of the licensee's business or was still in force but did not respond to the claim. In some cases licensees leave their compensation liabilities behind and re-emerge to carry on business in a new guise.

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

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

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

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

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

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

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

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

Table 2.3: Outcome of complaints to FOS against insolvent financial advisers

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

Source: FOS data.

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

2.157 FOS believes that the available information is likely to under-represent the number of claims relating to insolvent licensees. This is because many claims, or initial approaches to FOS, are withdrawn or not pursued once the licensee becomes insolvent as the complainant considers the chances of recovery to be low. Other clients with grievances against an insolvent licensee (or a licensee on the verge of insolvency) may not take their complaint to an EDR scheme for the same reason.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Phoenix activity by some licensees

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

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

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

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

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

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

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

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

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

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

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

Source: ASIC.

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

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

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

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

Operation of EDR schemes

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

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

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

2.180 The concerns relate to matters such as:

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

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

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

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

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

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

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

Assessment

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

Regulatory approach

(a) The Corporations Act declares that financial services licensees who deal with retail clients should have arrangements for compensating those clients for loss or damage attributable to a licensee's breach of its statutory obligations.

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

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

Insurance as a basis for compensation

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

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

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

Protection for consumers

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

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

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

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

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

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

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

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

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

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

Specific schemes of last resort

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

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

Operation of EDR schemes

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

Chapter 3: Compensation following recent licensee failures

The ability of consumers to recover compensation for licensee misconduct is looked at in the context of recent high profile cases in which the collapse of a financial services issuer resulted in large scale consumer loss.

The primary loss suffered by consumers in these cases is the loss of their investment following the failure of the product issuer. Consumers are left in those circumstances with whatever rights they may have as unsecured creditors in an insolvency. They generally do not have rights to compensation by reason of the failure of their investment as such.

In some circumstances however consumers may be able to attribute part of their loss to misconduct on the part of a licensee with whom they dealt, and to claim compensation on that basis. This will typically be the case where they have invested through a financial adviser and where they are able to demonstrate that the advice was inappropriate to their circumstances.

Consumers who invested in such products direct - as many do - are less likely to have effective rights of recovery even where they can point to misconduct such as misrepresentation of the product by the product issuer.

Following the recent collapse of Trio Capital, some but not all retail investors were able to access compensation. APRA-regulated superannuation funds that had invested in Trio products were able to claim compensation under Part 23 of the *Superannuation Industry (Supervision) Act 1993* (SIS Act) on the basis that fraud had substantially diminished the assets of their fund and its capacity to pay benefits. Other consumers who invested in Trio products direct or as trustees of self managed superannuation funds (SMSFs) did not have the same opportunity. It is understood that some of those consumers are pursuing action against financial advisers for inappropriate advice. Beyond claims of that kind it remains to be seen whether those consumers will be able to recover compensation from the product issuer where the loss in value of their investment resulted from fraud.

Circumstances of recent failures

3.1 Reference is made in this chapter to a number of recent collapses of managed investment schemes and other financial service providers. There are some recurring features in these cases:

- the financial services provider operated without a licence and/or failed to register the managed investment scheme;
- flaws in the scheme's business model, rather than licensee misconduct, resulting in liquidity problems and in turn the collapse of the product issuer;
- some consumers who acquired an interest in financial products based on financial advice may not have been properly warned of the risks of investing in the products, or may have been induced to invest by misleading or deceptive statements about the features and risks of the products, or the financing of those

investments. In some cases, the advice given was standardised and may not have been appropriate for individual clients;

- some product issuers offered high commissions to financial advisers for the recommendation of their products.

In addition, in some cases consumers who invested direct with the product issuer may have received defective product disclosure statements.

3.2 In the wake of a product issuer's collapse a distinction needs to be drawn between investment losses that result from the collapse and those that can be attributed to licensee misconduct. The compensation arrangements under Chapter 7 are not intended to compensate for consumer loss following the collapse of a product issuer, nor for failures in investment or market performance of the product. They are only intended to support the recovery of losses that can be attributed to licensee misconduct.

3.3 Consumers who acquire an interest in a financial product on the recommendation of a financial adviser may be able to base a claim for compensation on inappropriate advice or some other misconduct if that can be established. This might also be the case if inappropriate advice was given for an investment in an unlicensed or unregistered managed investment scheme.

3.4 On the other hand consumers who invest in a financial product direct have little chance of compensation following the collapse of the product issuer other than as an unsecured creditor in the insolvency process. As discussed in Chapter 5 this is likely to be the case even if the product disclosures made to investors were inadequate by licensing standards, because for example they did not disclose significant risks associated with holding the financial product.

3.5 This highlights an apparent imbalance between the responsibilities borne by financial advisers for their part in the investment chain compared to the issuers of products whose failure underlies the consumer loss.

3.6 Consumers who deal direct with unlicensed financial service providers (or unregistered managed investment scheme operators) have no recourse to compensation arrangements under the Corporations Act for loss suffered.

3.7 In some instances, ASIC acting pursuant to section 50 has stepped in to take class actions on behalf of consumers against financial advisers, directors and/or auditors. Such actions may lead to the partial recovery of consumer losses.

3.8 In the case of Westpoint, which operated an unregistered property development scheme without a licence, ASIC took action based on inappropriate advice against several financial advisers who had recommended Westpoint products to their clients. Table 3.1 provides information about those actions. As far as ASIC is aware, the compensation agreed in the settlement of those actions has been paid, or will be paid, to affected clients. ASIC has also taken or is pursuing action against auditors, directors and a trustee. ASIC says the total amount recovered through its litigation is around $93 million and that in all it expects investors to see a return of around $160 - 170 million of the $388 million in losses.[1]

1 ASIC Annual Report 2010-11, pages 36-7.

Table 3.1: ASIC recovery action against advisers for Westpoint investors

Defendant financial adviser	Insolvency of adviser	Number of investors	Damages claimed	Compensation agreed (a)(b)
Masu Financial Management Pty Ltd	No	85 (25 other investors took separate legal proceedings).	$12.6 million	Settlement not disclosed
Professional Investment Services Pty Ltd (PIS)	No	247	$22.8 million	$5.9 million
Bongiorno Financial Advisers Pty Ltd/Bongiorno Financial Advisers (Aust) Ltd	One licensee is no longer licensed, and the other is still trading	125	$8.5 million	$2.6 million
Glenhurst Corporation Pty Ltd	Yes	90	$7.1 million	$2.5 million
Brighton Hall Securities Pty Ltd	Yes	200	$14 million	Not yet resolved
Dukes Financial Services Pty Ltd (now known as Barzan Pty Ltd)	No	159	$12.2 million	$1 million
Strategic Joint Partners Pty Ltd	No	80	$6.5 million	$1.39 million settlement awaits court approval

Source: ASIC FIDO and Westpoint investor websites and ASIC Annual Report 2010-11.

(a) For cases where the settlement amount is publicly known, the average claim against adviser groups was approximately $81,000 and the average settlement amount was approximately $19,000 per investor.

(b) ASIC has pursued or is in the process of pursuing other actions against auditors, directors, and a trustee in relation to Westpoint. To date those settlements have recovered an additional $67.45 million for the benefit of investors through the liquidation process. Overall, investors in Westpoint have recovered an average of around 43 cents for each dollar invested.

3.9 Table 3.2 describes the circumstances of the failure of a number of financial services providers, including whether the provider in question was licensed and/or had registered its scheme, and the nature of any misconduct by a provider that may form the basis of a claim for compensation by consumers.

3.10 In each case it appears that some consumers may be able to pursue claims for compensation on the basis of inappropriate advice in relation to their investment. On the other hand, consumers who invested direct in those products would appear to have little chance of compensation even if the disclosures by the provider did not meet the standards of the law.

Table 3.2: Recent collapses of financial services providers

Circumstances of collapse	Scope for consumer compensation claims (a)
Westpoint Consumers acquired financial products such as promissory notes which were used to fund the group's property development schemes. Investors were effectively lending money to property developers (or to finance companies who on-lent it to developers). Westpoint was unlicensed and operating unregistered managed investment schemes. Some businesses which provided financial advice in relation to Westpoint products were also unlicensed. In early 2006, the Federal Court ordered the winding up of Westpoint following an application by ASIC on the grounds of insolvency. Investors had invested $388 million in Westpoint. The liquidator said the investment schemes failed because of high levels of gearing, delays, inappropriate and costly financial structuring, and ineffective management and risk mitigation.	**Inappropriate advice** Through ASIC's class action almost 1,000 clients have claimed against seven financial advisers who had recommended Westpoint products (see Table 3.1). The action against those advisors was based on negligent advice, misleading and deceptive conduct and/or acting in breach of their licence conditions. Specific breaches were said to include: • failing to investigate and understand the nature and risks of financial products recommended; • failing to undertake a full analysis of the client's financial circumstances, and making recommendations to invest in the products that were not suited to the client's risk profile; • failing properly to warn the client of the risks of investing in the products, and the risks of investing against equity in the family home; • making misleading or deceptive statements concerning the features and risk of the products; and • providing inaccurate or incomplete information to clients. In addition, FOS says it dealt with complaints from over 400 Westpoint investors, largely against financial advisers, resulting in 37 awards valued in all at $2.4 million. FOS understands those awards were not paid due to the insolvency of the respondent licensees. Consumers who invested in Westpoint products based on recommendations from unlicensed advisers could not progress claims through FOS because those advisers had not joined an EDR scheme.
Agribusiness collapses Consumers invested in managed investment schemes which provided capital for a number of agribusiness schemes relating to tree or olive plantations for example. Under these schemes some years would pass before the plantations could be harvested and make returns. They collapsed when they incurred cash flow problems. In some cases, a new scheme operator was found and investors may have received a return lower than that offered in the PDS. Otherwise the schemes were wound up and assets were distributed between the banks (as secured creditors) and investors (who lost all or part of their investments as unsecured creditors).	**Inappropriate advice** In some cases it seems that consumers who invested through advisers have claimed compensation on the basis of inappropriate advice, which for example failed properly to warn of the risks of investing or of the unsuitability of the investment given a client's risk profile. **Disclosure (b)** Some concerns were expressed about the accuracy and adequacy of disclosure by certain agribusiness managed investment schemes operating prior to mid 2009, particularly the non-disclosure of historic yield information and inclusion of favourable opinions about performance by third parties who might not be best qualified to provide such opinions. ASIC assessed the disclosure documents of 20 agribusiness schemes marketed in that period and took action against 12 including by requiring the issue of supplementary PDSs, issuing stop orders on misleading PDSs, and by having one PDS removed from offer.
Babcock & Brown Consumers invested in high risk and complex structured investments, such as hedge funds and infrastructure funds, which failed due to difficulties in the debt market during the global financial crisis.	**Inappropriate advice** In some cases it seems that consumers who invested through advisers have claimed compensation on the basis of inappropriate advice, which for example failed properly to warn of the risks of investing or of the unsuitability of the investment given a client's risk profile.

Storm Financial Storm Financial was a financial adviser which appears to have provided 'one size fits all' advice to clients to invest in 'Storm-badged' managed investment schemes which were backed by shares and managed by other fund managers. Storm Financial arranged for approximately 3,000 investors to be double-geared with loans against equity in their homes as well as margin loans that increased their exposure to risk. When margin calls were made in a falling sharemarket many investors could not pay the call. This jeopardised their initial investment as well as their home or other assets used as collateral for the margin loan.	**Inappropriate advice** Whether Storm Financial engaged in inappropriate advice is currently the subject of court proceedings. In some cases it appears that consumers who invested through advisers may be able to claim compensation on the basis of inappropriate advice, which is alleged to include: • failing to provide efficient, honest and fair financial services; • failing to provide financial advice tailored to each client's circumstances; • providing false and misleading information in Statements of Advice; • providing negligent financial advice to clients in breach of duty to exercise reasonable care and skill in providing financial advice to clients.
Trio Capital Trio Capital Limited (formerly Astarra Capital Limited) was the trustee of five superannuation entities. It also held a licence as a responsible entity to operate 24 registered managed investment schemes (including Astarra Strategic Fund) and was the operator of three unregistered managed investment schemes. Investors in Astarra Strategic Fund included four APRA-regulated superannuation funds whose trustee was Trio Capital, as well as self managed superannuation funds and direct investors. It is alleged that Astarra Strategic Fund invested its assets into hedge funds located in the Caribbean and that there may be little, if any, evidence that the purported investments were actually made, or if they were, they may not have had any realisable value. Most of the assets invested appear to have been subsequently lost. Trio Capital products were recommended by some financial advisers and claims for compensation have been made through FOS against those advisers. In December 2009, APRA suspended Trio as the trustee of registered superannuation entities and appointed ACT Super Management Pty Limited (ACT Super) as the acting trustee. At the same time, ASIC suspended Trio Capital's licence as a responsible entity. This regulatory action was taken because of numerous breaches of licensing conditions and concerns regarding the valuation of superannuation assets and the legitimacy of investments. A former director of Trio's investment management company has been convicted of dishonest conduct and making false statements in relation to financial products. Trio Capital was placed into administration and Astarra Strategic Fund was ordered to be wound up, but to date the liquidator has been unable to recover the vast majority of investments made by Astarra Strategic Fund.	**Inappropriate advice (c)** In some cases it seems that consumers who invested through advisers have claimed compensation on the basis of inappropriate advice, which is said to include: • failing to investigate and understand the nature and risks of financial products recommended; • failing to undertake a full analysis of the client's financial circumstances, and making recommendations to invest in products that were not suited to the client's risk profile or did not achieve adequate diversification of client assets; • failing properly to warn the client of the risks of the gearing strategies recommended; • failing to disclose matters that may be reasonably expected to have influenced their advice to recommend Astarra products and gearing strategies – including the receipt of commissions and a marketing allowance paid by Trio Capital.
Opes Prime Opes Prime on-lent to secured creditors shares that were transferred to Opus Prime by clients in exchange for margin loans. Clients were unaware that the ownership of their shares had been transferred to the secured creditors. It was alleged that Opus Prime operated unregistered schemes.	**Inappropriate advice** In some cases consumers who invested on the basis of financial advice have claimed compensation on the basis of inappropriate advice, which for example failed properly to warn of the risks of investing and the unsuitability of the investment based on a client's risk profile.

Source: ASIC information provided to the review and on public record.

(a) In many of these cases ASIC has/is taking action for corporate misconduct by directors and officers, breaches by auditors and breaches by lenders or credit providers.

(b) PJC Inquiry into aspects of agribusiness managed investment schemes, September 2009, paras 4.72 – 4.74, and ASIC Submission to that Inquiry, August 2009, p 32-33 and 60.

(c) FOS submission to the PJC Inquiry into the collapse of Trio Capital, pp 5- 6.

Trio Capital

3.12 The Parliamentary Joint Committee on Corporations and Financial Services (PJCCFS) has been conducting an inquiry into issues associated with the collapse of Trio Capital Limited.[2] It is expected to report in May 2012.

3.13 As noted in Table 3.2, Trio Capital was the trustee of five superannuation entities and also held a licence as a responsible entity to operate 24 registered managed investment schemes. In its interim report, PJCCFS says there was a 'large level of cross investment between superannuation funds and the schemes where Trio was the common trustee' and that the collapse of Trio centred on fraudulent behaviour mainly in relation to funds in two registered managed investment schemes, Astarra Strategic Fund and ARP Growth Fund.[3] PJCCFS says it is considering a number of issues including the extent to which APRA and ASIC are able to conclude that ARP Growth Fund was the victim of 'market failure rather than fraud'.

3.14 Trio Capital has since been placed into administration and to date the liquidator has not been able to recover the vast majority of assets held through Astarra Strategic Fund (reported to be $125 million).

3.15 Given the focus of the PJCCFS on Trio, this review has not given the particular circumstances of that case the same level of attention. Consideration is given however to the scope for recovery by consumers who suffer losses from fraudulent conduct such as has been alleged in the case of Trio, and the extent to which last resort compensation arrangements would assist. Differences are drawn out between the position of various types of investors in Trio products.

Uneven recourse to compensation

3.16 The case of Trio Capital, where the facts and legal liabilities are still unfolding, has thrown into sharp contrast differences in the ability of various categories of consumers to obtain relief in circumstances where the value of investments in a managed investment scheme appears to have been destroyed by fraudulent activity.

3.17 Consumers who were exposed to Trio Capital through their membership of an APRA-regulated superannuation fund were able to benefit from compensation pursuant to the last resort arrangements provided under Part 23 of the SIS Act. For other consumers who were exposed to Trio, whether through SMSFs or as direct investors, the position is less clear. Whether or not in the facts and circumstances of that case they will have claims and be able to recover compensation against a licensee for loss or damage caused by a breach of its obligations remains to be seen.

3.18 The uneven outcome, where some investors had recourse to financial assistance following the collapse of Trio Capital, while others may not have is a consequence of the way in which compensation arrangements for consumers of financial services have developed over the years. The degree of protection afforded in those arrangements reflects the perceived intensity of the financial promises in question.

3.19 Part 23 of the SIS Act was introduced in 1993 as part of a legislative package to strengthen the security of superannuation savings and protect the rights of fund

2 PJCCFS Media Release, *New Inquiry into the collapse of Trio Capital,* 1 July 2011.
3 PJCCFS Interim Report, PJC *Inquiry into the collapse of Trio Limited*, 24 November 2011.

members. Under Part 23 a trustee of an APRA-regulated superannuation fund (or approved deposit fund) can apply to the Minister for a grant of financial assistance if the superannuation fund incurs a loss as result of fraudulent conduct or theft.[4] The Minister is required to seek advice from APRA and must be satisfied that the loss has caused a substantial diminution of the fund leading to difficulties in the payment of benefits, and that the public interest requires a grant to be made. The Minister has discretion over the grant of financial assistance up to the amount of the eligible loss.

3.20 The financial assistance granted in this way is funded initially from the Consolidated Revenue Fund and may be recouped through an industry levy on APRA-regulated superannuation funds and approved deposit funds.[5] The effect is that a loss in one superannuation fund is borne by the members of other APRA-regulated funds that contribute to the levy.

3.21 ACT Super, the acting trustee of the former Trio Capital superannuation funds, has been granted financial assistance under Part 23 of the SIS Act. ACT Super is responsible for the equitable distribution of the grant to the superannuation accounts of affected superannuation fund members with investments in the Astarra Strategic Fund.[6]

3.22 In announcing the grant of financial assistance, the Minister said he was satisfied that the fund had suffered an *eligible loss* under the Act and that the public interest required that a grant of assistance be made to the fund.[7] The assets of APRA-regulated superannuation fund members were found to be substantially diminished as a result of fraudulent conduct or theft, and compensable under Part 23 of the SIS Act on this basis (with such compensation funded by a levy on other APRA-regulated superannuation funds). The operation of Part 23 of the SIS Act is described in more detail in Appendix C.

3.23 Other consumers who were exposed to Trio Capital, and suffered losses after its collapse, did not have recourse to the protection available under Part 23 of the SIS Act. Consumers who invested in Trio products direct, or through their SMSFs, were not eligible for such protection.[8]

3.24 Not surprisingly, there has been marked disquiet on the part of other investors (trustees of SMSFs or individual investors) who invested in Astarra Strategic Fund or other Trio Capital managed investment schemes and whose investments were also diminished as a result of the alleged misconduct of Trio Capital.

3.25 The policy rationale for the exclusion of SMSF trustees from Part 23 of the SIS Act is that, as trustees of their SMSF, they have direct control over their superannuation savings and unlike investors in other superannuation funds are in a position to protect their own interests. It would be difficult also to justify levying other funds for fraud perpetrated within a closely held SMSF. They are subject to a less onerous regulatory regime and are not subject to levies under the financial

---

4 Part 23 applies to a regulated superannuation fund or an approved deposit fund but not a SMSF.

5 *Superannuation (Financial Assistance Funding) Levy Act 1993* and the *Superannuation (Financial Assistance Funding) Levy and Collection Regulations 2005.*

6 Astarra Superannuation Plan, Astarra Personal Pension Plan, My Retirement Plan and Employers Federation of NSW Superannuation Plan.

7 The Hon Bill Shorten MP (Assistant Treasurer and Minister for Financial Services and Superannuation), Press Release No 051, 13 April 2011 and Press Release No 4, 8 February 2012.

8 Subparagraph 229(1)(aa)(i)) of the *Superannuation Industry (Supervision)* Act 1993 specifically excludes SMSFs from applying unless the SMSF was an APRA-regulated superannuation fund or approved deposit fund at the time of the eligible loss (and subsequently became an SMSF in the intervening period).

assistance provisions. It is understood that the assistance scheme in Part 23 has been affirmed in several reviews over the years.[9] My own disposition is to regard SMSFs for this purpose as more akin to private investors than to the broader based APRA-regulated funds for the protection of whose members Part 23 is designed.

3.26 The uneven treatment of different categories of investors in Trio Capital is further exacerbated by the fact that the fraud, on the basis of which financial assistance was granted to several superannuation funds, apparently did not occur within those funds but within a managed investment scheme - Astarra Strategic Fund - in which those funds had invested.

3.27 Part 23 makes provision for the grant of financial assistance for certain superannuation funds that have 'suffered loss as a result of fraudulent conduct or theft'. While the provision is not so limited in terms, it might be expected that fraudulent conduct of the kind contemplated in Part 23 would ordinarily be fraud within the management and operation of the superannuation fund in question. In the Trio case however the fraudulent conduct appears to have taken place in relation to a managed investment scheme in which the superannuation fund had invested, and the loss suffered was judged to be of an order that met the statutory test of having 'caused substantial diminution of the fund leading to difficulties in the payment of benefits'.

3.28 A consequence of the grant of financial assistance in that case is that the position of other investors in Trio Capital products, who did not have open to them a comparable avenue for compensation, was highlighted. From the perspective of those other investors, they were as much the victims of any fraud as were the members of superannuation funds that had invested in the same product.

3.29 APRA says it suspended Trio Capital as the trustee of its superannuation funds because of numerous breaches of APRA's licence conditions including a failure to demonstrate due diligence in investing in hedge funds as well as failure to act in the best interests of beneficiaries.

3.30 The four APRA-regulated superannuation funds which will benefit from the grant of financial assistance had each invested a proportion of their total assets in one managed investment scheme, Astarra Strategic Fund. The fact that a large part of superannuation funds' assets appear to have been invested in one scheme itself raises questions about the governance of those funds, their investment policy and risk management. It may also raise questions about the adequacy of regulation in this area.

3.31 There are some relevant requirements in the SIS Act for trustees of APRA-regulated superannuation funds to have in place a sound and prudent risk management strategy that deals with the material risks of the trustee, and a risk management plan for each fund.[10] As part of this trustees must address fraud risk, that is, intentional acts to manipulate the fund for personal gain. Guidance is provided by APRA on fraud risk and the elements of the mitigation strategy required to be put in place.[11] Trustees are also required to subject their risk management

9 The reviews included the *Financial System Inquiry* (Wallis Inquiry) in 1997, the *Review into the operation of Part 23 of the Superannuation Industry (Supervision) Act* in 2003 and the *Super System Review* in 2010.

10 Part 2A Division 8 and Part 2B Division 5B, *Superannuation Industry (Supervision) Act 1993* and *Superannuation Industry (Supervisions) Regulations 1994*.

11 APRA Prudential Practice Guide, *SPG 200 – Risk Management*, August 2010, paragraph 66, pages 17-18 and other guidance published by APRA on managing fraud.

framework to assurance processes through their auditors, and to provide an annual signed attestation as to the existence and efficacy of the risk management framework they have in place.[12]

3.32 Notwithstanding these requirements, APRA apparently does not currently have power itself to set prudential standards in relation to superannuation funds. As part of the Government's *Stronger Super* reforms, a Bill has been introduced into Parliament which would impose new duties on superannuation fund trustees, including to develop an investment strategy, and would give APRA powers to make prudential standards in relation to superannuation.[13] APRA says it will use such powers to issue a prudential standard on processes for investment governance and due diligence on investments, as well as on risk management.[14] It expects to finalise the standards during 2012 for commencement during 2013.

Position of investors affected by fraud

3.33 The position of investors exposed to Trio Capital, whether through SMSFs or as direct investors, is problematic in a case where, as appears to have happened in Trio, the value of their investment in a financial product was destroyed or diminished by fraudulent conduct on the part of the product provider.

3.34 Where fraud can be established the perpetrators may be subject to criminal prosecution and civil action may be open (to the liquidator of the product provider for example) to recover missing assets.

3.35 Chapter 7 of the Corporations Act does not deal specifically with a licensee's obligations to compensate clients for loss arising from fraud. ASIC has stated that:

> a consumer will generally be unable to obtain compensation through the licensee or representative where fraud has been perpetrated against the fund as a whole unless the client can show they have a personal action against the licensee or representative.[15]

ASIC appears to be saying that there may be a basis for a compensation claim if the complainant can show it has a personal right of action in relation to some misconduct by the licensee or representative.

3.36 A consumer who suffers loss from fraud on an investment in a pooled investment, such as a managed investment scheme, will not necessarily be able to establish a claim against a licensee for compensation for breach of a statutory obligation upon the basis of that fraud.

3.37 In a case involving loss from fraud, a consumer might be able to establish that the licensee had engaged in dishonest conduct in breach of section 1041G of the Corporations Act.[16] A consumer who suffers loss or damage by a licensee's dishonest conduct may claim compensation whether or not the licensee is convicted

---

12 Section 10 *Superannuation Industry (Supervision)* Act 1993 and schedule 1AAA of the *Superannuation Industry (Supervision)* Regulations.

13 Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012 introduced to Parliament on 16 February 2012.

14 APRA Submission to PJCCFS, *Inquiry into the collapse of Trio Capital*, 24 August 2011, paragraphs 29-33 and APRA Discussion Paper, *Prudential Standards for Superannuation*. September 2011.

15 ASIC Submission to the PJCCFS, *Inquiry into the collapse of Trio Capital*, paragraph 217.

16 Paragraph 1041G(2) *Corporations Act 2001,* defines dishonest conduct according to the standards of ordinary people and where known by the person to be dishonest according to those standards.

of the offence.[17] It is noted also that, under section 50 of the ASIC Act, ASIC can take action on behalf of investors who have suffered loss if it appears to be in the public interest to do so. Such action can be taken to recover damages from fraud committed in connection with a matter which ASIC is investigating, amongst other things.[18]

3.38 In the investigations following the collapse of Trio Capital, a former director of the investment management company Astarra Asset Management Pty Limited, which invested funds raised by Trio, has been convicted of dishonest conduct in the course of carrying on a financial business and of making false statements in relation to financial products.[19] Whilst dishonest conduct on the part of a director was established in that case, in practice it may not always be possible to establish that the licensee's conduct was dishonest.

3.39 There could be practical problems given the murky facts and circumstances that commonly surround fraud in identifying dishonest conduct and assessing how much of the failure of an investment product can be attributed to that conduct.

3.40 There is also a specific obligation upon licensees in sections 981B and H to hold certain monies held on behalf of a client in a trust account before for example investing it with a product issuer as directed by the client. A consumer who suffered loss where a licensee did not hold investment monies in a trust account as required would have a basis to claim compensation for loss resulting from that breach. In a recent case of licensee fraud the financial adviser in question failed to invest client funds as instructed but misappropriated them upon receipt.[20] Whether or not there were funds available to meet the claim may be another matter.

3.41 A consumer might possibly seek to rely on a breach by a licensee of a general licensing obligation such as to:

- do all things necessary to provide the financial services efficiently honestly and fairly;
- manage conflicts of interest that might arise for a licensee or representative;
- adequately train and ensure the competence of its representatives; and
- have adequate risk management systems in place.[21]

3.42 Further, a consumer may be able to recover where the loss can be attributed to fraudulent conduct on the part of a representative (including an authorised representative, employee or director) of the licensee.[22] Under section 917E, a licensee is liable to a client in respect to any loss or damage suffered by the client as a result of a representative's conduct. ASIC says in Regulatory Guide 126 that a minimum feature of adequate professional indemnity insurance cover is that it indemnifies the licensee against liability for loss or damage suffered by retail clients

17 Section 1041I *Corporations Act 2001*.
18 ASIC says that it considered but decided not to pursue recovery action under section 50 of its Act on behalf of Trio investors. ASIC Submission to PJCCFS, *Inquiry into the collapse of Trio Capital*, paragraphs 221 – 225.
19 ASIC Media Release, 10-261AD, 7 December 2010 and Media Release 11-169MR, 12 August 2011.
20 ASIC Media Release, 11-247AD, 9 November 2011.
21 Subsection 912A(1) *Corporations Act 2001*.
22 Sections 910A and 917A *Corporations Act 2001*.

because of breaches of Chapter 7 by the licensee or representatives including liability:

> for fraud or dishonesty by directors, employees and other representatives of the licensee (although such cover is not required for a sole trader).[23]

3.43 While consumers may be able to make out a claim against the licensee, it does not follow that they will be able to recover compensation. In some cases the licensee's business will have collapsed and it will have ceased trading following the fraudulent misappropriation of funds. In those circumstances there would be little prospect of recovery. It should be noted that, while any professional indemnity insurance held by the licensee should cover fraudulent conduct on the part of a licensee's representative, it would not extend to fraudulent conduct by the licensee itself. Given the inherent moral hazard a licensee would not be able to acquire professional indemnity insurance cover for fraud committed by itself.

3.44 FOS says it is not dealing with any complaints against Trio Capital itself but only against financial advisers who recommended that their clients invest in Trio Capital.[24] FOS also says it could not accept new complaints against Trio Capital because Trio is no longer a member subject to its scheme.[25] It seems that FOS, in taking this position, has not exercised its discretion to continue to deal with complaints brought against a former member. ASIC requires of an EDR scheme that:

> ... its Constitution and/or Terms of Reference allows the scheme to exercise a discretion about whether to cancel a scheme member's membership and/or handle complaints or disputes in respect of the scheme member where the scheme member ... ceases to carry on business ... ceases to have a licence; and/or becomes insolvent under administration.[26]

3.45 Where a product issuer has failed following fraudulent activity, affected consumers might look to bring a claim against another licensee in the distribution chain with whom they have dealt. In most cases of this kind it appears action has been taken against a financial adviser who advised a consumer to invest in a pooled investment scheme that becomes the subject of fraud. FOS says it has received complaints from individuals and trustees of SMSFs who were advised by financial advisers to invest in Trio Capital products:[27]

> Twenty-eight of those disputes have been lodged against one Australian financial services licensee. The remaining four disputes are shared between three other licensees...
>
> Generally the applicants have alleged that the recommended gearing strategies exposed them to unsustainable levels of debt, there was inadequate diversification of assets within their portfolios and the assets used as leveraged security carried significant liquidity risks and the licensee used poor or inadequate know-your-client practices.
>
> They also are alleging misleading and deceptive conduct in relation to the risks of the Astarra fund. They have also made allegations about possible conflicts where the marketing allowance that was paid to the adviser was ... a significant incentive for the licensee to recommend the

---

23 ASIC Regulatory Guide 126, December 2010, paragraph 54. In the same paragraph, ASIC also says that the policy must not have the effect of excluding 'fraud and dishonesty by directors, employees and other representatives (although fraud cover is not required for sole traders)'.
24 FOS Submission to PJCCFS, *Inquiry into the collapse of Trio Capital*, page 3.
25 ibid and FOS Terms of Reference, paragraph 4.2(c).
26 ASIC Regulatory Guide 139, April 2011, paragraph 211.
27 Alison Maynard, Ombudsman, Financial Ombudsman Service, testimony to the PJC Inquiry into the collapse of Trio Limited, Hansard 30 August 2011, page 2.

product. They also make allegations about failure to disclose the significant risks in the investments.

FOS is still handling these cases and has not decided any of them yet.

Possible remedial action

3.46 The introduction of a statutory compensation scheme to underpin the existing compensation arrangements would not in itself provide relief for consumers who do not have access to compensation for losses suffered in a case such as Trio Capital. It would not resolve the question whether fraud as a factor in the diminution of the value of an investment gives rise to a claim against a licensee. The ability of consumers to claim compensation would still depend on being able to show they had suffered loss as a result of the breach by a licensee of a relevant obligation, such as the bar in section 1041G on dishonest conduct.

3.47 Apart from any further measures that may be needed for the punishment of fraudulent conduct, it is questionable whether the law could meaningfully go further in imposing obligations on a licensee that would pave the way for a consumer to recover compensation from that licensee for the fraudulent impairment of the value of an investment.

3.48 It follows that the introduction of a statutory compensation scheme of last resort, of the kind discussed in Chapter 6, would not be a ‘silver bullet’ to resolve the question whether fraud as a factor in the failure of an investment would give rise to a claim for compensation. Recourse to such a scheme would still be dependent on the consumer being able to establish loss or damage suffered as a result of a licensee’s breach of its legal obligations.

3.49 In the course of the review the question has been raised whether a scheme of financial assistance along the lines of Part 23 of the SIS Act could be introduced for investors in managed investment schemes. Any move in that direction would, it is suggested, call first for a substantial upgrading of the regulatory regime for such schemes. It would be difficult to justify spreading the cost of investment losses through fraud across other scheme operators in circumstances short of some kind of prudential regime for those schemes.

3.50 There is a significant difference in the regulatory frameworks that apply to APRA-regulated superannuation funds compared to that applying to licensees who are not prudentially regulated. The special arrangements in Part 23 for superannuation funds were introduced in 1993 as part of a package to strengthen the security of superannuation savings and protect the rights of fund members. That regulatory approach no doubt reflects the fiduciary nature of such funds and the importance of maintaining the integrity of and confidence in funds to which consumers are obliged to contribute for their retirement savings. On the other hand the regulatory treatment of managed investment schemes does not appear to provide a solid enough framework upon which to transfer to other licensees the cost of compensation for consumer loss resulting from licensee fraud. It would be difficult to justify a requirement for other licensees to pay compensation for a loss to consumers resulting from the deliberate actions of a fraudulent licensee for personal gain in the absence of some significant enhancement of the regulatory regime administered by ASIC.

3.51 In any move to provide consumers with better protection against fraud a starting point would be through a strengthening of the regulatory regime for managed investment schemes. There is scope in particular to require better management of the risk of loss to investors through fraud particularly the opportunity for fraud by employees or representatives. There are no specific obligations upon licensees at present to mitigate the risk of fraud. There is only a general obligation on licensees to have 'adequate risk management systems' and a requirement on the responsible entity of a managed investment scheme in regard to the separation of scheme assets which ASIC expects would ensure that 'scheme property is held in a way that minimises the risk of loss by misappropriation'.

3.52 There is a model for a stronger approach to the management of risk of fraud under the SIS Act where trustees of APRA regulated superannuation funds are required to have in place a risk management strategy that deals with the material risks of the trustees and each fund. Within that strategy the trustees have to address the risk of fraud (that is intentional acts to manipulate a fund for personal gain) and to institute assurance processes through their auditors.

3.53 With the Stronger Super reforms, the requirement for a trustee to have a risk management strategy will remain in the legislation, and will be supplemented by prudential standards issued by APRA that will provide further requirements for risk management.

3.54 While a responsible entity of a managed investment scheme, unlike the trustees of a superannuation fund, may not owe fiduciary duties to members, there is still a question whether higher standards of risk management should be expected from them given the potential risk of fraudulent misappropriation of pooled investment assets.

3.55 One possibility would be to require responsible entities of managed investment schemes to have a risk management system that reflects the nature, scale and complexity of its business. The risk management system might also require independent scrutiny, such as an assessment by an auditor that the controls adequately safeguard investment assets held on a pooled basis and mitigate the risk of fraud. Licensees would be expected to include a process to monitor their risks on an ongoing basis and update their controls as required.

3.56 Requirements along those lines would go some way but might be of limited value in circumstances where fraudulent conduct is endemic in the management and operation of a managed investment scheme.

Retail client test

3.57 As indicated above, SMSF trustees are specifically precluded from seeking financial assistance under Part 23 of the SIS Act. They are therefore broadly in the same position as other investors in regard to access to compensation in a case such as Trio Capital. Whether or not their position is on a par with other retail clients depends on the application of the retail client test in the Corporations Act.

3.58 Submissions by SMSF trustees provide examples of considerable financial loss from investments in Trio.[28] FOS says it has received compensation claims from SMSF trustees and individual investors for losses incurred in Trio investments:

28 Association of ARP Unitholders Inc, ACTEK Superannuation Pty Ltd, and RADE Provident Fund submissions.

> The disputes we have received have a total amount claimed of approximately $5,200,000 ... (but this) would be an underestimate ... the majority were through self-managed super funds (or) ... investors who invested ... directly. The typical features of the applicants ... are that they were at or approaching retirement age, were retail clients, had more than $500,000 to invest ...[29]

3.59 The definition of *retail client* in Chapter 7 of the Corporations Act is relevant to the standards of conduct required of licensees in their dealings with retail clients, and to the protection thereby offered to consumers. A consumer has to satisfy that test in order to make a claim for compensation through an EDR scheme.

3.60 Section 912B only requires a licensee to make arrangements for compensating consumers for loss or damage suffered because of breaches of its obligations if it provides financial services to retail clients. Similarly an EDR scheme is only obliged to deal with a claim lodged by a consumer who is a retail client for the purposes of the Corporations Act. The FOS terms of reference provide that it:

> ... may not consider a dispute ... where the value of the applicant's claim in the dispute exceeds $500,000; and
>
> may refuse to consider, or continue to consider, a dispute if ... the applicant is not a retail client as defined in the Corporations Act.[30]

3.61 The Corporations Act approaches the definition of a retail client in several ways. On one test a person who acquires a financial product or service is generally taken to be a retail client unless the product in question or to which the service relates exceeds $500,000, or the investor meets one of four other tests that look respectively at the investor's wealth or whether the consumer is a business, a professional investor or a sophisticated investor.[31]

3.62 Under another test a person who acquires certain types of financial products, including a superannuation product, is generally treated as a *retail client*. The definition goes on to say, at paragraph 761G(6)(c), that a financial service that relates to a superannuation product, when provided to the trustee of a superannuation fund

---

29 Alison Maynard, Ombudsman, Financial Ombudsman Service, testimony to the PJC Inquiry into the collapse of Trio Limited, Hansard 30 August 2011, page 2.

30 FOS Terms of Reference paragraphs 5.1(o) and 5.2(b).

31 The definition in subsection 761G and 761GA provides that:

- a person or small business (for use in connection with that business) that purchases certain general insurance products (such as motor vehicle or home and contents) is treated as a retail client, as well as a person who purchases a superannuation or retirement savings account, or financial service related to one of these;
- the purchase of all other financial products or services are taken to be by a retail client unless they meet one of the following five tests:
  - ***Product value***: price of financial product or value of financial product or service is $500,000 or more – in which case the client is classified as wholesale;
  - ***Individual wealth test*** (not for businesses) – has net assets of $2.5 million or gross income for each of the last 2 financial years of at least $250,000 per annum, certified by an accountant – in which case the client is classified as wholesale;
  - ***Business test*** – the financial product or service is to be used in connection with a business – in which case the client is classified as wholesale. This does not apply however to a small business – in which case the client is classified as retail;
  - ***Professional investor test*** –includes, for example, financial service licensees, bodies regulated by APRA (but not trustees of superannuation funds holding less than $10 million in assets) and persons controlling more than $10 million in investments;
  - ***Sophisticated investor test*** – requires a financial services licensee to be satisfied on reasonable grounds that the client has previous experience in using financial services and investing in products such that the client can assess the merits, value, risks of the product as well as the adequacy of information given – if this is the case, the client is classified as wholesale.

that has net assets of at least $10 million, is not to be regarded as the provision of a financial service to a retail client.

3.63 In ASIC's view, financial services provided to a trustee of a superannuation fund, including a SMSF, are generally provided to them as a *retail client* if the net assets of that fund are less than $10 million at the time the service is provided.[32] This view is based on an interpretation that subsection 761G(6) will apply to the exclusion of the wholesale client test in subsection 761G(7).

3.64 The test is said to be applied to the asset value of the fund at the time the service is provided and not to other assets held by trustees in their individual capacities. This separate assessment of a consumer's assets, depending on whether they are held in their individual capacity or through a superannuation fund, gives those clients greater scope to meet the *retail client* test and the consumer protection that it affords. However, it has the potential to cause uncertainty for licensees, particularly financial advisers, who may not readily be able to tell whether they are dealing with a retail or wholesale client, and thus the standards of protection required.

3.65 A number of submissions to Treasury's review of the retail client definition disagree with ASIC's view and suggest that the law needs to be clearer in its treatment of superannuation fund trustees as retail or wholesale clients.[33] Those submissions suggest that it is possible to interpret the relevant tests in a different way than ASIC does and that this provides uncertainty for SMSFs in particular. There appears to be some force in these submissions. It is not clear as a matter of policy why trustees of SMSFs should be treated more favourably in regard to consumer protection than other private investors.

3.66 Treasury is currently considering submissions in response to an options paper published as part of the *Future of Financial Advice* reforms, and in particular on the possible need for changes to the definition of a *retail client* in Chapter 7 of the Corporations Law.

3.67 This is an area where certainty is desirable. The statutory definition is complex and convoluted and should be clarified in the interests of licensees as well as investors. The circumstances in which trustees of SMSFs are treated as a *retail client* should be clarified in particular. It is arguable that the trustees of a SMSF should be treated as more akin in this context to private investors than to a general superannuation fund.

32 ASIC Frequently Asked Questions, QFS 150.

33 The Treasury, *Wholesale and Retail Clients – Future of Financial Advice Options Paper*, 24 January 2011. The paper and submissions (other than those provided in confidence) are available at futureofadvice.treasury.gov.au.

Assessment

General

The above overview of recent cases in which the collapse of a financial services provider has resulted in large scale consumer losses:

(a) refers to some of the circumstances surrounding the collapse of those providers;

(b) points out that some consumers may have recourse to other licensees, and in particular financial advisers with whom they have dealt, for compensation in relation to their failed investment (typically on the basis of inappropriate advice or other mis-selling);

(c) notes the reality that many consumers (those who invested direct with the provider in question and not through an adviser) may have no access to compensation beyond any rights as unsecured creditors in the insolvency of the provider;

(d) does not throw much more light on the question, discussed in Chapter 2, of the extent to which consumers are unable in practice to recover compensation owing to the insolvency of the licensee in question.

Trio Capital

The following points emerge from the consideration of the case of Trio Capital where the facts and legal consequences are still unfolding:

(a) Consumers who were exposed to Trio Capital through APRA-regulated superannuation funds were able to obtain the benefit of financial assistance under Part 23 of the SIS Act.

(b) The award of financial assistance under Part 23 was on the basis that their fund had incurred loss as a result of fraudulent conduct or theft, that the loss had caused a substantial diminution of the fund's assets leading to difficulties in the payment of benefits and that the public interest required a grant to be made.

(c) The trustees of SMSFs (who are specifically excluded from financial assistance under Part 23) and other private investors do not have the same ready basis for compensation for losses suffered in the collapse of Trio apart from any rights they have through their investments as unsecured creditors. In order to recover compensation they will have to attribute their loss to a breach of a licensee's obligations and even then recovery will depend on the licensee's capacity to pay.

(d) Consumers who invested in Trio through financial advisers may have a basis to claim compensation if the advice was inappropriate, for example because it did not properly warn of the risks of investing or of the unsuitability of the investment given a client's objectives, needs and risk profile.

(e) There appears to be a reasonable basis in policy for the exclusion of SMSFs from the Part 23 scheme. Any move to include SMSFs would entail a marked change in the regulatory approach to SMSFs.

(f) Not surprisingly the fact that some consumers but not others have recourse to compensation in a case like Trio is the cause of disquiet for those who miss out.

(g) The seemingly uneven outcome is a consequence in part of the piecemeal way in which compensation arrangements for consumers of financial services have developed over the years. The Part 23 arrangements were introduced in 1993 as part of a package to strengthen the security of superannuation savings and protect the rights of fund members. This special provision no doubt reflects the fiduciary nature of such superannuation funds and the importance of maintaining the integrity of and confidence in funds to which consumers are obliged to contribute for their retirement savings.

(h) The fact that the alleged fraudulent conduct in Trio Capital appears to have occurred in relation to a managed investment scheme in which assets of prudentially-regulated superannuation funds were invested, rather than in those funds themselves, accentuates the difference in the position of the members of those funds who were able to be compensated, and SMSFs and other consumers who invested in the same managed investment scheme.

(i) The circumstances in which APRA-regulated superannuation funds apparently invested a large part of their assets in one managed investment scheme itself raises questions about the governance of those funds, their investment policy and risk management. It may also raise questions about the adequacy of regulation in this area. It is noted that proposed new powers for APRA to make prudential standards under the *Stronger Super* reform process are aimed at providing more effective governance of investments.

(j) Aside from the members of APRA-regulated superannuation funds, the position of consumers is problematic in a case where their investment in a financial product is destroyed or impaired by fraudulent conduct on the part of the product provider. They may have a basis for claiming compensation where they can attribute losses to dishonest conduct on the part of the licensee, where the fraud was perpetrated by an employee or representative of the licensee or funds provided to a licensee for investment purposes were misappropriated before being so invested. However, where the product issuer has failed their prospects of recovering compensation may be another matter unless there is insurance cover in place that will respond to their claim.

(k) The introduction of a statutory compensation scheme of last resort would not be a 'silver bullet' that would resolve the question whether fraud as a factor in the failure of an investment would give rise to a claim for compensation. It would still be necessary for a consumer to attribute loss to the breach of a licensee's obligation.

(l) Apart from any further criminal sanctions, it is questionable whether the law could meaningfully go much further in imposing obligations on a licensee that would pave the way for a consumer to recover compensation from a licensee for fraudulent impairment of the value of an investment.

(m) It is noted in any event that by reason of the inherent moral hazard a licensee would not be able to acquire professional indemnity insurance cover for fraud committed by itself.

(n) Any move to introduce a scheme of financial assistance along the lines of Part 23 of the SIS Act for investors in managed investment schemes would call first for a substantial upgrading of the regulatory regime for such schemes. A starting point in any such move might involve requirements for better management by such schemes of the risk to investors of loss through fraud. How far such measures would be effective where fraudulent conduct is endemic in the operation of a particular managed investment scheme is another matter.

(o) Consideration of the position of SMSFs in relation to Trio has drawn attention to complexity and lack of clarity in the definition of *retail client*. Clearer tests that can be applied in a practical way are desirable in the interests of licensees as well as consumers. In the application of the definition to trustees of a SMSF there is an argument for treating those trustees, for the purposes of the definition, as more akin to private investors than to a general superannuation fund.

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.[1]

---

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.[2] 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

---

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.[3] 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.[4]

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.[5] 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 certainty 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

---

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.[6]

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.[7] 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.

6 Slater and Gordon submission, page 2.
7 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.[8]

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.[9]

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.[10] It would be more efficient and cost effective for both licensees and ASIC for all required information to be submitted at the same time.

---

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.[11]

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.[12]

This general obligation is supplemented through more detailed licensing conditions and ASIC's Regulatory Guide 166.[13] 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.[14]

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'.

---

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.[15] 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.[16]

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.[17]

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

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

16 ibid and ASIC Consultation Paper 156: *Retail OTC derivate 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.[18] 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

---

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.[19]

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.

19 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.[20] ASIC keeps a register of authorised representatives notified to it by licensees.[21] 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.[22]

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.[23] 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.[24]

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

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.[25]

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

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.[26]

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.

26 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.[27] 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'.[28] 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].[29]

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 believe 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.[30] 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

---

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.[31]

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.[32] 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:

---

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.[33]

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.[34] 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.[35]

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.

---

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.[36]

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.

36 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.[37] 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:

---

37 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.[38] 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.[39] 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.[40]

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.[41]

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.

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.[42]

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.[43] 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.[44] 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

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.[45]

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.[46]

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.

---

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.[47] 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.[48] 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

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

insurance arrangements that meet regulatory requirements and may facilitate regulatory efforts in monitoring compliance with those requirements.[49]

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.[50]

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.

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.[51] 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.[52]

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*

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.[53] 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.[54] 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.

53 Slater and Gordon submission, page 2.
54 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.

Chapter 5: Rebalancing responsibilities of licensees

This chapter discusses an apparent imbalance in the responsibilities of issuers of financial products on the one hand and financial advisers on the other towards retail clients.

This imbalance stands out in any consideration of the current arrangements to provide those clients with assurance about the recovery of compensation where they suffer loss as a result of licensee misconduct. Substantial claims for compensation by retail clients often arise in the context of the failure of a managed investment scheme. Where retail clients suffer losses in such circumstances, those clients who invested on the basis of advice may be able to claim compensation from their adviser on the basis of the inappropriateness of that advice.

Other clients who purchased the product direct from the issuer, as is often the case, are unlikely to have an avenue for compensation. This is in part because of difficulties in attributing loss to shortcomings in the kind of disclosure issuers make to the market in general. Also, where a product issuer has failed consumers may see little point in pursuing a claim against the issuer owing to the poor prospect of recovery. It is noteworthy also how few complaints are brought against product issuers, as compared with financial advisers, under EDR schemes.

As a matter of strategic approach, it would be timely to review the current light-handed regulatory regime for the issue of certain financial products into the market, in particular managed investment schemes, and the possible need for some tightening of that regime. While the report does not reach conclusions in this regard, possible first steps in any such review would include the imposition on product issuers of more positive obligations in regard to the suitability of their products for retail clients as well as the introduction of standardised key product labelling.

Such an approach would be consistent with attention being given at the international level, following recent financial market turmoil, to the need for product issuers to assure the appropriateness of their product to retail consumers. The case for giving more attention to the responsibilities of product issuers is underlined by the prominence of direct consumer investment into products such as managed investment schemes.

This would be with a view both to providing better protection for clients, and reducing the instances of consumer loss, as well as paving the way for possible compensation claims where those obligations are breached.

Consideration is also given to related matters including the ability of EDR schemes to apportion responsibility for misconduct amongst relevant licensees including product issuers. The desirability of clarifying the scope of exclusion of disputes about the 'management of the fund or scheme as a whole' from the jurisdiction of FOS is also noted.

Licensee conduct and compensation obligations

5.1 The conduct and disclosure obligations imposed on licensees by Chapter 7 of the Corporations Act aim to protect retail consumers through the application to licensees of standards that require consumers to be informed about the features and risks of a product and not to be misled.

5.2 A consumer who acquires an interest in a financial product upon the basis of financial advice can expect the adviser to have provided personal advice that is appropriate to the consumer's circumstances. The Corporations Act requires the licensed adviser, in providing personal advice, to assess and make reasonable inquiries into the client's personal circumstances.[1]

5.3 On the other hand, a consumer who acquires a financial product direct from an issuer can look to the product disclosure statement to be clear, concise and effective.[2] The product disclosure statement should also cover certain matters, such as significant benefits and risks associated with holding the product, and information about any other significant characteristics or features of the product.[3] While aimed to elicit relevant information, these disclosure obligations are general in nature and will not necessarily draw out or point up information relevant to the circumstances of particular categories of consumers. The Corporations Act also prohibits licensees from engaging in dishonest, misleading or deceptive conduct in relation to a financial product or service, or from making false or misleading statements that are likely to induce persons to acquire a financial product.[4]

5.4 A consumer who suffers loss where a licensee has not acted in accordance with its statutory requirements may seek compensation. However, a consumer does not have an entitlement to compensation for loss in the value of their investment, such as where there is a failure of the product or the issuer or where returns are lower than expected, unless the loss can be attributed to licensee misconduct.

5.5 It has become apparent in the review that the failure of a managed investment scheme underlies many of the cases in which consumers find it difficult to recover compensation for losses attributable to licensee misconduct. Where consumers have acquired a product through an adviser they may, depending on the particular circumstances, be able to claim compensation on the basis of the inappropriateness of the advice that led them to invest in the product.

5.6 On the other hand, the many consumers who acquire those products direct from an issuer are unlikely to have such a claim. As a practical matter, very few claims seem to be brought against issuers of such investment products, whether based on misconduct in the description or marketing of that product or otherwise.

5.7 It is not questioned that financial advisers should bear responsibility for the consequences of inappropriate advice. They owe a responsibility to their clients, should be well informed about the products in question, and they are rewarded for the service they provide.

1 Section 945A *Corporations Act 2001*.
2 Paragraph 1013C(3) *Corporations Act 2001.*
3 Section 1013D *Corporations Act 2001.*
4 Sections 1041E, F, G and H *Corporations Act 2001*.

5.8 There is a question however whether they bear a disproportionate degree of responsibility for their part in the investment chain compared to the issuers of products whose failure generally underlies the losses suffered by consumers.

5.9 In practical terms those retail clients who dealt with a financial adviser stand a better chance of recovering compensation for misconduct than those who acquired their interest direct from the product issuer.

5.10 This is in part because of the difference in the nature of the responsibilities imposed on financial advisers compared to product issuers. The statutory expectations on financial advisers in dealing with a client on a one-to-one basis are more intensive than those on product issuers dealing with prospective clients on a whole of market basis.

5.11 Retail clients who invest direct in financial products are less likely to be able to recover compensation. This is in part because of the greater difficulty in making out misconduct on the part of a product issuer. It also reflects the reality that in some cases where loss is incurred the product issuer will itself has failed leaving little prospect of recovery of compensation.

Access to EDR schemes

5.12 The apparent imbalance in the responsibility towards consumers borne by product issuers compared with intermediaries is reflected also in the claims brought before EDR schemes by consumers. EDR schemes generally present consumers with an accessible avenue for the pursuit of compensation claims against licensees. Financial advisers appear to be shouldering almost all of the compensation awarded through EDR schemes in relation to managed investment scheme products.

5.13 FOS (the EDR scheme dealing with most investment related complaints) says that, by number of disputes, 'more than half (58 per cent) of the investment disputes it handled were about products or services provided by financial advisers or planners'. In dollar terms, the proportion of claims against financial advisers was even higher, representing 65 per cent of aggregate claims during the period 2006 to 2009.[5]

5.14 In comparison only 19 per cent of aggregate claims (in dollar terms) were against providers of managed investments.[6] The majority of the allegations of misrepresentation by a managed investment scheme brought to FOS appear to be about operational issues (such as the timing or approach to redemption requests, or costs of early termination of an investment) rather than about the misrepresentation or marketing of a product.

5.15 FOS has confirmed that it has handled only one dispute involving an allegation of misrepresentation by the licensee in its PDS. That case was decided against the responsible entity of the managed investment scheme. One other complaint involved an allegation of misleading and deceptive conduct in verbal representations in a sales presentation for a timeshare scheme, and was decided against the licensee.[7]

5 FOS data, see Table 2.1.
6 ibid.
7 FOS determinations 17681 and 208661 respectively.

5.16 It is noteworthy that so few complaints about product disclosure or marketing practices have been brought against product issuers, especially when questions have been raised about the accuracy or adequacy of disclosures made to consumers by particular product issuers (see Table 3.2).

5.17 There would appear to be two reasons for this imbalance in cases handled by FOS between the redress attainable in practice from financial advisers and product issuers (including responsible entities of managed investment schemes) for consumer losses arising from financial products that in some way might be regarded as having been mis-sold.

5.18 First, in many cases consumers only realise a loss on their investment when the product issuer fails. At that time, even if misrepresentation in a PDS or directly by the product issuer could be established, the consumer might see little value in pursuing a claim against a product issuer that is insolvent and might already have exhausted any professional indemnity insurance. The consumer would have little recourse to compensation in those circumstances other than as an unsecured creditor.

5.19 In such circumstances, consumers who invested in a managed investment scheme or other product through an intermediary may see their adviser as a better prospect for redress, provided there is some basis for a claim for inappropriate advice or other misconduct. Consumers understandably will pursue a claim against the most accessible target in the investment chain, not necessarily against a licensee who may also bear some responsibility for the loss.

5.20 Also it is generally a more straightforward matter to determine whether there was mis-selling or other misconduct by a financial adviser than by a product issuer given the one-to-one relationship an adviser has with each client. In providing personal advice to a client an adviser is obliged to provide advice which is appropriate to the client's personal circumstances having regard to the adviser's reasonable inquiries into those circumstances and its investigation of the subject matter of the advice. In contrast, in looking to the product issuer a consumer will, in the absence of any personal representations, only be able to rely on general disclosures or conduct to prospective investors as a class.

5.21 The second reason, according to FOS, is that as a matter of law a statement made by a product issuer at the time an investment is made is an implicit representation of present fact.[8] That is, the product issuer must believe the statements it makes to be true at the time they are made. For this reason FOS has told the review that it does not hold a product issuer liable for consumer loss resulting from changes in the nature of the investment that occur over time, for example because there has been a change in investment strategy for a scheme from that originally held out to investors.

5.22 It follows that, while EDR schemes generally appear to provide retail clients with a consumer friendly vehicle for pursuing claims, this course is almost non-existent where consumers have acquired financial products direct from an issuer and have not used a financial adviser.

5.23 Further, in assessing the compensation payable as a result of a breach, EDR schemes may consider whether there was any contributory negligence by the consumer who suffered the loss, but will not consider the liability of licensees other

8 Global Sportsman Pty Ltd v Mirror Newspapers Pty Ltd [1984] FCA 180.

than the licensee against whom the claim has been made (see paragraph 2.56). This means that, in the absence of any contributory negligence by the consumer, an adviser who recommended a financial product that was inappropriate might be liable to compensate the consumer's loss fully (subject to the scheme caps of $280,000) irrespective of the contribution of other licensees in the investment chain. That is, a product issuer's responsibility will not be taken into account in determining the award of compensation payable by the adviser.

5.24 It would be open to the adviser in theory to bring separate legal proceedings against the product issuer in regards to its contributory negligence. At best the adviser would have to carry the full compensation liability in the first instance, with subsequent partial recovery of the liability from the product issuer. In practice the adviser may not see separate legal action as worthwhile having regard to the cost of such action, or because the issuer is insolvent.

5.25 Another issue that seems to complicate the approach by FOS to complaints against product issuers is the exclusion from its jurisdiction of disputes about the 'management of the fund or scheme as a whole'.[9] In its operational guidelines, FOS says this is intended to exclude disputes about 'the day to day operation of the fund or scheme as a whole', such as investment decisions by the fund manager, or a dispute that 'applies to or affects all members of the fund or scheme'. While it is understandable that FOS should not be an arbiter on the internal operations of a scheme or fund, the exclusion is going too far if it denies consumers access to FOS in respect to misleading product disclosure statements or other practices in regard to the offering of products. There would seem to be a case, given some lack of clarity in this regard, for making it clear that such outcomes are not intended.

Scope to rectify imbalance

5.26 As noted above, it is arguable that a disproportionate burden is borne by financial advisers under the current arrangements. The costs of the compensation arrangements appear to fall heavily on financial advisers in comparison to product issuers. In turn this impacts on access to and the cost of professional indemnity insurance for advisers, and ultimately on consumer access to financial advice.

5.27 Reference is made in this regard to ICA's submission that:

> ...reinsurers being more selective in the risks they were willing to cover. This was particularly the case for a sector such as financial planning where there had been considerable losses in Australia due to several large scale financial collapses. These developments have been reflected in the pricing of PII.[10]

5.28 Overall financial advisers who have recommended financial products to their clients from issuers that have subsequently collapsed bear the brunt of compensation for consumer loss for those products and consumers who invested in those products direct have little prospect of compensation on the basis of licensee misconduct. Product issuers for their part do not appear to bear a proportionate responsibility, even where advisers acted on the basis of a misrepresentation of the product by the product issuer, or where the product issuer had set up a marketing arrangement for the distribution of its products direct.

---

9 FOS Terms of Reference, 1 January 2010 (as amended 1 January 2012) paragraph 5.1(i).
10 ICA submission, page 1.

5.29 As a matter of strategic approach it would be timely to consider measures by which product issuers could assume more responsibility for the protection of consumers who look to invest in their products. The need for this is supported by the prominence of direct consumer investment with an estimated 70 per cent of investments in the managed funds industry being made direct and 30 per cent made through a financial adviser.

5.30 Given the focus of this review, it has not been possible to develop or test such an approach. However, reference is made below to the scope for reviewing the regulatory approach to the issue of financial products and to some possible measures to redress the balance of responsibility between financial advisers and product issuers.

Underlying regulatory approach to product issuers

5.31 More fundamentally, it may be timely to review the adequacy of the underlying conduct and disclosure approach to the regulation of financial product issuers as the means of protecting consumers. There has now been some ten years' experience of the current approach which relies largely on the disclosure of information to consumers and sets some standards for the quality of that information. Any additional measures would be aimed at reducing the risk to consumers that they acquire financial products that are not suited to their needs. They would be preventative measures that aim to reduce consumer loss, and the eventual need for consumer compensation.

5.32 The impact of the global financial crisis on consumers has led to a new focus by the international regulatory community on the adequacy of conduct and disclosure regimes. Consideration is being given to the possibility of a more interventionist approach with product issuers. The aim is to catch problems early on in a financial product's life cycle as a means of preventing widespread detriment to consumers.

5.33 FSA in the United Kingdom has said the regulatory reliance thus far on 'fair sales processes and transparent product disclosure' has been insufficient in protecting consumers from a series of product failures. FSA's analysis suggests that the disclosure regime has not overcome problems of asymmetric information for consumers, weakness in bargaining power with financial service providers nor incentives in the distribution chain that are not in the interests of consumers.[11]

5.34 In response, the UK Government has directed FSA to intervene 'more intensively at all points of the value chain' to 'seek to minimise consumer detriment'.[12]

5.35 Given the experience over recent years with consumer losses from the failure of managed investment schemes, it may be timely to undertake a policy review to determine whether a more interventionist regulatory approach towards product issuers is required to offer better consumer protection. Such a review could consider a range of possible measures such as:

- consumer and industry warnings for certain products;
- limiting sales of certain products to certain classes of consumers;

11 Financial Services Authority (UK) Discussion Paper D11/1, Product Intervention, January 2011.
12 Financial Services Authority (UK), Feedback Statement FS11/3, Product Intervention, June 2011, p7.

- preventing distribution of certain products in the absence of financial advice;
- mandating or banning of certain product features;
- a 'stop order' power to enable the regulator to intervene to halt the issue and distribution of 'toxic' products to retail investors (similar to the power that is available where ASIC is satisfied that information in a disclosure statement or document, or an advertisement, contravenes the statutory requirements on the product issuer);
- increased capital adequacy requirements for issuers of riskier products.

It is not suggested that a radical change of approach is required such as by a move to require pre-vetting of new investment products. There would seem to be scope however to consider changes that would adjust the regulatory approach in a stepped way.

5.36 In the light of recent experience in Australia and developments in overseas jurisdictions, it is suggested that the regulatory approach to the issue of financial products could usefully be reconsidered.

5.37 A first step in any such review might be to consider measures by which product issuers would be expected to assume more responsibility for the protection of consumers of their products. The objective would be to provide better protection for clients, and reduce the instances of consumer loss, as well as paving the way for possible compensation claims where those obligations are breached. Possible measures for consideration include the imposition on product issuers of more positive obligations in regard to the suitability of their products for retail clients and the introduction of standardised product labelling.

Product issuer responsibility to consumers

5.38 As has been noted most cases of large case consumer loss are associated with the failure of financial products, and managed investment schemes in particular. In such cases a common issue appears to be that consumers had not been properly informed of, or had not understood, the complexity, suitability or risks of their investments.

5.39 Under the current regulatory approach, there is limited regulation of the development and marketing of new investment products. There is no pre-vetting of new products and any financial product can be placed on the retail market by a registered and licensed financial product issuer if accompanied by the required disclosure statements.

5.40 As things stand, the Corporations Act requires product issuers when releasing a financial product to the market to issue a Product Disclosure Statement that:

- is worded and presented in a clear, concise and effective manner;[13]

13 Subsection 1013C(3) *Corporations Act 2001*.

- makes specific disclosures, including about any significant benefits which the holder will or may become entitled to, as well as any significant risks associated with holding the product;[14] and

- includes all other information that might reasonably be expected to have a material influence on the decision of a reasonable person, when investing as a retail client, about whether or not to acquire the product.[15]

5.41 The product issuer also has obligations to provide ongoing disclosure on material changes to the investment and significant events, and to provide periodic statements to investors.[16]

5.42 ASIC in its guidance in respect of various categories of financial products states that disclosure should include information, for example, about a responsible entity's financing arrangements, track record and financial position.

5.43 In practice, there is a question whether the information provided by product issuers in a PDS is framed in a manner that assists consumers to understand whether the product would suit their needs. For example, in assessing the quality of disclosure available to retail investors in agribusiness schemes ASIC has said that:

> many PDSs currently in use for agribusiness schemes do not adequately explain the way agribusiness schemes work, and the risks associated with investing in them (which) …has resulted in retail investors investing in these schemes without an adequate understanding of the risks.[17]

Further, in looking at infrastructure entities ASIC found that risks were often disclosed as a 'laundry list' which would be difficult for consumers to understand and consider in the context of their own risk profile.[18]

5.44 Whilst ASIC is pursuing improved product issuer performance in the area of product disclosure, overall there is a more fundamental question whether consumers might be better protected if more were expected of product issuers in releasing products to the retail market. There is a question whether issuers of financial products should have to take more responsibility for the suitability of new products made available to retail investors and for more forthright disclosure of matters such investors should take into account. This question is accentuated where, as is often the case, products are marketed direct to retail investors and not just through advisers.

5.45 Given the reliance on a PDS to provide information to consumers who invest direct, consideration might be given to requiring the inclusion of more guidance to assist consumers to make choices that are appropriate to their needs and help them avoid those that are not. ASIC has raised the need for consideration to be given to more stringent disclosure requirements at the asset level of registered managed

14 Section 1013D *Corporations Act 2001*.
15 Section 1013E *Corporations Act 2001*.
16 Sections 675, 1017B and 1017D *Corporations Act 2001*.
17 ASIC Regulation Impact Statement, *Agribusiness managed investment schemes: Improving Disclosure for retail investors*, para 2.
18 ASIC Regulation Impact Statement, *Infrastructure entities: Improving Disclosure for retail investors*, paragraph 29.

investment schemes as a means of placing consumers and advisers in a better position to assess the exposure of such schemes to particular assets.[19]

5.46 Another possibility would be to have product issuers disclose in the PDS the potential suitability or unsuitability of the product for particular classes of investors or risk profiles. While a suitability statement by a product issuer could not address the circumstances of an individual investor, statements of characteristics relevant to particular categories of consumers would help consumers to ascertain whether or not a product is potentially suitable for them.

5.47 A product issuer would of course need to take care that the terms of any suitability statement were not misleading, for example by implying that any individual from a targeted class would find the product suitable to their needs. It would be a matter for consideration whether a suitability requirement should extend to financial products, such as simple managed investment schemes, that will be subject to the shorter form PDS from mid-2012.[20]

5.48 A suitability requirement could be designed to apply at every stage of a product's life cycle, from design and development, to distribution and operation. For example, it might aim for a more rigorous process of product development before a product is released, such as stress testing of the risks to assess the product's performance in a range of market conditions to give the issuer a more realistic basis for disclosure statements on the product's risks.

5.49 The breach of a suitability requirement would be subject to administrative sanctions and, where consumer loss can be established, it would provide a basis for compensation.

5.50 An obligation to assess the suitability of products for consumers already applies as part of the responsible lending conduct required of licensed credit providers. Credit providers are obliged to ensure they do not provide a credit contract that is unsuitable for the consumer.[21] A similar obligation applies to margin lenders who are required to ensure, before issuing or increasing a margin loan, that it is not unsuitable for a retail client after making reasonable endeavours to verify the client's financial situation and capacity to meet repayments.[22]

5.51 In both of those cases the provider is dealing with the retail client on a one to one basis and is in a position to assess the suitability or otherwise of the product given its ability to assess the consumer's personal and financial circumstances. Statements by product issuers to the retail market about the suitability of a product might need to be more broadly based, whilst framed in a way that is useful and not misleading. Where the product issuer has direct dealings with a consumer it might be required to go further in providing guidance at the point of sale.

5.52 The application of a suitability requirement to product issuers on a life cycle basis, or some alternative that looks at placing more onus on issuers to provide products that are appropriate to their target consumer market, is worth further consideration. There is growing attention at the international level to the need for

19 ASIC Submission to PJCCFS, Inquiry into the collapse of Trio Capital, August 2011, paragraphs 270 – 272.
20 'Corporations Regulation 1.1.02 defines 'simple managed investment schemes' and Schedule 10E *Corporations Act 2001* sets out form and content of PDF.
21 Chapter 3 *National Consumer Credit Protection Act 2009*.
22 Section 985K *Corporations Act 2001*.

product issuers to take on greater responsibility for the appropriateness of their products to retail consumers.

International developments

5.53 As noted above, questions are being asked by the international regulatory community about the adequacy of conduct and disclosure requirements for financial products and the need for a more interventionist approach.

5.54 The G20 Finance Ministers and Central Bank Governors recently endorsed common principles on consumer protection which include:[23]

- Principle 3 - *the equitable and fair treatment of consumers* - which requires:

  all financial consumers should be treated equitably, honestly and fairly at all stages of their relationship with financial services providers...;

- Principle 4 - *disclosure and transparency* - which requires financial service providers and their authorised agents to:

  ...provide consumers with key information that informs the consumer of the fundamental benefits, risks, and of the product ..(and) on conflicts of interest associated with the authorised agent through which the product is sold...;

- Principle 6 - *responsible business conduct of financial services providers and authorised agents* - which requires them:

  ...to work in the best interest of their customers and be responsible for upholding financial consumer protection...depending on the nature of the transaction ...providers should assess the related financial capabilities, situation and needs of their customers before agreeing to provide them with a product, advice or service...

  ...where the potential for conflicts of interest arise, financial services providers and authorised agents should endeavour to avoid such conflicts. When such conflicts cannot be avoided …providers ...should ensure proper disclosure, have in place internal mechanisms to manage such conflicts, or decline to provide the product, advice or service.

5.55 The International Organization of Securities Commission (IOSCO) is currently consulting on *suitability requirements with respect to the distribution of complex financial products.* Its consultation paper sets out:

> proposed principles relating to the customer protections, including suitability and disclosure obligations, which relate to the distribution by intermediaries of complex financial products to retail and non-retail customers.[24]

In terms of disclosure, the proposed principles look to the provision of investor access to 'material information to evaluate the nature, costs and specific risks of the complex financial product' and to have the intermediary communicate to the investor 'in a fair, comprehensible and balanced manner'.[25] Further, IOSCO proposes that

23 OECD, *G20 high-level principles on financial consumer protection* October 2011. The principles were developed by the Task Force on Financial Consumer Protection of the OECD Committee on Financial Markets, in close cooperation with the Financial Stability Board and others.

24 IOSCO, Media Statement 04/2012, 21 February 2012.

25 ibid, page 1.

where a complex product is sold 'on an unsolicited basis (no management, advice or recommendation), the regulatory system should provide for adequate means to protect customers from associated risks'.[26]

5.56 In the United Kingdom financial product issuers and distributors are subject to '*treating customers fairly'* obligations that aim to deliver improved outcomes for retail consumers.[27] These require amongst other things that products and services marketed and sold in the retail market are 'designed to meet the needs of identified consumer groups and are targeted accordingly'. This requirement applies to product issuers even if they distribute their products solely or mainly through intermediaries as is commonplace in that market. It also requires firms to keep consumers appropriately informed about the product before, during and after the point of sale, and to provide products that perform as they have led consumers to expect.

5.57 As noted above, FSA in the United Kingdom has said the regulatory reliance thus far on 'fair sales processes and transparent product disclosure' has been insufficient in protecting consumers from a series of product failures. The UK Government for its part has directed FSA to intervene 'more intensively at all points of the value chain' to 'seek to minimise consumer detriment'.[28]

Standardise key product labels

5.58 Consistent with the objective of requiring more guidance from product issuers to assist consumers to make financial product choices that suit their circumstances, it is suggested that consideration also be given to the adoption of standardised product labels across the industry. This would help to give consumers more clarity about the nature of the products they are looking to invest in, and help them to undertake more meaningful comparisons of 'like' products by different issuers.

5.59 The lack of common labelling for financial products, and the diversity of product descriptors used across the financial services industry at present, is likely to be confusing for consumers and not help them choose products appropriate to their needs.

5.60 There has been some effort already to specify the characteristics of certain financial products and their potential risks. In particular:

- the Corporations Regulations define the characteristics of a *capital guaranteed fund* with respect to public superannuation funds and require issuers of such products to provide certain information in the periodic statements provided to investors;[29]
- from June 2012, APRA will require superannuation funds to provide additional disclosure for their products and to identify and disclose, on a standardised

26 ibid, page 2.
27 Financial Services Authority (UK), *Treating customers fairly – towards fair outcomes for consumers,* July 2006. Specific reference is made to Outcomes 2, 3 and 5 on page 3.
28 Financial Services Authority (UK), Feedback Statement FS11/3, *Product Intervention*, June 2011, page 7.
29 Corporations Regulations 1.0.02 and 7.9.22.

basis, the risk of negative returns over a 20-year period for each of their investment options;[30] and

- as part of a current consumer credit Bill, it is proposed to restrict the use of the term *reverse mortgage* to those products which meet the definition in the *National Consumer Credit Protection Act 2009*.[31]

5.61 FSA in the United Kingdom has recognised the need for consistent labelling of products across the financial product industry. In a recent consultation paper, FSA notes that it has reviewed the promotion of financial products described as *guaranteed*, *protected* or *secure* and

> concluded that some firms promote these products without any clear and adequate justification for the descriptions used. [32]

FSA's assessment is that this

> could be implicitly misleading and could lead to consumers misunderstanding what is actually offered to them.

FSA has sought comment on its proposal to provide guidance in its rule book on the use of those terms and on the information to be given to consumers when promoting such products.

5.62 As a further measure to help guide consumers to make appropriate investments, and to avoid inadvertently taking on undue risks, consideration should be given to the standardisation of key labels for financial products, particularly managed investment scheme and superannuation products, across the industry so that products are described on a consistent and more meaningful basis. This might apply to such terms as: *capital guaranteed*, *capital protected; conservative; balanced; diversified; growth; defensive; fixed interest; or hedged*, as well as other like descriptors.

5.63 The development of standardised and generally accepted product labels is not likely to be a simple or quick task. It might be undertaken, on a progressive basis, by the regulator with involvement by industry and consumer groups. This could be done with a view to a regulatory requirement on the use of standardised labels in product disclosure statements and promotional material. The support of professional bodies might also be sought in making the use of standardised product descriptors a requirement of membership.

Allocation of cost of compensation between licensees

5.64 It is relevant, in any consideration of a rebalancing of responsibilities between product issuers and advisers, to look at the way in which investment disputes are handled through the EDR scheme process. There is scope for some rebalancing of responsibilities through changes to the operation of EDR schemes to facilitate a more

---

30 The standard risk measure to be used for this purpose was developed at APRA's request by a working group comprising the Financial Services Council and the Association of Superannuation Funds of Australia. See *Standard risk measure to provide greater transparency for consumers*, ASFA Media Release, 1 August 2011.

31 Consumer Credit and Corporations Legislation Amendment (Enhancements) Bill 2011.

32 Financial Services Authority (UK), Quarterly Consultation (No 29), Consultation Paper 11/11, June 2011, pages 27-28.

equitable distribution of the cost of compensation between financial advisers and product issuers.

5.65 As discussed earlier, EDR schemes only look to establish whether or not a financial adviser is liable for compensation but do not take into account any contribution to the loss by other licensees in the investment chain.

5.66 The adviser has no opportunity to draw into an EDR scheme dispute a product issuer that may rightfully share responsibility for the loss, but could take private legal action through the courts against the product issuer to seek to recover that part of the compensation liability that is attributable to the issuer's misconduct.

5.67 Given the quantum of claims that they can handle, EDR schemes should be open to assessing more holistically the circumstances that led to consumer loss by considering whether the loss was attributable to a breach by the relevant product issuer as well as financial adviser. This would allow a more equitable distribution of the cost of compensation between the respective licensees involved in providing the financial products and services that resulted in consumer loss.

5.68 To achieve this, the operating rules of EDR schemes would need to be made more flexible to allow a licensee against whom a claim has been made to bring another licensee member into the dispute to account for its role in the claimant's loss, or a consumer to bring an action against more than one licensee member in respect to the same loss. Such a course of action would be open for example where a consumer alleges false or misleading statements by the product issuer through its product disclosures as well as inappropriate advice by the adviser.

5.69 In such circumstances, if it were established that the claimant's loss resulted from a breach of obligation by both the product issuer and the financial adviser, the scheme would apportion the loss between the two licensees based on their respective contributions to the loss.

5.70 For practical reasons, financial advisers might need to be required to be members of the same EDR scheme as the issuer of the products represented in their approved product list.

5.71 Attention should therefore be given to changing the terms of reference of EDR schemes to make sure there is no obstacle to them considering disputes and making awards that recognise the proportionate liability of more than one licensee member. This would have a practical effect in rebalancing the responsibilities of financial advisers and product issuers to consumers, especially if coupled with a new obligation on product issuers for the suitability of their products.

5.72 Such a change would be consistent with the application of the principle of proportionate liability under Chapter 7 of the Corporations Act which applies to proceedings against a financial services licensee for recovery of loss or damage as a result of misleading and deceptive conduct.[33] Under these provisions the liability of a licensee that contributed to a loss is limited to an amount reflecting the proportion of the loss attributable to that licensee.

33 Division 2A of Part 7.10 Corporation Act 2001. The provisions also preclude the apportionment of a claim where the concurrent wrongdoer intended to cause the loss or acted fraudulently.

5.73 It is recognised that a procedural change of the type suggested would introduce an element of complexity into EDR scheme proceedings. Given the substantial quantum of claims that EDR schemes can now deal with, such a change seems warranted and fair. It is hard to see why a licensee should be at a distinct disadvantage in defending a significant claim for compensation before an EDR scheme compared with its position in defending a suit brought in the courts. Such a change could be confined however to claims for significant monetary damages and not be applied to the numerous more minor or run of the mill disputes about the administration of financial products and services that are handled by EDR schemes.

Role of gatekeepers in protecting consumers

5.74 Although the review has not sought to explore the issue in any depth, the role of gatekeepers in guiding consumers to make investment decisions should be recognised. The Chairman of ASIC has pointed out that consumers rely on a range of information about financial products provided to them by various parties or gatekeepers who 'collect, evaluate, advise on and endorse information about companies, assets and investments'.[34] He noted that:

> investors and financial consumers rely on gatekeepers to act with the utmost integrity [and]...where they fail in their role, this can have serious consequences for retail investors and financial consumers.[35]

5.75 Reference has been made to the role of research houses in this context. Financial advisers use research reports to identify products for inclusion in their approved product list, from which in turn they draw products recommended to their clients. Consumers in effect become indirect users of research house reports through the financial advice they receive.

5.76 Research houses are required to hold a license authorising them to provide general advice and to meet the general obligations set out in section 912A. ASIC provides detailed guidance on one of those general obligations, that is, to have adequate arrangements for the management of conflicts of interest.[36]

5.77 ASIC recently released a consultation paper in response to industry and consumer concerns about whether research houses are adequately managing their conflicts of interest and providing high quality reports.[37] Some research reports had recommended products close to the time of the product issuer's collapse.

5.78 ASIC found limited awareness by research houses of their obligations and says it will need to revise them and educate the providers of research reports on the standards expected of them. Changes to RG 79 and licensing conditions being considered by ASIC relate to:

- the need for regular compliance reports to be lodged with ASIC;

---

34 Greg Medcraft, ASIC Speech to FOS National Conference, June 2011, page 4.
35 ibid.
36 ASIC Regulatory Guide 79*, Managing conflicts of interest: A guide for research report providers.* November 2004.
37 ASIC Consultation Paper 171, *Strengthening the regulation of research report providers (including research houses),* November 2011.

- ensuring that conflicts of interest are properly managed in the research process (for example by requiring the segregation of the research function from the provision of other financial services) and are clearly disclosed;
- quality of research reports, both through the analysis and sign-off of the research, and the information provided to help users understand the material;
- the methodology used and its transparency.

5.79 Users of research reports have suggested to ASIC that research houses should be held liable for the general advice and recommendations provided in their reports when relied upon by advisers and consumers in making investment decisions.

5.80 Given the significant role played by gatekeepers, such as research houses, in the working of the financial services system, there is merit in continued efforts to clarify their responsibilities in regard to the protection of consumers. The significance of the role of gatekeepers, such as research houses, should be kept in mind in any strategic consideration of consumer protection in the financial services sector.

Recommendations

There is an apparent imbalance in the responsibilities of the issuers of financial products on the one hand and financial advisers on the other towards retail clients. Financial advisers are subject to more particular responsibilities in dealing with retail clients and in consequence bear a greater part of the burden of compensation following the failure of financial products. While most cases of serious loss relate to the failure of financial products, consumers commonly only have recourse to compensation where they have acquired a product through a financial adviser and can point to inappropriate advice or other misconduct. They have little prospect of compensation where, as in many cases, they acquired the product in question direct from a financial product issuer.

As a matter of strategic approach, it would be timely to review the present light-handed regulation of certain product issuers, in particular managed investment schemes, including the possible need, in accord with developments at the international level, to move to a somewhat more interventionist approach.

It would make sense also, in the course of any such review, to direct more attention to the responsibilities of licensees who provide financial products for retail clients. While the review has not had an opportunity to test these proposals, a first step might be to consider measures along the following lines by which product issuers would be expected to assume more responsibility for the protection of consumers of their products:

(a) Subject product issuers to more positive obligations in regard to the suitability of their product for retail clients.

Such obligations might be applied in particular to managed investment schemes in issuing products to the retail market, and would apply at each stage of a product's life cycle including its distribution and marketing. Amongst other things, the product issuer might be required to state the particular classes of consumers for whom the product is suitable and for whom the product is unsuitable, and the potential risks of investing in the product.

(b) Consider the development of standardised product labelling so that financial products, particularly managed investment schemes, are described on a consistent and more meaningful basis.

This might apply to such terms as *capital guaranteed*, *capital protected, conservative, balanced, diversified, growth, defensive, fixed interest, or hedged*, as well as other like descriptors.

In addition, some rebalancing of responsibilities could be addressed through changes to the operation of EDR schemes by resolving the inability of EDR schemes to apportion responsibility for misconduct amongst responsible licensees. The operating rules of EDRs should be changed to enable them to make awards that recognise the proportionate liability of product issuers, financial advisers or other licensees.

Further, there would seem to be a case to clarify clause 5.1(i) of the terms of reference of FOS which excludes consideration of disputes about the 'management of the fund or scheme as a whole'. The aim would be to remove any doubt about the ability of FOS to deal with consumer disputes in respect of misleading product disclosure statements or other practices of issuers in marketing their products.

While the review has not looked into these matters in any depth, the significance of the role of gatekeepers, such as research houses, should be kept in mind in any strategic consideration of consumer protection in the financial services sector.

Chapter 6: Observations on a last resort scheme

The conclusion reached in this report is that it would be inappropriate, and possibly counter-productive, to introduce a last resort compensation scheme at this stage. Nevertheless, given the attention afforded in the review to such a scheme, this chapter canvasses issues and provides views on the design and governance of a scheme should one be desired.

Ideally any last resort scheme would be integrated as far as possible with the schemes of last resort that are already in place in key areas of the financial sector, namely the National Guarantee Fund (NGF), the Financial Claims Scheme (FCS) and Part 23 of the Superannuation Industry (Supervision) Act 1993 (SIS Act).

6.1 The review was asked to consider the need for a statutory scheme of last resort to underpin the existing arrangements to provide assurance to retail clients of their ability to recover compensation for loss or damage attributable to misconduct of a financial services licensee. Such a scheme would be designed to provide retail clients with recourse to payment in circumstances where they are unable to recover compensation to which they are entitled from a licensed provider of financial services because the licensee has disappeared, become insolvent or otherwise has insufficient assets.

6.2 A scheme of the kind that has been canvassed would in effect extend or supplement the recourse already available to clients whose claims fall within the scope of other schemes of last resort such as NGF, FCS or Part 23 of the SIS Act.

6.3 Ideally a scheme of last resort for compensation would be integrated as far as possible with the NGF at least if not with the FCS and the last resort arrangements under Part 23 of the SIS Act. The existing last resort arrangements have developed in a piecemeal fashion and their amalgamation into a single scheme would have the advantages of clarity and efficiencies in both administration and cost. An integrated scheme would be simpler for consumers to interact with than multiple schemes.

6.4 That said, the report acknowledges the practical problems of implementing a single scheme in the short term given that the circumstances for recovery under each scheme vary significantly. Therefore, as a possible starting point, this chapter looks at issues that would arise with a stand-alone scheme.

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

6.6 The review has had the benefit too of a submission by FOS on the design and structure of a last resort compensation scheme. Reference is made below to aspects of that submission.

6.7 While the reviewer does not recommend the introduction of a last resort scheme, this chapter provides his views on the elements of such a scheme should one be desired at any stage. The following aspects are addressed:

- purpose of scheme;
- liability standard;
- eligible claims;
- capping of payments;
- membership of scheme;
- scheme funding;
- authority for scheme;
- governance;
- systemic improvements;
- relationship to EDR schemes;
- relationship to existing schemes of last resort.

The key elements of a possible scheme are summarised in Table 6.1.

Table 6.1: Elements of a possible compensation scheme of last resort

Eligible claims	Retail client suffers loss or damage from a breach by a licensee of the relevant liability standard (breach of licensee's Chapter 7 obligations or related breach of contract or negligence) and licensee cannot be found, is insolvent or otherwise has insufficient assets. The scheme would make a decision on eligibility, including by reviewing awards made by a court or EDR scheme, and determine the amount of *compensable loss* on which a scheme payment would be based.
Payment of claims	Payments made under the scheme would be capped at a level lower than the amount of *compensable loss* in question. A suggested formula for this purpose is: • 70 per cent of the first $50,000 of the *compensable loss;* plus • 50 per cent of the next $130,000; and • no part of the award that exceeds $180,000. This would result in a maximum scheme payment of $100,000.
Membership base	All licensees who provide a financial service to retail clients would be required to be members, including APRA-regulated insurers, ADIs and trustees of superannuation funds.
Scheme funding	Members in a particular sector would contribute to an annual *compensation levy* if the scheme is dealing in that year with *compensable losses* that arise from licensees in that sector. The scheme would be post funded with levies 'ring fenced' to each sector. This means that members in a particular sector would not contribute to an annual compensation levy if the scheme is not dealing in that year with *compensable losses* that arise from licensees in that sector. Levies would be calculated on the member's *proxy revenue base*.
Authority for scheme	Scheme to be established by statute.
Governance	Members of the governing body would be appointed by and report through the Minister.

Purpose of scheme

6.8 A last resort scheme would be designed to underpin the existing compensation arrangements. It would enable retail clients to be compensated in circumstances where, by reason of the insolvency or lack of available financial resources of a financial services licensee with whom they have dealt, they are unable to recover loss or damage that is attributable to misconduct on the part of that licensee.

Liability standard

6.9 The current compensation arrangements are designed to support claims by retail clients based on a breach by a licensee of its obligations under Chapter 7 of the Corporations Act.

6.10 Accordingly, the standards of conduct and disclosure to which licensees are subject under the statute provide the starting point in considering the liability standard for compensable claims under a scheme of last resort.

6.11 As discussed in chapter 2, those standards go beyond the duties and obligations set out in Chapter 7 of the Corporations Act and require compliance with *financial services laws* more broadly including other Commonwealth, State or Territory laws dealing with conduct in the provision of financial services.

6.12 It is noted that a Treasury Paper in 2002 said it was not intended that the compensation arrangements cover the general obligation on licensees that they comply with *other financial services laws.*[1] Whatever the intention, the compensation arrangements do not appear to have been so limited in their application. It is suggested that the liability standard for a last resort scheme should be broad enough to encompass claims based on breach of other such relevant laws. In other words the liability standard should cover a breach of other financial services laws as defined in the Corporations Act.

6.13 There appears to be good reason also to go further and allow a last resort scheme to entertain claims based on negligence or breach of contract by a licensee in its provision of financial services to a retail client. Given the likely overlap in practice between the elements of relevant statutory and common law obligations, this would avoid fine distinctions and complex points of argument about the legal basis of a client's claim. Apart from complicating the claims handling process, such distinctions would be largely inexplicable to a consumer who is left with an outstanding claim based on a licensee's misconduct.

6.14 It is not proposed however that the relevant liability standard should extend to claims based on breach of general notions of fairness or obligations under the licensee's industry code of conduct, even though EDR schemes may make an award on this basis.

6.15 Nor is it proposed that the relevant liability standard should extend to claims based on loss from fraud that cannot otherwise be attributed to a breach of a licensee's obligations, negligence or breach of contract. For example, the liability standard would be met if the consumer were to establish that, in perpetrating fraud

1 The Treasury, *Compensation for loss in the financial services sector: issues and options*, September 2002 paragraph 189.

that resulted in consumer loss, the licensee had engaged in dishonest conduct in breach of section 1041G of the Corporations Act. The liability standard would not be met if the claimant is unable to establish that the licensee's actions were in a breach of its statutory or common law obligations.

6.16 The suggested liability standard, as discussed above, would approximate the position under the UK FSCS where a claimant has to make out an outstanding claim based on a 'civil liability' of a licensed firm.

Eligible claims

6.17 In order to qualify for compensation under a last resort scheme a consumer would need to establish not only a claim against a licensee for damages based on a breach of the relevant liability standard but also that a licensee was not in a position to meet the claim.

6.18 A scheme should be able to respond to a claim where it is satisfied the claimant suffered loss or damage from a breach by a licensee of the relevant liability standard and that the licensee is not in a position to compensate the claimant for that loss. This could be on the basis that the licensee is:

- insolvent or bankrupt;
- cannot be contacted at its last place of business and reasonable steps have been taken to find it (that is, it has disappeared); or
- is otherwise unable to pay its liabilities.

Where satisfied that a licensee is in this position the scheme would declare it to be in default, thereby paving the way for possible claims by other clients.

6.19 Given that the current compensation arrangements are designed for the protection of retail clients, it might be expected that a scheme of last resort would be confined to claims by parties who satisfy the definition of retail clients under the Corporations Act. In principle this approach makes sense. It is noted however that this would be a difficult test to apply in practice. An alternative approach, along the lines of the UK FSCS, would not require claimants to establish that they were retail clients but would rely on the capping of payments under the scheme to limit the exposure of the scheme to any claimants who may be regarded as non-retail. In any event, any changes to the relevant definitions in the Act, arising from the current Treasury review, could affect the practicality of relying on the definition of retail clients to limit eligible claimants.

6.20 If a scheme is intended to benefit only retail clients, another more straightforward approach might be to rule out claims that exceed say $500,000 (that figure being a relevant threshold in the statutory distinction between wholesale and retail clients). This approach is used by EDR schemes to determine whether or not to accept a dispute as one with a retail client. For example, the terms of reference for FOS provides that a dispute is outside the jurisdiction of FOS 'where the value of the applicant's claim in the dispute exceeds $500,000'.[2]

---

2 FOS Terms of Reference, 1 January 2010 (as amended 1 January 2012), paragraph 5.1(o)

Decision making by scheme

6.21 The scheme would need to satisfy itself that an earlier award of a court or EDR scheme was based on a breach of the liability standard. This review process might result in the scaling down of an award so as to recognise only that portion of the award attributable to a breach of the relevant liability standard, and to exclude any punitive damages or costs.

6.22 A last resort scheme should be in a position to assess for itself the merits of claims for compensation. This would include the eligibility of the claimant, the existence of relevant liability to pay compensation on the part of a licensee, the licensee's inability to meet that liability and the amount of the compensable loss.

6.23 The scheme in its discretion would determine the *compensable loss* eligible for last resort payment. This is the amount, or proportion, of the consumer's loss that relates to the licensee's breach of the relevant liability standard.

6.24 The scheme would not expect a claimant to go through a court or EDR process before submitting a claim to the scheme. The scheme would be able to take into account but would not be bound by an award of compensation already made by a court or an EDR scheme.

6.25 FOS suggested in its submission that the scheme should pay out individual unpaid awards made in favour of a claimant by an EDR scheme. In its view a re-evaluation of the eligible claim by the scheme 'would add significantly to costs and professional resources required and add major delays to the delivery of compensation [and] would also require further explanation to consumers who are already distressed'.[3]

6.26 While those concerns are understandable, it is important that a scheme make an independent judgment about a consumer's entitlement to a last resort payment, and the amount to be paid. Given that the cost of payments under the scheme will be transferred to other licensees who are not at fault, the scheme itself should be accountable for decisions on the payment of last resort compensation. As a practical matter, the existence of an earlier EDR award or court decision may facilitate the scheme's decision making but it should still go through the process. Also, once a licensee is found to be in default, it would make more sense for further claims to be brought direct to the scheme, rather than referred back to an EDR or a court process.

6.27 This approach would be consistent with that of FSCS in the United Kingdom which in making its own assessment of the merits of a claim may have regard to court decisions or ombudsman determinations but does not give effect to them as such.

6.28 FSCS makes its own ruling on a firm's insolvency or incapacity to pay without waiting for insolvency or bankruptcy to be formally declared. It considers the eligibility of a claim for compensation under its rules. It gathers and examines evidence of conduct, and look at the client's attitude to risk to determine whether advice given was suitable to the client's needs. FSCS must be satisfied there was a financial loss for which the firm is civilly liable. FSCS may have regard to a decision or determination of a court or ombudsman in its assessment of the merits of a claim.

3 FOS submission 2009, prepared by Professional Financial Solutions Pty Limited, *Proposal to Establish a Financial Services Compensation Scheme*, October 2009, page 13.

6.29 It is noted also that, in the decision making and review mechanisms for a scheme of last resort, care would be needed to ensure it is based on the exercise of administrative powers rather than judicial powers which would risk the scheme being invalid on constitutional grounds (see also 'authority for scheme').

Transfer of disputes from EDR schemes

6.30 It is expected that a dispute being handled by an EDR scheme would generally be transferred to the last resort scheme once a licensee was declared to be in default. Arrangements could be made between the last resort scheme and EDR schemes for the continued handling or transfer of claims that are in train when a licensee is found to be in default.

Time limit for claims

6.31 There would need to be a time limit for the bringing of claims in the interests of manageability of a last resort scheme. It would be reasonable to expect consumers to bring their claims within a period of say one year of the licensee's default or insolvency. Once a licensee is found to be in default it would be appropriate for the scheme to publicise that fact in order to draw out other claims. This process would bring some finality to the calculation, funding and settling of *compensable losses* arising from the misconduct of an insolvent licensee member of the scheme.

6.32 Also, a last resort scheme would ordinarily be expected to operate prospectively and deal only with claims from defaults arising after the scheme comes into place. While this could lead to harsh results for some consumers, the introduction of transitional arrangements to enable a scheme to accept claims arising within a limited time before its introduction would complicate the funding of the scheme by industry. No matter what approach is used, there is likely to be some arbitrary divide between consumers who are able to bring claims and those who are not.

Capping of payments

6.33 It is suggested that, as a matter of principle, payments under a last resort scheme should be less than the *compensable loss* calculated for an eligible claim and that payment should also be subject to an upper limit, or dollar cap.

6.34 One reason for this is to lessen the risk of moral hazard if consumers make decisions in the knowledge that compensation will be available on a last resort basis in the event of any misconduct on the part of the licensees with whom they choose to deal.

6.35 It has been argued that the existence of a scheme could result in riskier conduct by licensees too given that their clients will have recourse to compensation. It is questionable however whether this is likely to be the case where access to compensation under the scheme will depend on the financial failure of a licensee, particularly if the licensee is required to have more 'skin in the game' (as proposed in this review).

6.36 A second reason is to contain the cost of the scheme that will be funded by licensees who were not themselves responsible for the consumer losses in question.

6.37 It is proposed therefore that payments under any last resort scheme should be limited to a proportion of the compensable loss up to a specified cap. The actual payment formula would be a matter for judgment, with a range of options possible.

6.38 In its submission, FOS proposes a maximum compensation payment linked to the compensation cap ($280,000) that applies to EDR schemes for investment related complaints. It suggests a payment formula of:

- 90 per cent of the first $120,000; plus
- 70 per cent of the next $80,000; plus
- 50 per cent of the next $80,000.

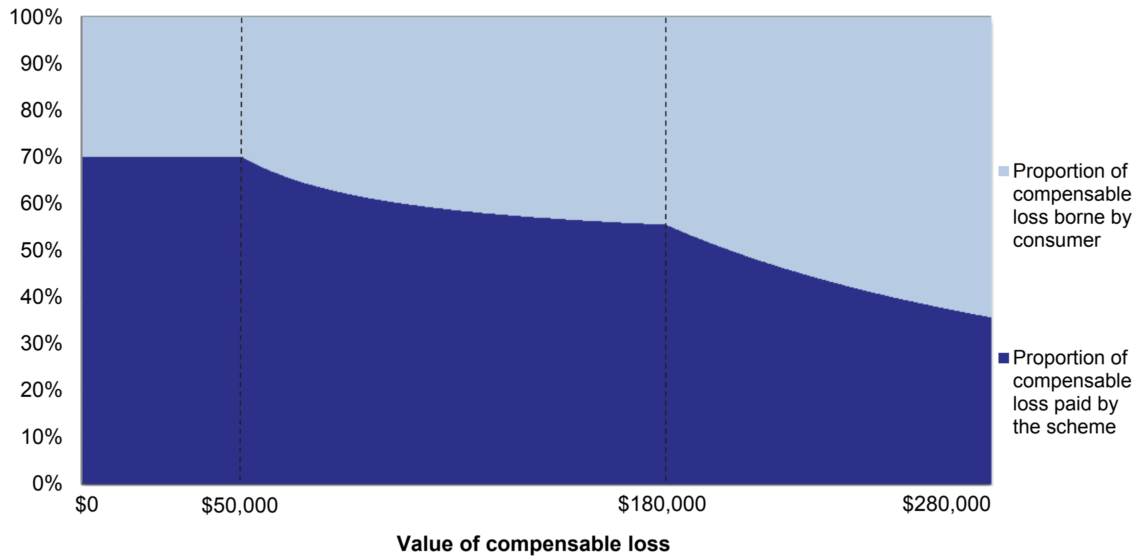
This formula would allow a maximum scheme payment of $204,000.

6.39 It is suggested that, as a starting point, a more modest payment formula would be appropriate. For example:

- 70 per cent of the first $50,000 of the *compensable loss;* plus
- 50 per cent of the next $130,000; and
- no part of the award that exceeds $180,000.

This formula would allow a maximum scheme payment of $100,000. The proportion of a *compensable loss* that would be paid under this approach, and the proportion that would remain unpaid for a compensable loss up to $280,000, is shown in Chart 6.1.

Chart 6.1: Proportion of compensable loss paid by last resort scheme



6.40 By way of comparison, FSCS provides a maximum recovery of 100 per cent of a claim up to £50,000 per claimant (£100,000 for couples). It is understood that around 95 per cent of compensation claims fall within the cap.

6.41 A scheme should also have discretion to make payments of lesser value than would be calculated under such a formula or to stagger payments over (say) a two year period. This might be necessary where the scheme is faced with large-scale claims that exceed the maximum funding that could be levied in any one year.

Timing of payments

6.42 It would be desirable for the scheme to be able to compensate a claimant promptly once it has been determined that a licensee is in default and that a compensable loss has been suffered. If the scheme is to operate on a post-funded basis it would need the capacity to borrow funds or levy members on an interim basis. Once a scheme has operated for a few years, it will be better able to estimate the average annual working capital it requires and where necessary impose interim levies on that basis.

6.43 The scheme should have discretion to spread payments to claimants over two years or more if dealing with an insolvency that has caused loss to numerous consumers.

Membership of scheme

6.44 It is envisaged that a scheme of this kind would be funded by industry, with membership required as a licensing condition for licensees who provide financial services to retail clients. Adherence to the scheme would be part of the overall compensation arrangements required of licensees.

6.45 Consideration needs to be given to the sectors of the industry that would be required to participate in funding the scheme and to the allocation of contributions across those sectors. It is suggested that members should be categorised into appropriate sectoral groups and each sector should bear the primary responsibility for *compensable losses* arising within that sector. A sectoral approach is used for the purposes of collecting EDR scheme levies, though the composition of the sectors used for the FOS funding base may not be entirely appropriate for a last resort scheme especially in regard to the funds management sector (see scheme funding below).

6.46 Some submissions suggest that their sector should be excluded from a scheme based on their good track record with consumers - that is, either consumers have not suffered loss in dealing with the sector, or have been compensated.[4] The argument put forward is that more financially secure or responsible sectors should not be expected to underwrite claims against licensees who are less well capitalised or have a poor track record with their clients.

6.47 Those submissions in effect support a narrowly based scheme that draws its membership from sectors that experience uncompensated consumer loss as a result of licensee insolvency.

6.48 While that approach is understandable, there is an argument that a viable last resort scheme would need a broad industry base and draw its licensee membership from all sectors that provide services to retail clients. This view is supported by some other submissions.[5]

4 ICA, NIBA and Stockbrokers Association of Australia submissions.
5 FOS submission 2011, Joint Consumer Submission and Professional Investments Services submission.

6.49 It is noted that trustees of self managed superannuation funds are not required to be licensed under the Corporations Act and would thus not be required to be members of a scheme. They may however be eligible to make claims under the scheme.

6.50 A broad base would give a scheme the capacity to make last resort payments in respect to unpaid awards of compensation arising from an insolvency in any sector should the need arise. Such a base would include licensees who are exempt from the need to hold professional indemnity insurance as an APRA-regulated insurance company or ADI.

6.51 It is accepted that there is a lower risk of failure within some sectors than in others. For example, prudentially regulated sectors (that is, general insurance, life insurance, ADIs and APRA-regulated superannuation funds) have to meet APRA capital and other requirements. These higher financial standards provide some further assurance that prudentially regulated licensees will not fail.

6.52 However, the prudential system refrains from providing a guarantee that an APRA-regulated entity will not fail. The Wallis Report noted this possibility in stating:

> The cornerstone of prudential regulation of [ADIs] and other regulated financial institutions is capital to provide a buffer against unexpected loss. In the absence of major, unexpected economic upheaval or regulatory failure, the prudential regulator should have adequate notice of financial distress before a capital deficiency emerges. In these circumstances, the regulator should be in a position to arrange the exit of the distressed institution, by merger or sale, before depositors' funds are put at risk. This risk, however, cannot be eliminated, especially in a world where technology is continually opening up new instruments, markets and risks.[6]

6.53 In recent decades there have been a number of large and notable failures in the financial sector. These include the collapse of the State Bank of South Australia and the State Bank of Victoria, the Farrow Group of building societies, the case of fraud and subsequent collapse of life insurers Occidental Life and Regal Life, and the failure of general insurers, the HIH Group of Companies (HIH). Some of these failures led to one-off support schemes for affected consumers, including a rescue package for HIH policyholders and a $900 million bail out of depositors implemented by the Victorian Government following the collapse of the Farrow Group building societies.[7] Some of these collapses occurred before the affected financial institutions were regulated under the current APRA regulatory framework.

6.54 The existence of FCS explicitly recognises that failure of prudentially regulated entities is a possibility since it provides depositors and policyholders with last resort compensation if their ADI or general insurer becomes insolvent.

6.55 Further, Chapter 7 of the Corporations Act requires all licensees who have retail clients to have compensation arrangements and does not exclude any sector from those requirements. Whilst the Corporations Regulation provides that prudentially regulated insurers and ADIs are not required to hold adequate professional indemnity insurance, it does not mean that these entities are exempt from the need to pay compensation to retail clients should they be liable.[8] The apparent rationale is that

6 Financial System Inquiry, *Financial System Inquiry Final Report (Wallis Inquiry),* 1997, page 353.
7 The corporate group comprised the Pyramid Building Society, the Geelong Building Society and the Countrywide Building Society.
8 Corporations Regulation 7.6.02AAA(3).

insurers and ADIs are able to self insure any compensation liabilities that might arise because they meet APRA's prudential requirements.

6.56 The establishment of a scheme on a broad industry base would also facilitate a process of rationalising the several last resort compensation schemes for financial services. It would recognise a shared interest of all participants in the financial services industry in maintaining retail confidence in their market.

Scheme funding

6.57 Members of an industry sector would be subject to an annual *compensation levy* if the scheme is dealing in that year with *compensable losses* that arise from the insolvency of licensees within that sector. They would not have to meet a compensation levy if the scheme does not deal in the year in question with relevant *compensable losses* within that sector.

6.58 In order to provide licensees with some certainty, levies when required from the members of a sector should be limited to no more than a fixed percentage of their *proxy revenue base* (as explained below). FOS proposes in its submission a maximum levy rate of one per cent of the *proxy revenue base.*[9] Such an approach is adopted here for working purposes.

6.59 In the interests of equity and efficiency, and to limit the potential exposure of each licensee, it is suggested that levies should also be calculated with reference to minimum and maximum amounts (or 'floors' and 'ceilings'). The application of the 'floor' would mean that a member would not be asked to contribute an amount that is uneconomic to collect, whereas the application of the 'ceiling' would limit the maximum contribution expected from members with large revenue bases. For example:

- if one per cent of a member's proxy revenue base resulted in a levy below a minimum levy amount, the member would still be asked to contribute the minimum levy amount; and
- if one per cent of a member's proxy revenue base would result in a levy above the maximum levy amount, the member's contribution would be limited to the maximum levy amount.

In principle all members in the sector in which a *compensable loss* was recognised by the scheme would be required to fund the last resort payments to cover those losses.

Ring fencing

6.60 An important question is whether levies from one sector should be ring fenced and only used to compensate losses in the same sector or whether levies from one sector could in some circumstances also be used to support compensation in another sector.

6.61 In principle, the cost of a scheme should be spread amongst its members in the most equitable and effective way. If all member licensees contribute to the

9 FOS submission 2009, page 9.

compensation levies the cost is spread across a broader base and each member's share is lower.

6.62 Careful consideration would need to be given to the classification of sectors for the purposes of scheme funding. Broadly speaking each sector should include licensees that provide similar financial products and services, and are required to operate with similar professional indemnity insurance and/or capital requirements. This suggests that a sector should not mix prudentially regulated licensees with those that are not. Managed investment schemes for example should be grouped separately from APRA-regulated superannuation funds.

6.63 It needs to be borne in mind that levies upon APRA-regulated superannuation funds would be funded from the assets of those funds and would reduce returns to members. Therefore, it might be appropriate to contain levies from APRA-regulated superannuation funds to compensate losses in that sector rather than exposing member assets to levies to meet compensable losses in other sectors.

6.64 For these practical reasons a 'ring fenced' approach is supported. This means that members in a particular sector:

- would contribute to an annual compensation levy if the scheme is dealing in that year with *compensable losses* that arise from licensee insolvencies in that sector; and

- would not contribute to an annual compensation levy if the scheme recognises no *compensable losses* in that year arising from licensee insolvencies in that sector.

6.65 As a starting point, it is proposed that the following categories would be treated as separate sectors for the purposes of a scheme:

- general insurance;

- life insurance;

- APRA regulated superannuation funds (as noted above, self managed superannuation funds would not be subject to a last resort scheme);

- fund managers (other than APRA regulated superannuation funds, but including product issuers of pooled investment products such as managed investments);

- financial advice;

- authorised deposit taking institutions; and

- other credit providers.

It should be noted that the broad category of 'fund managers' currently used by FOS for its membership levies would be separated into two sectors – APRA-regulated superannuation funds and other fund managers.

6.66 Even with a ring fenced approach, consideration might be given to allowing a scheme flexibility in some circumstances to impose levies in a related sector. This might need to happen in a case where the insolvency of a licensee or licensees leads to compensation liabilities that exceed the capacity of the sector in question.

6.67 Any ability to draw on levies from another sector should be limited to cases where a linkage can be established between the sectors in question. For example, where *compensable losses* attributable to the financial advice sector exceeded the capacity of the sector to pay, the scheme might be empowered to seek a co-contribution from the funds management sector on the basis of that sector's reliance on financial advisers to distribute their products.

6.68 FSCS for its part has multiple layers of classes which allow levies to spill into a related sector should the need arise and ultimately to extend across all classes where last resort payments for a particular sector exceed the levy thresholds of that sector. Under FSCS:

- when a financial provider defaults, a levy is made first against that firm's sub-class up to its annual levy limit;
- if the compensation required exceeds that levy limit, the other sub-class within the class will be required to contribute up to its annual levy limit;
  - four of the five classes in the FSCS have sub-classes, such as fund management and intermediaries in the investment class;
- if the compensation required exceeds the annual levy limit from that class, all other classes are asked to contribute to a general pool.

This flexible approach allows FSCS to meet exceptionally high claims that exceed the capacity of a particular sector. In this respect, it goes further than the sectoral approach to levies in last resort schemes such as NGF, FCS and Part 23 of the SIS Act.

Proxy revenue basis for levies

6.69 All licensees would contribute to the establishment costs and operating costs of the scheme. In addition, member licensees would contribute to compensation levies if the scheme is dealing in that year with *compensable losses* that arise from the member's specific sector.

6.70 FOS and Professional Financial Solutions (PFS) have carried out work to estimate the possible revenue base for a scheme. This work is discussed below for indicative purposes.[10] It includes actuarial modelling undertaken by PFS of a funding model for a scheme. The Australian Government Actuary has given some assurance on the methodology used by PFS.

6.71 The PFS modelling uses a proxy revenue base for each sector to calculate the maximum funding base for the scheme given certain assumptions. It would calculate the specific levies for each member by reference to that member's proxy revenue base. Proxy revenue bases are currently used to calculate FOS membership levies. FOS members have accepted and used proxy revenue bases to produce a broadly equitable distribution of fees between sectors despite their varying income bases.

6.72 Where required, each member would contribute a levy of up to one per cent of its individual proxy revenue base, but subject to floors and ceilings as described above.

---

10 FOS submissions 2009 and 2011, with clarification provided to the review by FOS and PFS.

6.73 The operating costs of a scheme were estimated by FOS and PFS to be in the order of $3 million per annum.[11] This estimate assumed that the scheme would make last resort payments based on awards that had already been made by the courts or EDR schemes. The decision making process proposed in this report could add to the resources needed and costs of the scheme.

6.74 The modelling by PFS estimates that the scheme would deal with up to $12 million of compensable losses in an average year.[12] This estimate is based on FOS experience of uncompensated consumer loss under the current arrangements. As discussed in Chapter 2 it is difficult to verify this estimate independently and the measure has to be used with some caution. Whatever the total of compensable losses, actual payouts by the scheme would be reduced by the application of any capping formula.

6.75 The preventative measures proposed in this report, as well as the *Future of Financial Advice* changes for financial advisers, might be expected in time to place downward pressure on the size of compensable losses paid by the scheme.

6.76 The proxy revenue base for each sector and the maximum annual contribution that could be levied is shown in Table 6.2. The table shows the maximum contribution that could be levied upon each sector if one of the following alternative bases were applied:

- each licensee contributes one per cent of its proxy revenue base; or
- each licensee contributes one per cent of its proxy revenue base with a minimum individual contribution of $500 and a maximum of $250,000.

As discussed above, the possible application of floors and ceilings would be with a view to moderating the financial impact on the largest licensees whilst requiring even the smallest licensees to pay a tangible amount.

11 In FOS submission 2009, a lower annual operating cost was quoted (page 17). It has been clarified with PFS that this was for a part year operating cost, and that their estimate for a full year operating cost is in the order of $3 million.

12 FOS submission 2009, page 16.

Table 6.2 Possible basis of sectoral funding for a last resort scheme [a]

Sector	Proxy revenue base	Maximum annual contribution based on levy of one per cent $ million	Maximum annual contribution based on levy of one per cent with a minimum of $500 and a maximum of $250,000 $ million
General insurance	20 per cent of premiums	$44 million	$12 million
Life insurers	20 per cent of premiums	$37 million	$5 million
Insurance brokers	100 per cent of brokerage fees	$20 million	$12 million
Funds under management [b]	0.7 per cent of funds under management	$102 million	$34 million
Financial advisers	0.3 per cent of funds under advice	$19 million	$8 million
Authorised deposit taking institutions	1.5 per cent of deposits	$178 million	$11 million
Other credit providers [c]	1 per cent of loan portfolio	$173 million	$14 million

Source: FOS submission using PFS modelling, and further information provided by PFS.

a The information in the table is based on FOS membership data collected on the basis of current FOS sectors for membership levy purposes.

b Data from the current FOS membership base does not separate 'funds under management' into APRA regulated superannuation funds and other funds under management (eg managed investment schemes). This classification might need to be reconsidered for an appropriate levy base for a last resort scheme.

c The current FOS membership base separates ADI business into 'deposit' and 'loan portfolio' with membership fees calculated on both proxy revenue bases for those entities that undertake both deposit taking and lending. This classification might need to be reconsidered for an appropriate levy base for a last resort scheme.

Post funding basis

6.77 As foreshadowed in the discussion of 'payment of claims', the scheme would technically levy its members on a post funded basis. This means that compensation levies if required would be sought once a year from relevant sectors to meet the scheme's known annual *compensable losses*. However, funding the scheme entirely on a post funded basis would put the scheme in the position of delaying payments to eligible claimants until the scheme received its annual funding levies or borrowed the required funds.

6.78 Therefore, the scheme might need the capacity to raise an interim levy based on an estimate of expected *compensable losses* from each sector within an annual cycle. The scheme would be expected to make such an estimate based on prior experience of *compensable losses* in that sector as well as its assumptions of the further loss not yet brought to the scheme from known licensee insolvencies. In this way the fund could effectively 'pre fund' a proportion of the levy to improve its cash flow to deal with likely *compensable losses* from a sector.

6.79 In practice a scheme might need to use a mix of interim and post-funded levies to meet the timing and size of compensable losses in a year.

Borrowing facilities

6.80 The scheme should have a borrowing facility to help it pay consumers ahead of funding from annual levies being received. Given the additional costs that would be incurred by borrowing, this facility might be used on a fall back basis.

Assignment of rights

6.81 The scheme should also take an assignment of rights from claimants who accept a last resort payment. This would put the scheme in the consumer's shoes as an unsecured creditor in the licensee's insolvency. Any amount recovered in such proceedings would be returned to the scheme, and the consumer would be entitled to any amount in excess of the last resort amount received under the scheme.

Funding large scale loss

6.82 In order to manage an exceptional incidence of *compensable losses*, such as following large-scale consumer losses from licensee insolvency, the scheme might need to reduce the payments made to individual claimants in order to ensure they were all able to receive some compensation within the scheme's available financial resources. Alternatively, the scheme might consider compensating claimants on the usual basis but spreading payments over more than one year.

6.83 There is no proposal for financial support by Government in the event that member levies or other funding were insufficient to deal with consumer loss.

Authority for scheme

6.84 A last resort scheme would need statutory backing in order to ensure its funding through the ability to impose levies on licensees.

6.85 All three of the other last resort schemes that operate in the financial system are established by statute, as is the Superannuation Complaints Tribunal (SCT).[13]

6.86 In the United Kingdom, FSCS operates as a company limited by guarantee established under the *Financial Services and Markets Act 2000*.

6.87 Having regard to constitutional constraints, care would need to be taken to ensure that in dealing with claims for compensation the scheme was exercising administrative rather than judicial powers. This points towards an approach whereby the scheme administrator would have a discretion, but would not be obliged, to compensate a consumer where satisfied that the preconditions had been met. This is broadly the approach followed under FSCS and Part 23 of the SIS Act.

Governance

6.88 Having regard to the power under the scheme to impose levies on licensees, as well as the importance of decisions on claims for consumers, there should be a clear line of accountability to government. While a body to administer the scheme might include individuals with relevant industry or other experience, appointments should be made by government and there should be appropriate reporting arrangements.

---

13 The Financial Claims Scheme was established by the *Financial System Legislation (Financial Claims Scheme and Other Measures) Act 2008* which amended both the *Banking Act 1959* and the *Insurance Act 1973*. The National Guarantee Fund has its statutory basis in Division 4 of Part 7.5 of the Corporations Act (it was originally established by the *Australian Stock Exchange and National Guarantee Fund Act 1987*). The scheme for loss by APRA-regulated superannuation funds is established in Part 23 of the *Superannuation Industry (Supervision) Act 1993*.

6.89 The Superannuation Complaints Tribunal (SCT) provides a possible governance model. SCT is an independent dispute resolution body that deals with superannuation related complaints arising from decisions and conduct of regulated trustees and insurers in relation to a superannuation fund member. SCT is established by statute, and the chairperson and other members are appointed by the Government.[14] It reports annually to the relevant Minister and its report is tabled in Parliament. SCT's decisions are not subject to review by the Administrative Appeals Tribunal.

6.90 FSCS in the United Kingdom is a company established by statute and funded by the financial services industry through levies which are paid to the regulator in the first instance. FSCS provides its annual report to the regulator. Under proposed changes to the regulatory architecture expected to commence at the end of 2012, the dual regulators - the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) - will be jointly responsible for board appointments, with the chairman's appointment subject to approval by HM Treasury. FSCS will be required to produce an annual plan to be approved by PRA and FCA, and it will be subject to audit by the National Audit Office. The parties to a claim may request an internal review of an FSCS decision with final review by an executive director of FSCS.

6.91 It is noted that, under Part 23 of the SIS Act, formal decision making power lies with the Minister. It may be thought however that, under a broader scheme with potentially a larger volume of claims, it would be appropriate to delegate the administration of a scheme and the processing of claims to a board or authority.

Systemic improvements

6.92 A last resort scheme should be in a good position to assess the workings and any shortcomings in the compensation arrangements required of licensees. It could play a role in drawing the attention of industry bodies, regulators and government to areas that may call for systemic improvements.

6.93 The scheme could be required to provide feedback to stakeholders on systemic problems with a view to identifying ways in which licensee standards can be raised, the incidence of harm to consumers can be mitigated and claims against the scheme can be contained. This would be consistent with the requirement on EDR schemes to report any 'systemic issues' and 'serious misconduct' to ASIC.[15]

Relationship to EDR schemes

6.94 A scheme of last resort would be expected to establish a working relationship with EDR schemes. This might involve protocols between those bodies on operating procedures including the management of complaints that are being dealt with by an EDR scheme when a licensee goes into default.

14 *Superannuation (Resolution of Complaints) Act 1993.*
15 ASIC Regulatory Guide 139, April 2011, paragraphs 109-32.

Relationship to existing schemes of last resort

6.95 The existing last resort schemes in the financial services sector have developed over the years in a somewhat piecemeal fashion. They are structured along different lines, are administered by different bodies, and have different rules and processes. The establishment of a further scheme of last resort within the same industry would add to the multiplicity of arrangements.

6.96 There will be a need at the very least to ensure the development of protocols for the guidance of consumers, as well as scheme administrators, in identifying the appropriate scheme to handle a particular claim.

6.97 Beyond that it would make sense to move to develop an overall framework that would encompass the various last resort schemes. While the rules for handling different categories of claims might vary, the overall administration and responsibility would be brought under one roof. This would lead to administrative and cost savings as well as providing more clarity for consumers.

6.98 FSCS provides a model for such a comprehensive scheme. FSCS is a single last resort scheme for financial services that provides similar coverage to NGF for customers of stockbrokers, to FCS in compensating deposit holders and policyholders upon the insolvency of a bank or general insurer, to Part 23 of the SIS Act for trustees of superannuation funds, and to a last resort scheme for compensation of consumer loss from licensee misconduct as discussed in this chapter. FSCS began operating in its current form in 2001 following the amalgamation of six sectoral compensation schemes.

6.99 The practical problems of bringing together three existing schemes that have been established on a piecemeal basis and a new scheme are not to be underestimated. Issues such as the treatment of funds contributed to NGF by brokers in the past would need to be resolved. This could possibly be addressed by ring fencing those funds for relevant categories of claimants. It is noted too that the last resort schemes under the SIS Act and FCS are not operated as separate entities like NGF, but rather on the basis of ministerial discretion.

6.100 The features of the current last resort schemes for consumers of financial products are summarised in Table 6.3.

Table 6.3: Current last resort schemes for consumers of financial products

	National Guarantee Fund	Financial Claims Scheme	Part 23 of SIS Act
Coverage	Client loss from dealing with market participant of ASX where the participant: • fails to complete a sale or purchase of securities; • makes unauthorised transfer of securities; • cancels or fails to cancel certificate of title to quoted securities; or • becomes insolvent and cannot meet obligations to client on property entrusted to participant.	Retail client recovery of protected deposits in the event their authorised deposit-taking institution (ADI) becomes insolvent. Eligible policyholders and other claimants are covered for the amount payable in respect of a valid claim by a general insurer when the insurer becomes insolvent.	Ministerial discretion to make grant of financial assistance to an APRA-regulated superannuation fund if the superannuation fund incurs a loss as a result of fraudulent conduct or theft and the Minister is satisfied that the loss caused a substantial diminution of the fund leading to difficulties in the payment of benefits, and that public interest requires a grant to be made.
Claimants	Wholesale or retail clients.	Retail depositors of ADIs, and policyholders of APRA-regulated general insurance companies.	Trustees of APRA-regulated superannuation funds.
Compensation limits	No cap on claims of compensation for loss arising in any of first three cases (other than the overall limit of the amount available to the fund); Where loss arises from stockbroker insolvency, compensation is limited to 15 per cent of minimum size of NGF (currently required to be $76 million).	$250,000 per depositor per ADI. For general insurance, APRA appoints a party, such as the failed insurer, a designated insurer or an agency, to determine payments based on a standard claims assessment process.	At Minister's discretion. The last grant of assistance made under Part 23 was for 100 per cent of the eligible loss. Previous grants were for 90 per cent of the eligible loss.
Funding	ASX participants (via past contributions to the former state exchange fidelity funds), and investment growth on this amount. There is provision for a levy mechanism should additional funds be required. No levy is currently imposed.	Recovery action through insolvency proceedings, and if assets insufficient, through industry levy on other ADIs or general insurers respectively.	Industry levy on APRA- regulated superannuation funds and approved deposit funds.
Administration	The statutory basis of this scheme is Division 4 of Part 7.5 of the *Corporations Act 2001*. Cases are administered and decided by the Board of Securities Exchanges Guarantee Corporation (SEGC) or its delegate.	FCS was established by the *Financial System Legislation (Financial Claims Scheme and Other Measures) Act 2008* which amended both the *Banking Act 1959* and the *Insurance Act 1973*. FCS is administered by APRA and the scheme is activated at the discretion of the Treasurer after APRA has applied to the Federal Court for the relevant ADI or general insurer to be wound up.	Part 23 of the *Superannuation Industry (Supervision) Act 1993* establishes the scheme which is administered by APRA. The Minister must seek advice from APRA and must be satisfied that the loss has caused a substantial diminution of the fund leading to difficulties in the payment of benefits and, if satisfied, must determine whether the public interest requires the grant of financial assistance and the amount of assistance.
Review mechanism	If the Board of SEGC disallows a claim, the claimant may appeal to the court within 3 months and the court may order the Board to allow the claim.	The founding statute does not establish a review mechanism.	The founding statute does not establish a review mechanism.

UK compensation arrangements

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

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

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

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

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

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

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

6.108 Recently FSA announced that it will resume a review of the funding model for FSCS which will look at issues such as the composition of the funding classes, the levy thresholds applicable to each and their tariff bases.[16] FSA expects to consult interested parties in the first half of 2012.

Operation of UK arrangements

6.109 The effectiveness of the first tier requirements in protecting consumers is hard to gauge. Professional indemnity cover is not a product which is intended to protect consumers directly. It is designed to cover the liability risk of the insured (the investment firm) and in so doing may enable consumers to recover from the firm. The regulator pays attention to the financial adequacy of firms as well as their insurance cover.

6.110 The effectiveness of FSCS appears to have been more robustly tested following the global financial crisis and global downturn.

6.111 FSCS received 24,301 claims in the investment sub-class in 2009-10 compared with around 4,000 in the previous year. This class of claims represented by far the largest proportion of the total of 31,592 claims across all classes. The significant increase in investment claims is attributable in large part to the number of claims received following the failure of Keydata Investment Services Limited, Pacific Continental Securities (UK) Limited and Square Mile Securities Limited.

6.112 FSCS processed around 15,000 claims in the same period and 90 per cent resulted in payout offers. The average compensation payment was £10,799.[17] According to FSCS's annual report, most of the claims were in relation to the mis-selling of investment products such as pensions, 'penny' shares and endowment policies. Further details of FSCS are provided in Table 6.4.

16 Financial Services Authority (UK) Media Release, 3 October 2011. The statement says the review initially started in 2009 but was put on hold.

17 FSCS Annual Report 2009-10.

Table 6.4: UK Financial Services Compensation scheme

Scope
FSCS works as a fund of last resort for certain customers of firms, authorised by FSA, which provide deposit taking, insurance, home finance, investment, pension and endowment services. Claims may be brought by retail and small business customers.
Grounds for compensation
A customer can look to the scheme for compensation where a financial services provider is unable to pay claims against it because it has stopped trading, has insufficient assets or is insolvent. Claims against a firm that is still trading must be dealt with by the firm or the Financial Ombudsman Service. For investment claims, FSCS provides protection where: • an investor suffers a loss giving rise to a civil liability based on bad investment advice, poor investment management, misrepresentation or fraud; or • an authorised firm cannot return investments or money owed to a customer. For claims based on inappropriate advice, FSCS only pays compensation for actual (or direct) financial loss that is essential and fair (to put the consumer back in the position he or she would have been in but for the advice). The Financial Ombudsman Service, on the other hand, may also order a firm to pay for 'distress and inconvenience' (or indirect or consequential loss).
Compensation not available
Compensation is not available where: • the claimant has not suffered financial loss; • an investment has not performed well; • the financial services firm did not cause the financial loss; • the financial services firm is still trading and has sufficient resources to meet a claim itself; • the firm is no longer in business but it (or its owners) are still able to pay the claim.
Conditions
Claimants may be asked to assign their rights against the financial services firm to FSCS. Any recoveries by FSCS through the exercise of those rights, in excess of the compensation paid, are returned to the claimant.
Assessment of claims
FSCS considers the eligibility of a claim for compensation under its rules. FSCS has regard to guidance from the regulator where relevant and discusses approaches with the Financial Ombudsman Service and relevant trade bodies. In considering a claim based on inappropriate advice, FSCS gathers and examines evidence (from the consumer, as well as client files and information from the product provider) and looks at the consumer's attitude to risk and investments to establish whether: • the advice to invest in the product was suitable for the needs of the consumer at the time; and • the consumer was advised of the risks associated with the product. To proceed with the claim, FSCS must be satisfied that there is a financial loss for which the firm is civilly liable. This assessment process is followed whether or not a court or the Financial Ombudsman Service has made a decision in favour of the claimant. While FSCS's rules do not specifically recognise court decisions and ombudsman determinations, FSCS is not precluded from having regard to a decision or determination in its assessment of the merits of claim.

Compensation payable

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

Funding

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

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

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

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

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

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

The levy limits for each class are:

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

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

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

Levies are collected on a pay as you go basis to reflect the amounts known, or likely, to be required each year to provide liquidity for timely payment of compensation claims.

Governance

The compensation scheme is operated by FSCS, a company limited by guarantee and established by FSA under the *Financial Services and Markets Act 2000*. FSCS is independent of the government and the financial industry. It is independent of FSA in decision-making but is accountable to it as FSCS's rules are made by FSA and included in the compensation section of its Handbook.[18]

Board appointments are made by FSA with HM Treasury approval for the Chairman .

18 Financial Services Authority (UK) *Handbook.*

Chapter 7: Conclusions

This Chapter provides an overview of the report and its findings and conclusions. It sets out a number of recommendations for further action as proposed elsewhere in this report.

7.1 In this report I consider the adequacy of compensation arrangements for the protection of consumers in the financial services sector. I have had regard to experience over a number of years since the *Financial Services Reform Act 2001* was introduced and implemented.

7.2 I consider in particular the case for a more comprehensive statutory compensation scheme to protect consumers of financial services. In essence the question is whether consumers who have claims against a financial services firm, arising from the misconduct of that firm, should have resort to a scheme of last resort in circumstances where the firm becomes insolvent or is otherwise unable to meet those claims.

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

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

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

7.6 The more recent collapse of Trio Capital, currently the subject of inquiry by the Parliamentary Joint Committee on Corporations and Financial Services, has thrown up further issues about the ability of consumers to recover compensation following the failure of a financial product in circumstances involving fraud.

7.7 It became apparent early in the review that the question of a last resort scheme could not be looked at in a meaningful way in isolation. It needs to be addressed more holistically in the context of the overall regulatory arrangements for the financial services sector, including the current regime for the protection of consumers, the characteristics of the market and the way in which participants interact in practice.

7.8 The various elements of the system are interconnected and adjustments or changes to one element can affect the balance elsewhere. The conferral of new rights and obligations on participants in one area who will benefit or bear a cost may have unintended consequences for firms or consumers elsewhere in the system. It can also have the effect of highlighting unevenness in the position of some participants, who will benefit or bear a cost, and that of others who are treated differently.

7.9 The challenge is to strike a balance between the effectiveness of any enhanced compensation arrangements in protecting retail participants and promoting confidence in the financial services sector, and their impact on the cost and supply of financial services to retail clients and the overall efficiency of the sector.

Regulatory framework

7.10 We already have a relatively well developed system for the regulation of the financial services sector and for the protection of consumers. This includes:

- a system of licensing for firms that provide financial services;
- an array of enforceable legal obligations and rights;
- relatively well resourced and empowered regulators in ASIC and APRA;
- a readily accessible ombudsman system for consumer redress as well as access to the courts.

7.11 Licensed financial services firms have a responsibility to meet their own obligations to consumers including to compensate for losses arising from any misconduct. The risk to consumers in this as in other areas of trade, commerce or personal transactions is that a party who owes them money may become insolvent or otherwise be unable to pay.

7.12 Consumers are already provided with enhanced protection against that risk in the sensitive areas of bank deposits, general insurance and APRA-regulated superannuation funds. Firms providing products of those kinds are subjected to a more intensive form of regulation — prudential regulation — designed to reduce the risk of firm failure. This approach recognises the intensive nature of the financial promises in question and the potentially dire risks posed by firm failure to consumers and the financial system. Moreover, last resort schemes have been introduced to provide a measure of compensation to consumers if a firm in one of those sectors does fail, notwithstanding the prudential regulation to which it was subject. The cost of such compensation is recouped by levies imposed on all firms in the relevant industry sector.

7.13 Likewise clients of stockbrokers are provided with additional protection by a relatively tight system of regulation that applies to brokers and other participants in ASX and other licensed markets. That system is underpinned by a safety net — the National Guarantee Fund in the case of ASX — to cover claims by clients if a broking firm fails.

Default compensation arrangements

7.14 The focus of the review has been on the adequacy of the default arrangements for protection of consumers in those areas of financial services that are not covered by the more intensive level of protection, including the last resort arrangements that are available to deposit holders, general insurance policy holders, members of APRA-regulated superannuation funds or clients of stockbrokers.

7.15 Under these default arrangements firms who provide financial services are required to be licensed and to comply with stipulated standards in their conduct towards clients and in the disclosure of information to their clients. Consumers who suffer loss or damage by reason of the misconduct of a licensee with whom they have dealt can pursue claims against that licensee. They can do this through the courts or an external dispute resolution scheme such as the Financial Ombudsman Service (FOS).

7.16 While there are measures in place to provide consumers with a degree of assurance, there is no last resort scheme to provide a safety net following the failure of a firm against which they have outstanding claims for compensation. The current arrangements rest on a legislative declaration that financial services licensees who deal with retail clients should have arrangements for compensating those clients for loss or damage attributable to a licensee’s breach of its statutory obligations. The legislation itself leaves open the nature of those arrangements.

7.17 As they have been implemented by regulation and by ASIC, the compensation arrangements call on most licensees to hold professional indemnity insurance cover that is adequate for their business. Other licensees, mostly firms that are prudentially regulated, are exempt from any such requirement on the basis of their apparent financial strength and ability to meet claims for compensation from their own resources.

7.18 The exemption of APRA-regulated deposit takers and insurers from the requirement to hold professional indemnity insurance appears reasonable and does not appear to have given rise to problems. They are presumed to have the financial capacity effectively to self insure against the risk of compensation claims from clients.

7.19 Professional indemnity insurance works by assisting licensees to meet claims by clients and reduces the risk that retail compensation claims will not be met due to a licensee’s lack of financial resources. It provides a valuable buffer but, under current regulatory arrangements, limited assurance that a licensee will be able to compensate a client who suffers loss from a breach of a licensee’s statutory obligations. Whether or not a licensee in fact maintains insurance cover, and cover that is adequate by ASIC standards, is left largely to the licensee’s own judgment.

7.20 In some cases a policy will no longer be in force or it may not respond to a particular claim or provide sufficient cover. Insolvency issues, policy exclusions, and gaps in the cover that the market will provide, as well as caps on the amount of cover taken out, limit the extent to which professional indemnity insurance can ensure that clients are in fact compensated where they succeed in a claim against a licensee.

7.21 There is also a question whether in practice licensees are maintaining professional indemnity insurance that is adequate to their needs.

7.22 The light-handed nature of the primary level of regulation designed to make licensees responsible to meet their own compensation obligations is noteworthy:

- ASIC largely relies on licensees to decide what insurance cover is adequate for their needs and to maintain that cover. There is very little checking or pressure on licensees in this regard; and
- the standard of adequacy for compensation arrangements is largely dependent on regulatory guidance by ASIC.

Uncompensated claims

7.23 Where a licensee does not have a policy that responds to a successful claim the licensee remains under an obligation to meet that claim. A client's prospects of recovering compensation will depend on the available resources of the licensee. The compensation arrangements do not require licensees in general to maintain any significant level of financial resources apart from insurance cover.

7.24 The risk for a client with a compensation claim is that the licensee may have stopped trading, become insolvent or have insufficient assets. Moreover, where a licensee becomes insolvent any insurance cover it holds is likely to come to an end and not cover claims made thereafter.

7.25 Overall the current arrangements appear to provide a fair measure of assurance that consumers will be able to recover compensation for loss or damage resulting from licensee misconduct. FOS has said that in the vast majority of complaints it handles against financial services licensees, consumers who get a decision in their favour will be paid.[1]

7.26 In some cases however consumers with a claim against a licensee are left out of pocket following the disappearance or failure of the licensee. These claims could be based on grounds such as failure to carry out a client's instructions or the misappropriation of funds entrusted to a licensee for investment purposes. Commonly however the claims in question follow the failure of a financial product, generally a managed investment scheme, and are based on inappropriate advice in the selling of that product.

7.27 There is surprisingly little quantitative data about compensation claims by consumers based on licensee misconduct and the extent to which they are not met by licensees. Not a lot of attention appears to have been paid to the collection of such information on a systematic basis. Notwithstanding efforts by ASIC and FOS to quantify the shortfall in the current arrangements, there is limited information on the number and size of claims where consumers are unable to recover compensation following the failure of a licensee. It is not clear either whether failed licensees maintained adequate insurance cover while they were still in business.

7.28 What ASIC and FOS do say is that a number of small and medium sized licensees are likely to be wound up each year with outstanding compensation liabilities running to several million dollars. On this basis it appears that the incidence of claims where consumers cannot recover compensation to which they are entitled

---

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

is substantial but not all that large in overall terms. There is no denying the potential seriousness of the consequences for individual consumers who miss out on compensation in such circumstances.

Limits of compensation arrangements

Compensation for licensee misconduct not investment failure

7.29 It needs to be stressed that consumers generally do not have a claim against a licensee by reason only of the failure of the product or poor investment performance, other than any rights they may have as creditors in the insolvency of a product issuer. Losses suffered by consumers upon the failure or poor performance of an investment in which they have put their money are not in themselves compensable now and would not be compensable under a last resort scheme or other measures canvassed in this report. Such losses are only compensable where they can be attributed to a breach of a licensee's obligations.

Limited recourse where financial products purchased direct

7.30 Retail clients only have a claim against a licensee where they can point to loss or damage suffered as a result of breach of a duty or other obligation of the licensee. It has become apparent in the review that the failure of financial products, and managed investment schemes in particular, underlies many cases of large case consumer loss. In such cases a common issue appears to be that the consumers had not been properly informed of, or had not understood, the complexity, suitability or risks of their investments.

7.31 Following the failure of an investment product claims are commonly brought against advisers for mis-selling of that product. It may be claimed for example that the product in question was inappropriate for the consumer's circumstances, or that too large a proportion of the consumer's funds were invested in that product.

7.32 While in theory a consumer might have a claim against the product issuer for misconduct, at least where that issuer is licensed, consumers do not have much success in practice in pursuing such claims. There are a few reasons for this including the difficulty of attributing liability to a product issuer for misrepresentation or mis-selling, and the reluctance of consumers to pursue a claim against a licensee that has failed. It follows that the introduction of a last resort scheme would be of little help to the sizeable proportion of consumers who invest in financial products direct and do not go through advisers.

Imbalance in responsibilities of licensees

7.33 Financial advisers make the point that in practice they bear a lot of responsibility for their part in the investment chain compared to the issuers of products whose failure leads to the losses suffered by consumers. Without suggesting that financial advisers should be relieved of responsibility for their own conduct, there is a reasonable basis for their concern. Where no other avenue for compensation is available, there is an understandable effort to attribute responsibility to licensees who played a part in putting a consumer into an investment that ultimately failed. It would be timely to consider ways to redress this imbalance. Such measures could include putting more responsibility on issuers for the suitability of a product for retail investors and to address relevant risk factors in a more meaningful way in their disclosure.

7.34 Moreover, given that many of the more egregious instances of consumer loss relate to the failure of managed investment scheme products wider questions about the regulatory and governance frameworks for such schemes, and their risk management obligations, may call for consideration.

Exposure to outlaws

7.35 It should be noted too that the consumer protection regime is built upon a licensing system for providers of financial services. With any licensing system there is always a risk to consumers who deal with individuals or firms operating outside the licensed environment. This may occur where firms conform their business to take advantage of exemptions or where they ignore the licensing requirements and carry on business as outlaws. A scheme of last resort or other measures to underpin the licensing system for financial services providers will not help consumers who are left in the lurch by firms which operate outside that system.

Product failure through fraud

7.36 The case of Trio Capital, where the facts and legal liabilities are still unfolding, has thrown into sharp contrast the problems some categories of consumers face in circumstances where the value of investments in a managed investment scheme appears to have been wiped out by fraudulent activity.

7.37 Consumers who were exposed to Trio Capital through their membership of an APRA-regulated superannuation fund were able to benefit from compensation pursuant to the last resort arrangements provided under the *Superannuation Industry (Supervision) Act 1993* (the SIS Act). Other consumers who were exposed to loss from fraud in Trio, whether through self managed superannuation funds or as direct investors, would need to establish that the licensee had engaged in dishonest conduct in breach of section 1041G or a breach of other provisions of the Corporations Act. Whether or not in the facts and circumstances of that case they will be able to claim against a licensee for loss or damage caused by a breach of its obligations remains to be seen.

7.38 The fact that the alleged fraudulent conduct in Trio Capital appears to have occurred in relation to a managed investment scheme, in which assets of prudentially-regulated superannuation funds amongst others were invested, rather than in the superannuation funds themselves, accentuates the difference in the position of the members of those funds who were able to be compensated, and the self managed superannuation funds and other consumers who invested in the same managed investment scheme. The introduction of a last resort scheme would not in itself resolve the question whether fraud as a factor in the diminution of the value of an investment would give rise to a claim against a licensee for compensation. Such a scheme would however provide some assurance of compensation where a consumer is able to establish breach of a relevant obligation by the licensee.

Enhancement of consumer protection

7.39 There is a case for bolstering the current default regime for the assurance of compensation to consumers who suffer loss or damage from licensee misconduct. It is important however to maintain a sense of proportion about the problems, the priorities and what can be achieved.

7.40 The underlying promise by licensees — that they will compensate retail clients for losses attributable to any misconduct on their part — is significant but may be regarded as less intensive than the promises underlying prudentially-regulated services such as deposit taking, insurance or superannuation. It is important therefore to keep in mind the cost and impact of any new measures.

Last resort scheme

7.41 I caution against looking to the introduction of a last resort scheme to underpin the compensation arrangements as a shortcut means of remedying shortcomings in the current regime.

7.42 In my view the introduction of a last resort scheme to underpin the existing arrangements would not address the underlying problems. I have concluded that it would be inappropriate, and possibly counter-productive, to introduce such a scheme at this stage.

7.43 A last resort scheme would have the effect of imposing on better capitalised and/or more responsibly managed licensees the cost of bailing out the obligations of failed licensees. It would not work to improve the standards of licensee behaviour or motivate a greater acceptance by licensees of responsibility for the consequences of their own conduct. It could well introduce an element of regulatory moral hazard by reducing incentive for stringent regulation or rigorous administration of the compensation arrangements.

7.44 What has stood out in this review is the relatively light-handed nature of the primary level of regulation designed to put financial advisers and other licensees in a position to meet their own obligations to consumers. It is not tight enough in my view to provide an appropriate filter to limit the instances in which consumers are unable to recover compensation and for which it might be reasonable to look to other licensees to meet the cost. For example:

- ASIC largely relies on licensees to decide what insurance cover is adequate for their needs and to maintain that cover. There is very little in the way of checking or other pressure on licensees to comply. It is in essence an honour system. While it may be reasonable to expect most licensees to act responsibly in this regard, there is cause for concern that less well managed firms, or firms that are financially stressed, may cut corners in regard to their insurance cover.

- ASIC's powers in administering the licensing system including its ability to enforce its own view of what is required and to sanction firms that do not comply are quite limited and the standard of adequacy for compensation arrangements is largely dependent on regulatory guidance by ASIC;

- In practice ASIC, in juggling its responsibilities and resources, has put limited effort into monitoring the compliance record of licensed firms. While its resources will always be stretched I see a need for ASIC to be more pro-active in a targeted fashion.

- ASIC acknowledges that there is a problem with phoenix type activity in this area with firms folding with unpaid compensation obligations and the principals then re-emerging in another firm. There is a pressing need to address this problem. The existence of outlaws who operate outside the licensing regime in providing financial services also calls for concerted regulatory attention.

- As a practical matter some licensees such as financial advisers can carry on business with a relatively low level of capitalisation. There is virtually no regulatory requirement for them to maintain a level of financial resources that would provide some buffer, in addition to any professional indemnity insurance held, and expose them to risk ('skin in the game'), in the event of consumer claims.

7.45 This light-handed regulatory approach may be contrasted with the more robust regulatory approach to the providers of services elsewhere in the financial system, including prudential regulation, where last resort protection is offered to consumers.

Further measures

7.46 My conclusion is that it would be better to proceed step-by-step and aim to strengthen the current approach as a necessary first stage before consideration is given to any move to a more comprehensive scheme of last resort to deal with compensation claims for licensee misconduct in circumstances where the licensee has become insolvent.

7.47 Action to enhance the protection of consumers should be directed on the one hand at reducing the incidence of licensee misconduct that causes loss or damage to the consumers of financial services. The *Future of Financial Advice* reforms, which seek to clarify and reinforce the duties of financial advisers, fall into this category.

7.48 The further measures or directions I propose recognise, and are intended to complement, the legislative and regulatory steps already being taken to raise the standards of professionalism by financial advisers and to improve the financial literacy of consumers including:

- Recent or proposed changes to the Corporations Act which:
  - require lenders to lend responsibly and clarify margin call arrangements through the regulation of margin loans as financial products;[2]
  - lift the professional standards and conduct of financial advisers and quality of advice through the *Future of Financial Advice* package now before Parliament, and related measures, which include:[3]
    - a best interest obligation requiring an adviser to act in the best interests of the client when providing personal advice, and to give priority to the needs of the client if conflict arises;
    - a ban on conflicted remuneration structures and a requirement for advisers to send renewal notices and fee disclosure statements to their clients;

---

2 Section 985K *Corporations Act 2001*.

3 Corporations Amendment (Future of Financial Advice) Bill 2011 and Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011.

- the lifting of professional standards for financial advisers, including through competency requirements and training.[4]

- Ongoing efforts to improve the financial literacy of consumers and help equip them to look out for their own interests and understand the risks in making investment decisions or otherwise utilising financial services. ASIC for example provides basic information through its new *MoneySmart* website and has announced a national financial literacy strategy to be delivered through mainstream education, the workplace and in the community.[5] Programs of this kind are clearly necessary and have the potential in the longer term to empower consumers and bridge the gap that too often exists between their level of knowledge and understanding and that of the providers of financial services with whom they deal.

Measures of this kind should work over time to reduce the instances of egregious licensee misconduct. They are unlikely however to remove the risk of licensee misconduct altogether.

7.49 Beyond measures of that kind the critical need in my view is to develop a more robust and effective system to make licensees responsible for the consequences of their own conduct. This approach, while it will have a cost will in itself provide licensees with incentive to raise their standards and reduce the incidence of consumer claims based on misconduct. This in turn could lead over time to beneficial changes in the supply and cost of insurance to licensees.

7.50 The aim should be to reduce the number of cases where consumers cannot recover compensation for losses suffered through licensee misconduct because of the financial failure of the firm in question. To put it another way, the regulatory platform for financial advisers and other licensees needs to be made more robust and stable before a safety net, funded by all licensees, is suspended beneath it.

7.51 A relatively stringent primary platform of regulation is a feature of professional and other compensation schemes which are underpinned by schemes or funds of last resort. Accordingly, in any effort to bolster the regime for the protection of consumers the initial focus, in conjunction with the *Future of Financial Advice* reforms and other efforts to raise industry standards, should be on developing a more robust and effective system to make licensees responsible for the consequences of their own conduct. This could be done by:

- placing more onus on licensees to establish that they in fact have adequate insurance cover;

- in conjunction with requiring licensees to be able to demonstrate that they have capital at risk in their business;

- together with steps where necessary to strengthen ASIC's ability to police the licensing system; and

- a more pro-active stance by ASIC targeted at licensees who are most at risk.

4 A newly established advisory panel on financial advice and professional standards will provide views to the Government on professional standards for financial advisers. The panel has been involved in ASIC's development of a framework for assessment and professional development of financial advisers - ASIC Consultation Paper 153, *Licensing: Training and assessment framework for financial advisers,* April 2011.

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

7.52 A more robust regulatory approach along these lines will not be cost free. While it is not suggested that financial advisers and other licensees should be subjected to prudential regulation any increased cost of holding adequate professional indemnity insurance or meeting a financial adequacy test may have the effect of raising barriers to entry or add to pressure for some firms to consolidate. There could be some tension in this regard with the policy objective of promoting consumer access to financial advice. However, I see some tightening of the current regulatory approach as a necessary first step if it is desired to give more substance to the legislative recognition in section 912B of the need for protection of consumers who are let down by licensees with whom they deal.

7.53 The report also addresses the imbalance in the responsibilities of product issuers and financial advisers towards consumers. Given that most cases of serious consumer loss relate to the failure of financial products, it would be timely as a matter of strategic approach to review the present relatively light-handed regulation of certain product issuers, in particular managed investment schemes. Such a review could include the possible need, in accord with developments at the international level, to move to a somewhat more interventionist approach. As a first step consideration could be given to imposing on licensees who make products available for retail clients more responsibility for the suitability of those products for such investors, together with related disclosure obligations.

7.54 Given the attention afforded in the review to a last resort scheme, including the proposal put forward by FOS, I have set out in Chapter 6 my views on the design and governance of such a scheme should it be desired to proceed with one. I make the point that ideally any last resort scheme would be integrated as far as possible with the National Guarantee Fund at least, if not the Financial Claims Scheme and the last resort arrangements under Part 23 of the SIS Act. The existing last resort arrangements have developed in a piecemeal fashion. There would be advantages in terms of clarity, efficiency and cost in integrating their administration. The Financial Services Claims Scheme in the United Kingdom provides an example of a comprehensive scheme which brought together a number of schemes that previously operated in the industry.

7.55 I suggest however that it would be preferable to defer further consideration of any such scheme pending the implementation of the measures I propose, as well as other changes underway in the financial services sector, including the *Future of Financial Advice* reforms. Deferral would also allow time to get a clearer picture of any remaining shortcomings in the compensation arrangements, and the likely costs of such a scheme.

Recommendations

In summary the recommendations in this report are directed to the following matters.

Last resort scheme

Recommendation 1: Last resort scheme

It would be inappropriate and possibly counter-productive to introduce a last resort compensation scheme at this stage.

Strengthen current compensation arrangements

In any move to strengthen the regime for the protection of consumers the initial focus, in conjunction with the *Future of Financial Advice* reforms and other efforts to raise industry standards, should be on developing a more robust and effective system to make licensees responsible for the consequences of their own conduct. Recommendations for changes to strengthen the current compensation arrangements are summarised below.

Reference is also made in Chapter 4 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.

Recommendation 2.1: Licensees to demonstrate adequacy of their insurance

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

Recommendation 2.2: Licensees to hold appropriate capital resources

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.

Recommendation 2.3: 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.

Recommendation 2.4: Policing the licensing system in regards to compensation

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 licensees who 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.

ASIC for its part should 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 for regulatory standards on the adequacy of insurance or financial resources.

Other matters

The following issues relevant to the provision and operation of compensation arrangements and the protection of consumers, referred to in Chapter 4, should be addressed.

Recommendation 2.5.1: Compensation where licensees cease to trade

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.

Recommendation 2.5.2: Protection from unlicensed providers

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 should be transparent and provide as much feedback to complainants as possible in order to encourage further assistance.

Recommendation 2.5.3: Third party rights under licensee's insurance policy

(a) 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.

(b) 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.

Recommendation 2.5.4: Defence costs

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.

Recommendation 2.5.5: External Dispute Resolution scheme processes

Given their key role in the regime for the protection of consumers of financial services, and marked increases in their jurisdiction, External Dispute Resolution schemes and ASIC should give more attention to the adequacy of the EDR scheme processes as those schemes grow beyond their origins as forums for small claims. Issues for consideration include: rights of review; transparency; capacity of a member to join in a proceeding other members that might be liable; cost contribution by complainants; liability standards; relevance of regulatory guidance and other operational issues discussed in Chapter 2.

Rebalance responsibilities of licensees

Having regard to an apparent imbalance in the responsibilities of product issuers and financial advisers towards retail clients, and the fact that most cases of serious consumer loss relate to the failure of financial products, consideration should be given to measures to enhance the responsibilities of product issuers and the protection offered to retail clients. This would pave the way for possible compensation claims against issuers where their obligations are breached.

Recommendation 3.1: Review regulation of product issuers

As a matter of strategic approach, it would be timely to review the present relatively light-handed regulation of certain product issuers, in particular managed investment schemes, including the possible need, in accord with developments at the international level, to move to a somewhat more interventionist approach.

It would be appropriate also, in the course of any such review, to direct more attention to the responsibilities of licensees who provide financial products for retail clients. While the review has not had an opportunity to test these proposals, a first step might be to consider measures along the following lines by which product issuers would be expected to assume more responsibility for the protection of consumers of their products:

(a) Subject product issuers to more positive obligations in regard to the suitability of their product for retail clients.

Such obligations might be applied in particular to managed investment schemes in issuing products to the retail market, and would apply at each stage of a product's life cycle including its distribution and marketing. Amongst other things, the product issuer might be required to state the particular classes of consumers for whom the product is suitable and for whom the product is unsuitable, and the potential risks of investing in the product.

A stronger approach by managed investment schemes to the management of risk of fraud, particularly by employees or representatives, might also be sought.

(b) Consider the development of standardised product labelling so that financial products, particularly managed investment schemes, are described on a consistent and more meaningful basis.

This might apply to such terms as *capital guaranteed*, *capital protected, conservative, balanced, diversified, growth, defensive, fixed interest, or hedged*, as well as other like descriptors.

(c) While the review has not looked into these matters in any depth, the significance of the role of gatekeepers, such as research houses, should be kept in mind in any strategic consideration of consumer protection in the financial services sector.

Recommendation 3.2: Responsibility of product issuers through EDR schemes

Some rebalancing of responsibilities of product issuers and financial advisers towards retail clients could be addressed through changes to the operation of EDR schemes by resolving the inability of EDR schemes to apportion responsibility for misconduct amongst responsible licensees. The operating rules of EDRs should be changed to enable them to make awards that recognise the proportionate liability of product issuers, financial advisers or other licensees.

Further, consideration should be given to the clarification of clause 5.1(i) of the terms of reference of FOS which excludes consideration of disputes about the 'management of the fund or scheme as a whole'. The aim would be to remove any doubt about the ability of FOS to deal with consumer disputes in respect of misleading product disclosure statements or other practices of issuers in marketing their products.

Appendix A: Summary of consultation paper

Background

A.1 The review is directed to the adequacy of arrangements for the compensation of retail clients where they suffer damage as a result of a breach by a provider of financial services of its statutory obligations, rather than loss in value of an investment in the absence of misconduct by a licensee. The rationale for the focus on retail clients is that they are less likely to be able to look after their own interests than are wholesale clients.

A.2 The review is being undertaken in the context of the Future of Financial Advice reform package announced in April 2010. It follows a recommendation of a Parliamentary Committee that the Government investigate the costs and benefits of different models of a statutory last resort compensation fund for investors.

A.3 The regulatory framework for financial services, based on the Wallis Report, subjects deposit takers, insurers and superannuation funds to prudential regulation and applies to all providers of financial services a set of requirements governing the way they conduct their business.

A.4 Providers of financial services are required to be licensed and to comply with stipulated standards in their conduct towards their clients and in the disclosure of information to clients.

A.5 Licensed providers of financial services who deal with retail clients are also required to have in place a system for the resolution of disputes and arrangements to compensate clients for loss or damage arising from a breach of the licensee's statutory obligations in regard to conduct or the disclosure of information.

Current compensation arrangements

A.6 Compensation arrangements required of licensees are intended to reduce the risk that claims by retail clients cannot be met by licensees due to their lack of available financial resources.

A.7 The compensation arrangement required of most licensees is to hold professional indemnity insurance. Certain licensees are exempt from this requirement on the basis of their relative financial strength.

A.8 Professional indemnity insurance is an indirect means for compensating clients. Where a licensee's policy responds to a claim it assists the licensee to pay any compensation awarded to a client. Where this is not the case, the client's prospects of recovery will depend on the available financial resources of the licensee.

A.9 Retail clients may seek redress by legal action through the courts or by using the dispute resolution process a licensee has to make available.

A.10 Separate more direct statutory compensation arrangements cover some critical elements of the financial services sector:

- National Guarantee Fund (and similar arrangements) protects clients of stockbrokers;
- Financial Claims Scheme covers losses by depositors or policyholders due to insolvency of an authorised deposit taking institution or general insurer; and
- a scheme of financial assistance to compensate for loss incurred by a superannuation fund trustee from fraud.

A.11 There appears to have been a hardening in the professional indemnity insurance market for some, but not all, financial services providers in recent years. On the supply side, the number of insurers providing cover for financial advisers has contracted. Anecdotal evidence suggests that premiums for financial advisers have increased substantially in recent years.

A.12 Claims lodged by financial service providers under professional indemnity insurance policies appear to have increased significantly, particularly from 2008 onwards.

A.13 Professional indemnity insurance assists licensees to meet claims by clients in many cases, but has some limitations where there are insolvency issues, policy exclusions, and gaps in the cover. Caps on the amount of cover taken out limit the extent to which insurance can ensure that clients are compensated where they succeed in a claim against a licensee.

A.14 Where a licensee does not have a policy that responds to a successful claim, the client's prospects of recovering compensation will depend on the available financial resources of the licensee.

A.15 While precise data is hard to come by, there are cases where retail clients succeed in obtaining awards of compensation but are not able to recover that compensation.

Comparison with other arrangements

A.16 The United Kingdom has a two tiered approach to the protection of retail consumers and small businesses with claims against financial intermediaries:

- investment firms generally have to meet a capital requirement as well as hold professional indemnity cover; and
- a comprehensive scheme provides last resort protection where a firm becomes insolvent or is otherwise unable to meet a claim.

A.17 Other members of the European Union, Canada and the United States have narrower compensation arrangements to protect clients against losses of funds held by investment firms on their behalf.

A.18 Within Australia, compensation arrangements are in place in some industry sectors apart from the financial sector.

Observations and issues

A.19 Australia has a relatively well developed regime for the protection of consumers in the financial services sector, including a licensing regime for providers of those services, the imposition of statutory conduct and disclosure obligations and rights of redress for consumers — which include access to a low cost dispute resolution system and arrangements to provide some assurance about recovery of compensation for loss or damage attributable to licensee misconduct.

A.20 The focus of the review is on the adequacy of the default arrangements for the protection of consumers where they do not have access to the last resort protection in relation to stockbrokers, deposit takers, general insures and superannuation funds.

A.21 The current compensation arrangements, based largely on professional indemnity insurance, provide a measure of assurance but no guarantee that retail clients will be able to recover compensation to which they may be entitled.

A.22 The risk for a client, where a licensee does not have recourse to insurance to cover the client's claim, is that the licensee may have stopped trading, become insolvent or have insufficient assets.

A.23 There is an apparent shortfall in the delivery of compensation under current arrangements. Cases have arisen where retail clients have not been able to recover compensation to which they are entitled. While it is not easy to quantify the problem, clients have missed out on substantial recoveries and in any case the consequences for individuals can be harsh.

A.24 Any move to provide further protection for retail clients could include measures to reduce the incidence of cases where clients suffer loss or damage from inappropriate licensee advice or conduct. This might be through improvements in professional standards for financial advisers on the one hand, and efforts to improve the financial literacy of consumers on the other.

A.25 Mechanisms to enhance the effectiveness of professional indemnity insurance in underpinning the compensation arrangements could also be considered. This might include:

- a tighter approach to the administration of the requirement for professional indemnity insurance;
- the promotion of standard professional indemnity insurance cover including to deal with claims after licensees cease to trade; and
- improved disclosure of insurance arrangements and facilitation of third party rights.

A.26 The ultimate risk for clients in recovering compensation stems from a licensee's creditworthiness. This raises the question whether more attention should be given to the adequacy of licensee financial resources.

A.27 Beyond measures of this kind, or in conjunction with them, a further option would be to introduce a scheme to provide retail clients with last resort recourse to compensation to which they are entitled. In designing such a scheme, key issues would include:

- liability standards;
- eligible claims;
- payment of claims;
- membership of scheme;
- funding of scheme;
- authority for scheme;
- governance arrangements;
- systemic improvements;
- relationship to EDR schemes; and
- relationship to existing schemes of last resort.

A.28 A balance will have to be made between the effectiveness of any enhanced compensation arrangements in protecting consumers and promoting confidence in the financial services sector, and their impact on the cost and supply of financial services to retail clients and the overall efficiency of the sector. It is relevant to consider:

- the degree of harm suffered by retail clients under current arrangements;
- the impact of that harm on confidence in financial markets and consumer participation in those markets;
- the effects on wider regulatory settings and market impacts; and
- the effects on barriers to entry in the financial services sector and on the cost of provision of those services.

A.29 Current compensation arrangements do not purport to deal with loss or damage suffered by consumers from investment failures other than as a result of licensee misconduct. In practice the line may be somewhat blurred and this needs to be kept in mind in considering possible new measures.

Appendix B: Overview of submissions

Overall reactions in submissions

Submissions supported a comprehensive approach to addressing the limitations of the current compensation arrangements, with the pursuit of remedial solutions on a number of fronts or through a strengthening of key obligations on licensees, such as their financial resourcing.

Views were divided on the need for, and operation of, a statutory compensation scheme of last resort (described in more detail below). Submissions by retirees who suffered personal losses through their SMSF investments in managed investment schemes operated by Trio Capital sought a last resort scheme to give them similar redress to APRA-regulated superannuation funds under the SIS Act.

Some submissions went further than the Consultation Paper and supported stronger obligations on product issuers to better protect consumers from incurring loss in the first instance. They argued that this should be seen as a precondition to a last resort scheme.

Possible remedial measure[a]	Reactions
Scope for further measures to lift the standards of licensee conduct and to assist consumers look after their own interests	Submissions generally support measures being taken as part of the *Future of Financial Advice* package and suggest these changes will reduce the incidence of consumer loss from inappropriate advice over time. There was a suggestion that those sectors that met higher professional standards, or dealt in lower risk products or services, should be allowed to reduce the limits of their insurance policies.
Scope for a tighter approach to the administration of the current requirement to hold professional indemnity insurance	Some submissions express the need for a more proactive administration of professional indemnity insurance, including by providing more guidance on the measure of adequate cover and an onus on licensees to inform ASIC of the cover held. Other submissions doubt whether there would be any benefit in licensees providing a copy of their insurance contract to ASIC, and noted the cost of such an approach.
Improved disclosure of a licensee's professional indemnity insurance cover	Consumer advocates support more access to information about a licensee's professional indemnity insurance cover as a means of reducing discovery costs and assisting consumer to access the prospect of recovery. Others suggest further disclosure of complex professional indemnity insurance cover would not be meaningful to consumers.
Possible arrangements to deal with claims after a licensee ceases to trade	Consumer advocates support the notion that licensees who cease to trade should be required to make provision for claims arising thereafter. Practical concerns were raised by insurers and financial planners about the supply of run-off cover over the long term and its cost.
Additional requirements in regard to the financial security of licensees	An industry group supported strengthening capital requirements for licensees. One submission suggests that capital held by a licensee should be sufficient to cover excess payments that might be required under an insurance policy. Submissions caution against setting capital requirements at a level that acts as a barrier to entry and disadvantages independently owned licensees. A suggestion was made that licensees who deal in less complex products or services should be spared the need to hold additional capital.
Merits, and key design components, of a last resort scheme to provide compensation for retail clients, including the approach to industry funding	Supporters of a last resort scheme suggest that it would lessen the impact of uncompensated loss on individuals and the community more broadly, improve consumer confidence in the financial services sector and in EDR schemes, and provide a stronger incentive by each sector to self regulate and report poor conduct to the regulator. Concerns were raised about higher risk of moral hazard to consumers and financial intermediaries, increased cost of providing licensed financial services, and the subsidisation of poor conduct by licensees that act properly and prudently. Some submitters said their own industry sector had a good record with their customers and should not be required to participate in a scheme. It was also suggested that the Future of Financial Advice changes should be bedded down before the introduction of a scheme, and other changes should be made to reduce the risk of mis selling by product issuers.

Source: Submissions in response to Consultation Paper with copies of all submissions made available for public release are available at futureofadvice.treasury.gov.au.

(a) Outlined in Chapter 5 of the Consultation Paper.

Appendix C: Other financial sector compensation arrangements

C.1 Apart from the section 912B arrangements, separate statutory compensation arrangements are already in place covering significant segments of the financial services sector. These arrangements have developed over the years in a somewhat piecemeal fashion.

Compensation regime for financial markets

C.2 The Corporations Act regulates the operation of financial markets such as securities and futures markets. Under Chapter 7 a person licensed to operate a market is generally required to establish a compensation regime if its participants provide financial services for retail clients that involve the participants holding money or property on behalf of those clients.[1]

C.3 The purpose of these compensation arrangements is to promote confidence for retail investors in the handling of money or property provided to intermediaries for investment purposes. When the NGF was established, it was hoped that it would instil confidence and encourage participation in the share market, given the low level of participation at that time.[2]

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

C.5 In addition to the requirement that market operators establish compensation arrangements, participants in those markets, such as stockbrokers and futures traders, are required to have the financial capacity to meet claims for compensation from their clients. Under ASX operating rules, participants are required to meet capital adequacy requirements and core liquid asset ratios. Stockbrokers and other participants are required to hold professional indemnity insurance against a breach of duty owed in a professional capacity, whether in contract or at law.[3] Failure to meet the obligation to have insurance attracts a maximum penalty of $100,000.

C.6 In practice it is understood that stockbrokers take out professional indemnity insurance that meets their dual obligations as financial service licensees and as participants in the securities market. The latter requirement is broader in respect to cover 'against a breach of duty the market participant owes in a professional capacity whether owed in contract or otherwise at law'. Another distinction is that the market participant must advise ASIC within 10 business days of the renewal of its insurance

1 Section 881A *Corporations Act 2001*.
2 *Australian Stock Exchange and National Guarantee Fund Bill 1987,* Hansard, second reading speech to the House of Representatives, 18 February 1987.
3 ASIC Market Integrity Rules (ASX Market) 2010, February 2011, rule 2.2.1.

policy, including the amount and nature of cover, and to advise ASIC immediately of any notification to its insurer of a claim.[4] Failure to meet these obligations attracts a maximum penalty of $20,000.

National Guarantee Fund

C.7 SEGC administers the NGF as the compensation regime for the ASX which currently is its only member.

C.8 NGF was established in 1987 from the amalgamation of state and territory fidelity funds following a long history of stock exchanges operating their own fidelity funds.[5]

C.9 The Financial Services Reform Bill 2001 found that the financial system regulation was piecemeal. The Bill proposed that the NGF be replaced by Part 7.5 Division 4 of the Corporations Act.

C.10 NGF provides compensation for clients who incur a loss in their dealings with stockbrokers on the ASX in the following circumstances:[6]

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

C.11 In the first three of those circumstances, there is no cap on the amount that can be claimed under NGF. In respect to a loss arising from a stockbroker's insolvency, compensation is limited to 15 per cent of the minimum size of NGF — which is currently required to be a minimum of $76 million.[7]

C.12 NGF in practice covers claims by wholesale as well as retail clients.

C.13 Compensation is not available from NGF:

- for a loss arising from investment decisions or from relying on investment advice given by a participant;

---

4 ibid, rules 2.2.3 and 2.2.4.

5 NGF was established by *the Australian Stock Exchange and National Guarantee Fund Act 1987*. The Sydney Stock Exchange established a fund in 1937, and funds were subsequently established by the Perth Stock Exchange in 1968, by the Melbourne Stock Exchange in 1970 and by the Brisbane Stock Exchange in 1971. The *Securities Industry Act 1980* required all stock exchanges to establish and keep a fidelity fund and required a contribution to the fund of at least $500 from all members, with additional levies imposed if the fund became insufficient.

6 Corporations Regulations Part 7.5, Division 4, Subdivisions 4.3, 4.7, 4.8 and 4.9.

7 Section 889I *Corporations Act 2001*.

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

C.14 SEGC may impose a levy on operators or participants in their market if the amount in NGF falls below the minimum prescribed. SEGC has not found it necessary to impose any levies to date given the availability of assets rolled over from the pre-existing funds and subsequent investment earnings. NGF had $106.1 million in assets as at June 2011.

C.15 Where a retail client of a stockbroker is unable to receive compensation through NGF the client could still bring a claim under the broker's s912B compensation arrangements if the broker failed to meet its obligations under Chapter 7. An example might be where a client relied on a broker's investment advice and the broker did not have a reasonable basis for the advice provided.

Compensation regimes for other market operators

C.16 Market licensees who are not members of SEGC must obtain approval from the Minister for compensation arrangements to deal with losses in the following circumstances:[8]

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

C.17 The market operator must have 'an adequate source of funds available to cover claims' which arise from the losses described above.[9] Examples of arrangements that have been accepted include a fidelity fund, insurance arrangements, an irrevocable letter of credit or a combination of these.[10] The following market licensees have established compensation arrangements:

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

8 Sections 881B, 882A and 885C *Corporations Act 2001* and Corporations Regulation 7.5.15.
9 Section 885H *Corporations Act 2001*.
10 Notes to section 885H *Corporations Act 2001*.

- Sydney Futures Exchange Fidelity Fund; and
- Chi-X Australia Pty Ltd, which has a minimum amount of cover of $10 million comprising a fidelity fund of at least $200,000 together with insurance arrangements and/or an irrevocable letter of credit.

Financial Claims Scheme for depositors and policyholders

C.18 Following an announcement in June 2008, the FCS was established in October 2008 to provide depositors of authorised deposit-taking institutions (ADIs) and general insurance policyholders with certainty and timely access to funds in the event of the failure of such a financial institution. [11] In December 2010, FCS was confirmed as a permanent feature of the financial system.[12]

C.19 The FCS was developed over the period leading up to the global financial crisis, but its introduction was accelerated to support consumer confidence in the banking sector at the height of that crisis. It followed support for guarantee arrangements by the HIH Royal Commission in 2003, by the Council of Financial Regulators dating from 2005, and the Global Financial Stability Forum in 2008.

C.20 The Government committed to review the settings of FCS for depositors after three years. A consultation paper on the future of the FCS for depositors was released in May 2011.[13] That process led to the announcement of a new cap of $250,000 per depositor per ADI from 1 February 2012 in place of the current cap of $1 million per depositor per ADI.[14] The amounts available to meet payments and administer the FCS for insurance policyholders is capped at $20.1 billion per failure.[15]

C.21 APRA is responsible for the administration of the FCS. Under FCS any payments to eligible depositors or general insurance policyholders will be made out of APRA's Financial Claims Scheme Special Account.

C.22 In the event of a payout to depositors or policyholders, the Government meets the cost of the payments in the first place, but recovers these costs when the failed ADI or general insurer is wound up. Should the available assets be insufficient, a levy is applied to industry to recover the difference between the amount expended and the amount recovered in the liquidation process.

Compensation arrangements for superannuation funds

C.23 The superannuation industry is subject to a prudential regulatory system. APRA supervises trustees of superannuation funds but allows trustees a degree of

---

11 Deputy Prime Minister and Treasurer, Media Release, *New Protections for Depositors and Policyholders* and *Financial System Legislation Amendment (Financial Claims Scheme and Other Measures) Act 2008*, 2 June 2008.

12 Deputy Prime Minister and Treasurer, Media Release 91, *A Competitive and Sustainable Banking System*. 12 December 2010.

13 The Treasury, *Financial Claims Scheme Consultation Paper,* May 2011.

14 Deputy Prime Minister and Treasurer, Media Release 109, *New Permanent Financial Claims Scheme Cap to Protect 99 per cent of Australian deposit accounts in full,* 11 September 2011.

15 The *Banking Act 1959* establishes the Early Access Facility for Depositors as the mechanism for making payments to depositors under the FCS, and the *Insurance Act 1973* establishes the Policyholder Compensation Facility as the mechanism to protect certain policyholders under the FCS.

freedom to operate their funds. This regulatory approach aims to minimise rather than prevent failure of the superannuation funds.

C.24 In 1993, the then Government introduced legislation which aimed to strengthen the security of superannuation savings and protect the rights of superannuation fund members. [16] The Explanatory Memorandum stated that one of the most important elements of this package of measures was 'for financial assistance to be provided to funds that have suffered a loss due to fraudulent conduct or theft'.[17] This policy intent was the basis for Part 23 of the *Superannuation Industry (Supervision) Act 1993*.

C.25 Under Part 23 of that Act a trustee of an APRA-regulated superannuation fund (or approved deposit fund) can apply to the Minister for a grant of financial assistance if the superannuation fund incurs a loss as a result of fraudulent conduct or theft.[18] The Minister is required to seek advice from APRA and must be satisfied that the loss has caused a substantial diminution of the fund leading to difficulties in the payment of benefits, and that the public interest requires a grant to be made.

C.26 The Minister has discretion over the grant of financial assistance up to the amount of the eligible loss.

C.27 The financial assistance granted in this way is funded initially from the Consolidated Revenue Fund and can be recouped through an industry levy on APRA- regulated superannuation funds and approved deposit funds.[19] The effect is that a loss in one superannuation fund is borne by the members of other funds that contribute to the levy.

C.28 The Minister has a discretion to impose conditions on the grant of financial assistance and can use this discretion to impose a requirement that any monies recovered from the perpetrator of the fraud or theft against the superannuation fund be refunded to the Commonwealth up to the amount of the grant.

C.29 Part 23 specifically excludes self-managed superannuation funds (SMSF) from being able to apply for financial assistance under Part 23.[20] This is on the basis that SMSF members, as trustees of their SMSF, have direct control over their superannuation savings and are in a position to protect their own interests. The trustees of an SMSF, in circumstances where they qualify as retail clients under the Corporations Act, have rights to compensation in line with other retail clients.

Compensation arrangements for credit providers

C.30 A provider of consumer credit and credit-related brokering services and advice must hold an Australian Credit License under the *National Consumer Credit Protection Act 2009.*[21] In some instances, an Australian Financial Services Licensee

16 *Superannuation Industry (Supervision)* Act 1993.
17 *Superannuation Industry (Supervision)* Act 1993, Explanatory Memorandum.
18 Part 23 applies to a regulated superannuation fund or an approved deposit fund but not a self managed superannuation fund.
19 *Superannuation (Financial Assistance Funding) Levy Act 1993* and the *Superannuation (Financial Assistance Funding) Levy and Collection Regulations 2005.*
20 The Minister may grant financial assistance to SMSFs under s231 (3) of the *Superannuation Industry (Supervision) Act 1993* where a fund was an APRA-regulated fund at the time the fund suffered the loss.
21 Generally commenced on 1 July 2010, or 1 January 2011 for ADIs and Registered Financial Corporations.

may also hold a credit licence. A financial planner who also advises on mortgages, for example, will be subject to a dual regulatory regime, including compensation arrangements imposed under both the financial services and credit regimes.

C.31 Credit providers are required to have an IDR process, to be a member of an EDR scheme and to have adequate compensation arrangements for loss or damage to the consumer as a result of a breach of an obligation of the credit licensee, such as the obligation to ensure they do not provide a credit contract that is unsuitable for the consumer. These consumer protection mechanisms are broadly similar to those that apply to Australian Financial Services Licensees.

C.32 Under the regulations for credit providers, the obligation of the licensee to have compensation arrangements can be met by holding professional indemnity insurance cover that is adequate.[22] Licensees who are APRA-regulated insurers or ADIs are exempt from the requirement to hold professional indemnity insurance. In assessing the adequacy of the cover, the licensee is to have regard to:

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

C.33 An overview of the compensation arrangements that apply to financial services licensees is provided in Table 2.2.

22 *National Consumer Credit Protection Regulations 2010.*

Appendix D: Compensation arrangements in other countries

D.1 A number of other countries have compensation arrangements to provide some protection for consumers who suffer losses as a result of their dealings with providers of financial services. Most of these arrangements are limited to the provision of compensation to investors in securities, derivatives or futures markets who suffer losses due to the insolvency of intermediaries holding funds or securities on their behalf.

D.2 Arrangements of this kind are required in the European Union (EU) and are found also in the United States (the Securities Investor Protection Corporation) and Canada (the Investor Protection Fund). The rationale for these schemes appears to be to enhance trust, confidence and integrity in intermediary firms that hold funds on behalf of clients. They apply to losses arising from failures in undertaking financial transactions through a financial services provider rather than losses arising from financial advice. These regimes more closely resemble the market compensation regimes under Part 7.5 (including the National Guarantee Fund) rather than the compensation arrangements for licensees under Part 7.6 of the Corporations Act.

D.3 Within the EU, the investment compensation scheme directive requires member states to establish compensation schemes in relation to authorised investment firms supplying investment services.[1] The measures aim to protect investors against the risk of losses should an investment firm be unable to repay money or return financial instruments held on a client's behalf. The schemes protect investors' assets against the risk of fraudulent misappropriation, as well as administrative malpractice or operational errors. They do not protect consumers for losses arising from inappropriate investment advice.

D.4 The directive establishes principles, provisions and definitions but member states can implement the Directive to suit their domestic situations (including going beyond recommended standards). In practice, the schemes operating in member states vary considerably.

D.5 In July 2010, the European Parliament increased the level of compensation for investors under the directive from €20,000 to €50,000, and extended the scheme to protect them from fraudulent misappropriations where there assets are held by a third party.

D.6 The investment compensation scheme directive was modelled on the deposit guarantee schemes directive which sets minimum rules to compensate savers affected by the failure of a bank or credit institution.[2] Under this directive the deposit guarantee scheme provides a safety net for bank depositors, both individual and business, up to a cap of €100,000. The EU is reviewing the funding arrangements for the scheme and exploring contributions by banks on a pre and post funded basis, but

1 Directive 97/9/EC: The Investment Compensation Scheme Directive.
2 Directive 94/19/EC.

based on the risk posed by individual banks, borrowings from other member state schemes, and contingencies.

D.7 The EU is consulting on the possibility of setting up Insurance Guarantee Schemes in all Member States.

D.8 In the United Kingdom, on the other hand, there is a single comprehensive compensation scheme that covers the activities of all financial service providers and is not limited to client losses of money or financial instruments held by an investment firm on a client's behalf.

D.9 The scheme includes a fund of last resort (the Financial Services Compensation Scheme (FSCS)) which pays compensation in specific circumstances if an investment firm is unable to meet a claim by a client.

D.10 The compensation arrangements in the EU, the United States, Canada and the United Kingdom all have the following features in common:

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

There is a high level comparison of the schemes found in other countries in Table D.1.

.

Table D.1: Summary of overseas compensation schemes

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

Appendix E: Corporations Regulations

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

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

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

(i) any particular claim against the licensee; and

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

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

(i) the volume of business; and

(ii) the number and kind of clients; and

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

(iv) the number of representatives of the licensee.

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

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

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

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

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

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

(d) a licensee (related licensee):

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

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

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

B. is approved in writing by ASIC.

Financial Services Guide given by financial services licensee: compensation arrangements

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

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

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

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

Glossary

ADI	Authorised deposit-taking institution
AGA	Australian Government Actuary
APL	Approved Product List
APRA	Australian Prudential Regulation Authority
ASX	Australian Securities Exchange
ASIC	Australian Securities and Investments Commission
ASIC Act	*Australian Securities and Investments Commission Act 2001*
Corporations Act	*Corporations Act 2001*
EDR scheme	External dispute resolution scheme
FCS	Financial Claims Scheme
FOS	Financial Ombudsman Service
FSCS	Financial Services Compensation Scheme (UK)
FSA	Financial Services Authority (UK)
NGF	National Guarantee Fund
PDS	Product disclosure statement
PJCCFS	Parliamentary Joint Committee on Corporations and Financial Services
SIS Act	*Superannuation Industry (Supervision) Act 1993*
SMSF	Self managed superannuation fund
RG	ASIC Regulatory Guide
Wallis Report	The final report of the Financial System Inquiry, March 1997