



ASIC

Australian Securities & Investments Commission

CONSULTATION PAPER 87

Compensation and insurance arrangements for AFS licensees

July 2007

About this paper

This consultation paper:

- sets out how ASIC proposes to administer the new compensation requirements; and
- seeks the views of AFS licensees and representatives, their clients, and insurers.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act);
- explaining how ASIC interprets the law;
- describing the principles underlying ASIC's approach; and
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Document history

This paper was issued on 23 July 2007 and is based on the Corporations Act as at 1 July 2007.

Disclaimer

The proposals, explanations and examples in this paper do not constitute legal advice. They are also at a preliminary stage only. Our conclusions and views may change as a result of the comments we receive or as other circumstances change.

Contents

The consultation process	4
A Our approach to administering the compensation requirements	6
Purpose of the requirements	6
Policy objective	7
Basic policy principles.....	7
Link to EDR schemes	7
Limitations of the compensation requirements	8
We will work with industry.....	9
B Adequate PI insurance	10
Amount of cover.....	10
Scope of cover	12
Exclusions, excesses and deductibles	13
C PI insurance that is not fully adequate	14
Background.....	14
Process where cover is not fully adequate	14
Licensees' financial requirements	16
D Alternative arrangements	17
Applying for approval of alternative arrangements	17
Assessment criteria for applications	18
E Issues in implementing the PI insurance requirements	21
Role of PI insurance	21
The current market for PI insurance	21
The effectiveness of PI insurance: some issues	22
Availability of compensation when a licensee ceases business.....	24
Practical options for improving compensation arrangements.....	26
F Assessing and obtaining PI insurance	27
Our policy.....	27
Process	28
Disclosure in FSGs	32
Small business licensees.....	33
Licensees with existing PI insurance requirements.....	33
New licensees.....	34
G Exemptions	36
Licensees who are exempt under the Regulations	36
Our policy.....	36
H Regulatory and financial impact	38
Appendix 1: Summary of the Regulation and additional information ...	39
When will the requirements commence?.....	39
What is required during the transition period?.....	39
When will ASIC discharge security bonds?	40
What are your options for complying?	40
What is required to be disclosed in Financial Services Guides?.....	42
Is relief available?	42
What is the impact on existing financial requirements?	43
Appendix 2: PI insurance cover—additional guidance for small licensees	44
Key terms	46

The consultation process

In this paper we are consulting on how we will administer the compensation requirements in s912B of the *Corporations Act 2001* (Corporations Act) and reg 7.6.02AAA of the Corporations Regulations 2001 (Regulations) (together, the **compensation requirements**).

Note: Regulation 7.6.02AAA was inserted by the Corporations Amendment Regulations 2007 (No 6), made on 28 June 2007. For a copy of the Regulation, explanatory statement and Regulatory Impact Statement (RIS), see <http://www.comlaw.gov.au/>.

The compensation requirements are generally satisfied by the licensee holding adequate professional indemnity (PI) insurance. Licensees with an AFS licence that commenced before 1 January 2008 must have insurance in place by 1 July 2008. Those with a new AFS licence commencing on or after 1 January 2008 need to meet the compensation requirements from the date their licence commences.

This paper explains how ASIC plans to administer the requirement to hold such insurance.

You are invited to comment on the proposals in this paper, which are only an indication of the approach we may take and are not our final policy.

As well as responding to the specific proposals and questions, we also ask you to describe any alternative approaches you think would achieve our objectives.

We are keen to fully understand and assess the financial and other impacts of our proposals and any alternative approaches. Therefore, we ask you to comment on:

- the likely compliance costs;
- the likely effect on competition; and
- other impacts, costs and benefits.

Where possible, we are seeking both quantitative and qualitative information.

We are also keen to hear from you on any other issues you consider important.

Your comments will help us develop our policy on the compensation requirements. In particular, any information about compliance costs, impacts on competition and other impacts, costs and benefits will be taken into account if we prepare a Business Cost Calculator Report and/or a Regulation Impact Statement: see Section H Regulatory and financial impact.

Making a submission

We will not treat your submission as confidential, and may make it publicly available, unless you specifically request that we treat the whole or part of it (such as any financial information) as confidential.

Comments should be sent by 14 September 2007 to:

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What will happen next?

Stage 1	23 July 2007	ASIC consultation paper released
Stage 2	14 September 2007	Comments due on the consultation paper
	September-October 2007	Drafting of regulatory guide
Stage 3	November 2007	Regulatory guide released

A Our approach to administering the compensation requirements

Key points

Recent amendments to the Corporations Regulations introduce specific provisions enabling licensees to comply with their obligations to have adequate arrangements for compensating retail clients for losses they suffer as a result of breaches by an AFS licensee of any of their obligations under the Corporations Act.

The compensation requirements are a means of reducing the risk that a licensee cannot pay claims because of insufficient financial resources.

We have identified four guiding principles for how we will administer the compensation requirements (see paragraph 7).

The compensation requirements are not designed to cover all losses a financial services client might incur. It is based on PI insurance, which has some inherent limitations (see paragraphs 10–15).

- 1 Our key policy proposals are in Sections A to D. These proposals are to help you understand the decisions you need to make and how we will assess whether you comply with the compensation requirements. We include more detailed material in Sections E-G. This makes the consultation paper longer, but we include it to help you understand more fully the issues and comment on our proposals.
- 2 The legislation and regulations introducing the compensation requirements are summarised in Appendix 1.

Purpose of the requirements

- 3 In any industry, from time to time clients might suffer loss due to inappropriate advice or other misconduct by a service provider. Individual service providers or firms might not have sufficient resources to meet claims arising from these losses. In the financial services industry there needs to be a mechanism to ensure that funds are likely to be available where retail clients suffer loss due to breaches by financial services licensees of their obligations under the legislation.
- 4 The Commonwealth Government describes the objective of the compensation requirements as to:
 - ‘reduce the risk that compensation claims to retail clients cannot be met by the relevant licensees due to the lack of available financial resources’,

Compensation Arrangements for Financial Services Licensees, Regulation Impact Statement, April 2007 p. 7.

- 5 The compensation requirements are not a mechanism for providing compensation directly to consumers. Rather they are a means of reducing the risk that a licensee cannot pay claims because of insufficient financial resources.

Policy objective

- 6 We will administer the compensation requirements to maximise their potential to reduce the risk that a retail client's losses (due to breaches by a licensee) cannot be compensated by the licensee due to the lack of financial resources, as far as this is practically possible. In this paper, we will call this the Policy Objective.

Basic policy principles

- 7 The following basic policy principles will guide our administration of the compensation requirements:
- (a) The primary way for licensees to comply with the compensation requirements will be to have adequate PI insurance.

Note: The Government decided to 'prescribe professional indemnity insurance as the primary means of complying with the compensation requirement', *Compensation Arrangements for Financial Services Licensees, Regulation Impact Statement, April 2007 p. 25.*
 - (b) The PI insurance must substantially deliver the Policy Objective. The requirement that the PI insurance be 'adequate' means that it is fit for achieving the Policy Objective as far as practically possible.
 - (c) The standard of 'adequate PI insurance cover' will be the benchmark for ASIC approval of any alternative arrangements to PI insurance that licensees put to us.
 - (d) It is the basic responsibility of each licensee to determine what arrangements are 'adequate' in their circumstances.

Link to EDR schemes

- 8 As part of its dispute resolution arrangements, a licensee must be a member of an external dispute resolution scheme (EDR scheme) approved by ASIC. The scheme must cover complaints made by retail clients for the financial services provided. EDR schemes play an important role in the compensation requirements.

Note: Membership of an EDR scheme is required under s912A(1)(g) and 912A(2) of the Corporations Act.

- 9 The role of EDR schemes as a main venue for compensation claims is recognised by reg 7.6.02AAA. Under that regulation, a licensee's PI insurance cover must be adequate having regard to its EDR scheme membership. The Regulation Impact Statement states, 'the insurance must be sufficient to meet liabilities arising from decisions made by external dispute resolution schemes' (p. 4). Therefore only PI insurance arrangements that cover claims that might be brought under a licensee's EDR scheme can be adequate. Licensees who intend to have other compensation arrangements in place to cover claims under EDR schemes will need to have these arrangements approved by ASIC under the process outlined in Section D.

Note 1: For further information on ASIC's policy for approving EDR schemes and how we will administer the obligations of licensees subject to the dispute resolution provisions, see Regulatory Guide 165 *Licensing: Internal and external dispute resolution* (RG 165).

Note 2: Claims resolved through an EDR scheme include awards made through an adjudication process and agreed decisions made through a conciliation process. We suggest licensees check that their PI insurance covers awards and that conciliated settlements can be met either from the licensee's own resources or through its PI insurance.

Limitations of the compensation requirements

- 10 The compensation requirements are not intended to cover product failure or general investment losses.
- 11 The compensation requirements are not designed to cover all possible consumer losses relating to financial services. They are intended to cover losses that result from poor quality services (e.g. poor advice or execution of services) and other misconduct by a financial services provider (e.g. fraud).
- 12 It is not intended to cover claims for loss solely as a result of the failure (e.g. through insolvency) of a product issuer (i.e. it is not intended to underwrite the products of a product issuer), or because the return on a financial product has not met expectations.

Note: See paragraphs 31–36 and 60–67 for a discussion of the scope of losses that the compensation requirements are designed to cover and our proposal on this issue (proposal B4).

Limitations of PI insurance

- 13 The primary method of complying with the compensation requirements will be by taking out PI insurance cover. PI insurance is a way of reinforcing a licensee's ability to meet any consumer losses caused by negligence or a

breach of duty by the licensee or its representatives by making funds available to the licensee under the terms of the insurance policy. Consumers generally have no direct right of access to these insurance policies.

- 14 The ability of PI insurance to achieve the Policy Objective is subject to practical limitations. These can have a material impact on the effectiveness of the PI insurance cover. We will have regard to these limitations in the way we administer the requirements.
- 15 Research conducted for ASIC also suggests that what PI insurance will cover is currently limited by what the insurance market will provide.

Note: See Section E for further explanation, particularly the discussion of the results of the research outlined at paragraph 57.

We will work with industry

- 16 We expect that the insurance industry will respond to the opportunity created by mandatory PI insurance cover to develop new products that will help PI insurance fulfil the purpose of the compensation requirements.
- 17 We encourage relevant industry and professional bodies to provide guidance on the compensation requirements to their members, and to consider what standard PI insurance policies and other measures they can develop to assist their members.
- 18 We also expect that licensees will work actively (alone or collectively) to encourage insurers to meet the demand for PI insurance products that are consistent with the compensation requirements. This includes exploring the possibility of developing standardised policies that can cover similarly situated licensees in the same industry, or industry sector.

B Adequate PI insurance

Key points

Whether a PI insurance policy is adequate depends on three factors:

- the amount of the cover—proposals B1–B3;
- the scope of the cover—proposal B4; and
- whether terms and conditions of the cover undermine the overall effect (e.g. by excluding cover for key aspects of the licensee’s business)—paragraphs 32–35.

- 19 In Section A we say that a licensee’s PI insurance will be adequate if it substantially delivers the Policy Objective. We also say that we will use adequate PI insurance cover as a benchmark if a licensee wants to use something other than PI insurance and asks us to approve it is an alternative arrangement.
- 20 Against that general policy background, in this Section we set out our more detailed thinking on what is an adequate PI insurance policy. We also set out some detail about how we are considering assessing the adequacy of arrangements proposed as an alternative to PI insurance.
- 21 We do this to promote discussion of the detail of how the new requirements will work, and to enable clear and constructive dialogue with us while we are settling our policy. We believe this is best achieved by being specific about what we think licensees will need to have in place to satisfy the new requirements. At the same time, we do not want to be taken to have closed off discussion, or to have prejudged what outcome we think is required. We will settle our policy only after extensive consultation, consideration of your responses to this paper and by further targeted discussions we plan to conduct during the consultation period.
- 22 The proposals in this Section draw on the research we have conducted, our preliminary discussion with insurers and representatives of licensees, and our administrative experience in dealing with similar policy questions. More detail is provided in Sections E and F. In particular, further detail on the process of assessment of their own arrangements that licensees should undertake is outlined in Section F.

Amount of cover

- 23 To be adequate overall, a PI insurance policy must have an adequate amount of cover. Amount in this context means both:

- (a) the limit of liability under the insurance policy ‘per claim’ (i.e. the maximum insurance cover for each individual claim); and
- (b) the limit of liability under the insurance policy ‘in the aggregate’ (i.e. the maximum insurance cover for all claims).

24 What is an adequate amount of cover is likely to vary from licensee to licensee, depending on:

- (a) the size of the licensee;
- (b) the nature of its business; and
- (c) the likelihood of claims against that licensee.

Proposal

- B1** We propose that a licensee's PI insurance policy should have a *per claim* limit at least as high as the maximum monetary limit that applies to their EDR scheme(s).
- B2** For insurance brokers, we propose that maintaining the *aggregate* amount of cover required under the superseded *Insurance (Agents and Brokers) Act 1984* would mean the amount of cover is adequate.
- B3** For other licensees, we propose that:
- (a) the appropriate measure of a licensee's size is the total gross revenue derived from the licensee's dealings with retail clients;
 - (b) minimum *aggregate* cover should be assessed on a sliding scale as follows:
 - (i) for licensees whose actual or expected revenue from retail services is up to \$1 million – minimum \$2 million cover;
 - (ii) for licensees with revenue greater than \$1 million – minimum cover should be two times actual or expected revenue from retail services (up to a capped minimum of \$20 million cover).

Your feedback

- B3Q1 Do you agree with our proposals on what is an adequate amount of cover *per claim*? Please give reasons.
- B3Q2 Do you agree with our proposals on what is an adequate *aggregate* amount of cover for insurance brokers? Please give reasons.
- B3Q3 Do you agree with our proposals on what is an adequate *aggregate* amount of cover for *other* licensees? Please give reasons.
- B3Q4 Should we continue to distinguish between insurance brokers and other types of licensees? Please give reasons.

Rationale

- 25 It is not possible for ASIC to suggest a set amount of cover that will be adequate for all licensees, or to set out a simple formula a licensee can use to calculate the appropriate amount. However, ASIC's research and its experience and understanding of other compensation and PI insurance regimes suggest that some general proposals can be made and tested in the consultation process.
- 26 A licensee's PI insurance policy should have a *per claim* limit at least as high as the maximum monetary limit that applies to the EDR scheme(s) that they are a member of. As the EDR scheme(s) that the licensee subscribes to is a key venue for resolving any disputes between the licensee and its clients, the licensee's PI policy cover on a 'per claim basis' should be at least as high as the scheme's monetary limit per claim. This applies to all licensees.
- 27 Insurance brokers have been subject to PI insurance requirements under the former *Insurance (Agents and Brokers) Act 1984* for many years, and we understand that the regime was reasonably effective. Therefore, we propose to continue to treat the amount of cover specified under that Act as adequate for licensees in the business of insurance broking (as that concept was understood under the former *Insurance (Agents and Brokers) Act 1984*).
- 28 Our research suggests that most licensees will need a minimum cover of \$2 million in aggregate. This is likely to be adequate for smaller licensees, but might not be for larger licensees.
- 29 This approach raises two questions: what is the right way to measure licensee 'size' for these purposes; and what relationship should there be between a licensee's size and the minimum aggregate cover they should have? In proposal B3 we set out some tentative proposals as to how size and amount of cover might be determined for licensees other than insurance brokers.
- 30 An adequate amount of cover is discussed in more detail in Section E at paragraphs 68–69.

Scope of cover

- 31 Section 912B requires that the insurance must cover loss or damage suffered by retail clients because of breaches of obligations under Chapter 7 and extends to all financial services covered by Chapter 7. Losses caused by negligent, fraudulent or dishonest conduct that amounts to a breach of the Corporations Act are to be covered. Licensees' obligations under Chapter 7 are broad and include a duty to act efficiently, honestly and fairly.

Proposal

- B4** We propose that the Policy Objective and the legislation (as summarised in Appendix 1) require the following as key features of an adequate PI insurance policy:
- (a) it must cover loss or damage suffered by retail clients because of breaches of obligations under Chapter 7 of the Corporations Act;
 - (b) it must cover breaches by both the licensee and its representatives;
 - (c) it must be available to cover compensation awards made by the EDR to which the licensee belongs; and
 - (d) as far as possible, it must continue to provide cover for a period of time after the licensee ceases business (e.g. run-off cover).

Your feedback

B4Q1 Do you agree with our proposal on what is an adequate scope of cover? Please give reasons.

Exclusions, excesses and deductibles

Exclusions

- 32 If exclusions in a PI insurance policy undermine the Policy Objective, it is hard to see how it could be adequate. This applies especially to exclusions that relate directly to the minimum scope of cover described above.
- 33 Of special concern are exclusions that mean cover is not available for breaches of obligations under Chapter 7 (by a licensee or its representatives) for services (most often advice) that relate to products that are outside the licensee's approved product list.
- 34 Exclusions from cover are discussed in more detail in Section E at paragraphs 60–67. Significant exclusions will mean the policy is not fully adequate (see Section C).

Excesses and deductibles

- 35 We are aware that PI insurance policies might be subject to conditions that mean whether a licensee can pay compensation awards depends significantly on the use of its own funds. Excesses or deductibles in the policy can have this effect. High excesses or deductibles might mean the policy is not fully adequate (see Section C).

Note: We understand that standard excesses are 1–2% of licensee revenue.

C PI insurance that is not fully adequate

Key points

Some PI insurance policies will not be adequate to fully cover a licensee against potential claims.

Where a licensee is considering a 'partially adequate' policy, they should:

- identify and estimate their exposure to uninsured claims; and
- ensure that their cash flow is sufficient to cover this exposure (proposal C1).

However, a policy that means a licensee is relying more on its own resources than on the insurance policy is unlikely to be sufficient to ensure the licensee is meeting their compensation requirements (paragraph 44).

Background

- 36 We recognise that that some PI insurance policies will not be fully adequate, as what licensees can purchase will depend on what cover is available in the market. Some inherent limitations of PI insurance are discussed in Section E at paragraphs 58–76.
- 37 We envisage a three-tiered model, being:
- (a) fully adequate PI insurance (discussed in Section B);
 - (b) partially adequate PI insurance (discussed in this Section) with the remaining liability being self-funded; and
 - (c) approved alternative arrangements (discussed in Section D).

Process where cover is not fully adequate

- 38 Some licensees might have cover that is not fully adequate when assessed by the criteria outlined above (paragraphs 32–35). In this situation, the PI insurance policy will only partly deliver on the Policy Objective. Any shortfall will need to be made up by a licensee using its own financial resources. In effect, the licensee's ability to be able to meet compensation claims will depend partly on its PI insurance policy and partly on whether the licensee has enough of its own funds to meet claims.
- 39 The PI insurance policy will be the main source of financial resources to meet compensation claims. However, where a policy is not fully adequate

and gaps or shortfalls need to be met from a licensee's own financial resources, there needs to be a robust and effective mechanism to work out what resources are required. The licensee needs to be confident it will have financial resources available whenever they are needed for this purpose.

Proposal

- c1 Where licensees have PI insurance cover that is not fully adequate, we propose that any shortfall be made up by a licensee using its own financial resources. We propose licensees take the following steps to calculate what is needed and ensure the resources are available for this purpose:

Table 1: Steps to undertake where the cover is not fully adequate

Step 1—the PI insurance gap	Estimate the total exposure to claims not covered by the policy (i.e. those potential claims not covered by the policy as discussed in proposal B4). This could be determined by: <ul style="list-style-type: none"> estimating the maximum exposure to a single client under each gap in cover (eg the maximum exposure for loss arising from advice provided in relation to products not on the approved product list); and estimating the number of these kinds of claims that will be expected in the policy period.
Step 2—anticipated excess payments	Estimate the excess payments that you will be required to meet in the policy period.
Step 3—projected cash flows	Ensure that your 3-month projected cash flows will at all times be sufficient to cover the estimate generated in Step 1 (the PI insurance gap) and the estimate generated in Step 2 (anticipated excess payments) (together, the estimated exposure).
Step 4—audit report	Ensure that the audit report you are required to provide to ASIC under RG 166.27–RG 166.28 addresses your projection of cash flows, taking into account the contingencies discussed at Step 1 and 2.

Your feedback

- C1Q1 Do you agree with our proposal on partially adequate cover? Please give reasons.
- C1Q2 Are there any practical problems with our proposal that licensees manage this issue of partially adequate cover by setting aside sufficient own financial resources?
- C1Q3 Is the cash flow method suggested here sufficient to deal with the issue of partial adequacy? What role do you think overdrafts and other forms of financial support may play here? Please give details.

Licensees' financial requirements

- 40 Gaps or shortfalls in PI insurance cover that need to met from a licensee's own resources will have an impact on the licensee's cash flows. Regulatory Guide 166 *Licensing: Financial requirements* (RG 166) sets out minimum cash needs requirements that apply as licence conditions to most licensees. Under this requirement, most licensees prepare a cash flow projection (some licensees may instead rely on a commitment from an Australian authorised deposit taking institution (ADI) or large parent company). Proposal C1 means that licensees must include their estimated exposure in their cash flow projections, and ensure that their cash flow can cover the estimated exposure. This would need to be verified in the usual way under RG 166, including through the audit report described at paragraphs (RG 166.27–RG 166.29).
- 41 The base level financial requirements in RG 166 are not intended to provide for compensation arrangements, but in practice any estimated exposure needs to be factored into a licensee's cash flow projections. For example, the need to pay an excess on each claim will have to be factored into the licensee's cash flow projections.
- 42 Licensees could estimate the anticipated excess payments that they will be required to meet in the policy period by multiplying their estimate of claims volume that will be covered by the PI insurance policy during the policy period by the excess specified in the policy.
- 43 Under proposal C1 (Step 3 above) we expect licensees to ensure that their expected cash flows will be sufficient to cover the sum of the estimate generated in Step 1 (the PI insurance gap) and the estimate generated in Step 2 (anticipated excess payments). This could be achieved by reviewing the cash flow projection used to satisfy the base level financial requirements (outlined in RG 166.26) and ensuring that it takes into account the estimated exposures calculated at Steps 1 and 2 above.
- 44 If the licensee is depending more on its own resources than on its PI insurance policy (e.g. the majority of claims are likely to be excluded from the policy or below the policy's excess), the policy is unlikely to be adequate at all. In such cases, the licensee will need to consider applying for its arrangements to be approved as alternative compensation arrangements (see Section D).

D Alternative arrangements

Key points

Licensees wishing to apply for ASIC approval of alternative compensation arrangements under s912B(2)(b) will need to lodge an application for approval.

Applications for approval of alternative arrangements will be assessed on a case-by-case basis.

Existing compensation arrangements must remain in place while new alternative arrangements are assessed.

- 45 We are looking for feedback on what might constitute adequate alternative arrangements to PI insurance, as well as how any alternatives should be assessed. This might also be relevant to licensees who are unable to obtain adequate PI insurance cover as discussed in Sections B, C and F of this paper.

Applying for approval of alternative arrangements

- 46 Existing licensees wishing to apply for ASIC approval of alternative arrangements will need to lodge an application. New licensees will be asked on their licensing application whether they are going to ask ASIC to approve something other than PI insurance and should apply for approval of their alternative arrangements as part of their licence application process.

- 47 An application to ASIC for approval of alternative compensation arrangements should address the following issues:

- (a) which licensees will be covered by the arrangements (e.g. do the arrangements cover a group of related licensees or an industry sector?);
- (b) how the arrangements meet the criteria for assessing adequate PI insurance under the Regulations (reg 7.6.02AAA(1)) as discussed in Sections B, C and F of this paper;

Note: When individual licensees ask us to approve alternative arrangements, we will also ask them to follow the steps in Table 2 in Section F, and share the calculations with us: see paragraph 94.

- (c) any benefits, risks or costs to retail clients arising from the licensees using these arrangements as opposed to PI insurance; and
- (d) any circumstances particular to the licensee or the industry sector which make these arrangements more appropriate than PI insurance.

- 48 We will assess each application on its merits. We will give priority to group applications, for example in relation to an industry sector or sub-sector.
- 49 Where a licensee wishes to maintain existing arrangements, such as large highly capitalised licensees wishing to 'self-insure' (i.e. cover the cost of claims using their own available financial resources), we will assess these arrangements using the same process as for new arrangements. However, licensees who currently rely on a security bond will not receive approval to continue those arrangements.

Assessment criteria for applications

- 50 Under s912B(3), ASIC is required to have regard to:
- (a) the nature of the financial services covered; and
 - (b) whether the arrangements provide cover after the licensee ceases the business and, if so, for how long.
- 51 We are also obliged to take into account the factors used to assess adequacy of PI insurance in reg 7.6.02AAA(1) in approving alternative arrangements. This means that any non-PI insurance compensation arrangements must also be adequate having regard to:
- (a) the licensee's membership of an EDR scheme or schemes taking into account the maximum liability that has, realistically, some potential to arise;
 - (b) the volume of business;
 - (c) the number and kind of clients;
 - (d) the kind or kinds of business; and
 - (e) the number of representatives.

Proposal

- D1 We propose to assess applications for alternative arrangements against the same criteria as apply to PI insurance arrangements to ensure that licensees and their clients have comparable protection where alternative arrangements are used in lieu of PI insurance. We propose to approve alternative arrangements *only* where they provide no less protection than adequate PI insurance cover.

Your feedback

- D1Q1 Do you agree with our approach to assessing alternative arrangements? Please give reasons.
- D1Q2 Should applications for approval of alternative arrangements have to be accompanied by external expert reports (e.g. an assessment by an actuary or auditor)?

D2 We propose to assess applications for alternative arrangements on a case-by-case basis. For the purposes of illustrating how this concept might work, we have proposed below some hypothetical examples of what might possibly be considered alternative arrangements to PI insurance. However, by inclusion in this list, ASIC makes no statement as to whether arrangements of this kind would constitute 'adequate' compensation arrangements or would be approved by ASIC in any particular circumstances or for any given licensee.

D3 We propose that the following hypothetical examples illustrate what might or might not be alternative arrangements.

(a) Self-insurance approach

Some very highly capitalised financial services providers might take a self-insurance approach (i.e. to completely replace PI insurance). This might be appropriate for providers that are so substantial that failure to pay claims is very unlikely (akin to the exemption for some APRA-regulated entities).

We think this is unlikely to be appropriate other than for a small number of very highly capitalised providers.

(b) Industry member fund

Alternative arrangements proposed by an industry body may be approved by ASIC. For example, an industry body's members might wish to set up a compensation fund supported by compulsory levies of members.

This could be in addition to PI insurance (i.e. to compensate clients where a member's insurance is inadequate or they cease trading or become insolvent) or instead of PI insurance. Approval of a fund would depend on the amount of compensation that would be available for clients and the circumstances in which the fund would compensate clients.

We encourage industry bodies to consider whether an alternative arrangement is appropriate for their members and we are keen to discuss any such arrangements further with them.

Your feedback

D3Q1 Do you agree with our choice of examples? Please give details of any other example you believe is appropriate.

Summary of alternative arrangements in FSGs

52 Under the Regulations, if licensees have an alternative compensation arrangement in place that has been approved by ASIC, they must include a statement in their FSG and the FSG of any of their authorised representatives about:

- (a) the kind of compensation arrangements they have in place; and

- (b) whether those arrangements satisfy the requirements under s912B (i.e. whether they have been approved by ASIC in accordance with s912B(1)).

Compensation requirements during the assessment process

- 53 ASIC will need time to assess various alternatives submitted to us for approval. If a licensee applies to ASIC for approval of alternative arrangements, they should continue to hold PI insurance that they have previously obtained (or to keep other ASIC approved alternative arrangements they have previously implemented in place).

E Issues in implementing the PI insurance requirements

Key points

PI insurance cover supplements a licensee's own financial resources.

Some issues for PI insurance in achieving the Policy Objective are:

- the scope of losses that PI insurance is likely to provide (paragraphs 60–67);
- what will be an adequate amount of cover (see paragraphs 68–69); and
- whether PI insurance will be available to licensees as a source of funds when it is needed to cover a loss by a retail client (see paragraphs 70–78).

We have identified some possible responses to these issues (see paragraphs 78–81).

Role of PI insurance

- 54 PI insurance cover is intended to operate as a means of supplementing a licensee's own financial resources as part of its overall risk management arrangements.

Note: See Section A for more detail on the objectives of the compensation requirements.

- 55 We expect that PI insurance will be most important as a source of funds for compensation where:
- (a) retail clients bring large claims or multiple claims for which the licensee's financial resources are insufficient (including losses in excess of the EDR scheme limit); and
 - (b) retail clients identify the losses and make claims while the licensee remains a going concern.

The current market for PI insurance

- 56 Research conducted for ASIC suggests that the ability of PI insurance to put licensees in funds to meet claims from consumers will be limited by what the insurance market is prepared to provide. To assist in developing our policy on administering the compensation requirements, ASIC commissioned a report into the market for PI insurance for AFS licensees by Alan Mason,

former chief executive of the Insurance Council of Australia: *Compensation Arrangements for Financial Services Licensees—Research into the Professional Indemnity Insurance Market* dated December 2006 (PII Market Report).

Note: The PII Market Report outlines research into the affordability and availability of PI insurance, level of cover and excess purchased, the scope of cover under current insurance policies and the extent to which this cover would meet the obligations on licensees under the Corporations Act and Regulations. A copy of this report has been released with this paper and is available on the ASIC website (www.asic.gov.au). The findings of this report were current as at 14 December 2006.

- 57 The PII Market Report's key findings include that:
- (a) there are currently no policies available that are explicitly based on the obligation for AFS licensees to hold PI insurance;
 - (b) the PI insurance market is currently highly competitive but might not always be so;
 - (c) current policies might not cover the full range of breaches under the Corporations Act (e.g. there is generally no cover available for fraud by the licensee, representatives acting outside the scope of authority of licensees and products not on an 'approved product list');
 - (d) the quantum of cover is not uniform because of differing excesses and indemnity levels (amounts of cover);
 - (e) the availability of run-off cover (i.e. cover for claims after a licensee has ceased business) is quite limited; and
 - (f) PI insurance policies are generally 'claims made' policies, which means that the claim must be made and notified to the insurer by the insured within the policy period. Consumers might bring claims against financial services licensees years after the conduct on which the claim is based occurred, by which time the policy might have expired.

The effectiveness of PI insurance: some issues

- 58 ASIC has identified a number of issues to be dealt with if PI insurance is to achieve the Policy Objective. Issues relate to both inherent limitations and current market limitations. The challenges include:
- (a) issues about the scope of losses that PI insurance is likely to provide;
 - (b) issues about whether PI insurance is available as a source of funds to licensees when it is needed to cover a loss by a retail client; and
 - (c) what will be an adequate amount of cover.

59 We discuss these issues below to obtain feedback to better understand the current market and help facilitate the development of policies that allow licensees to comply more easily with the compensation requirements.

Policies providing the cover required by the compensation requirements might not be available

60 We recognise that PI insurance policies that cover all consumer losses falling within the scope of the obligation under s912B might not be commercially available to all licensees. Commercially available policies might also include significant exclusions that undermine the effectiveness of the policy cover. We will work with industry to explore further the potential of the current market for PI insurance to meet the Policy Objective.

61 As discussed in Section B at paragraphs 32-35, if a licensee's PI insurance policy contains significant exclusions from the losses contemplated by s912B, the PI insurance policy will only be 'partially adequate' and the licensee will be effectively self-insuring for those excluded claims. In Section C we set out a process for licensees to ensure that they will have sufficient financial resources to meet excluded claims as part of their overall risk management arrangements. In this Section we now set out further detail on what gaps in cover licensees should look for and factor into this assessment.

62 We consider the following exclusions to be significant:

- (a) EDR scheme awards;
- (b) loss caused by the conduct of representatives generally;
- (c) fraud and dishonesty by agents and representatives;
- (d) claims for misrepresentations about services; and
- (e) claims arising from incidents that have been notified to ASIC (such as through a breach report on the basis that, by making the notification, the licensee has admitted liability and as a result the insurance policy will not cover the claim).

63 Some exclusions in a policy might in themselves make the policy inadequate for the purposes of the compensation requirements. For example, a policy that excluded cover for breaches of Chapter 7 would not meet the Policy Objective.

Note: See our proposal on the required scope of cover and its key features outlined in Proposal B4 at paragraph 31.

Cover for fraud by the principal

64 We understand that PI insurance policies do not generally cover criminal activity or fraud by the principal as this may be against public policy. For

example, fraud committed by a sole trader licensee would not be covered. This means that consumer losses caused by fraud of a principal are likely to be uninsured and would have to be met from other financial resources.

Approved product lists

65 We understand that many current PI insurance policies do not cover losses caused by advice provided by a licensee's representatives about products that are not on the licensee's approved product list.

66 ASIC considers that this is a key area of potential retail client loss and encourages licensees to endeavour to get cover for this exposure as part of their overall risk management strategy.

Note: See the discussion at paragraph 33 in Section B.

67 If such policies are not reasonably commercially available, we expect licensees to set aside sufficient financial resources to cover this risk.

Amount of cover

68 The effectiveness of the PI insurance requirements to achieve the Policy Objective also depends on whether licensees obtain adequate amounts of cover. Our proposals on the amount of cover licensees need are set out in Section B at proposal B1–B3.

69 Research conducted for the PII Market Report suggests that, as at December 2006, \$2 million indemnity would cover approximately 90% of all individual claims lodged for an average licensee. APRA reported in its information paper: *Superannuation—Trustee Liability Insurance* dated 30 June 2006 that in a survey of insurance brokers who arrange trustee liability insurance for trustees of superannuation entities, the brokers suggested that trustees should have a minimum level of cover between \$1 million to \$5 million.

Note: These are illustrative figures only, and are provided for the general assistance of licensees in considering what amount of PI insurance is adequate in their circumstances. These figures are current at the date stated and may no longer be current.

Availability of compensation when a licensee ceases business

70 We are concerned about possible limitations in the ability of PI insurance to provide a source of compensation if a licensee becomes insolvent or ceases business.

Licensee insolvency

- 71 PI insurance is designed to help an entity that is a going concern to remain in business, by providing it with compensation in the event of a substantial claim against it. It might not protect clients of an entity that becomes insolvent. This is especially true if policies are ‘claims made’ rather than ‘claims incurred’ policies, because only claims brought within the policy period will be covered. An insolvent entity is unlikely to be in a position to continue to renew the policy for a further period. So the capacity of PI insurance to provide a source of effective compensation when licensees become insolvent might be very limited.
- 72 Further, where the licensee is insolvent, clients will generally have to prove their claim in the general pool of unsecured creditors. Any PI insurance payments might become part of the general pool of assets of the insolvent licensee.

Note: There are some statutory protections for insurance payments, for example under s562(1) of the Corporations Act.

Claims might not be notified within the policy period

- 73 We understand PI insurance generally operates on a ‘claims made’ basis and only covers claims notified within the policy period. A licensee in financial difficulties might fail to notify claims promptly or might fail to maintain its PI insurance. Because most advice claims are ‘long tail’ (i.e. claims arise 2 to 7 years after the advice), there is a risk that the licensee might have retired or been wound-up, and the period for notifying claims to the insurer passed, before the client realises they have suffered a loss.
- 74 If the policy period ends and the licensee does not have run-off cover, liabilities crystallised by claims made after this time will not be covered.
- 75 Run-off cover might extend the policy period, but we understand from the PII Market Report that there is not a ready market for run-off cover and it can generally only be obtained for orderly run downs (members’ voluntary liquidations) for a period of 12 months, where ideally 7 years of run-off cover would be desirable.

Insufficient funds to pay excesses

- 76 Many policies have an excess that an insolvent licensee might be unable to pay.
- 77 Policies also have a fixed limit of indemnity, which can be quickly exhausted where there are numerous claims resulting from the same incident or a few unrelated large claims.

Practical options for improving compensation arrangements

Optimising PI insurance

- 78 We encourage licensees and the insurance industry (e.g. insurers, underwriters and insurance brokers) to look at practical ways to help s912B PI insurance policies function as effectively as possible in the event of licensee insolvency; and also to provide as strong a risk management tool for the licensee as possible.
- 79 We encourage licensees and insurance providers to explore options for improving the effectiveness of PI insurance for licensees and their clients. Options might include:
- (a) run-off cover is included for the longest period commercially available;
 - (b) the policy is a ‘claims incurred’ policy rather than a ‘claims made’ policy; and
 - (c) the policy permits retail client claimants to deal directly with the insurers (e.g. permitting the client to notify claims directly to the insurer and pay any necessary excess where the licensee is unwilling or unable to notify claims and pay excesses). For example, this could be achieved by defining retail client claimants as a class of third party beneficiaries in the policy.

Run-off cover

Proposal

- E1 Licensees should obtain run-off cover for as long a period as is commercially available.

Your feedback

- E1Q1 If you do not agree with requiring run-off cover, what do you suggest as an alternative to ensure cover is available for losses that are only identified some time after the original incident (eg the poor advice)?

- 80 Run-off cover is a factor that ASIC is required to consider in assessing alternative arrangements under s912B(3)(b), so the legislature clearly regards run-off cover as important.

Industry initiated group compensation arrangements.

- 81 Industry bodies might also consider facilitating group compensation arrangements such as a group insurance scheme or a compensation fund supported by levies from members. ASIC may consider such proposals as alternative arrangements under s912B(2)(b): see Section D.

F Assessing and obtaining PI insurance

Key points

Licensees are primarily responsible for assessing what is adequate PI insurance and obtaining such insurance.

This Section explains:

- who PI insurance can be obtained from (proposal F1);
- what steps a licensee should follow (paragraphs 88–93);
- our expectations on ongoing compliance (paragraphs 95–97); and
- the FSG disclosure requirements (proposal F2 and paragraphs 98–99).

Additional guidance for small business licensees is in Appendix 2.

This Section also set out our proposed approach to existing and new licensees (proposals F3–F4).

- 82 The primary method of complying with the compensation requirements is to obtain adequate PI insurance cover. The specific requirements under the legislation are outlined in Appendix 1 to this paper.

Our policy

It is a licensee's responsibility to assess what is adequate

- 83 The Regulation makes the licensee responsible for assessing what is adequate PI insurance in their circumstances.
- 84 Whether a particular PI insurance policy is adequate depends on all of the facts and circumstances, including the nature, scale and complexity of the licensee's business, and their other financial resources, and therefore the licensee is in the best position to assess what will be adequate. It is up to licensees to determine what is adequate PI insurance (including the amount of cover) to meet their obligations under s912B and to obtain such cover.
- 85 In Section B we set out ASIC's proposals on minimum requirements for adequacy.

Who can provide the cover?

Proposal

- F1 Generally, the cover needs to be from an insurer regulated by APRA under the *Insurance Act 1973*.

Your feedback

F1Q1 Should anyone other than an APRA-regulated insurer be able to provide PI insurance cover for the purposes of the compensation requirements? Please give reasons.

86 The Government has announced plans to amend the *Insurance Act 1973* to cover direct offshore foreign insurers selling directly or indirectly into Australia, so that they will be required to be regulated by APRA. A licensee could then obtain PI insurance provided by an APRA-regulated direct offshore foreign insurer. However currently not all direct offshore foreign insurers are regulated by APRA. Until the *Insurance Act 1973* amendments are finalised, we recognise that some licensees might be able to obtain insurance from a non-APRA-regulated foreign insurer.

Note: See the announcement by the Hon Peter Dutton, MP, Minister for Revenue and the Assistant Treasurer: Press release 042 *Enhancing the Integrity of Insurance in Australia* [03/05/2007], available at <http://assistant.treasurer.gov.au/>.

87 We consider that the Regulation requires licensees to obtain a contract of PI insurance and therefore membership of a discretionary mutual fund would not satisfy the requirements.

Process

88 ASIC will assist licensees by developing guidance on what processes they should go through to determine what are adequate compensation arrangements for them. However, ASIC will not 'approve' a licensee's PI insurance arrangements.

89 Whether they already have PI insurance cover in place or not, licensees need to review their operations to assess what type and amount of cover they need. This involves licensees both:

- (a) undertaking an initial assessment of their business; and
- (b) having a process of ongoing assessment.

Initial assessment process

90 Under the Regulation, whether PI insurance cover is adequate is to be determined having regard to:

- (a) the licensee's membership of an EDR scheme or schemes, taking account of 'the maximum liability that has, realistically, some potential to arise' in connection with any particular claim against the licensee and all claims in respect of which the licensee could be found to be liable; and

- (b) relevant considerations of the financial services business carried on by the licensee, including:
- (i) the volume of business;
 - (ii) the number and kind of clients;
 - (iii) the kind or kinds of business; and
 - (iv) the number of representatives.

91 The list of factors in the Regulation is not an exhaustive list of the factors licensees need to take into account in assessing what PI insurance cover is adequate in their circumstances. Terms of the insurance policy itself also have an impact upon whether the cover complies with the obligations under s912B and the Regulation.

92 Minimum standards set by relevant industry and professional bodies might provide a guide. However, compliance with these standards does not necessarily mean that a licensee meets the requirements. Licensees should undertake their own analysis of what is adequate PI insurance cover for them. Some licensees might find it helpful to engage external consultants, actuaries, brokers or advisers to undertake a risk assessment of their business and provide advice on the amount and type of cover that they should obtain.

93 We suggest that licensees go through the following process to determine what will be adequate PI insurance for them:

Table 2: Initial assessment process

Step 1	Assess the business: Claims history, level of business and risk management procedures (taking into account any proposed changes to the business).
Step 2	Assess potential liability: We suggest that licensees can determine 'the maximum liability that has, realistically, some potential to arise' under the Regulation by making a reasonable estimate of the following factors: <ul style="list-style-type: none"> • the maximum exposure to a single client ('worst loss scenario' per client); • the number of claims that could arise from a single event (potential for multiple claims); and • the number of claims that might be expected during the policy period.
Step 3	Ask their insurers or insurance brokers for a list of key policy features, exclusions and available extensions (based on full disclosure of the information the licensee has assembled under Steps 1 and 2).
Step 4	Consider whether the amount and scope of cover is adequate (see Section B).
Step 5	Review the policy by asking themselves the questions in Table 3 below.

Alternatives to PI insurance

- 94 When individual licensees ask us to approve alternative arrangements, we will also ask them to follow the steps in Table 2, and share the calculations with us. This is to help us evaluate whether the alternative arrangements are adequate. If the licensee is unable to demonstrate that its proposed alternative arrangement can confidently cover the estimated exposure (as confirmed by an external expert, e.g. an auditor or actuary), the arrangement is unlikely to be approved by ASIC.

Key questions for licensees to ask

Table 3: Key questions for licensees

Policy feature	Questions to ask
Scope of cover and extensions	<p>Does the policy cover losses from breaches of Chapter 7 of the Corporations Act by the licensee and its representatives?</p> <p>Does the policy cover negligence, fraud and dishonest conduct (e.g. of directors, employees and other officers)?</p> <p>Does the policy cover EDR scheme awards? Does the policy cover agreed decisions reached through the EDR scheme conciliation process? (If not, the licensee will be effectively self-insuring to cover any conciliated agreements it reaches through its EDR scheme)</p> <p>Note: Under s912A, a licensee's EDR scheme may have jurisdiction to hear claims that are outside the scope of s912B. Licensees should consider whether the policy would also cover these claims. Failure to meet the requirements of an EDR scheme might place the licensee in breach of s912A(1)(g).</p>
Amount of cover	<p>Does the policy have an adequate level of indemnity to cover a reasonable estimate of retail clients' losses?</p> <p>Is the level of indemnity adequate to cover claims brought both inside and outside of an EDR scheme?</p> <p>Note: The regulation prescribes EDR scheme membership as a key factor in assessing the adequacy of PI arrangements. However, an estimate of claims under the EDR scheme might not always provide an accurate guide to a licensee's potential liability, as claims could be brought outside the EDR schemes, such as through the courts.</p> <p>Does the level of indemnity cover claims made by wholesale clients or claims relating to losses for which an AFS licence is not required (which fall outside s912B)? (If so, this might reduce the amount of cover available for claims that fall within s912B and licensees might need to increase the amount of cover accordingly.)</p> <p>Are defence costs covered separately from the amount of indemnity cover? (If not, the limit might need to be increased to as much as double the limit to provide the same cover as a policy that covers defence costs separately.)</p> <p>Note: The PII Market Report suggests that, as at December 2006, legal costs for a court action were generally between 30% to 50% of a claim and a typical defence cost on a claim against a financial planner was between \$4,000-\$5,000 for a small claim, but could be up to \$20,000. The conditions of the PI insurance market change from time to time.</p>

Policy feature	Questions to ask
This information is intended as an example only.	
	<p>Does the policy provide for automatic reinstatement? (Automatic reinstatement means that if the limit of the policy is exhausted before the end of the policy period, the licensee can pay a new premium so that the limit of indemnity is reinstated for the balance of the period to cover any new claims that might arise. This is important, as licensees must ensure their PI insurance cover is adequate at all times.)</p> <p>Does the business carry a higher risk of claims (e.g. does it give advice on higher risk products) or is it exposed to a higher volume of claims and therefore requires a larger amount of PI insurance cover?</p> <p>Have weaknesses been identified in your compliance systems, such as a high number of claims or high-risk products/practices, which might mean a higher level of cover is required?</p>
Excess / deductibles	<p>Is the excess at a level that the business can confidently sustain as an uninsured loss taking into account the licensee's financial resources?</p> <p>Note: A business with a lower cash flow available to meet claims might require a larger amount of cover and/or cover with a lower excess. If there is a limited asset base available to meet claims, a policy with a lower excess might be preferable. We understand from the PII Market Report that currently available PI insurance policies generally have an excess. Therefore we consider that whether a licensee has sufficient cash flow to meet the excess for a reasonable estimate of claims is a relevant consideration in determining whether a PI insurance policy is adequate under the regulation.</p>
Exclusions	<p>What are the exclusions from cover? Are the exclusions significant? Does the licensee have sufficient financial resources to cover these exclusions? (See Section C).</p>
Approved product list	<p>Is cover limited to services provided in relation to an agreed list of products?</p> <p>Note: Licensees should review the product list on a regular basis and inform the insurer if there are other products that should be included on the product list. If this exclusion applies, the licensee might need to consider alternative compensation arrangements to PI insurance as outlined in Section D. See further discussion at paragraphs 65–67.</p>
Who is covered?	<p>Does the policy cover the licensee and all of its representatives (either under the policy or separately covered by a policy under which the licensee has a right of indemnity)?</p> <p>Note: Licensees need to take into account all of their representatives (i.e. not just authorised representatives) when considering the type and extent of cover that will be adequate. A client will generally have the same remedies against the licensee as it has against its representatives.</p> <p>Are there many representatives and are they geographically dispersed? If so, the limit of indemnity might need to be appropriately higher to manage this risk.</p> <p>Note: In our experience, the greater the number of representatives that are working for a licensee, and the more geographically dispersed they are, the greater the potential for client losses to occur. The number and distribution of representatives might affect the licensee's ability to adequately supervise its representatives and a licensee with a greater number of representatives is likely to provide services to a greater number of clients.</p>
Retroactive cover	<p>If the licensee had a previous PI insurance policy, does the new policy provide retroactive cover from the date of expiration of the previous policy?</p>

Policy feature	Questions to ask
'Run-off' cover	Does the policy provide run-off cover? If so, for how long? Note: To be adequate, ASIC considers that PI insurance cover should have run-off cover for as long a period as is reasonably commercially available.

Your feedback

F1Q2 Are these questions helpful for licensees to consider in assessing what is adequate cover? Are there any other processes or procedures that you follow when obtaining and maintaining PI insurance that ASIC should discuss in its policy?

F1Q3 Is the guidance in this Section likely to directly result in any increase in your compliance costs? Please give details, including figures and reasons.

Ongoing assessment process

- 95 We expect that licensees will review their PI insurance or other compensation arrangements at least annually to ensure they continue to be adequate (e.g. when their existing policy is due for renewal). Licensees should also review the adequacy of their compensation arrangements in light of any major changes in their business (e.g. if they start providing new services or products or engage more representatives).
- 96 From time to time, ASIC may require a licensee to provide a copy of their PI insurance policy or a certificate of currency and other information relating to their compensation arrangements. For example, ASIC may ask for these documents when it is conducting a compliance review of a licensee.

Compliance systems

- 97 We expect licensees will ensure that a senior officer or manager is accountable for ensuring that their PI insurance policy is renewed when required, that premiums are paid on time and that their policy or other compensation arrangements continue to be adequate. Licensees will need to make provision in their dispute resolution systems for ensuring that claims that are brought to their attention are promptly notified to insurers.

Disclosure in FSGs

- 98 Under the Regulation, licensees are required to make a statement in their Financial Services Guide (FSG) and in the FSG of any authorised representative of the licensee about whether they are complying with the obligation to have adequate PI insurance in place under reg 7.6.02AAA.

- 99 To minimise the risk of clients misunderstanding the nature of PI insurance cover, we encourage licensees to refer to PI insurance as ‘professional indemnity insurance’ rather than compensation arrangements.

Proposal

- F2 We propose that to avoid any client confusion, licensees and their representatives might also wish to explain in their FSG (as relevant) that:
- (a) the insurance is there to meet claims where the licensee or its representatives are found to be liable (e.g. by an EDR scheme or court) during the period of the policy;
 - (b) the consumer is not directly covered and has no right to bring an action under the policy;
 - (c) the policy will not necessarily be adequate to meet all possible claims against the licensee (e.g. if an extraordinary level of losses occurred for a licensee, the losses might exceed the agreed level of cover under the policy);
 - (d) PI insurance is designed to help an entity that is a going concern to remain in business, and might not be able to protect clients of an entity that becomes insolvent;
 - (e) cover might be less effective in the event of insolvency of the licensee because the proceeds might be available to meet the claims of other creditors;
 - (f) the policy operates on a ‘claims made’ basis and will only respond if a claim is made during the policy is on foot; and
 - (g) certain exclusions apply.

Your feedback

F2Q1 Do you agree with our guidance on disclosure in FSGs?

Small business licensees

- 100 For small business licensees who would like more guidance on what ASIC will generally consider to be adequate PI insurance cover for a small business, additional guidance is set out in Appendix 2 to this paper.

Licensees with existing PI insurance requirements

- 101 ASIC currently requires the following groups of licensees to hold PI insurance as a condition of their AFS licence:
- (a) responsible entities of managed investment schemes under Regulatory Guide 167 *Licensing: Discretionary powers* (RG 167) at paragraph (RG 167.40); and

Note: See also Regulatory Guide 133 *Managed Investments: Scheme property arrangements* (RG 133) at paragraph RG 133. 20.

- (b) investor directed portfolio service (IDPS) operators under Regulatory Guide 167 *Licensing: Discretionary powers* (RG 167) at paragraph RG 167.40; and

Note: See also Regulatory Guide 148 *Investor directed portfolio services* (RG 148) at paragraph RG 148.27.

- (c) operators of managed discretionary account (MDA) services under Class Order [CO 04/194] *Managed Discretionary Accounts*, see Regulatory Guide 179 *Managed discretionary account services* (RG 179) at paragraph RG 179.59.

102 Some other regulatory regimes require licensees to hold PI insurance cover. For example, some superannuation trustees are obliged to hold PI insurance under APRA's RSE licence regime. As their existing cover was obtained under a different regime with different objectives, such licensees still need to consider whether their existing cover is adequate for the purposes of the Corporations Act.

Proposal

F3 We propose to administer the obligation to have adequate PI insurance by requiring licensees who fall within these groups to have at least the cover that is required under our existing policies. Therefore, these existing requirements will continue to apply to these licensees.

Your feedback

F3Q1 Do you agree with our proposals regarding maintaining our existing PI insurance requirements or should those regimes be replaced with the new PI insurance requirements?

F3Q2 Should ASIC treat compliance with any existing PI insurance regimes administered by other regulators as adequate for the purposes of the Corporations Act? Please give reasons.

New licensees

103 New licence applicants applying for a AFS licence that is expected to commence on or after 1 January 2008 will need to confirm in their application that they have:

- (a) an adequate PI insurance policy in place; or
- (b) a process to ensure that they will have adequate PI insurance in place when their AFS licence takes effect.

Proposal

- F4** We propose to ask applicants for a licence that is expected to commence on or after 1 January 2008 questions about:
- (a) the insurer and the type and level of PI insurance cover they have in place;
 - (b) the scope of cover and whether the policy covers claims relating to all the products that the licensee wishes to provide under the licence; and
 - (c) whether the policy contains certain important features (e.g. the features discussed in this Section).

Your feedback

F4Q1 Do you agree with our proposals regarding new licensees (i.e. new licensees from 1 January 2008)?

G Exemptions

Key points

Some APRA-regulated entities are exempt from the requirement to hold PI insurance.

Subsidiaries of some APRA-regulated entities may also be exempt from the requirement to hold PI insurance where they have an ASIC-approved guarantee from the APRA-regulated entity (proposal G1).

Licensees who are exempt under the Regulations

- 104 The Regulations provide that certain licensees are exempt from the compensation requirements. This applies to general insurance companies, life insurance companies and authorised deposit taking institutions regulated by APRA. Licensees who are related to these APRA-regulated entities are also exempt where they have a guarantee by the APRA-regulated entity that has been approved by ASIC. The specific requirements under the legislation and regulations are outlined in Appendix 1 to this paper.

Our policy

Proposal

- G1 We propose to approve guarantees *only* where they provide no less protection than adequate PI insurance cover (reg 7.6.02AAA(3)(b)(ii)(B)).

Your feedback

- G1Q1 Do you agree with our proposal on approved guarantees? Please give reasons.
- G1Q2 We understand that APRA may treat such guarantees as a form of capital support. Taking this into consideration, to what extent do you think this exemption is likely to be used?

Rationale

- 105 In considering whether to approve a guarantee, ASIC will consider the same factors outlined in Sections B, C and F in relation to PI insurance. We understand that APRA-regulated entities are permitted to give guarantees that are limited in time and amount and we have no in principle objection to

such limits in guarantees put to us for approval (assuming, of course, that the limits are appropriate).

106 The Explanatory Statement to the Regulation suggests that to provide clarity, exempt and related licensees might also wish to provide their appropriate disclosure about their compensation arrangements in their FSGs (p. 5).

H Regulatory and financial impact

- 107 In developing the proposals for administering the compensation requirements discussed in this paper, we have carefully considered their regulatory and financial impact. On the information currently available to us we think they will strike an appropriate balance between:
- (a) the aims of the legislation of reducing the risk that successful compensation claims to retail clients cannot be met by the relevant licensees due to the lack of available financial resources; and
 - (b) facilitating activity in the financial services industry, including not unreasonably burdening licensees.
- 108 Before settling on a final policy, we will comply with the requirements of the Office of Best Practice Regulation (OBPR) by:
- (a) considering all feasible options;
 - (b) if regulatory options are under consideration, undertaking a preliminary assessment of the impacts of the options on business and individuals or the economy;
 - (c) if our proposed option has more than a low impact on business and individuals or the economy, consulting with OBPR to determine the appropriate level of regulatory analysis required; and
 - (d) conducting the appropriate level of regulatory analysis, that is, if required, completing a Business Cost Calculator report (BCC report) and/or a Regulation Impact Statement (RIS).
- 109 All BCC reports and RISs are submitted to the OBPR for approval before we make any final decision.
- 110 To ensure that we are in a position to properly complete the preliminary assessment and any required BCC report or RIS, we ask you to provide us with as much information as you can about:
- (a) the likely compliance costs;
 - (b) the likely effect on competition; and
 - (c) other impacts, costs and benefits, of our proposals or any alternative approaches: see ‘The consultation process’, p. 4 of this paper.

Appendix 1: Summary of the Regulation and additional information

Introduction

- 111 Under s912B licensees who provide services to retail clients must have compensation arrangements in place that meet the requirements of the Regulations or have been approved in writing by ASIC. The Regulations require that licensees have adequate PI insurance cover.
- 112 The compensation requirements are part of the licensees' general obligations under the Corporations Act to operate efficiently, honestly and fairly, and (unless APRA-regulated) to have adequate resources and adequate risk management arrangements. A licensee is unlikely to comply with these general obligations if they are not complying with the compensation requirements. Having adequate compensation arrangements also helps licensees comply with their other obligations, including the obligation to operate efficiently, honestly and fairly.

When will the requirements commence?

Commencement

- 113 New reg 7.6.02AAA commenced on 1 July 2007.
- 114 The Regulations provide for the following transition periods so that licensees have time to assess their business and obtain PI insurance:
- (a) licensees who have a financial services licence that commenced or commences before 1 January 2008 will need to comply with the compensation requirements from 1 July 2008; and
 - (b) new licensees whose licence commences on or after 1 January 2008 need to comply with the compensation requirements from the date of commencement of the licence.

What is required during the transition period?

- 115 Transitional compensation arrangements (under reg 7.6.02AA and ASIC's AFS licence conditions) have been in place during this time. This included the obligation for some licensees to lodge and maintain a security bond with ASIC and some licensees were required to have professional indemnity insurance under the repealed *Insurance (Agents and Brokers) Act 1984*.

- 116 These transition arrangements continue to apply to licensees from 1 July 2007 under the amended reg 7.6.02AA until licensees put in place compensation arrangements that comply with the new compensation requirements under s912B and reg 7.6.02AAA. However, all licensees must be complying with the new compensation requirements by 1 July 2008.

When will ASIC discharge security bonds?

Circumstances in which ASIC may discharge a security bond under the Regulations

- 117 Where a licensee has compensation arrangements in place that comply with the requirements under s912B and reg 7.6.02AAA, ASIC has the discretion to discharge the security bond and return it to the licensee. A licensee may lodge a certification with ASIC in the prescribed form stating that it has compensation arrangements in place that are adequate to cover claims to which the security bond could otherwise apply.

Note: Compensation arrangements may take form of either:

- (a) PI insurance cover (see Sections B, C and F);
 - (b) an ASIC approved guarantee from an APRA-regulated entity that is a related body (see the requirements for exempt licensees under Section G); or
 - (c) ASIC approved alternative arrangements (see Section D).
- 118 The licensee may take into account their own financial resources in making this certification, if, for example, they cannot obtain retroactive insurance cover for potential claims against the security bond.
- 119 ASIC has the discretion to discharge security bonds to licensees who are exempt under reg 7.6.02AAA(3) (i.e. general insurance companies, life insurance companies and authorised deposit taking institutions regulated by APRA). These licensees do not need to make any application to ASIC for the release of any existing security bonds.
- 120 Before releasing the security bond, ASIC will advertise in a daily newspaper with national circulation that it is proposing to release security bonds. ASIC will then provide details on its internet website (www.asic.gov.au) of the existence of the bond and invite people to submit valid claims against the bond. If no valid claim has been submitted three months after publication, ASIC may discharge the bond back to the licensee.

What are your options for complying?

- 121 Licensees have the following options to comply with the compensation requirements:

- (a) licensees can obtain adequate PI insurance in accordance with reg 7.6.02AAA—this is the primary method of compliance (see paragraphs 122–124 and Sections B, C and F);
- (b) some licensees are exempt from the requirements under reg 7.6.02AAA (see paragraphs 125–126 and Section G); or
- (c) some licensees can obtain ASIC approval of an alternative arrangement to PI insurance under s912B(3) (see paragraphs 127–128 and Section D).

Professional indemnity insurance

122 Following public consultation, the Commonwealth Government proposed that the primary method of compliance under the Regulations would be PI insurance. Regulation 7.6.02AAA reflects this.

Note: The Government released an Issues Paper entitled *Compensation for Loss in the Financial Services Sector—Issues and Options* for public consultation on 6 September 2002. Following public comments on the 2002 paper and further consideration, the Government released a Position Paper in December 2003, which proposed that PI insurance would be the preferred method of compliance with the obligation to have compensation arrangements.

123 Regulation 7.6.02AAA requires that financial services licensees hold ‘adequate’ PI insurance cover unless they are an ‘exempt licensee’.

124 Under the Regulations, whether the cover is ‘adequate’ is to be determined having regard to both:

- (a) reg 7.6.02AAA(1)(a): the licensee’s membership of an EDR scheme or schemes, taking account of the maximum liability that has, realistically, some potential to arise in connection with any particular claim against the licensee and all claims in respect of which the licensee could be found to have liability; and
- (b) reg 7.6.02AAA(1)(b): relevant considerations in relation to the financial services business carried out by the licensee including:
 - (i) the volume of business;
 - (ii) the number and kind of clients;
 - (iii) the kind, or kinds, of business; and
 - (iv) the number of representatives.

Exempt licensees

125 Certain licensees are exempt from the requirements under the Regulations. Under reg 7.6.02AAA(3)(a), this applies to general insurance companies, life

insurance companies and authorised deposit taking institutions regulated by APRA.

- 126 Licensees who are related to the entities listed in reg 7.6.02AAA(3)(a) are also exempt where these entities have provided a guarantee that ensures the payment of the obligations of the related licensee to its retail clients. The guarantee must have been approved in writing by ASIC. (See the definition of ‘related entity’ in s9 of the Corporations Act.)

Alternative arrangements approved by ASIC

- 127 Under s912B(3) ASIC may approve alternative compensation arrangements.
- 128 In approving any alternative arrangements to PI insurance cover, under s912B(3), ASIC must have regard to the financial services covered, whether the arrangements provide cover after the licensee ceases the business and for how long. Under reg 7.6.02AAA(2), ASIC must also have regard to whether those arrangements provide coverage that is adequate, having regard to the same kinds of factors that are considered in determining whether PI insurance is adequate (under reg 7.6.02AAA(1)).

If you cannot comply

- 129 If a licensee is unable to obtain PI insurance, is not exempt and has not obtained our approval for an alternative arrangement by the commencement of the compensation requirements, it might need to cease operating as a licensee.

What is required to be disclosed in Financial Services Guides?

- 130 Licensees must also include a statement in their FSG and the FSG of their authorised representatives about the kind of compensation arrangements they have in place and whether those arrangements satisfy the requirements for compensation arrangements under section 912B of the Corporations Act.

Is relief available?

- 131 Our policy on relief applications is set out in Regulatory Guide 167: *Licensing: Discretionary powers* (RG 167). In addition to this policy, we would also consider the clear Parliamentary intention in s912B that all licensees with retail clients have arrangements to minimise the risk that client losses cannot be compensated. Therefore we would be unlikely to give any relief from s912B.

What is the impact on existing financial requirements?

- 132 The compensation requirements are separate from and in addition to the financial resources requirement (s912A(1)(d) and the associated ASIC licence conditions). These are set out in Regulatory Guide 166 *Licensing: Financial Requirements* (RG 166). We impose these financial requirements to help ensure that licensees have access to sufficient resources to conduct their financial services businesses.

Appendix 2: PI insurance cover—additional guidance for small licensees

Who does this additional guidance apply to?

- 133 This schedule describes what ASIC will generally consider to be adequate PI insurance cover for small business licensees who want more detail about ASIC's expectations.
- 134 Licensees that have an annual turnover of less than \$2 million will be small business licensees for the purposes of our proposed additional guidance that follows.
- 135 Larger licensees may consider these factors in assessing the adequacy of PI insurance cover, however they will probably need to also consider other factors, such as those outlined in Sections B, C and F.

Additional guidance for small business licensees

- 136 If a small business licensee has obtained cover consistent with the guidance in this appendix, ASIC will generally treat this as adequate cover.
- 137 A PI insurance policy would generally be adequate if it includes the features listed in the table below.

Table 4: Key features of an adequate small business PI insurance policy

Feature	ASIC expectation
Amount of cover	see the proposal B1 for the amount of cover that is needed in <i>per claim</i> . see the proposals B2–B3 for the amount of cover that is needed in <i>aggregate</i> .
	has one automatic reinstatement.
	covers defence and administrative costs separately to the amount paid out as a result of a successful claim where possible.
Excess/ deductibles	has an excess at a level that the business can confidently sustain as an uninsured loss. Generally the excess is no more than 5% of average annual revenue.
Scope of cover	covers all breaches of the obligations of the licensee and their representatives under Chapter 7 of the Corporations Act.
	does not operate to deny or reduce claims on the basis that the licensee has informed ASIC of the claims (i.e. this should not be considered an alteration of risk under the PI insurance policy).
	has an extension to cover fraud and dishonesty of directors, employees and other

Feature	ASIC expectation
	representatives.
	has an extension to cover awards made by the relevant EDR schemes.
Exclusions	<p>does not contain the following exclusions:</p> <ul style="list-style-type: none"> • statutory breaches in general; • breaches of Chapter 7 of the Corporations Act; or • exclusions for claims relating to the very types of financial products that the business provides services in relation to under its licence (for example, if the business is to provide advice on derivatives, there should not be an exclusion in the policy for claims relating to derivatives).
Who is covered	indemnifies the licensee for the acts of its representatives.
Retroactive cover	has retroactive cover from the expiration of the previous PI insurance policy if the licensee has previously held PI insurance.
'Run-off' cover	includes run-off cover for the longest period reasonably available.

Key terms

Term	Meaning in this document
AFS Licence	<p>an Australian financial services licence under s913B that authorises a person who carries out a financial services business to provide financial services</p> <p>Note: This is a definition contained in s761A.</p>
AFS licensee or licensee	holder of an AFS licence
APRA	the Australian Prudential Regulation Authority
ASIC	the Australian Securities and Investments Commission
Automatic reinstatement	if the limit of the policy is exhausted before the end of the policy period, for payment of a new premium by the insured, the limit of indemnity is reinstated for the balance of the period to cover any new claims that may arise. The number of automatic reinstatements refers to the number of times the limit of indemnity may be reinstated
Claims incurred policy	a liability policy for claims arising out of incidents that occur during the policy period, regardless of whether the policy is still in effect at the time the claim is made
Claims-made policy	a contract that provides cover for claims made against the insured and notified to the insurer during the period of cover
Deductible or excess	the first part of a loss, which is borne by the insured. The insured is responsible for the loss up to the deductible amount and the insurer pays the remainder of the loss, up to the policy limit
EDR scheme	an external dispute resolution scheme: see s912A(2)(b) and 1017G(2)(b)
Exclusion	a provision of an insurance policy that precludes coverage in particular circumstances
Financial product	<p>generally a facility through which, or through the acquisition of which, a person does one or more of the following:</p> <ul style="list-style-type: none"> (a) makes a financial investment (see s763B) (b) manages financial risk (see s763C) (c) makes non-cash payments (see s763D) <p>Note: See Div 3 of Part 7.1 for the exact definition.</p>
Financial service	has the meaning given in Pt 7.1 Div 4 of the Corporations Act

Term	Meaning in this document
FSG or Financial Services Guide	a document that must be given to a retail client in relation to the provision of a financial service in accordance with Div 2 of Part 7.7 Note: See s761A for the exact definition
PII Market report	the report commissioned by ASIC into the market for PI insurance: Compensation Arrangements for Financial Services Licensees—Research into the Professional Indemnity Insurance Market (December 2006)
Policy Objective	is defined in paragraph 6
Product list	a list of products in relation to which the licensee and its representatives provide financial services that is agreed between the insurer and the insured and covered by the policy
Professional indemnity insurance or PI insurance	liability insurance that covers loss arising from an error, omission or negligent act occurring in conduct of the holder's professional business
RG 164	(for example) an ASIC regulatory guide (in this example numbered 164)
Regulations	the Corporations Regulations 2001
Related entity	has the meaning given under the Corporations Act for bodies corporate
Representative	has the meaning given in s910A of the Corporations Act
Retail client	a client defined as such under s761G and Chapter 7 Part 7.1 Div 2 of the Regulations
Retroactive cover	where a 'claims-made' policy extends cover into the past to cover a period of time before the policy was obtained (up to the retroactive date)
RSE licence	has the meaning given in the <i>Superannuation Industry (Supervision) Act 1993</i>
Run-off cover	cover in respect of claims made after the insurance policy has ended which have arisen from the acts or omissions of the insured during the period of insurance cover
Self-insurance	setting aside a calculated amount of money to form a source of compensation for potential claims.