

# **COMPENSATION ARRANGEMENTS IF FINANCIAL SERVICES ARE PROVIDED TO RETAIL CLIENTS UNDER SECTION 912B OF THE CORPORATIONS ACT 2001**

## **COMMENTARY ON DRAFT REGULATIONS**

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. Note that 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.

Section 912B of the Corporations Act 2001 (the Act) requires that financial services licensees providing a financial service to retail clients must have certain arrangements in place to ensure that persons who successfully claim for losses suffered due to breaches of the licensee's obligations will be paid their claims. Commencement of section 912B has been deferred until 1 January 2007 to enable consultation on the details of the required arrangements.

In September 2002, the Australian Government released an Issues Paper titled '*Compensation for Loss in the Financial Services Sector*'. Following consideration of submissions received in response to that paper, a Position Paper of the same name was released in December 2003.

In the Position Paper, the Government expressed a preference for arrangements based on professional indemnity insurance, and proposed that regulations should specify professional indemnity insurance as the primary type of arrangement acceptable for the purposes of section 912B. There would, however, be exceptions for classes of licensees that were unlikely to be unable to meet any claims against them. Further, the requirements would be subject to the power of the Australian Securities and Investments Commission (ASIC) to approve alternative arrangements. Submissions on the Position Paper generally supported the Government's preferred position in that regard.

### **THE DRAFT REGULATION**

The draft regulation is designed to:

- prescribe adequate professional indemnity insurance as the required compensation arrangement under section 912B (subject to ASIC approving alternative compensation arrangements—see below);
- prescribe the factors to take into consideration when determining what type of insurance cover is adequate;

- require licensees to note their professional indemnity cover in their Financial Services Guide;
- prescribe factors that ASIC must take into account before approving alternative arrangements to professional indemnity cover; and
- exempt certain licensees (prudentially supervised institutions and certain related entities) from the requirements.

### **What level of professional indemnity cover would be adequate?**

Rather than prescribing a form of ‘standard’ acceptable cover, the regulation makes licensees primarily responsible for analysing their own circumstances and business operations to ensure adequate cover is obtained. The intention is not to guarantee that all retail claims will be met in all circumstances. However, the requirement will substantially limit that risk without being unduly prescriptive about the level and type of insurance that must be taken out so that cover can be appropriately tailored to meet the requirements of individual businesses.

Chapter 7 of the Act requires that financial service licensees who provide services to retail clients be a member of one or more external dispute resolution schemes approved by ASIC. The schemes set caps on the size of claims. Any claims larger than the capped amounts would need to be addressed through the court system. External dispute resolution schemes are, in practice, the primary mechanism by which claims are made against licensees.

Given the importance of external dispute resolution schemes as a compensation mechanism, the potential liability for compensation that a licensee may face as a result of membership of one or more such schemes is one of the main factors that must be considered when determining whether the cover provided by professional indemnity insurance is adequate. Licensees need to ensure that their insurance cover is sufficient to cover all potential compensation claims under such schemes.

Other elements that must be taken into account include the specific characteristics of the licensee’s business such as the volume of business, number and type of clients, number of licenses held and number of authorised representatives.

### **Provisions under which a licensee could be liable**

Financial services licensees could be liable to pay compensation where they or their representatives have breached certain provisions within Chapter 7. Some of the key provisions that allow for compensation for retail clients include:

- section 1041I which allows for a person to undertake civil action for loss or damage for contravention of provisions including matters related to false and misleading statements, dishonest conduct and misleading or deceptive conduct; and
- sections 953B and 1022B which allow for civil action for loss or damage in relation to inappropriate advice and breaches in regard to disclosure and related documents.

## **Summary of professional indemnity cover in Financial Services Guide**

The draft regulation provides that licensees and their authorised representatives must summarise their professional indemnity in their Financial Services Guide. This will allow clients to review the information provided to satisfy themselves that the amount and extent of coverage is adequate should the licensee breach their obligations.

This proposed disclosure requirement will promote market discipline to assist in ensuring licensees obtain an adequate level of cover.

## **Exemption for prudentially supervised entities and related entities**

In the Position Paper, it was noted that the purpose of having compensation arrangements is to reduce the risk that providers do not have sufficient assets to meet proved claims of clients. However, some licensees are highly unlikely to be in a position that they cannot meet the claims, so should not have to have compensation arrangements in place. In the Position Paper it was proposed that such entities might include licensees subject to prudential supervision, such as insurance companies and authorised deposit-taking institutions and related entities whose obligations are guaranteed by such entities.

The draft regulation proposes that financial services licensees that are general and life insurance companies or authorised deposit-taking institutions are exempt from the requirement to have compensation arrangements in place. Related entities that have had their obligations guaranteed by such a prudentially supervised entity, in a form approved by ASIC, will also be exempt.

## **Approval by ASIC of alternative arrangements**

Under paragraph 912B(2)(b), ASIC may approve alternative compensation arrangements to those prescribed under the regulations for the purposes of paragraph 912B(2)(a). Subsection 912B(3) sets out some details that ASIC must have regard to in approving alternative arrangements, and the regulations may prescribe additional details.

## **TRANSITIONAL ARRANGEMENTS**

It is understood that many financial services licensees would already have professional indemnity cover in place sufficient to meet the adequacy requirements of the draft regulation. Nevertheless, it may be desirable to have some transitional arrangements in place to give licensees an opportunity to review their arrangements. The Government and ASIC are still considering the transitional arrangements that may be needed.

Some licensees have security bonds lodged with ASIC pursuant to prior requirements for compensation arrangements. The Government and ASIC are also considering whether transitional regulations are needed to ensure the orderly discharge of those security bonds.

**Comments are sought on:**

- whether a transitional period is required prior to the draft regulation becoming effective;
- what a reasonable transitional period would be (for example, 3 months); and
- what would be the main reasons for providing a transition period?

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**DRAFT EXPLANATORY STATEMENT AND REGULATION IMPACT STATEMENT**

A draft Explanatory Statement for the regulation is at [Attachment A](#).

A draft Regulation Impact Statement for the regulation is at [Attachment B](#).

**DRAFT EXPLANATORY STATEMENT**

Issued by the Parliamentary Secretary to the Treasurer

*Corporations Act 2001*

*Corporations Amendment Regulations 2006 (No. )*

Section 1364 of the Corporations Act 2001 (the Principal Act) provides that the Governor-General may make regulations prescribing matters required or permitted by the Act to be prescribed by regulations or necessary or convenient to be prescribed by regulations for the carrying out or giving effect to the Act.

Subsection 912B(1) of the Principal Act imposes requirements on financial services licensees to have arrangements in place for compensating retail clients. Subsection 912 B(2) of the Principal Act provides that regulations may prescribe requirements applicable to those arrangements. The arrangement must satisfy those requirements, or be approved by ASIC. Subsections 912(3) and (4) of the Principal Act provide that regulations may prescribe matters to which ASIC must have regard when approving any such arrangement. Section 912B of the Principal Act does not commence operation until 1 January 2007.

Section 942 of the Principal Act provides that regulations may prescribe supplementary information to be included in the Financial Services Guide of financial services licensees.

The Regulations amend the Corporations Regulations 2001 (the Principal Regulations) to provide for:

- compensation arrangements that financial services licensee must hold under section 912B(1), being adequate professional indemnity insurance cover;
- factors used to determine whether the cover is adequate;
- a requirement for financial service licensee holders to summarise that cover in their Financial Services Guide;
- factors regarding adequacy that ASIC must have regard to before approving alternative compensation arrangements; and
- some exemptions from the compensation arrangement requirements.

Further details on the Regulation are set out in the [Attachment](#).

The Regulations are a legislative instrument for the purposes of the *Legislative Instruments Act 2003*.

The Regulations commence on the day after they are registered on the Federal Register of Legislative Instruments.

## ATTACHMENT TO EXPLANATORY STATEMENT

### Details of the Corporations Amendment Regulations 2006 (No. )

#### Regulation 1 — Name of Regulations

This regulation provides that the name of the Regulations is the *Corporations Amendment Regulations 2006 (No. )*.

#### Regulation 2 — Commencement

This regulation provides that the Regulations are to commence on the day after they are registered.

#### Regulation 3 — Amendment of *Corporations Regulations 2001*

This regulation provides that Schedule 1 of the Regulations amends the *Corporations Regulations 2001* (the Principal Regulations).

#### Schedule 1

##### **Item [1] – After regulation 7.6.02**

Item [1] will insert a new regulation 7.6.02AAA in the Corporations Regulations.

##### *Subregulation 7.6.02AAA(1)*

Subregulation 7.6.02(1) will provide that, unless a financial licensee is an exempt licensee under subregulation 7.6.02(4), then to comply with paragraph 912B(1)(a) of the Act, they will need to have professional indemnity insurance. The professional indemnity insurance would have to comply with the adequacy requirement in subregulation 7.6.02AAA(2), and be summarised in the Financial Services Guide of the licensee and any authorised representative of the licensee.

Under paragraph 912B(2)(b) of the Act, a licensee need not comply with the professional indemnity insurance requirements of subregulation 7.6.02AAA if they have alternative compensation arrangements in place that have been approved by ASIC.

##### *Subregulation 7.6.02AAA(2)*

Subregulation 7.6.02(2) provides that the cover obtained under subregulation 7.6.02AAA(1) must be adequate, having regard to a number of factors. There are two main limbs to the adequacy test. The first limb is the liability of the licensee that might arise out of the licensees' membership of an external dispute resolution body. The second limb is other considerations relating to the licensees' business.

In relation to the first limb, expressed in paragraph 7.6.02AAA(2)(a), the regulation requires regard to be had to the highest possible liability that a licensee might be subject to as a result of membership of one or more external dispute resolution schemes. External dispute resolution schemes have a monetary cap on the liability in relation to any particular claim. It is intended that paragraph 7.6.02AAA(2)(a) would

require regard to be had to both the monetary cap that applies in relation to relevant schemes, and the volume of claims that the licensee could be expected to face. Obtaining professional indemnity cover sufficient to meet potential liability under external dispute resolution schemes would represent a ‘bare minimum’ of cover.

The second limb, expressed in paragraph 7.6.02AAA(2)(b), requires regard to be had to various key aspects of the licensee's business, such as volume, clients, kind of business. The number of financial services licenses held and the number of authorised representatives are also relevant factors. The factors in the second limb could inform consideration of the expected volume of claims under the first limb. They are also independently relevant because, even though most claims faced by a licensee relating to a breach of Chapter 7 would be expected to be brought through an external dispute resolution scheme, some may also be brought through the courts. This may occur if, for example, a retail client has a claim that exceeds the monetary cap on claims under an external dispute resolution scheme by a considerable margin. The extent to which potential claims outside of the external dispute resolution framework need to be considered would depend on the nature and scope of the licensee's business.

#### *Subregulation 7.6.02AAA(3)*

Subregulation 7.6.02AAA(3) is made under paragraph 912B(3)(c) of the Act. It provides that, before ASIC approves an alternative compensation arrangement to professional indemnity cover under paragraph 912B(2)(b), ASIC must have regard to the same factors to determine adequacy that are set out in subregulation 7.6.02AAA(2). These are in addition to the factors ASIC is required to consider under paragraphs 912B(3)(a) and (b) of the Act.

#### *Subregulation 7.6.02AAA(4)*

Subregulation 7.6.02AAA(4) provides for exemptions from the requirements of the regulation. Those licensees are not required to have professional indemnity cover because it is highly unlikely that they would be unable to meet claims made against them regarding misconduct in favour of retail clients. There will be two categories of exempt licensees:

- general insurance companies, life insurance companies and authorised deposit-taking institutions that are regulated by the Australian Prudential Regulation Authority (APRA); and
- a licensee that is related to one of the APRA-regulated entities and the entity has guaranteed the obligations of the licensee in a form approved in writing by ASIC.

The definition of ‘related entity’ in section 9 of the Act may assist with determining whether a licensee is ‘related’ to an APRA-supervised entity for the purposes of paragraph 7.7.02AAA(2)(b).