

**COMPENSATION ARRANGEMENTS FOR
FINANCIAL SERVICES LICENSEES**

Regulation Impact Statement

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REGULATION IMPACT STATEMENT - COMPENSATION ARRANGEMENTS FOR FINANCIAL SERVICES LICENSEES

1. BACKGROUND

Under section 912B of the *Corporations Act 2001* (Corporations Act), financial services licensees providing a financial service to retail clients must have arrangements for compensating those persons for losses suffered due to breaches of relevant obligations in Chapter 7. This requirement was introduced by the *Financial Services Reform Act 2001*, which amended the Corporations Act in a wide range of areas.

At the time of introduction, a number of concerns were raised about making arrangements to meet liabilities where compensation payments were ordered to be paid. Commencement of the obligations under section 912B was deferred and will not take effect until 1 January 2007. This has allowed the Government to consult on and finalise the details of prescribed compensation arrangements for financial services licensees.

2. THE PROBLEM

The complexity and non-tangible nature of financial products and services increases the probability that financially unsophisticated consumers can misunderstand or be misled about the nature of the product or service being offered, particularly in relation to the obligations and risks attached. Most countries have established a regulatory regime for financial products and services that is considerably more developed than that for most non-financial markets, due to the complexity of the products and services on offer and the critical function that they play in the economy.

An important part of the Australian regulatory framework is set out in Chapter 7 of the Corporations Act which sets out certain requirements that must be met by financial services licensees. Licensees breaching these requirements are liable to compensate retail clients for losses suffered as a consequence. The problem is that financial services licensees are not always in a position to meet claims made against them, out of their own resources, leaving open the possibility that retail clients may not obtain adequate payments of compensation claims.

The type of breach giving rise to compensation claims under Chapter 7 may vary depending on the industry sector concerned. The main ones relate to disclosure (for example, Product Disclosure Statement requirements) and conduct (prohibitions on misleading and deceptive conduct). Financial services providers may be liable to their clients for losses arising out of such breaches themselves or because of the actions of their authorised representatives.

While it is not possible to provide specific statistics, it is recognised that virtually all adult Australians have an interest in some form of financial products, such as superannuation, life

insurance, directly held shares or managed investment schemes. The harmonisation of the regulation of financial service providers provides a prime opportunity to ensure that retail clients are better protected.

The size of the problem is difficult to estimate and was originally raised in December 1997 as an issue during the consultations leading up to the enactment of the reforms of financial services in 2000. In 2002 the then Minister asked that an issues paper be undertaken to obtain feedback from industry on the extent of the problem.

In that context, the Australian Securities and Investments Commission (ASIC) reported that there had been cases in the previous three years where clients had suffered substantial losses that had gone or were likely not to receive compensation payments. These occurrences tended to involve licensees whose insurance did not provide relevant cover, no insurance existed or the assets of the business were insufficient to cover claims. Those cases highlighted the fact that uncompensated claims have serious implications for investors, the financial services market as well as the economy.

The Government views the ability to make full payments of successful compensation claims as an essential element for the protection of consumers in the financial sector and to assist in ensuring a confident and healthy financial services market.

Market information

At 30 September 2006, ASIC records show there were 4,464 Australian financial services licensees, comprising mainly fund managers, stockbrokers, insurance brokers and financial advisers. Licensees vary widely in size. At one end of the spectrum are entities which are owned by major financial institutions such as banks and insurers and at the other are independently owned small businesses. ASIC's latest statistics show that for the period to 30 September 2006, just over 83 per cent of these licensees are authorised to provide personal advice (advice based on individual circumstances and needs) as well as general advice, to retail clients. By revenue, the majority of those licensees (around 80 per cent) are at the smaller end of the market, that is, they take in less than \$5 million in revenue.

A case in point

The importance of having adequate financial arrangements to meet liabilities arising from successful compensation claims has been highlighted in the context of a high profile collapse of several property development projects operated by the Westpoint Group (Westpoint) which ran into serious financial difficulties. There, a significant number of retail clients invested in promissory notes issued by Westpoint, and due to its collapse, many lost their investment. The total amount invested is estimated at around \$400 million and involves about 4000 retail clients. Some of these investors are self-managed retirees who have lost some or all of their retirement savings. These investments were vigorously promoted by various financial advisers and offered very high returns. From a survey undertaken by ASIC, it has determined that the majority of people investing in Westpoint did so through a licensed financial adviser, who they believe misled or deceived them.

Private litigation as well as investigation by ASIC continue.

3. OBJECTIVES

Retail consumers of financial services are protected under the provisions of Chapter 7 of the Corporations Act by having causes of action for compensation in appropriate circumstances. Licensees may be ordered to compensate a client for a breach of obligations in the first instance, through the decision of an external dispute resolution body (which relevant licensees must participate in) or, if ultimately necessary, through the courts.

The objective is 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.

4. OPTIONS

OPTION 1 – DO NOTHING

The first option is to allow section 912B of the Corporations Act to commence without supporting regulations. In that case, the provisions would operate as follows:

- subsection 912B(1) requires licensees to have arrangements for compensating retail clients for loss or damage suffered as a consequence of breaches of the relevant obligations under Chapter 7 of the Act by the licensee or its representatives;
- subsection 912B(2) provides that the arrangements must satisfy the requirements (if any) set down in regulations *or* be approved in writing by ASIC;
- subsection 912(3) sets out a number of factors to which ASIC must have regard in approving arrangements; and
- subsection 912(4) provides for regulations to be put in place in relation to matters to which ASIC must have regard.

Accordingly, in the absence of any regulation to satisfy subsection 912B(2), financial services licensees dealing with retail clients would either have to determine the appropriateness of compensation arrangements without statutory guidance or have alternative arrangements in place that were approved in writing by ASIC.

OPTION 2 – PROFESSIONAL INDEMNITY INSURANCE (WITHOUT DETAILED PRESCRIPTION)

The option proposes a regulation that would prescribe professional indemnity (PI) insurance as one means of complying with section 912B. Although there would be some principles-based requirements for the adequacy of cover, the regulations would not prescribe in detail the type of insurance required. The adequacy requirements would be linked to the licensee's exposure to claims through external dispute resolution bodies and other relevant characteristics of the licensee's business. The reason for the link to external dispute

resolution schemes is that financial service licensees must be a member of such a scheme to be licensed, and consequently, retail clients make the majority of claims for compensation through such schemes.

Licensees would be required to summarise their professional indemnity insurance coverage in their Financial Services Guide.

Under section 912B alternative arrangements would also be acceptable, provided they are notified to and approved by ASIC. The regulations would provide that ASIC should consider adequacy requirements when examining alternative arrangements.

Professional Indemnity Insurance

Professional indemnity insurance indemnifies professional people for their legal liability to their clients and others relying on their advice and/or services. It provides indemnity cover in the event that a client suffers loss, material, financial or physical, that is directly attributable to negligent acts of the professional. The nature of professional indemnity policies differ according to the professions being indemnified and their activities. The three largest PI product types identified by APRA through its National Claims and Policies Database (NCPD) report issued in July this year were: professional indemnity and errors and omissions, medical malpractice and directors and officers insurance which together make up 93 per cent of gross written premiums.

Given the nature of the insurance, it is not possible to isolate PI insurance provided to financial services licensees from the NCPD as the data covers all sectors. Other reasons for caution with the data include that all policies differ, some policies can be capped, can include significant exclusions and others can place an excess on the claims which can be quite large (sometimes as large as the limit placed on their external dispute resolution scheme claims).

The major players in the industry, by virtue of their size and capital base, would either have the assets to meet any payout claims, and/or already have some form of insurance in place to do so. Many of these licensees are also APRA regulated and as such will be exempted from the requirements because of their size or because of the obligations already placed on them by APRA. No prudential regulator can guarantee that a body under its supervision will not fail, but the risk is low. To do differently would duplicate coverage and place the financial burden of cover on the shoulders of the larger licensees who are better placed to meet costs.

Licensees that are prudentially regulated by the Australian Prudential Regulation Authority (APRA) would be exempt from these requirements.

OPTION 3 - PROFESSIONAL INDEMNITY INSURANCE (WITH DETAILED PRESCRIPTION)

This option is the same as Option 3 except that, rather than principles-based requirements regarding adequacy, the regulation would be very specific about the details of acceptable professional indemnity insurance coverage. It would, for example, prescribe in dollar terms the amount of coverage required by reference to some attribute(s) of the licensee's business and contain specifics about other key terms of the insurance policy.

OPTION 4 - CENTRALISED FUND

This option would require licensees to contribute to a central fund, similar to the ASX funded National Guarantee Fund, but one that would be dedicated to meeting compensation claims of retail clients under Chapter 7. Such a fund could be created by statute and supported by compulsory levies, or be private schemes run by industry/professional bodies.

OPTION 5 - SECURITY BONDS

This option would require licensees to lodge security bonds with, for example, ASIC, that could be used to meet compensation claims of retail clients if the licensee was unable to do so. Such an arrangement currently continues in place for persons who were defined as securities dealers under the previous law. However, these bonds are only for an amount of \$20,000. The application of the new system of security bonds to licensees would require a very substantial increase in the amount of the bond and a method for making bonds proportional to the size of the business of licensees.

5. IMPACT ASSESSMENT

IMPACT GROUPS

Three groups are impacted directly – financial services licensees, government/regulators and retail consumers of financial services and products.

DATA

The identification of the level of potential losses to retail clients is difficult to determine and therefore quantify. There is no available comprehensible and accurate data to indicate how often losses are incurred and to what extent. Figures on financial services licensees going into external administration also do not necessarily reflect losses to clients.

At 30 June 2005, there were 4,464 Australian financial services licensees, mainly comprising fund managers, stockbrokers, insurance brokers and financial advisers. Of those, more than 3700 (around 83 per cent) are authorised to provide advice to retail clients. Based on ASIC records to 30 September 2006, and in terms of revenue, the majority of licensees reported revenue of less than \$5 million (approximately 3500), representing 80 per cent of the licensees sector. At one end of the spectrum are entities which are owned by major financial institutions such as banks and insurers. At the other end are independently owned small businesses.

ASIC records, based on 2004 data, showed that around 60 per cent of the licensees at that time held professional indemnity insurance. Records show that the annual premiums paid at that time ranged from less than \$1000 to over \$25,000. Around 50 per cent of the premiums

paid were lower than \$25,000, with 22 per cent lying in the \$5000-\$15,000 range. The level of insurance ranged from less than \$1 million to over \$100 million with just under 87 per cent of indemnity coverage within the range of \$1 million - \$19 million.

ACCC data recorded that in 2004 the average yearly premium for professional indemnity insurance was just under \$10,000.¹

NOTE: The data above has been utilised for identifying likely costs for options. However the data needs to be viewed with caution as it is not necessarily up-to-date and, particularly in the case of ACCC data, has been collated across a number of sectors and not just the financial services sector. Stakeholders are invited below to comment or contribute information that would assist to ensure the estimated costs of options reflect current market prices and conditions.

IMPACT ASSESSMENT OF THE OPTIONS

Option 1 - Do nothing/status quo

Financial services providers

Costs

To refrain from making any regulation and allow section 912B to commence operation would require all licensees to have arrangements approved by ASIC under paragraph 912B(2)(b).

After obtaining the approval, licensees would need to comply with any conditions imposed which may produce some additional compliance costs. The costs for financial service providers that would result from this option would depend on the types of arrangements that ASIC permitted.

Unless transitional arrangements are put in place, licensees that did not have ASIC-approved arrangements in place at the commencement of section 912B would be in breach of the law, which would have undesirable consequences for the licensees and potentially result in additional costs.

Benefits

This option might provide a greater level of flexibility for licensees, although this would depend on the extent to which ASIC decided to take a flexible approach to considering applications or set down some guidelines on what sort of arrangements were acceptable.

¹ Australian Competition and Consumer Commission, *Public liability and professional indemnity insurance—Fifth monitoring report*, July 2005.

Government

Costs

ASIC would need to develop guidance on acceptable arrangements and potentially thousands of applications from licensees for approval of their proposed arrangements.

The costs for ongoing ASIC monitoring would depend on the arrangements that ASIC permitted. ASIC would need to either divert resources from other activities, or receive supplementation from the Budget to meet the demands of processing the applications.

Consumers

Costs

Any costs to licensees of having alternative arrangements in place and obtaining approval in writing from ASIC would ultimately be passed on to consumers in the form of higher charges for financial products and services.

Benefits

Having only ASIC-approved schemes being acceptable, rather than using a regulation to prescribe one or more acceptable schemes, would result in all compensation arrangements being subject to the direct scrutiny of the regulator. This scrutiny could provide retail clients with additional comfort that all arrangements entered into by financial services licensees are adequate to guarantee most compensation payments.

Option 1

Request for comment

Are there additional costs and benefits for the above option, which are not listed?

Information to assist with quantification of costs and benefits is sought for inclusion in the final regulation impact statement.

Option 2 - Professional indemnity insurance (without detailed prescription)

Financial services providers

Costs

ACCC figures across all sectors record the average yearly premium for professional indemnity insurance in 2004 at just under \$10,000.² ASIC figures for financial services

² Australian Competition and Consumer Commission, *Public liability and professional indemnity insurance—Fifth monitoring report*, July 2005.

licensees show that around 60 per cent of Australian financial services licensees paid premiums of less than \$25,000 for the year 2003-2004.

As licensees should currently have professional indemnity insurance or adequate alternative arrangements already in place, the additional cost of adopting this option is not expected to be great for most licensees. However, licensees will need to review their coverage to ensure it meets the 'adequacy' tests and possibly seek supplementary cover if their current coverage is inadequate.

Licensees will need to include a summary of their professional indemnity coverage in their Financial Services Guide (FSG). This will require licensees or their advisers to draft the summary and have it incorporated into all FSG publications. A transitional period would allow sufficient time for licensees to update their FSGs. Initial costs would be moderate, but once the exercise is completed, ongoing costs would be expected to be fairly low.

Licensees that wish to have alternative compensation arrangements will be required to make the appropriate application to ASIC - such alternative arrangements would also need to be assessed against the adequacy requirements. Note that the costs of applying to ASIC for written approval of alternative arrangements is a feature of all options—the only additional cost under this option is the costs of assessing the arrangements against the adequacy requirements. In terms of resource costs, this cost is difficult to quantify, and would be subject to meeting ASIC policy requirements.

Benefits

Financial services licensees will ultimately benefit through an increased level of consumer confidence, which assists with ensuring the market in which they operate is generally healthy.

Government

Costs

The key cost for Government would be ASIC's role in the start-up processes, initial transitional period and with ongoing monitoring. This would include the need to review the adequacy of coverage obtained by licensees. It is possible that professional indemnity insurers may, for their own commercial reasons, play a role in ensuring adequacy that could mitigate the extent to which ASIC would need to independently conduct reviews. Similarly, the disclosure requirement may have the effect of encouraging licensees to ensure their coverage is adequate as consumers may choose to deal with licensees that demonstrate in their FSGs that their arrangements will be sufficient to meet reasonable compensation claims.

Another administrative cost for ASIC would be in providing approval for alternative arrangements, including applying the adequacy requirement for alternative arrangements.

Benefits

Minimising the risk that retail consumers may not have compensation claims paid increases confidence in the financial services market, which will help in maintaining participation by retail customers. A high participation rate in the financial services markets benefits economic performance, which benefits the community generally.

Consumers

Costs

The cost of obtaining professional indemnity insurance, should it need to be modified, or for new take-ups, could be passed on to consumers, particularly in regard to smaller business operations. However, in many cases licensees already hold cover for their own commercial reasons, so the additional cost burden for consumers should not be significant overall.

Benefits

In the case of consumers who have a legitimate claim against a licensee for a breach of Chapter 7 obligations, it would substantially reduce the prospects that the claim would not be able to be met in full. This will provide significant protection to persons whose claims would otherwise not be met.

Option 2:

Request for comment

Are there additional costs and benefits for the above options, which are not listed?

Information to assist with quantification of costs and benefits is sought for inclusion in the final regulation impact statement.

Option 3 - Professional indemnity insurance (with detailed prescription)

The costs and benefits of this option are the same as for Option 2, with the following modifications.

Financial Services Providers

Costs/benefits: The detailed prescription of insurance policy requirements would reduce the scope for tailoring of professional indemnity policies to particular businesses. Effectively establishing a ‘pro forma’ form of policy document for this purpose may save time, but it would stifle competition and innovation and could lead to some policies being inappropriate to the needs of the licensees, leading to unnecessary costs. It would also result in many more licensees having to make changes to their existing professional indemnity cover in order to comply with the detailed requirements.

Government

Costs/benefits: Establishing a pro-forma policy would save some administrative costs for ASIC relative to assessing policies against the ‘adequacy’ principles in Option 2.

Consumers

Costs/benefits: The increased costs for licensees relative to Option 2 would be passed on to consumers.

Option 3

Request for comment

Are there additional costs and benefits for the above options, which are not listed?

Information to assist with quantification of costs and benefits is sought for inclusion in the final regulation impact statement.

Option 4 - Centralised fund

Financial services providers

Costs

The precise costs would depend on the way in which such a scheme is structured. However, licensees would be required to meet the bulk of the costs through, for example, levies and other charges to sustain the fund and meet the costs of its administration.

With a centralised fund, it is unlikely that the costs to individual licensees could be matched as precisely to the risks as would occur under Option 2. Accordingly, some licensees could effectively be cross-subsidising others.

If the fund were to be managed by industry/professional bodies, the costs of such bodies would need to be met through charges on its members or government funding may need to be provided.

Licensees who object to participating are likely to seek to have ASIC approve alternative arrangements, and if successful, this would reduce the number of licensees contributing to the fund, making it more costly.

Benefits

The benefit for financial services licensees would be similar to those under Option 2.

Government

Costs

If a central fund were to be established through a statutory scheme, establishment costs would be borne by the Government. These costs could be significant. However, they would need to be recouped from licensees through levies.

The costs of ongoing monitoring and compliance would be relatively less than for Option 2, because there would be no need to assess against adequacy requirements.

Benefits

The benefits for Government would be similar as for Options 2 and 3.

Consumers

Costs

Consumers would ultimately bear the costs of the licensees, in the form of higher charges for retail financial products and services.

Benefits

The benefits for consumer would be similar as for Options 2 and 3. However, the fund could be structured so that payouts were made regardless of whether the licensee concerned had made appropriate contributions. This may provide a slightly greater level of confidence that claims will be met.

Option 4

Request for comment

Are there additional costs and benefits for the above options, which are not listed?

Information to assist with quantification of costs and benefits is sought for inclusion in the final regulation impact statement.

Option 5 - Security bonds

Financial services providers

Costs

The costs for financial services licensees would be significantly more than under Options 2, 3 and 4. Providers of security bonds, such as financial institutions, usually require the licensee to offer up some security themselves to cover the risk, in the form of security over cash in an account or perhaps security in the form of a real property mortgage. Although this may be feasible in respect of relatively small security bonds, a large number of financial services licensees would not have sufficient unencumbered assets to cover the size of the security bond that would be required to guarantee meeting compensation claims under Chapter 7.

Further, those that could meet the requirements would have significant assets 'tied up' in order to service the security requirements of the bond provider, which would affect the potential financial performance of their business. There could be a strong inclination for licensees to instead seek ASIC approval for alternative arrangements.

More significantly, previous legislation prescribed only a \$20,000 bond, however it is clearly insufficient by today's standards and is more likely to be in the region of upwards of \$1 million in order to sufficiently cover both the size of potential individual claims as well as allowing for multiple claims that could potentially be made against individual licensees. This may well deny entrance to the market or result in the exit from the market of some licensees not willing to risk their own assets.

Benefits

The benefit for financial services licensees would be similar to those under Option 2.

Government

Costs

The costs of establishing and administering the security bond scheme would need to be met by ASIC. The costs of doing so would be greater for ASIC than Options 2 and 3.

Benefits

The benefits for Government would be similar as for Options 2 and 3.

Consumers

Costs

Consumers could ultimately bear the costs in the form of higher charges for financial products and services, as the costs for licensees would be greater than Options 2 and 3, the costs would also be greater for consumers.

Benefits

The benefits for consumer would be similar as for Options 2 and 3.

Option 5

Request for comment

Are there additional costs and benefits for the above options, which are not listed?

Information to assist with quantification of costs and benefits is sought for inclusion in the final regulation impact statement.

6. CONSULTATION

The initial consultation processes commenced in 2002 when the Government released an Issues and Options Paper titled 'Compensation for Loss in the Financial Services Sector' (the Issues and Options Paper). There was a general acceptance of the need for some

compensation arrangements but there was also concern that the mechanism adopted not be excessive in proportion to the problem and that cross-subsidisation be minimised. Following consideration of the responses to that paper, a Position Paper 'Compensation for Loss in the Financial Services Sector' (the Position Paper) was released in December 2003.

The position paper set out a number of options, with the Government's preferred option being an arrangement mainly based on professional indemnity insurance. A new regulation was proposed to give effect to the requirements under section 912B. Interested parties were invited to submit further comments on that option. Submissions generally supported the Government's proposed position for an arrangement mainly based on professional indemnity insurance.

ASIC has been consulted and has provided significant input into the development of the regulation.

7. CONCLUSION AND RECOMMENDATION

Doing nothing (Option 1), would result in significant costs and other negative consequences for financial services licensees and ASIC in preparing, lodging and processing applications for approval of compensation arrangements, with little corresponding benefit. The Government rejects this option.

Option 2, which would prescribe professional indemnity insurance as a means of complying with the compensation requirement, has a number of initial costs for financial services licensees, ASIC and ultimately consumers. However, due to the relative flexibility involved, it would be of least cost of all options overall. As some financial services licensees already have professional indemnity cover for other reasons that may not require any modification, this option has the least cost but also produces benefits for individual consumers and consumer confidence equal to, or nearly equal to, all the other options.

The benefits of Option 3 are very similar to those under Option 2 but increase the complexity of regulation through a prescriptive approach. On that basis, the initial and ongoing costs for financial services licensees are significantly greater. Therefore it is rejected.

Options 4 and 5 (centralised fund and security bonds) may provide greater benefits in that the risk of consumers having unpaid compensation claims is slightly less than under Options 2 and 3. However, under both of the options the costs for licensees and government is likely to be much greater than the professional indemnity insurance options. Accordingly, they are rejected.

Recommendation

The Government considers that Option 2 represents the most effective option from a cost/benefit perspective. The option is not expected to have significant effects on the financial services market or financial services licensees. The evidence suggests that many licensees (estimated by ASIC for the 2003-2004 periods to be nearly 60 per cent), have

already taken are professional indemnity insurance. Providing that insurance is adequate, it should not be a major cost to update that cover.

For those not already covered, and for new market entrants, PI insurance costs are not expected to be significant barriers to entry - neither in terms of the actual premium costs nor the processes that will need to be undertaken to obtain either insurance itself or alternative arrangements. However the cost impact of taking up alternative arrangements will very much depend on what ASIC may determine as being appropriate and the preference of the relevant licensee and the size of their business activities.

This option is seen as being most efficient in terms of reasonably low cost for Government, licensees and consumers in terms of its implementation and ongoing operation while also providing the market with increased integrity.

8. IMPLEMENTATION AND REVIEW

ASIC, through its role in monitoring compliance and approving alternative arrangements, will monitor the effectiveness of implementation and advise on any practical difficulties on an ongoing basis.

Request for Comment

The Government is seeking comments from stakeholders on an appropriate transitional period to enable licensees to review and, if necessary, make modifications to their professional indemnity cover, or obtain approval from ASIC for alternative arrangements.