



Australian Government

The Treasury

COMPENSATION FOR LOSS IN THE
FINANCIAL SERVICES SECTOR

POSITION PAPER

December 2003

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A request made under the *Freedom of Information Act 1982* (Cth) for a submission marked confidential to be made available will be determined in accordance with that Act.

FOREWORD



I am pleased to release this, the second, paper in the Commonwealth's review of compensation for loss in the financial services sector. The review was initiated to promote discussion on whether compensation mechanisms should be required in this sector and, if so, what they should cover and the appropriate mechanisms.

We were gratified with the level of interest in the first paper, entitled *Compensation for Loss in the Financial Services Sector Issues and Options*, which was released in September 2002 — twenty-nine responses were received, indicating a wide range of views.

The purpose of this paper is to pose a Government position and seek comments on further issues. It is only with public input that we will reach a viable and appropriate regime, having regard to both industry and consumer needs.

It should be noted that the exercise remains limited to losses incurred in connection with the provision of financial services. It is not about losses suffered as a result of changes in the value of financial products through, for example, market fluctuations or loss of insurance cover caused by the insolvency of the issuer.

Compensation arrangements are relevant where there has been misconduct in the provision of financial services, but their importance should not be overestimated. They form one element of the regulatory regime, which includes licensing and disclosure obligations.

There remains an onus on the consumer to make whatever checks they can. Consumers are encouraged to check ASIC's advice on the precautions they should take. No compensation arrangements or Government guarantees a financial service.

The position put in this paper takes into account difficulties with the professional indemnity insurance market, and envisages flexibility in the mechanisms which may be adopted. It seeks to reach an appropriate balance between consumer protection and the cost of such protection to industry.

Again we seek your comments on the points for discussion raised in this paper.

The Hon Ross Cameron MP
Parliament Secretary to the Treasurer
Parliament House
Canberra

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ABBREVIATIONS AND TERMS USED

AAPBS	Australian Association of Permanent Building Societies
Agents and Brokers Act	<i>Insurance (Agents and Brokers) Act 1984</i>
APRA	Australian Prudential Regulation Authority
ASFA	Association of Superannuation Funds of Australia
ASIC	Australian Securities and Investments Commission
ASX	Australian Stock Exchange
CASAC	Companies and Securities Advisory Committee (now the Corporations and Markets Advisory Committee)
CLERP	Corporate Law Economic Reform Program
CLERP 6	Paper No. 6 of the Corporate Law Economic Reform Program entitled <i>Financial Markets and Investment Products</i>
Corporations Act	<i>Corporations Act 2001</i>
CS facility licensee	Holder of a CS facility licence under Part 7.3 of the Corporations Act
CUSCAL	Credit Union Services Corporation (Australia) Limited
External dispute resolution scheme (EDR)	One of the schemes approved by ASIC under section 912A of the Corporations Act. Each financial services licensee providing services to retail clients must be a member or one or more such schemes.
FICS	Financial Industry Complaints Service
FPA	Financial Planning Association
financial services licensee	Holder of an Australian financial services licence under Part 7.6 of the Corporations Act
FSR Act	<i>Financial Services Reform Act 2001</i>
FSCPC	Financial Services Consumer Policy Centre

ICA	Insurance Council of Australia
ICAA	Institute of Chartered Accountants in Australia
IFSA	Investment and Financial Services Association Ltd
Issues Paper	<i>Compensation for Loss in the Financial Services Sector — Issues and Options</i> , released by the Parliamentary Secretary to the Treasurer in September 2002 and available on www.treasury.gov.au .
market licensee	Holder of an Australian market licence under Part 7.2 of the Corporations Act
NIBA	National Insurance Brokers Association of Australia
Proper authority holder	The authorised representative of a dealer under old Chapter 7 of the Corporations Act
RSA products	Products under the <i>Retirement Savings Account Act 1997</i>
SDIA	Securities and Derivatives Industry Association
SEGC	Securities Exchanges Guarantee Corporation Limited
SFE	SFE Corporation Limited
TCA	Trustee Corporations Association of Australia

1. INTRODUCTION

1. This is the second paper on the review of compensation for loss in the financial services sector in Australia (the compensation review).
2. The first was entitled *Compensation for Loss in the Financial Services Sector — Issues and Options* (the Issues Paper). It was released in September 2002 for a two month public exposure period, ending on 8 November 2002.
3. Its purpose was to trigger discussion on the major issues involved in compensation in this sector by posing a series of issues.
4. The purposes of this paper are:
 - to refer to the views expressed in response to the Issues Paper (Chapter 2) (with a summary in Attachment B);
 - to discuss various issues arising from those views (Chapter 3);
 - to outline the Government's position (Chapter 4); and
 - to raise a number of specific issues which require further consideration (Chapter 5).
5. The address where you should send your comments is to be found on the page of this paper immediately following the title page. The deadline for comments is at the same place. Submissions received after that date may not be able to be taken into account.

What is the purpose of the review?

6. As indicated at the beginning of the Issues Paper, the purpose of the compensation review is to consider the need for and requirements of compensation arrangements in the financial services sector. The aim is to ensure that Australia has a comprehensible and efficient compensation regime that provides appropriate protection for investors and does not impose an unjustified burden on participants in the sector.

What triggered the review?

7. The compensation review follows the enactment of the *Financial Services Reform Act 2001* (the Financial Services Reform Act, also known as CLERP 6). That Act harmonised the regulation of financial markets, and of financial service providers in a new

Chapter 7 of the Corporations Act, but wholesale review of compensation arrangements was not part of the CLERP 6 agenda.

8. During consultation on the exposure draft of the Financial Services Reform Bill, some basic questions with the then current and proposed compensation arrangements were brought forward. We were asked whether continuing to require market licensees to have compensation arrangements was justifiable. It was suggested that the obligation to have compensation arrangements should instead rest on financial services licensees.

9. Since time did not allow a considered review of compensation arrangements as a whole before the proposed introduction of the Financial Services Reform Bill, only modest amendments were included. However, in his second reading speech, the Hon Joe Hockey MP, who was then the Minister for Financial Services and Regulation, indicated that the reforms in the Bill were not the Government's final position and that more detailed research and consultation was needed in this area.

Consideration by the Companies and Securities Advisory Committee

10. Following introduction of the Financial Services Reform Bill, Mr Hockey asked the Companies and Securities Advisory Committee (CASAC) on 26 April 2001 to consider issues relating to compensation in the financial services sector and report on them within nine months.

11. In September 2001 CASAC issued a Consultation Paper that proposed for discussion a scheme to compensate retail clients of insolvent financial services licensees who were intermediaries¹. The scheme, which was limited to certain investments, would apply only when the intermediary was insolvent or unable to pay, and would cover the return of client property held by the licensee and losses to retail clients arising from any improper conduct by the licensee.

12. The CASAC Consultation Paper received only limited circulation, given the time restraints for reporting. The nine responses received were mixed.

13. The Convenor of CASAC conveyed the Committee's preliminary thinking and a summary of the comments received on consultation to the Treasurer in December 2001. The Convenor advised that the Committee needed to consider ASIC's policy on approved retail client compensation arrangements before finalising its report.

14. Further details of the proposal in the CASAC Consultation Paper and responses to it are included in Chapters 8 to 10 of the Issues Paper. Paragraphs 233 to 234 of that paper summarise the proposed scheme.

¹ This paper is available on the Committee's website: www.camac.gov.au.

Senator Campbell's announcement

15. On 28 February 2002, Senator Campbell, the Parliamentary Secretary to the Treasurer with responsibility for the Corporations Act, announced that he intended to release an Issues Paper for industry consultation on a framework for compensation arrangements in the financial services sector. Senator Campbell indicated that he had asked Treasury to prepare the Issues Paper in consultation with ASIC and CASAC (now renamed the Corporations and Markets Advisory Committee), with the aim of seeking industry feedback on the issues. This process therefore subsumes the previous CASAC review.

Release of the Issues Paper

16. The Issues Paper was released on 6 September 2002 for a two month public exposure period, ending on 8 November 2002. It is available in hard copy, and on the Treasury website <http://www.treasury.gov.au>.

Outline of the Issues Paper

17. The purpose of the Issues Paper was to promote discussion of the basic issues arising from this subject, including the justification and purpose of compensation arrangements in this sector, the conduct causing loss for which compensation should be payable, the persons on whom the obligation to make such arrangements should fall and the mechanisms available.

18. The Issues Paper sought to explore the problem and the government's objective in this connection. It asked whether compensation arrangements should be required by legislation. It outlined the current compensation arrangements and asked how they should be reformed. It asked in what circumstances should compensation be payable and to whom. The mechanisms available were also considered — including those involving an obligation on financial services licensees and those involving market licensees. It asked whether a broad statutory scheme is warranted and various subsidiary issues.

19. The approach adopted in the Issues Paper of raising all mechanisms, including a broad statutory scheme, was necessary in the light of the time available before the end of the FSR transition period, the need to minimise the number of papers to reach a conclusion and the CASAC recommendation.

20. The Paper specifically put 11 principal issues and 14 secondary issues.

Meetings held during the consultation period

21. As part of the consultation process, Treasury offered to hold one or more meetings during the consultation period to discuss the issues raised in the paper. The only persons

who expressed an interest in attending such a meeting were in Sydney or Canberra. A meeting were therefore held on 11 October 2002 in Sydney which 12 people representing 10 organisations attended. A subsequent meeting focusing on the current state of the professional indemnity insurance market, from an insurance broker's and underwriter's perspective, was held on 14 November 2002.

Submissions received in response to the Issues Paper

22. No submissions were received by the end of the public exposure period, 8 November 2002. 29 submissions were received between 9 November 2002 and 31 January 2003.

23. They were lodged by a variety of organisations and people including industry associations, banks and insurance companies, the exchanges, a consumer organisation and three individuals². We are very grateful to all those who made the effort to respond.

24. They indicate a wide range of views and limited consensus. In Chapter 2 of this paper you will find an overview of the views expressed and in Attachment B a summary of the submissions.

Release of this position paper

25. As indicated above, the purpose of this position paper is to progress the discussion by summarising the responses received, putting a position and posing further particular questions to which you are invited to respond.

26. Its release has been delayed in part by the need to consult members of the insurance industry on the availability of professional indemnity insurance.

27. In coming to the position put in this paper, the following factors have been important:

- the current state of the professional indemnity insurance market and steps being taken to address this;
- the mechanisms available and the state of evidence of loss to consumers of financial services; and
- the costs and benefits of the various options to consumers, business and the Government.

2 A list of the persons who made public submissions is at Attachment A.

The further consultation process and next steps

28. As part of the consultation process on this position paper, we are willing, as before, to undertake discussions of the position reflected in it.

29. In addition, we seek your written views on the specific questions put in Chapter 5. In providing your comments, please note that:

- We would value your views on the costs and benefits for consumers, business, Government and the community of the proposal put forward in this paper, and on any alternative which you suggest.
- In any response you make, it is necessary to keep the broader aims of the Financial Services Reform Act in mind — harmonisation of regulation across the financial services sector, with like conduct regulated the same way. This does not mean, however, that differences between, for example, debentures and superannuation should not be recognised, where appropriate.

30. Having considered the comments received in response to the position put in this paper, draft amendments will be prepared for introduction.

2. THE SUBMISSIONS

A Who responded

31. As indicated above, 29 submissions were received — all after the close of the consultation period! Of these, the authors of 4 sought to have their submissions treated as confidential, but one of these subsequently lodged a public version (omitting names).
32. There are thus 26 public submissions all of which have been put on the Treasury website: <http://www.treasury.gov.au>.
33. Submissions were lodged by:
- 13 industry associations (the Australian Association of Permanent Building Societies, the Securities and Derivatives Industry Association, the National Credit Union Association, the Trustee Corporations Association, the Institute of Chartered Accountants in Australia, the International Banks and Securities Association of Australia, the Credit Union Services Corporation, the Association of Superannuation Funds of Australia, the National Insurance Brokers Association, Boutique Financial Planning Principals Group Inc, the Insurance Council of Australia, the Financial Planning Association and the Investment and Financial Services Association Ltd);
 - 6 companies engaged in the financial services sector (including American Home Assurance, the Commonwealth Bank and APT Strategy);
 - the 2 major exchanges and a subsidiary (the Australian Stock Exchange Limited, the SFE Corporation Limited and the Securities Exchanges Guarantee Corporation Limited);
 - 3 individuals (Barry Buxton, John Jordan and Ian Donaldson);
 - 2 government agencies (WA Department of Consumer and Employment Protection and ASIC);
 - 1 external dispute resolution scheme (Financial Industry Complaints Scheme); and
 - 1 consumer organisation (Financial Services Consumer Policy Centre at the University of New South Wales).

B Tenor of the responses

34. The aim of this paper is to provide an overview of the responses received on the main issues. It does not attempt to provide details of all the submissions. If you are interested in a particular issue or point of view, you will need to go to the relevant submission or submissions. A summary of views expressed on particular issues is included in Attachment B.

35. There was very strong concern in most of the submissions received from industry associations and participants that any compensation arrangements not involve cross-subsidisation.

36. This arose from several perspectives:

- that larger well-capitalised licensees not have to underwrite smaller, poorly managed licensees;
- that segments of the industry subject to additional regulatory overlay (such as stockbrokers) not have to subsidise what they see as less well-regulated intermediaries;
- that risk relates to the product being sold and that therefore there should be separate requirements or arrangements on the grounds of the financial product concerned; and
- finally that risk relates to the service being provided and that therefore a licensee who is only dealing should not be expected to subsidise those who are advising (which is considered a higher risk activity).

37. However, it should be noted that both insurance and statutory scheme would involve pooling of risk to some extent and, in that sense, cross-subsidisation.

38. There was also concern that any solution adopted not place an unnecessary burden on smaller businesses.

39. A number of submissions expressed concern about the limitations on professional indemnity insurance as a compensation mechanism — both arising from its inherent character as indemnity insurance and problems currently being experienced in the professional indemnity market.

40. A recurring point was the need to make consumers aware of any compensation arrangements in place, the need to make their limitations known and such ancillary matters as encouraging consumers to check that their financial service provider is licensed or authorised.

41. Another recurring theme was the cost of any additional compensation arrangements and the fact that these costs would have to be passed on to clients — for example, as increased charges or in the form of poorer levels of service.
42. Responses from a number of industry participants indicated either that their current professional indemnity requirements were satisfactory (NIBA), or that any additional requirements should not apply to their segment (particularly, authorised deposit-taking institutions and general insurers).
43. Only the Commonwealth Bank argued that no action should be taken at this stage on the ground that the Financial Services Reform Act should be fully implemented and its reforms analysed before additional changes are considered — ie this debate should be deferred until 2006.
44. On the other hand, the ASX urged that the review proceed cautiously, and any significant changes be implemented possibly in stages with an adequate transition period.
45. A number of the submissions indicated different uses of the concept of ‘compensation arrangements’, some excluding insurance and focussing on fidelity funds and the like, while others considered that external dispute resolution services formed compensation arrangements.

C **Ambit of the review**

As described in the Issues Paper

46. The ambit of the review was addressed in paragraphs 7 to 11 of the Issues Paper. Those paragraphs indicated that the area of discussion in the Issues Paper was, in general terms, loss to a client suffered as a consequence of the misconduct of a financial services licensee or its representative in the course of providing financial services. The Issues Paper indicated that the discussion was not about loss suffered as a result of an investment which provides a poor return, whatever the cause, or the collapse of the issuer of a financial product.
47. Examples of issues not within the area of discussion were provided in the Issues Paper. They included the loss of insurance cover if the insurance company which issued your policy becomes insolvent and any loss which you, as an investor, may suffer if the superannuation fund in which you have invested is mismanaged or fails.

FSCPC argument

48. Only FSCPC argued for an extension of the review — to the operation of managed investment schemes, superannuation funds and general insurance companies on the basis

that complementary compensation arrangements should be developed for these categories of issuers.

49. The Government has not acceded to this request. Any schemes for recompensing deposit-holders or the insured following the failure of a bank or insurance companies are large and separate issues.

The HIH Royal Commission

50. The HIH Royal Commission received submissions advocating formal compensation arrangements in the event that prudentially regulated firms (such as insurance companies) become insolvent. This entails an external guarantee over the firm's liabilities, particularly those attaching to capital-backed products. These issues are outside of the scope of this particular review, which does not consider the losses caused by market fluctuations or insolvency of the issuer.

51. The HIH Royal Commission subsequently recommended that the Commonwealth Government introduce a systematic scheme to support the policyholders of insurance companies in the event of the failure of any such company. This issue is being reviewed separately- see <http://fsgstudy.treasury.gov.au/content/default.asp>.

Superannuation

52. Compensation in relation to losses caused, for example by fraud, in the running of a superannuation fund is addressed in Part 23 of the *Superannuation Industry (Supervision) Act 1993*, which is being reviewed separately as indicated in the Government's response to the Superannuation Working Group.

D The detailed responses

53. A summary of the responses received is included in Attachment B to this paper.

54. The summary shows the range of opinions on the issues raised in the Issues Paper of September 2002.

55. The differences of opinion relate to the perception of the problem and consideration of the appropriate response. While there was general acknowledgement of the need to address losses incurred, particularly by retail clients in the course of obtaining financial services, the appropriate courses included the professional standards model, a requirement for professional indemnity insurance and various tailored mechanisms.

56. The question whether any broad statutory scheme is warranted also met a variety of responses.

57. Inevitably the authors of submissions came with their own backgrounds and experience, and their firm's or constituency's own interests.

58. While the Issues Paper involved a discussion from first principles, it is necessary in this position paper to focus on the mechanisms that are in fact available.

E Use of the term 'compensation arrangements'

59. In this paper, 'compensation arrangements' is used in such a way that it includes professional indemnity insurance, security bonds, fidelity funds and broad statutory compensation schemes, but not external dispute resolution schemes, although clearly such schemes may complement compensation arrangements.

3. DISCUSSION

A The regulatory framework

60. The *Financial Services Reform Act 2001* substituted a new Chapter 7 in the Corporations Act. New Chapter 7 provides a harmonised regime for the regulation of financial service providers.

61. A single licensing regime has been introduced for all persons carrying on a financial services business. This replaces licensing requirements applying to securities dealers, investment advisers, futures advisers and brokers, general and life insurance brokers and foreign exchange dealers.

62. Financial services involve advising on, dealing in, or making a market in financial products, operating a managed investment scheme, or providing a custodial or depository service. Many issuers of financial products will need to have a financial services licence.

63. New Chapter 7 provides a number of measures designed to protect client assets and to provide other forms of investor protection. These are directly connected with the licence, or relate to conduct and disclosure by licensees. They include:

- the obligations on licensees, including:
 - to take reasonable steps to ensure that its representatives comply with the financial services laws;
 - (unless regulated by APRA) to have available adequate resources (including financial, technological and human resources) to provide the financial services covered by the licence and to carry out supervisory arrangements;
 - to maintain the competence to provide those services;
 - to ensure that its representatives are adequately trained and are competent to provide the services; and
 - (unless regulated by APRA) have adequate risk management systems in place³.
- additional obligations on licensees who offer services to retail clients including:

³ See subsection 912A(1).

- having in place a dispute resolution system (ie an internal dispute resolution procedure and being a member of one or more external dispute resolution schemes)⁴.
- minimum standards of conduct applying to financial service providers when dealing with clients including:
 - providing retail clients with a Financial Services Guide;
 - on providing personal advice to retail clients, handing over a Statement of Advice and, if a particular product is recommended, a product disclosure statement;
 - ‘know your client’ requirements in relation to retail clients;
 - disclosure of conflicts of interests to retail clients; and
 - separation of funds held on a client's behalf, and reporting and accounting requirements⁵.

64. A prohibition on unconscionable conduct in the provision of financial services applies.

65. Under the Financial Services Reform transitional provisions, entities providing financial services before the regime commenced on 11 March 2002 have up to two years to obtain an Australian financial services licence covering the provision of those services.

B The problem and the risk

66. The Issues Paper described the problem in the following terms — ‘that financial services licensees do not always have assets to meet claims arising from clients’ losses which result from misconduct in the course of providing financial services — for example, defrauding clients of their funds or financial products’.

Evidence of the problem

67. There is no one comprehensive source to indicate the nature and size of the problem. One reason is that the harmonised regulation of financial service providers (including stockbrokers, financial planners, foreign exchange dealers, insurance brokers and others) is only now commencing with the transition into the Financial Services Reform regime.

⁴ See paragraph 912A(1)(g) and subsection 912A(2).

⁵ See Part 7.8.

68. The Issues Paper outlined the evidence then available from the Australian Securities and Investments Commission (ASIC) and the Securities Exchanges Guarantee Corporation (SEGC) which administers the National Guarantee Fund⁶. The Issues Paper also sought better evidence of the problem from readers.

69. Ten submissions received in response to the Issues Paper addressed this question. However, statistics were provided by only ASIC, the Sydney Futures Exchange (SFE) and the SEGC.

70. **ASIC** reported:

- That the following financial service providers went into external administration⁷:
 - insurance brokers (general): 39;
 - insurance brokers (life): 5;
 - insurance brokers (foreign): 1;
 - insurance agents: 2;
 - securities dealers: 13;
 - futures dealers and brokers: 4.

However, it is not possible to establish the extent to which the former clients of these firms were owed money or securities, or had claims against the firm, at the time the administrator was appointed.

- For 2002-03:
 - 6 persons involved in the financial services industry were jailed;
 - 20 people were permanently banned. Criminal proceedings were initiated in respect of some of these matters;
 - a further 19 advisers were banned or undertook to stay out of the industry for shorter periods;
 - 6 financial services licences were revoked or voluntarily surrendered;
 - 4 insurance brokers were refused renewal of registration or undertook not to carry on business, or apply for a licence.

⁶ The role of the National Guarantee Fund, which provides investor protection and clearing support for transactions on the Australian Stock Exchange, is described in Attachment B to the Issues Paper.

⁷ For insurance intermediaries, the data dates from July 1998. For securities and futures dealers, the data covers roughly a ten year period.

71. This does not mean that clients in all these cases lost money. In the majority of cases where ASIC took action against a proper authority holder in the last three years, clients have received, or are likely to receive, compensation from the licensee for which the intermediary was a proper authority holder. Generally, the licensee will make a claim on its professional indemnity insurance for the client's losses. ASIC has often been able to help clients negotiate compensation with licensees in these circumstances.

72. However, ASIC reports that there were cases in each of the last three years where some or all clients of the impugned authority holder suffered substantial losses that have gone/are likely to go uncompensated. Cases where this has occurred have tended to involve smaller licensees where claims have not been covered by the licensee's insurance and the assets of the business have not been sufficient to meet the claims. Uncompensated loss also occurs where the intermediary has continued to trade (illegally) after ceasing to be a proper authority holder.

73. ASIC argues that apart from the number of claims, account also needs to be taken of the potentially serious implications of uncompensated loss for the persons affected, particularly for retirees.

74. The Sydney Futures Exchange reports:

- Over the 16 years during which SFE has operated fidelity funds, there have only been claims made against 3 (former) intermediaries, involving an aggregate of around 30 customers, with the aggregate payout being approximately \$640,000. There have been no claims since 1993.

75. The **SEGC** in its Annual Report for 2002-03 reports that:

- the SEGC has received 5,556 claims since its establishment in 1987, most of them in the period 1988-1991;
- in the period 1988-1993, 8 stockbrokers became insolvent (resulting in 5,333 claims);
- since 1993, there has only been one broker insolvency but there has been an increase in the claims for unauthorised transfer of securities;
 - almost three quarters of the total amount paid in the 1994-2003 period was paid in respect of claims for unauthorised transfer of securities — typically involving fraud by a person who was not necessarily within the broker effecting the transfer;
- since the National Guarantee Fund was formed:
 - \$21.7 million has been paid from it in claims and \$13.4 million recovered;

- \$121 million has been distributed to the securities industry development account⁸ (including \$3.5 million in 2002-03).

76. While this provides evidence of loss within the area covered by the investor protection provisions of the National Guarantee Fund, it is not necessarily indicative of comparable losses across the financial services sector (particularly as many of the recent claims relate to unauthorised transfer). Further, we do not agree with the suggestion that the level of claims is low because the existence of the National Guarantee Fund and the SFE's fidelity fund is unknown amongst consumers, without some evidence suggesting this conclusion.

77. Given the paucity of hard data, the authors of a number of submissions referred to perceptions, which obviously differed markedly (at least in part because they focussed on different segments of the industry) and examples of which they were aware:

- the **Financial Industry Complaints Service** pointed to 7 instances where it had been unable to assist complainants because the financial service provider had ceased business, its licence had been revoked or it had been wound up, etc;
 - in the worst case, this affected 15 complaints which could not be pursued through this Service. The relevant complaints ranged from \$2,198 to \$98,294 and totalled \$907,247;
 - in three cases, the total amount of the claims outstanding in relation to each were under \$30,000;
 - in the three remaining cases, the total amount of the claims outstanding in relation to each were between \$90,000 and \$158,000;
 - : while this does not prove that the claimants would be uncompensated, it is quite possible that a significant number will;
- The **Financial Services Consumer Policy Centre** expressed the view that the extent of uncompensated losses is significant and growing and pointed to, among other cases:
 - the case of *Ali v Hartley Poynton* in which a broker abused a wide discretion to trade on his behalf and lost his client's funds;
 - : a press report at the time indicated that this was covered by Hartley's insurance;

⁸ See Division 5 of Part 7.10 of the Corporations Act 2001 prior to the commencement of the *Financial Services Reform Act 2001*. Since that date, these provisions have been superseded by section 892G-892H and associated regulations, which apply in relation to all fidelity funds.

- Thompson Brindal/Retireinvest — in this case clients lost around \$17 million as a result of unauthorised trading;
 - : we understand that in this case a related company compensated clients and then sought reimbursement from the National Guarantee Fund;
- Hutchings and Tindall Partnership — in this case investors, who had been promised interest rates of 30 per cent to 50 per cent per annum, lost significant funds in an unregistered managed investment scheme;
- in considering the relevance of this case, and cases involving agribusiness, tax effective schemes, schemes devised to circumvent Chapter 5C, timeshare schemes, superannuation and mortgage schemes it is necessary to keep in mind the ambit of this review — financial services, not the failure of the financial product itself and that any compensation scheme is unlikely to protect against the conduct of unlicensed financial service providers;
- **IFSA**, while acknowledging that it did not possess information as to the size of the problem, indicated that it was not convinced that it was sufficiently large as to jeopardise, much less threaten, consumer confidence in the financial services industry.
 - ‘The problem appears to be small, therefore, in relation to levels of overall participation by consumers in the financial services market. This is not to say, of course, that the impact of losses occasioned by fraudulent activity on individual consumers is not significant.’

78. There is thus limited evidence of currently uncompensated loss arising from misconduct in the course of providing financial services.

Is there justification for mandating compensation arrangements?

79. From the submissions received (see Chapter 2 and Attachment B), it is clear that there is general acceptance of the need for some compensation arrangements (using that phrase to include professional indemnity/fidelity or fraud insurance) but concern that the mechanism adopted not be excessive in proportion to the problem and that cross-subsidisation be minimised.

80. There is a need to justify each particular measure taken to address this problem in accordance with the methodology of the Office of Regulation Review, included in its *A Guide to Regulation*, which has been endorsed by Cabinet.

C Obligations on financial services licensees

81. There was general agreement that the obligation should primarily rest on the financial services licensee, since it is its conduct (and that of its representatives) which is the basis of the problem.

82. The Issues Paper considered two mechanisms for compensation which can be imposed on financial services licensees — security bonds and professional indemnity insurance.

83. The tentative view put in the Issues Paper, and supported by submissions, indicates that security bonds are not appropriate as the starting point. The requirement in old Chapter 7 for a security bond provides a very limited source of compensation, while a substantial bond may prove an impediment to those wanting to start in the financial services sector in a small way. Further, being administered by ASIC, there are some administrative costs involved.

84. Instead, we are inclined to prefer professional indemnity insurance (with 'fidelity' or fraud insurance/policy extension), while recognising the possibility that other mechanisms may be more appropriate in given situations or preferred by the licensee.

85. Choosing such insurance means that the burden of making the arrangements and their cost falls on the relevant licensee. If insurers are assessing the risk of the individual licensee (and its representatives), then the cost of the premium will be proportionate to that risk. If a 'community rating' approach is being taken, then the result may be seen as less equitable.

86. However, we recognise that there are currently difficulties in the market for professional indemnity insurance (see below), including for financial service providers and that that market is changing.

Current requirement — section 912B

87. Section 912B of the new Chapter 7 requires that financial services licensees have arrangements for compensating retail clients for loss or damage suffered because of breaches of the relevant obligations under Chapter 7 by the licensee or its representatives.

88. It was the intention, when drafting the Bill, that the obligations referred to be those imposed by **Chapter 7** on the financial services licensee because it holds that licence. Therefore it would not encompass obligations imposed on the financial services licensee as an issuer, under Part 7.9, or in relation to market misconduct. To read it otherwise would result in inequitable results — for example:

- an issuer who was a financial services licensee would be required to have compensation arrangements covering conduct regulated under Part 7.9, while an issuer who was not a financial services licensee (or whose disclosure obligations were regulated by other provisions) would be obliged to comply with those provisions but not to have compensation arrangements covering that conduct.

89. A related difficulty arising from the wording of this provision relates to the encompassing of **obligations under other legislation**. It has been argued that the compensation arrangements are required to cover compliance with other 'financial services laws', one of the general obligations included in section 912A. The phrase 'financial services law' is defined in section 761A to include other relevant Commonwealth, State and Territory legislation.

- This reading would therefore require financial services licensees to have compensation arrangements covering losses from their breaches of, for example, Chapters 5C (Managed Investment Schemes), 6 (Takeovers), Division 2 of Part 2 of the *Australian Securities and Investments Commission Act 2001* and the *Trade Practices Act 1974*.

90. This effect was not intended when the Bill was being drafted, and, as in the first difficulty referred to above, would lead to an obligation not imposed on others who might breach the relevant Commonwealth or State/Territory legislation.

91. The result for the licensee of this wider interpretation would be increased premium costs, if cover were available.

D What should section 912B require

92. There is obviously, at least in theory, a range of risks which financial services licensees could be required to be covered for. However, if insurance is to be the expected method of compliance, the requirement cannot be set above the level of coverage of professional indemnity and similar insurance which is currently generally available. To do so would put a number of financial services licensees out of business.

93. For this reason it is proposed that section 912B be amended to require compensation coverage for:

- Acts, errors or omissions for which the licensee is legally liable and such conduct of its representatives for which it is responsible (but excluding civil penalty and criminal penalties imposed on the licensee);
- in the course of:
 - dealing on behalf of;

- advising; or
- providing custodial or depository services;⁹

to retail clients on financial products, but only to the extent that the conduct is within the licensee's licence.

94. The intention would be to cover losses to retail clients caused by breaches of both general law and statutory obligations (including Chapter 7 obligations) but only to the extent those obligations relate to providing the financial services specified.

95. It is envisaged that professional indemnity insurance (with 'fidelity' or fraud insurance/policy extension) could be used to fulfil this requirement. Discussion about the detail and subsidiary issues (including minimum cover, retroactive and run-off cover, allowable exclusions, alternatives and exemptions) is included below.

Width and Availability

96. If you consider that such coverage would not be available or that the width is inappropriate, you are invited to submit your views.

97. Your comments are also sought if you consider that any particular statutory obligation should be omitted from the coverage requirement because, for example:

- coverage might encourage non-compliance with the law;
- the trigger events are too uncertain or the risk unquantifiable.

98. These issues are raised in Issue 1, Chapter 5.

What is professional indemnity/fidelity insurance?

99. In very general terms, professional indemnity insurance covers loss arising from breaches of professional duties. Such policies generally cover loss arising from 'acts, errors and omissions' for which the insured is liable.

100. 'Fidelity' cover is seen by the underwriters as distinct. It provides coverage for fraud and dishonesty of employees. We understand that some insurers offer a package of professional indemnity and fidelity (or a fidelity extension on their professional indemnity policies).

⁹ With the possibility of extension to conduct prescribed under paragraph 766A(1)(f).

Relevance of other professional indemnity etc requirements

101. The requirement discussed above would be the minimum needed for compliance with the proposed revised section 912B.

102. If the financial services licensee is a member of an industry body which requires additional cover, then obviously the licensee would need to obtain a policy which also satisfies those requirements. Similarly, we see no difficulty in principle with the one insurance policy also addressing requirements stemming from other sources, for example, the operation of a managed investment scheme, an obligation to have trustee indemnity or membership of an external dispute resolution scheme.

Retail clients

103. The submissions indicated general agreement that retail clients (rather than some wider class) should be the beneficiaries of compensation arrangements. This therefore indicates agreement with the current scope of the requirement in section 912B, which is confined to the situation where the licensee 'provides a financial service to persons as retail clients'.

104. The concept of 'retail client' is described in section 761G (and Corporations Regulations 7.1.11 to 7.1.28). It provides separate tests for services in relation to general insurance products, superannuation and RSA products, and investment products.

105. We are not convinced that the test should be altered for the purpose of the compensation arrangements in section 912B according to the nature of the financial product concerned. The definition of 'retail client' already addresses this.

106. However, it appears that the definition of 'retail client' in section 761G does not adequately address the situation of unauthorised transfer of financial products. This is particularly an issue in relation to uncertificated securities traded on the Australian Stock Exchange and is considered in greater detail below (see paragraph 203).

What the requirement doesn't cover?

107. As indicated in the segment on ambit of the review in Chapter 1, this review focuses on the provision of financial services, not the conduct of the issuer once the product is issued.

108. The minimum coverage outlined above therefore does not cover losses incurred in connection with:

- managing a registered scheme;

- professional indemnity insurance is required in this connection under Policy Statement 131;
- making a market;
 - the requirement would appear not to have application in this regard;
- the breach of obligations by a trustee in managing a superannuation fund;
 - breach of these obligations is outside the scope of this review;
- the breach of obligations of a financial services licensee as an issuer ie obligations under Part 7.9.
 - again, this conduct is outside the scope of this review.

109. In addition, it only applies to licensees with whom a retail client has a direct business relationship.

Will the determinations of external dispute resolution schemes be required to be covered by insurance (or a substitute) under section 912B?

110. While a number of submissions suggested that professional indemnity insurance (or a substitute) should be required to cover the determinations of all approved external dispute resolution schemes, it is not proposed to specify that the determinations of external dispute resolution schemes be covered by complying cover (or a substitute). This is likely, however, to be the result of the contractual liability of the licensee to the scheme.

111. We note that some external dispute resolution schemes require participants to have insurance cover in relation to the scheme's determinations. However, apparently some insurance policies being offered explicitly exclude external dispute resolution determinations and some insurance companies hold concerns about covering external dispute resolution determinations.

112. Whether it would be appropriate to consent to an endorsement excluding the determinations of external dispute resolution schemes may need to be considered later.

Does this requirement assist in risk management, early detection of risk, better practices?

113. It was argued in several submissions that the compensation regime should assist in the detection and management of risk, and the adoption of better business practices.

114. However, should this be a focus of compensation arrangements? It seems preferable to keep the focus on the purpose as articulated in the Issues Paper, and then an assessment

can be made later as to the adequacy of those regulatory requirements with an impact on risk management, seen as a whole.

115. The adoption of a requirement to have professional indemnity insurance (with 'fidelity' or fraud insurance/policy extension) or a substitute, in relation to certain conduct is expected to have an effect on the conduct of the licensee (and its control over its representatives) to the extent that the licensee:

- believes that the insurance company sets its premiums having regard to the risk of the particular, or particular class of, business; or
- the insurance company takes other measures to manage the risk it is underwriting.

Does this requirement give excessive power to underwriters?

116. There is an argument that expecting insurance cover (or a substitute) in effect gives the power to revoke the licences of financial services licensees to insurance companies, without the appeal mechanisms available in relation to a decision by ASIC. This may arise from a refusal to renew a policy, an increase in the premium such that the licensee cannot afford it, the imposition of exclusions which would render the policy non-complying, or other measures.

117. However, alternatives to insurance form part of the proposal. We remain convinced that a market-based solution, such as professional indemnity insurance (with 'fidelity' or fraud insurance/policy extension) provides, should be the primary solution.

Access for consumers

118. Several submissions argued that compensation arrangements should include an access mechanism.

119. However, it would not be appropriate for this review to propose artificial access to insurance policies, further interfering with the commercial relationship between the insurer and the insured. The external dispute resolution services and the courts are available for pursuing claims against financial services licensees.

Does this solution give sufficient weight to the commercial impetus to protect reputation?

120. We note the role which industry groups can play in encouraging their members to adopt high standards for the benefit of the reputations of all in that segment of the financial services sector. Similarly, it has been argued that large institutions, with well-known brand names, have an interest in promoting high standards amongst their representatives to protect their own reputations.

121. While we acknowledge the value of the latter, not all companies which provide financial services and which are associated with well-known institutions carry a related name or are immediately identified with that institution. It is also not clear that two-tier requirements on the ground of the interest of the institution in protecting its name would be competitively neutral. We need to ensure that new or small players in the industry are not disadvantaged. Further, critics of such a proposal may refer to the outcome of the recent Australian Consumers Association/ ASIC survey of financial planners as not supporting the proposition that well-known brands always behave in such a way as to protect their reputation.

Difficulties in the professional indemnity insurance market

122. The submissions clearly indicate that some financial service providers have had difficulty in obtaining professional indemnity insurance, or obtaining it on the same terms as previously (see Attachment B).

123. More generally, the professional indemnity insurance market has been the subject of, or of substantial interest to, several reviews:

- The Senate Economics References Committee published *A Review of Public Liability and Professional Indemnity Insurance* in October 2002;
- The *Review of the Law of Negligence* by the Hon Justice David Ipp and a panel of experts — the final report was issued in September 2002;
- the insurance industry market pricing reviews of the ACCC;
- consideration of proportionate liability for economic loss and professional standards legislation by Treasury Ministers and others.

124. Significant law reforms which are being implemented or to which jurisdictions have committed to consider further include:

- encouraging the use of structured settlements for personal injury compensation;
- reforms to address the medical indemnity crisis;
- reform of the law of negligence;
- proportionate liability; and
- professional standards legislation.

125. It has been argued that, if professional standards legislation were adopted, insurance capacity for the lower layers of insurance is likely to expand and it may encourage further insurance companies to offer professional indemnity insurance in Australia.

126. We understand that the industry is likely to be able to provide the proposed cover. Certainly, the Commonwealth Government will not be entering into the insurance business in relation to financial service business, as several submissions suggested.

E What alternatives to insurance should be permitted?

127. As indicated above and anticipated in the drafting of section 912B, the requirement should be sufficiently flexible to recognise alternatives to professional indemnity insurance (with 'fidelity' or fraud insurance/policy extension).

128. It should be noted that:

- the alternatives would need to provide comparable consumer protection as that provided by the insurance cover;
 - this may involve regulations under paragraph 912B(3)(c) providing guidance to ASIC;
- ASIC will not be assessing individual solutions — licensees who do not take out complying cover or are not exempt will be expected to choose from the menu of alternatives and comply with the requirements for the one chosen.

129. Alternatives to a complying insurance policy (issued by one insurer) which have been suggested include:

- co-insurance;
 - we understand that this involves insurance organised by a broker involving a number of local or overseas insurers which would:
 - : underwrite 'horizontal' layers — for example, insurer A underwriting the first \$10 million, and insurer B the next \$30 million; or
 - : agree to underwrite the totality of the risk insured in agreed percentages;
 - it would appear more suitable for high exposure operations;
- pooled insurance schemes:
 - we understand that this involves insurers getting together to underwrite jointly particular risks for a significant group of persons;
 - an example is three insurers' actions in relation to the public liability risks of certain 'not for profit' organisations;

- mutuals:
 - a review is being undertaken to determine whether it is necessary and possible to provide the same level of protection to consumers (and third parties) of products supplied by discretionary mutual funds (and direct offshore foreign insurers) as is provided to consumers of products supplied by insurers subject to prudential regulation under the Insurance Act;
 - the review will consider the role of discretionary mutual funds (and direct offshore foreign insurers) in the Australian insurance market and their contribution to overall insurance capacity;
 - it is expected to report at the end of January 2004;
 - a view on their appropriateness as an alternative for financial services licensees will be made in the light of that report;

- self-insurance:
 - we would prefer to focus on the exemption proposed for insurers and authorised deposit-taking institutions regulated by APRA, those licensees with high capitalisation and those licensees with the requisite connection with such bodies (see below);

- security bonds, performance bonds, bank guarantees:
 - while there is no intention to require security bonds, it may be that these mechanisms should be retained as options although obviously the amounts are likely to be substantially greater than the bond required under old Chapter 7;
 - requiring such a bond or guarantee to be a particular, nominated amount regardless of the business appears inappropriate;
 - : if acceptable, how should such it be calculated?

- fidelity funds:
 - to be acceptable, such a fund would have to provide certainty where the claim was in the area required to be covered by insurance;
 - it is possible that some industry bodies may wish to develop such a fund which could be used to promote confidence in a particular sector;

- alternatives (see Issue 2, Chapter 5):
 - while ad hoc alternatives would create a significant administrative burden for ASIC, we would like to hear alternative solutions which you wish to put forward now;

- each alternative would be considered on its merits for inclusion in the menu.

131. Given the state of the professional indemnity insurance market, it is desirable that alternatives be available. However, they bring with them problems of comparability (for the regulator and the consumer). In addition there are two arrangements which fall within the ambit of professional indemnity insurance (with 'fidelity' or fraud insurance/policy extension) and therefore would not need specific provision as alternatives. They are:

- group insurance:
 - this occurs most commonly where membership of an organisation automatically brings with it the provision of insurance cover, arranged by the organisation, with no assessment of the individual risk which each member brings;
 - we are not aware whether complying cover in the form of group insurance would be available;
- individual insurance contracts in accordance with terms arranged previously by an industry organisation.

132. The question of acceptable alternatives is raised in Issue 2, Chapter 5. Consistently with paragraph 912B(2)(b), it will be up to ASIC to issue a policy statement indicating the detail of the alternatives that are likely to be approved.

F What exemptions from the requirement to have insurance (or a substitute) should there be?

133. Further, it is proposed that the following licensees be exempt from the requirement to have professional indemnity insurance (with 'fidelity' or fraud insurance/policy extension) as outlined above, or a substitute:

- those general and life insurance companies and authorised deposit-taking institutions regulated by APRA;
- those bodies which meet a high capitalisation test (see Issue 3, Chapter 5);
- those licensees which are related to a body in one of the first two categories, where the APRA-regulated body has guaranteed payment of the obligations of the licensee to its retail clients in relation to regulated conduct if the licensee becomes insolvent or unable to pay.

134. Details of the exemptions would be included in the regulations.

135. The advantage of the proposed exemptions is that it accords with the purpose of having compensation arrangements, that of having sufficient assets to meet proved claims of clients. Given the regulatory regime to which they are subject, it is significantly less likely that they will fail.

136. On the other hand, there is no guarantee that an APRA-regulated body will not fail. If the focus of the requirement is professional indemnity insurance (with 'fidelity' or fraud insurance/policy extension), then this involves the slight possibility of the insurer failing. Similarly, the proposed exemptions for certain licensees regulated by APRA (or associated with them) include the possibility of one of the relevant prudentially regulated entities failing.

137. In addition, if such a body looks unsteady, the situation will be worked through by APRA with the interests of depositors/policyholders given primary consideration.

G Other matters related to section 912B

Unlicensed providers and unlicensed conduct

138. The requirement in section 912B will only apply to financial services licensees, and with respect to their own conduct and that of their authorised representatives for which they are responsible. This means that the obligation will be on the consumer to check that a particular business is licensed, and that the person they are dealing with is licensed or authorised.

139. Further, the requirement will only apply to the extent of the licence and, in the case of authorised representatives, to the extent of the licensee's responsibility under Chapter 7 of the Corporations Act for that representative's conduct.

140. We note that, in particular, as long as Division 6 of Part 7.6 of the Corporations Act applies to the conduct (and the lack of authority is not disclosed to the client in accordance with section 917D), then the licensee will be liable for the representative's conduct, whether or not that conduct is within the latter's authority.

Who can issue complying insurance cover?

141. It appears undesirable to provide that only insurers regulated under the *Insurance Act 1973* can issue complying cover.

142. There is a limited number of insurers in Australia writing professional indemnity and similar cover and licensees may well find that they can only obtain cover from overseas insurers. Further, some licensees may be part of an international group which arranges group-wide professional indemnity cover.

143. It is proposed that complying insurance cover can only be issued by insurers which are:

- regulated in Australia; or
- regulated in a jurisdiction with a comparable regulatory framework.

However, it will be necessary to have regard to the outcome of the review of the role and regulation of direct offshore foreign insurers which is referred to in paragraph 130.

144. The value of any obligations on insurers discussed below will be reduced if the insurer has no presence in Australia.

Coincidence of licence and cover

145. We have been advised that the professional indemnity policies being offered to financial planners have included an increasing number of exclusions. These have included advice on 'tax-effective' schemes or agribusiness, advice on products which are not on an approved list, advice on the direct purchase of shares and FICS determinations.

146. This has the result that the licence may be wider than the current professional indemnity cover.

147. This is considered inappropriate. If compensation coverage is not available to cover the services covered by the licence in relation to which coverage is required, then the licensee should seek to have the licence limited so that it aligns with the compensation coverage.

Degree of prescription of complying insurance cover

148. Given the conclusion above, it is time to consider the details of the cover required.

149. The first issue is the degree of prescription. The Commonwealth Bank argued that the condition on Australian Financial Services Licence that the licensee maintain appropriate professional indemnity cover should not prescribe limits or deductibles. 'This is because the insured are likely to have different limits and deductibles according to their size.'

150. However, some degree of prescription is required so that:

- the licensee knows what to arrange in order to comply; and
- the regulator can determine which licensees are not complying (given the number of licensees a standardised approach is, as a practical matter, required).

151. A balance needs to be achieved between practical requirements and flexibility, keeping in mind that an approach viewed by insurers as heavy handed may discourage them offering complying cover. By way of comparison, the Agents and Brokers Act requires:

- that a broker must have an acceptable contract of professional indemnity insurance before registration by ASIC (paragraph 21(1)(a)) and must have such cover to carry on business (paragraph 19(1)(b));
- to be an 'acceptable contract of professional indemnity insurance', the contract must be accepted by ASIC and meet certain other requirements (subsection 9B(1)¹¹) including:
 - it must cover liabilities incurred as a result of a breach of professional duty (Insurance (Agents and Brokers) Regulations — regulation 3);
 - it must include run-off cover for a period never prescribed.

152. The Agents and Brokers Act also limits the actions which the insurer may take under the contract — this is discussed below.

153. A more prescriptive approach is adopted in the *Medical Indemnity (Prudential Supervision and Product Standards) Act 2002*.

What should be prescribed?

154. If it is accepted that some degree of prescription is appropriate, then the next issue is which facets of the cover should be prescribed and how should the detail be described (given the range of licensees and conduct subject to the requirement):

- how should the minimum annual cover be calculated?
- how should an appropriate amount of cover be determined where the insurance relates to a group of entities?
- how should the minimum amount payable by the insurer for multiple claims in the one period be calculated?
- should maximum excesses be prescribed?
- what exclusions are acceptable?
- should run-off cover be mandatory?
- how should retroactive cover be addressed?

¹¹ Section 9B of the Agents and Brokers Act is reproduced in Attachment D.

- is run-off cover available?
 - should it be required? if so, for what period?

155. Your input is sought on these issues (see Issue 4, Chapter 5).

Where should the prescription be located?

156. We propose that the detailed requirements be included, as appropriate in ASIC Policy Statements or regulations. An amendment to section 912B would result in an inappropriate level of detail being included in the Act and loss of flexibility.

Obligations on insurers

157. If insurance is going to assist in ensuring that consumers' claims are paid, then there is the issue of how to ensure that it is maintained and not cancelled or rendered void.

158. The solutions in the Agents and Brokers Act are:

- to provide that:
 - a failure to comply with a duty of disclosure by a person seeking to enter into an acceptable contract of professional indemnity insurance; or
 - a misrepresentation by such a person to an insurer before such a contract was entered into;

whether the failure or misrepresentation was fraudulent or not, is not a ground for the insurer to avoid the contract or to reduce its liability under the contract (subsection 9B(3));

- to ensure that claims made during the period of insurance are covered, even if the person has ceased to trade as an insurance intermediary or the contract has been cancelled (subsection 9B(4));
- to require the insurer to give at least 3 business days' notice in writing to ASIC before the intended cancellation of the contract (subsection 9B(5)).

159. It is arguable that the purpose of the Agents and Brokers Act provisions was to address the wrong policy being issued and not the handling of funds — while section 912B applies to a greater range of financial service providers and in relation to a wider range of conduct. It may be that insurers tolerate such restrictions in the Agents and Brokers Act context but would consider them so burdensome in relation to financial services licensees generally that it would affect availability of complying cover. Any statutory provisions which, in order to ensure pay-outs to claimants, restrict the ability of insurers to limit and

control their risk exposure under professional indemnity policies may also cause regulators to look again at the capital requirements covering such business. Any increase in capital requirements could result in fewer insurers being willing to write complying insurance for financial services licensees.

160. ASIC will obviously be concerned to ensure that licensees have and maintain complying cover and/or substitute arrangements that comply with the section 912B requirements. A requirement that insurers automatically alert ASIC to the cancellation or non-renewal of professional indemnity/fidelity cover taken out by financial services licensees would assist. We note that there is to be no requirement to lodge a certificate of currency with ASIC on a regular basis.

161. Your input is sought on the following questions (see Issue 5, Chapter 5):

- (a) should the insurer be required to give ASIC notice, including the reason, before cancelling a policy?
- (b) should the insurer be prevented from avoiding the contract or reducing liability under it on the ground of non-disclosure by the insured?
- (c) what effect would the measures referred to in (a) and (b) have on availability of complying cover?
 - Legislative requirements imposed on insurers outside the jurisdiction are likely to be of little effect.
- (d) Do you have any suggestions for other processes or mechanisms for enhancing ASIC's capacity to monitor compliance with the requirement?

Enforcement mechanisms

162. It is necessary to consider how the regulator is to check that the licensee has obtained and continues to have complying cover (or a substitute).

163. Under the law as it currently stands, compliance could be checked through:

- surveillance checks by ASIC (section 912E);
- the obligation to notify ASIC as soon as practicable and in any case within 3 days after the licensee becomes aware that it can no longer meet, or has breached an obligation under section 912A or 912B (section 912D).

Miscellaneous

164. In the light of the conclusions above, there is no need to discuss in detail the measure of damages, the necessary link with Australia and time limits on claims is limited to these issues as they arise in relation to insurance (or its substitutes). The rights of the client against the licensee will in general terms be determined by the applicable law. The terms of the insurance contract will be relevant to the rights of the licensee against the insurer.

H Is there a justification for a broad statutory compensation scheme?

165. As indicated in Chapter 2 and Attachment B, there was limited support for the idea of a broad statutory compensation scheme.

Broad statutory schemes proposed

166. The FSCPC recommended a broad compensation scheme:

- which would pay claims on insolvency/inability to pay on the following grounds:
 - failure to account;
 - gross incompetence;
 - fraud or fraudulent acts;
 - dishonesty;
 - fidelity breaches; and
 - grossly misleading and deceptive conduct.
- proof would only be on the basis of 'reasonable grounds to believe' and presumably it would apply in relation to the operation of managed investment schemes, superannuation and general insurance companies as well as financial services.

167. ASIC, on the other hand, suggested a scheme which would pay claims only if:

- the licensee were insolvent or unable to pay;
- and there was:
 - misuse or misapplication of client money or financial products; or
 - misuse or misapplication of the licensee's (or representative's) authority over money or products.

Assessment of broad statutory schemes

168. Before any such scheme is adopted, its cost needs to be weighed against the level and nature of the problem and the benefit that such a scheme would bring. What would be the impact of the scheme on the Government, financial services licensees and consumers?

Commonwealth regulatory assessment process

169. Before any additional regulatory requirements are imposed by the Commonwealth, a Regulation Impact Statement must be prepared and approved by the Office of Regulation Review. This commences with a description of the problem and risks, the objective, an identification and assessment of options, the consultation process, a conclusion and recommended option and a procedure for implementation and review.

The problem

170. In the case of this review, the problem has been identified in general terms. It was described in the Issues Paper in this way:

financial services licensees do not always have assets to meet claims arising from clients' losses which result from misconduct in the course of providing financial services — for example, defrauding clients of their funds or financial products¹².

171. Various submissions indicated that they consider the problem area to be when a financial services licensee becomes insolvent (and some added 'or unable to pay'). The FSCPC and ASIC suggestions for a statutory scheme target that area.

Data on quantum and risk of loss by retail clients

172. Even if you consider that the problem is somewhat wider, the identification of the risk remains difficult. By risk, in this context we mean the probability of such losses being incurred.

173. Currently there is little statistical data to indicate how often such losses have been incurred and the severity of the losses in these circumstances in recent years. The only comprehensive data relating to loss which we have is limited to stockbrokers and futures brokers. The figures on financial service providers going into external administration do not, of themselves, indicate loss to clients. The description from FICS of occasions where they were not able to help clients because, for example, the licensee gave up its licence, are not sufficient to justify a statutory scheme.

¹² Paragraph 34 of the Issues Paper.

174. One submission suggested that information about loss could be obtained from the Insolvency and Trustee Service of Australia (ITSA) and ASIC. The evidence received from ASIC is reproduced above. ITSA is responsible for personal bankruptcy and insolvency law and practice, but not the insolvency of companies.

Comments on the two proposals

175. Of the two proposed schemes, FSCPC covers a far wider area and includes situations where the loss arises from the performance of the financial product, not just where the loss has been caused in the context of the financial service. As indicated in the discussion on ambit, this review is about financial services, not conduct affecting the worth of a financial product, once it is received by the consumer.

176. Even when the proposal is limited to financial services, there is insufficient evidence available to assess the losses incurred by retail clients on those grounds which FSCPC enumerate which are within the ambit of this review.

177. The more modest suggestion by ASIC focuses on property either entrusted to the financial services licensee or over which the licensee has had authority. This is comparable to Subdivision 4.9 of Part 7.5 of the Corporations Regulations, one of the heads of claim against the National Guarantee Fund. It is also comparable to some overseas schemes although a number of those focus on market participants, market transactions or those products which can be dealt with on a formal market.

Costs of the proposals

178. Any statutory scheme involves considerable costs, including:

- the cost of developing a detailed scheme, in consultation with industry and consumers;
- the cost to industry of the additional returns necessary to assess the levies or other payments (including those on small financial services licensees);
- the cost to industry of paying levies and, for example, interest on trust accounts to fund the investigation of claims, the administration of the scheme and paying claims;
 - additional levies would be needed initially to establish a viable fund.

179. These additional costs would be passed on to clients, in higher charges or, as one submission suggested, poorer service.

Conclusion

180. On the information we currently have (paragraphs 67 to 78), there appears to be insufficient evidence to make a proper assessment as to whether there is justification for either the scheme proposed by FSCPC or that proposed by ASIC.

181. The evidence currently held by the Commonwealth does not indicate the losses being incurred by retail clients in relation to the provision of financial services which:

- would not be addressed by professional indemnity or similar insurance (or alternatives); and
- would be compensated by such a statutory scheme.

182. This conclusion does not mean that professional indemnity and similar insurance will result in satisfied clients in all cases.

183. While the response of some consumer advocates may be that we are waiting for a disaster before establishing such a scheme, the Commonwealth's process for assessing whether further regulation is justified requires assessment against known circumstances.

184. ASIC may decide to investigate the viability of collecting relevant data so that this issue could be reconsidered in the future. The availability of reasonably comprehensive data on uncompensated loss would have the added advantage of allowing time to see the effect of the new Chapter 7 requirements on the behaviour of licensees and relevant developments in the industry.

I Market-related schemes

If there is to be no broad statutory compensation scheme, should the market compensation schemes be dismantled?

185. If we were creating a compensation regime from scratch today, then there would clearly need to be discussion as to whether separate mechanisms relating to financial services in connection with on and off-market transactions, such as currently exist, would be warranted. The debate would include discussion about ongoing confidence in the market and international parity, as well as regulatory neutrality and role of demutualised exchanges.

186. We are not starting from scratch. There are already:

- the National Guarantee Fund which:

- currently does not cost ASX participating organisations or the ASX anything to maintain;
- has in recent years paid a number of claims on the ground of unauthorised transfers, a problem of greater significance in the uncertificated environment which CHESS provides;
- and has provided significant funding for securities/financial industry development purposes;
- fidelity funds held by the other exchanges;
 - again, we are not aware of them imposing on the market operator or the participants any significant additional costs;
- flexibility which may reduce costs, particularly for new players, is provided in new Part 7.5.

187. If no statutory scheme is justified, then dismantling the market compensation funds would involve:

- a reduction (or perceived reduction) in the level of protection provided by these mechanisms to the clients of market participants, particularly clients of participating organisations of the ASX;
- questions about what should be done with the money in these funds.
 - It is probably impossible that they be repaid to those who contributed to them.
 - : for example, the National Guarantee Fund in part derives from the fidelity funds of the pre-1986 capital city exchanges.
 - investors may be concerned if all the funds, previously set aside for investor protection, were instead allocated for 'financial industry development' purposes, particularly if those purposes involve payments to demutualised exchanges for what are perceived as commercial purposes.

188. Not dismantling them involves retaining a regime which can be said to be inconsistent with regulatory neutrality. On the other hand, the evidence of loss in this segment of the financial services sector is supported by statistics and requiring formal markets to have such arrangements can perhaps be justified by reference to the particular promise inherent in offering market services.

189. We note that of the five definite views on this issue included in the submissions, two (the Commonwealth Bank and IBSA) favoured retention of the current requirement for market licensees to have compensation arrangements. ASIC opposed it on the ground of neutrality with off-market transactions; however, ASIC's view was put in the context of

recommending a broad statutory scheme. FSCPC argued against the retention of market related schemes on the ground that market participants should be party to a broad based statutory scheme instead. SFE argued against retention of the requirement on the ground that it was an anomaly reflecting a failure of the Financial Services Reform amendments to take account of the significance of the prior demutualisation of the exchanges.

190. We doubt the weight of the argument that no obligation should rest on the market licensee because the cost should be with participant, not market operator. While the obligation to make the arrangements currently rests with the market licensee, we expect that the cost would be passed on to participants or be carried by the fund.

Is there any justification for requiring new market licensees, including those with innovative structures to have compensation arrangements?

191. To the extent that a new market licensee offers services comparable to those currently licensed and to retail clients, then regulatory neutrality would appear to require the imposition of equivalent obligations.

192. It may need to be examined if and when new market models come to light. Note the exemption and modification power in section 893A.

What about clearing participants who are not market participants?

193. With developments in the industry, the separate regulation of clearing and settlement facilities in new Chapter 7 and the effect of the 'third party forcing' provisions of the *Trade Practices Act 1974*, the exchanges have been making separate provision for clearing participants.

194. It is likely that clearing participants would hold property on behalf of clients. The heads of claim against the National Guarantee Fund have been amended to accommodate this change.

195. However, it is not addressed elsewhere in Part 7.5. We note that when the possibility of requiring clearing and settlement facilities to have compensation arrangements was previously raised, it was roundly condemned. The result may be incremental diminution in the value of the Division 3, Part 7.5 requirements.

What changes should be made to Part 7.5?

196. The changes under consideration are:

- limiting access to the heads of claim against the National Guarantee Fund which provide 'consumer protection' to retail clients;

- should there also or instead be a monetary cap on payments?

- a cap on levies under the National Guarantee Fund provisions (per levy and per year).

197. We are also willing to consider amendments to the provisions which attempt to allocate a particular transaction to a particular market (see section 885D).

198. These are discussed individually below.

199. It was also suggested that the SEGC take on the role of 'first' liquidator (by analogy with the US Securities Investor Protection Corporation) but this is not considered appropriate in the Australian context.

Retail clients — National Guarantee Fund

200. The first change involves limiting access to the heads of claim against the National Guarantee Fund which relate to 'consumer protection' to retail clients. (Currently there is no limit on who may claim and the only limit on payments is a limit on the total payments for claims with respect to a particular insolvency.)

201. The relevant heads of claim are:

- some aspects of the contract guarantee (Corporations Regulations 7.5.24-27);
- unauthorised transfer (Subdivision 4.7 of Part 7.5 of the Corporations Regulations);
- contraventions of ASTC certificate cancellation provisions (Subdivision 4.8 of Part 7.5);
- claims in respect of insolvent participants (Subdivision 4.9 of Part 7.5).

202. Such a change:

- would not be consistent with the original National Guarantee Fund heads of claim;
 - but would be consistent with the Part 7.5 arrangements applying to other market operators, as well as the tenor of the *Financial Services Reform Act 2001* generally;
- would omit the protection currently provided by the National Guarantee Fund to wholesale clients, including in relation to uncertificated holdings;
- may diminish the protection of property entrusted in connection with orders of retail clients received by brokers via, for example, financial planners in circumstances

where the financial planner (not the retail client) is, under the business rules, the client of the broker (referral business);

- would assist actuaries in calculating the appropriate amount for the Fund;
- will result, as will any limitation on payment, in less funds being required for the investor protection heads of claim against the Fund — this is particularly relevant in the context of any split of the Fund under section 891A and to the calculation of excess funds which might be available for financial industry development account purposes.

203. Given that the most frequent reason for claiming in recent years has been unauthorised transfer, the definition of 'retail client' needs to be examined to ensure that any such limitation works appropriately in these circumstances. If claimants are to be so limited, there would need to be clarification that the holder of the financial product which is transferred without authorisation is a retail client to the extent that any of the holdings transferred without authorisation were purchased by that person as a retail client. The purpose would be to address the following problems:

- the definition of 'retail client' currently anticipates that the client takes some action – for example, receives advice or sells a financial product;
- an unauthorised transfer can involve a range of shares, units in managed investment schemes etc held by the one person which in total may exceed the 'retail client' limit for investment products.

204. The aim is to provide certainty for the client and the Fund manager.

Capping of investor protection payments from the National Guarantee Fund

205. It has been suggested that there is justification for also or instead imposing a monetary cap on each successful claim.

206. The reasons put forward by the SEGC for a cap of \$500,000 include:

- structural soundness (to address the theoretical possibility of a large claim or series of large claims 'wiping out' the Fund) and to facilitate actuarial calculation of the amount required for the Fund;
- moral hazard;
- that it would be consistent with external dispute resolution schemes and reduce the possibility of forum shopping;
- comparison with the superseded fidelity fund requirements and international comparisons;

- such a cap would have limited payments on only 4 occasions since the Fund's inception.

207. The arguments in favour of capping payments instead of imposing a requirement that the claimant be 'a retail client' are:

- it provides greater certainty for the claimant, who does not have to worry whether or not they meet the 'retail client' test;
- it may assist with the problem of referral business;
- it provides a modest level of protection for wholesale clients;
- it means that all participants are available to be levied where significant investor protection losses have been incurred by the Fund.

208. On the other hand:

- it can be seen as inconsistent with the requirements applying to other market operators under Part 7.5 (in relation to which the fundamental distinction of the Financial Services Reform Act between 'retail' and 'wholesale' applies);
- it involves obligations on licensees providing services only to wholesale clients while providing possibly negligible protection for wholesale clients.

209. If claimants are limited to retail clients and a cap is also introduced, then:

- it may provide compensation only for a portion of the loss of retail clients;
- it would mean that only participants providing services to retail clients are available to be levied where there have been significant payments on investor protection claims.

210. We note that the SEGC, on page 12 of its submission, refers to the amount of caps in overseas schemes. These range from A\$35,000 per claimant under the Hong Kong scheme to A\$1.17 million per customer under the Canadian scheme.

211. While uncapped liability is undesirable, further discussion of this issue is required and it is therefore included in the questions in Chapter 5 (see Issue 6). We note that this discussion is also relevant to any later decision as to capping proposed under arrangements regulated under Division 3 of Part 7.5¹³.

¹³ See subsection 885E(3).

Capping levies on the National Guarantee Fund

212. IBSA and SEGC have requested a limit on the exposure of individual financial services licensees to the National Guarantee Fund.

213. Apparently authorised deposit-taking institutions wish to become participating organisations of the Australian Stock Exchange ie their broking/clearing activity would be conducted through the same company that holds the authority to carry on banking business, rather than through an associated company.

214. The reason given for this proposal is the commercial benefits seen — for example, financing programs could apparently be amalgamated to reduce funding costs and compliance costs could be reduced, as well as other administrative and operational savings achieved.

215. However, APRA is concerned about what it sees as unlimited exposure of any authorised deposit-taking institution to the National Guarantee Fund if it becomes a participating organisation.

- This is through the (statutory) power of the SEGC (which administers the National Guarantee Fund) to levy, either directly or indirectly, participating organisations when the Fund falls below its minimum.
- Currently, the National Guarantee Fund is approximately twice the minimum amount and, so far as we are aware, there have been no levies imposed since its inception in 1987.

216. It would be difficult to cap levies if payments out of the Fund are not capped or limited in some way. This is relevant to both of the current functions of the NGF — clearing support and investor protection.

217. It is proposed to cap levies for the benefit of the NGF. One possible cap would be the value of each participating organisation's transactions over the previous year as a percentage of the total value of transactions covered by the NGF, multiplied by the number of dollars the NGF is below its minimum.

218. Thus, if:

- the NGF's minimum is \$80 million;
- it has fallen to \$40 million; and
- the participating organisation has been a party to (whether as agent or principal) 10 per cent of the value of transactions covered by the NGF in the preceding year;

then the cap on levies for which it can be made liable is \$4 million. There would need to be a cap on each levy, and on total levies per year. This may mean that, in the event of substantial claims, the SEGC would need to borrow and levy in the next and subsequent years (rather than making significant calls on participants in the first year).

219. This change would not interfere with the discretion of the SEGC to determine the levy (under section 889J), or the market operator to do so (under section 889K) except to set a cap.

220. The discussion in the segment above about limiting claimants on the National Guarantee Fund is also relevant to amendments to the levying provisions — if claimants are limited to retail clients, then it may well be appropriate for participants providing services to retail clients to pay a higher levy, or (if a section 891A determination has been made) to be the only levy-payers.

221. This problem is reflected in Issue 6(c), Chapter 5.

Allocation of transactions

222. Those who see problems in section 885D need to bring forward details. The problems need to be realistic in the Australian context.

Relationship between Part 7.5 and 912B

223. We do not find the requirements in proposed revised section 912B and Part 7.5 to be in conflict. The two requirements should complement each other. The administrator of a Part 7.5 arrangement is subrogated to the rights of the claimant against the financial services licensee which is backed by the compensation arrangements required by section 912B (and any additional requirements imposed by the market operator, for example, to protect the compensation scheme).

J Other

Some other suggestions made in the submissions

Greater Government involvement

224. The philosophy behind these reforms is consistent with the Corporate Law Economic Reform Program. This philosophy puts substantial value on competition, and requires justification for government intervention in a market.

225. It is therefore understandable that calls for the government to set up an insurance company, provide a guarantee or organise the pooling of risk or group plans for the whole industry have not been accepted.

Payment orders by external dispute resolution schemes and ASIC

226. One proposal was that external dispute resolution schemes and ASIC have the power to order a licensee to pay compensation. If the licensee failed to pay, the consumer would be paid from a compensation scheme at the direction of the scheme or ASIC. If unpaid, ASIC would attempt to recover the funds from the licensee, which would be backed by professional indemnity insurance.

227. This suggestion requires a statutory compensation scheme which itself requires justification, although we acknowledge that professional indemnity and similar insurance may not achieve perfect coverage.

228. Further, external dispute resolution schemes are approved as just that — they are set up on an industry basis and while there is some oversight by ASIC, their staffing is ultimately a matter for the scheme administrators. It would therefore be inappropriate to give such schemes a power to order compensation from a compulsory industry fund ie other than through the contractual means already at their disposal. The proposal also involves a significant new role for ASIC, the legal ramifications of which have not been explored.

Professional standards model

229. The FPA suggested that the Commonwealth adopt a Commonwealth-wide scheme based on the professional standards legislation in NSW and WA.

230. The attractions included capping of liability, the promotion of risk management measures, and the belief that such schemes help to reduce the professional indemnity premiums charged.

231. However, this exercise relates only to the provision of financial services.

232. We note that professional standards legislation is being progressed by Treasury Ministers and other ministerial councils. If such schemes improve the capacity of the professional indemnity market and lower premiums, then their adoption may affect the choice for financial services licensees in meeting the section 912B requirements.

Joint and several liability/proportionate liability

233. The question whether provisions imposing joint and several liability for economic loss should be amended to impose proportionate liability instead is being examined generally by State, Territory and Commonwealth officers. The *Corporate Law Economic Reform Program (Audit Reform and Disclosure) Bill 2003*, which was introduced into the Commonwealth Parliament on 4th December 2003, is relevant in this regard.

Part 23 of SIS as a model

234. Part 23 of the *Superannuation Industry (Supervision) Act 1993* requires substantial diminution in the value of the superannuation fund arising from fraudulent conduct or theft leading to difficulty in the payment of benefits. It involves a determination by the Minister as to whether public interest requires that a grant of financial assistance should be made to the trustee and ultimately a levy on the industry to fund the payments.

235. The Part 23 scheme:

- was framed in the light of the special status of superannuation funds;
- is based on the assumption that it will be triggered very rarely, but that when it is, the amount involved may be considerable;
- is being reviewed following the Government's response to the Superannuation Working Group.

236. We do not see it as an appropriate model to adopt in relation to financial services.

Do the proposed requirements recognise the differences within the financial services sector?

237. While several submissions argued that there should be separate requirements prescribed depending on the financial product concerned or for each segment of the financial services sector, we are not convinced that this is the best way to go. Adopting this route would be inconsistent with:

- the harmonised regulatory theme of CLERP 6/*the Financial Services Reform Act 2001*;
- trends in the sector (for example, banks seeking to become stockbrokers) and the aim of the reforms to facilitate change.

238. It is not clear that the risk of poor financial service varies with the financial product involved.¹⁴ Similarly, it is also not clear that market-linked products should be treated separately. It would seem more likely that risk varies with the particular financial service involved — for example, advising is considered higher risk than dealing.

239. Flexibility is provided in the requirements through:

- retention of the current provisions of paragraph 912B(2)(a) for regulations to spell out the detail;
- retention of the current provisions of paragraph 912B(2)(b) which allow ASIC to approve other arrangements;
 - it is expected that these will be explained in an ASIC Policy Statement;
- inclusion of a provision empowering the making of regulations to exempt licensees from the requirements of section 912B.
 - the details would be included in the regulations;
- retention of section 893A which empowers the making of regulations which would exempt a market licensee from all or specific provisions of Part 7.5 or modify them in their particular application to a particular person or class of persons.

Simplicity

240. Clearly, the simpler the scheme, the more easily it is understood by consumers. However, the wider factors have to be taken into account — whether the problem justifies the particular scheme, and its cost.

241. If the scheme is not simple, then there will be a heavier burden on industry and ASIC to convey it effectively to the public, so that there are realistic expectations.

Assessing relevant information

242. ASIC already provides the public with the means of checking relevant information on the internet¹⁵:

- the Register of Licensees provides the licence number, licence status, responsible person details, etc.

¹⁴ However, losses resulting from the purchase of more risky products may lead consumers to claim that the advice was inappropriate when the product loses value.

¹⁵ Go to www.ASIC.gov.au and look under Companies — Searching & Lodging.

- It also includes links to a list of the Licensee's authorised representatives and the licence authorisation conditions (which includes the financial services and classes of financial products covered by the licence).
- The full conditions on the licence can be obtained by ordering a copy of the licence document and paying the required fee.
- The Register of Authorised Representatives provides, among other things, details of both the licensee and authorised representative and the classes of financial services the representative is authorised to provide.
- There are also Banned and Disqualified Registers.

243. A related issue is the need to ensure that clients do not have incorrect expectations of what compensation arrangements will cover. Your comments are sought as to the mechanisms to achieve this (see Issue 7, Chapter 5). In this context we note the requirement in section 792I for market licences to ensure that information about compensation arrangements is available to the public free of charge.

Small business

244. It is necessary to bear in mind the impact of any changes on smaller financial services licensees.

245. Issue 8 in Chapter 5 specifically asks this question.

Transitional

246. It is proposed that the current transitional arrangements in relation to section 912B be extended for a further year. The current transitional arrangements are reflected in Corporations Regulations 10.2.44 and 10.2.45.

247. This would mean that insurance brokers and 'securities' dealers and advisers that have Australian financial services licences would need to continue to comply with the 'old law' compensation arrangements until the new compensation regime under section 912B applied. As is currently the case, ASIC would also continue to impose professional indemnity insurance requirements on responsible entities and IPDS operators as conditions of their licences. Many of the remaining licensees are subject to industry association membership requirements that impose professional indemnity insurance.

248. This will allow time for:

- ASIC to develop its policy on alternatives and licensees to consider them and decide the appropriate solution for their circumstances;

- the insurance industry to consider any necessary changes to the wording of policies;
- licensees and industry associations to arrange cover; and
- take account of the renewal cycle for professional indemnity policies.

K Concluding comments

249. Licensing requirements are not going to provide a complete safeguard against incompetence and fraud; compensation arrangements will not provide against the range of losses which some consumers may seek.

250. Both are, however, aspects of the package of measures including conditions relating to financial resources, disclosure, existing avenues for redress and external dispute resolution schemes, the purpose of which is to provide an appropriate level of protection for consumers.

251. It is not the role of the government to make any financial service risk-free. The consumer must take some responsibility and make some assessment of the risks. In a similar vein, any industry groups which are concerned about how the public perceives them must take whatever measures they can to address those public concerns.

252. There also needs to be a balance between the costs and benefits of the various options for consumers, business and the government. The costs and benefits of various broad options are discussed in Attachment C.

253. Expectations may also need to be modified in the light of the limitations of the available mechanisms. It is necessary to accept that market-based mechanisms, such as professional indemnity and similar insurance, have inherent limitations which cannot be legislated away.

4. THE GOVERNMENT'S BASIC POSITION

254. The Government proposes that:

- section 912B of the Corporations Act be amended so that the requirement on financial services licensees is for compensation arrangements to cover acts, errors or omissions for which the licensee is legally liable and such conduct of its representatives for which it is responsible¹⁶ (but excluding civil penalty and criminal penalties imposed on the licensee) in the course of:
 - dealing on behalf of;
 - advising; or
 - providing custodial or depository services.¹⁷

to retail clients on financial products, but only to the extent that the conduct is within the licensee's licence.

- that the level and framing of the detailed requirements and any obligations on insurers should be discussed further — see Issue 4, Chapter 5.
- the basic method of complying with the obligation be professional indemnity insurance (with 'fidelity' or fraud insurance/policy extension);
 - that complying cover could be issued by Australian authorised insurers or those subject to a comparable regulatory framework;
- there are expected to be alternatives to complying insurance (these would need to be approved by ASIC);
 - regulations are expected to provide detail about acceptable insurance cover and provide guidance to ASIC on alternatives;
 - see Issue 2, Chapter 5;
- the transitional period for compliance with the revised section 912B be extended for 12 months (to 10 March 2005);

¹⁶ See Division 6 of Part 7.6.

¹⁷ With the possibility of extension to conduct prescribed under paragraph 766A(1)(f). We note that the requirement in section 912B would appear to have no application in relation to making a market, and that separate requirements apply in relation to operating a registered scheme.

- in addition, provision be made to empower the making of regulations to exempt licensees from this requirement where the licensee:
 - is regulated by APRA as a life or general insurance company or authorised deposit-taking institution; or
 - is of sufficiently high capitalisation — see Issue 3, Chapter 5 (details would be in the regulations); or
 - is guaranteed, in relation to the obligations of the licensee to its retail clients in relation to conduct required to be covered by amended section 912B, by such a body if the licensee becomes insolvent or unable to pay (again details in the regulations);
- the evidence of loss and risk of loss to retail clients in the provision of financial services is not such as to warrant consideration now of a wide-ranging statutory scheme;
 - it may be that, if more comprehensive data is able to be collected in the future, the question whether such a scheme is justified should be revisited;
- the basic requirements for market compensation arrangements, included in Part 7.5 of the Corporations Act, be retained, but that further discussion take place as to the means of:
 - restricting claimants against and/or payments from the National Guarantee Fund;
 - : this requires further discussion — see Issues 6(a) — (b), Chapter 5;
 - capping levies to fund the National Guarantee Fund — see Issue 6(c), Chapter 5;
 - : this requires further discussion as to the appropriate formula and in the light of any limitation that claimants be retail clients or that claims be capped.

Implementation

255. As indicated above, the final proposal would be implemented by:

- amendment of section 912B and relevant provisions of Part 7.5;
- regulations; and
- ASIC policy statement.

5. ISSUES FOR CONSIDERATION

256. Your contribution is sought on the following issues:

Issue 1

Ambit of the proposed insurance coverage

257. Is the ambit of the proposed insurance coverage appropriate? For example, should particular statutory obligations be exempt from coverage because it might encourage non-compliance?

(See discussion at paragraphs 92 to 98)

Issue 2

Alternatives

258. Are there other alternatives to professional indemnity insurance (with 'fidelity' or fraud insurance/policy extension) that should be considered?

(See discussion at paragraphs 127 to 132)

Issue 3

Exemptions—high capitalisation

259. What is the appropriate test for this exemption?

(See discussion at paragraphs 133)

Issue 4

Details of complying insurance cover¹⁸

18 For Insurance (Agents and Brokers) Act requirements, see Attachment D.

260. Your input is sought on:

- (a) the appropriate level of prescription;
- (b) which facets of the cover should be prescribed and how should the detail be prescribed (given the range of licensees and conduct subject to the requirement):
 - (i) how should the minimum annual cover be calculated?
 - (ii) how should an appropriate amount of cover be determined where the insurance relates to a group of entities?
 - (iii) how should the minimum amount payable by the insurer for multiple claims in the one period be calculated?
 - (iv) should maximum excesses be prescribed? if so, at what level?
 - (v) what exclusions are acceptable?
 - (vi) should run-off cover be mandatory?
 - (vii) how should retroactive cover be addressed?
 - (viii) is run-off cover available?

(See discussion at paragraphs 148 to 155)

Issue 5

Obligations on insurers?

261. Your input is sought on appropriate means of ensuring that complying cover is maintained:

- (a) should the insurer be required to give ASIC notice, including the reason, before cancelling a policy?
- (b) should the insurer be prevented from avoiding the contract or reducing liability under it on the ground of non-disclosure by the insured?
- (c) what effect would the measures referred to in (a) and (b) have on availability of complying cover?
 - (i) Legislative requirements imposed on insurers outside the jurisdiction are likely to be of little effect.

- (d) Do you have any suggestions for other processes or mechanisms for enhancing ASIC's capacity to monitor compliance with the requirement?

(See discussion at paragraphs 157 to 161)

Issue 6

Market compensation arrangements

- (a) Should the investor protection heads of claim against the National Guarantee Fund be limited to retail clients?
- (b) Should the amount of the payment from the National Guarantee Fund be limited instead of or as well as limiting claimants to retail clients?
- (c) Is a limitation on the levying power of the SEGC appropriate to assist ADIs to meet APRA requirements?
- do you agree with the proposed calculation of the minimum?
(see paragraph 218)

(See discussion at paragraphs 196 to 221)

Issue 7

Expectations

262. How should the public be informed about the compensation regime? In particular, to avoid false expectations.

(See discussion at paragraph 243)

Issue 8

Small business

263. What is the effect of the proposal on small business?

264. (see paragraph 244)

PUBLIC SUBMISSIONS RECEIVED

American Home Assurance Company

APT Strategy

Association of Superannuation Funds of Australia (ASFA)

Australian Association of Permanent Building Societies (AAPBS)

Australian Securities and Investments Commission (ASIC)

Australian Stock Exchange Limited (ASX)

Boutique Financial Planning

Barry Buxton

Commonwealth Bank

Credit Union Services Corporation (CUSCAL)

Ian Donaldson

Financial Planning Association (FPA)

Financial Industry Complaints Service Ltd (FICS)

Financial Services Consumer Policy Centre (FSCPC)

Insurance Council of Australia (ICA)

Institute of Chartered Accountants in Australia (ICAA)

International Banks and Securities Association of Australia (IBSA)

Investment and Financial Services Association (IFSA)

John Jordan

National Credit Union Association Inc

National Insurance Brokers Association (NIBA)

Securities and Derivatives Industry Association (SDIA)

Securities Exchanges Guarantee Corporation Limited (SEGC)

SFE Corporation Limited (SFE)

Trustee Corporations Association of Australia (TCA)

WA Dept of Consumer and Employment Protection

SUMMARY OF SUBMISSIONS ON MAIN ISSUES

A Responses on the more important issues

Losses incurred

Issue 1

Can you provide any evidence of the nature and extent of losses suffered by consumers of financial services to assist us to understand the extent of the problem?

265. As may have been expected, no one who made a submission could provide a comprehensive picture of the losses suffered by consumers.

266. However various pointers were given. For example:

- John Jordan had encountered losses arising from poor advice, bad research, loss of funds, failure to carry out instructions, loss of documents, loss of taxation or social security rights;
- The SEGC indicated that in the last 5 financial years, there had been 178 claims on the National Guarantee Fund — 7 had been allowed, 129 settled, 30 disallowed, 4 time-barred and 8 withdrawn (a number of these claims were in connection with the one course of conduct, so the claims received in this period (and the outcome) may not be representative);
- FICS provided an indication of 7 situations in which the service had been unable to assist complainants because, for example, the provider's licence had been revoked;
- SDIA expressed the view that the problem area was insolvency, particularly when the run-off cover did not handle all claims;
- The SFE indicated that over the last 16 years it has received claims in relation to only 3 (former) intermediaries, involving an aggregate of around 30 customers, with the aggregate pay out being approximately \$640,000. There have been no claims since 1993.
- The FSCPC referred to losses in a wide area including insolvency, inappropriate advice, fraud, agribusiness schemes, timeshare schemes, schemes which deliberately avoid the managed investments regime, superannuation, solicitors mortgage schemes and finance brokers;

- ASIC updated its statistics on intermediaries which had gone into external administration and provided statistics on criminal and civil action it initiated in 2001-02.

267. On the other hand, NIBA reported that there was no evidence of any significant losses being suffered by customers of insurance brokers.

- Mr Gerrard of APT Strategy, with 16 years' experience in financial planning, similarly expressed the view that it was rare for consumers to suffer loss as a result of misconduct in the course of providing financial services, and that he had never seen a loss of confidence in the financial services marketplace as a result of such conduct. He considered therefore that the objective had been satisfactorily achieved by the existing arrangements, but that did not mean that they could not be improved.

268. IFSA stated that it did not have in its possession information as to the size of the problem, and expressed the view that it was 'not convinced that it is sufficiently large as to jeopardise, much less threaten, consumer confidence in the financial services industry'.

269. More details of the evidence available are included in Chapter 3.

Justification for requiring compensation arrangements

Issue 2

Is requiring compensation arrangements in the financial services sector justified?

270. While there appears to be no satisfactory statistics on the level of loss caused by misconduct in the financial services sector, most of those who responded to Principal Issue 2 were of the view that requiring compensation arrangements in the financial services sector could be justified.

271. The ground generally given was that it promotes confidence in the financial services sector to the benefit of all market participants.

272. The SEGC was more specific and referred to:

- consumers not being in a position to protect their interests when dealing with financial services licensees due to a lack of information or experience in relation to financial products or the financial services industry;
- the comment in the Issues Paper that consumers may not make major investment decisions frequently, and hence may have little experience in relation to those decisions;

- the deficiencies of other remedies — the cost of legal action, and the possibility of assets not being available in a winding up to pay the claim;
- the loss resulting from insolvency and/or improper conduct of a financial services licensee may have a significant financial effect on the clients of that licensee — particularly, where the clients have all their investments managed by the one licensee.

273. The SEGC also suggested that without the confidence coming from compensation arrangements, consumers may be unwilling to use the services of the financial services industry and that this would be detrimental to that industry and the economy as a whole. Further, it referred to the desirability of being consistent with international practice.

274. ASIC referred to the expectation of financial services consumers that funds taken or held on trust will be safe. The Commission expressed the view that a limited assurance of the availability of compensation may help maintain and enhance consumer participation, including in smaller firms not connected with large financial institutions. It also referred to the potentially devastating consequences of loss in this connection, including on retirees.

275. The FSCPC referred to the government's retirement incomes policy as having dramatically pushed up participation rates in the sector and expressed the view that it is increasingly exposing unsophisticated and highly vulnerable groups, such as retirees, potentially to complete ruin.

276. However, the ICAA indicated that compensation arrangements were justifiable only if there is considered to be a hole in the myriad of mechanisms currently available to consumers. The Commonwealth Bank suggested that further investigation of the efficacy of existing arrangements and the different means to reduce insolvency risk should be undertaken before they are found to be flawed or major reform is desired. The Bank suggested that it was pointless trying to solve problems that were not entirely clear. It suggested that 'market-based' approaches, such as the need to protect reputation, should be explored.

277. Even amongst the many who considered that compensation arrangements were justified, various qualifications were expressed:

- compensation requirements should not apply to authorised deposit-taking institutions, or not apply to any APRA-regulated body;
- they should be carefully targeted, relative to the scale of the identified problem and not cover every breach of a licensee's obligation;

- compensation arrangements should not involve cross-subsidisation — the obligations on licensees should be proportionate to the degree of risk of fraud or failure in their area of business;
- they should be framed to minimise ‘moral hazard’, and with a limit on the liability of the financial services licensee to fund the arrangements;
- unwarranted costs should not be placed on licensees - the costs should be passed on to the consumer;
- according to NIBA, the protection should be reasonable but not absolute.

278. FSCPC pointed to existing compensation requirements as justification for their need.

The purpose of compensation arrangements

Issue 3

What is the purpose of compensation arrangements which are required by legislation?

279. As well as the more obvious purpose of being a source of funds to meet claims by clients suffering loss in the course of the provision of financial services, John Jordan pointed out that compensation arrangements could be used as a risk management device, to help identify and correct bad practice.

280. The FSCPC expressed the view that compensation arrangements must facilitate access to compensation.

281. The Financial Planning Association recommended that any compensation system should:

- perform a compensation function;
- encourage or legislate complete coverage of industry participants;
- perform a deterrence function;
- limit liability of professionals to reasonable levels having regard to the loss suffered by the consumer;
- encourage the adoption of good and secure business practices; and
- encourage access by all members of the public to financial planning services.

282. The FPA considered that the system should be simple, clear, accessible and affordable for both consumers and participants, and robust.

Unlicensed providers and unlicensed conduct

283. While not posed as numbered issues in the Issues Paper, paragraphs 126 and 127 put the questions:

- Should compensation arrangements be limited to the conduct of financial services licensees and their representatives, and not include unlicensed providers of financial services?
- Should compensation be payable when a licensee (or its representative) is acting outside the terms of its licence (or authority), but in circumstances which would require a financial services licence (or authority)?

284. Several submissions indicated 'yes' to the first question. This of course means that consumers should be encouraged to check ASIC's registers to ensure that the person they are dealing with is licensed or authorised.

285. However, the few responses to the second question — coverage of conduct outside the terms of the licence or authority — indicated its difficulty. Just how easy is it for a retail client to assess whether an authorised representative is acting within the scope of his or her authority from the licensee? On the other hand, how can any compensation mechanism realistically cover such unauthorised conduct?

286. ASIC's view was that it may be appropriate for any compensation scheme to cover circumstances where a licensee (or its authorised representative) acts outside the terms of its licence (or authority) but within the range of activities for which it could be licensed (or authorised) — ie in apparent compliance with Parts 7.7 and 7.8.

287. FSCPC expressed the view that compensation arrangements as a whole should include coverage where a licensee is acting outside the terms of its licence.

288. Without amendment, the responsibility of the licensee for conduct of their representative would be determined in accordance with Division 6 of Part 7. 6.

Circumstances Covered

Issue 4

What circumstances should compensation arrangements cover?

- (a) In what circumstances should compensation arrangements be required in relation to a financial services licensee?
- (b) Should different criteria or a different mechanism apply depending on whether the financial service provider is solvent or unable to pay/insolvent?
- (c) Should compensation arrangements relate only to the situation where the financial services licensee is unable to pay/insolvent?

289. A variety of responses was received to Issue 4(a). Fewer submissions addressed Issues 4(b) and (c). However, several responses indicated 'no' in response to the question whether different criteria should apply when the financial service provider is insolvent or unable to pay.

290. The following sought wide coverage:

- The FSCPC expressed the view that compensation arrangements should cover advising, dealing, and operating registered schemes, superannuation funds and insurance companies.
 - The arrangements should cover breaches of all of the licensee's obligations (including breaches of the Trade Practices Act and the Corporations Act, as well as fraud and dishonesty) and underpin external dispute resolution determinations and court judgments.
 - In the case of licensees who are insolvent or unable to pay, then the minimum compensation arrangements should cover failure to account, gross incompetence, fraud or fraudulent conduct, dishonesty, fidelity breaches and grossly misleading and deceptive conduct.
- John Jordan suggested that compensation should be available when ordered by a court, ASIC or alternative dispute resolution scheme;
- SEGC recommended that professional indemnity insurance be held covering negligence, breach of contract and statute and fraudulent acts by officers, employees or authorised representatives, and that it should extend to determinations of external dispute resolution schemes;
- ASIC expressed the view that licensees should be required to be insured generally against claims arising from breaches of all their and their representatives' legal

obligations to clients. The coverage should extend to all financial products and financial services provided. It should include negligence, breach of contract, breaches of the licensee's or representative's statutory obligation, fraud or dishonest conduct by employees of the licensee or its authorised representatives and legal costs, determinations of external dispute resolution schemes, run-off cover.

– However, the coverage of compensation arrangements where the licensee is insolvent or unable to pay should be limited to protecting client funds and other property if the licensee or representative is unable to account for the property (whether or not fraud is also established).

- The TCA argued that compensation should cover all the actions you could have taken against the licensee in his capacity as a licensee.
- The FPA suggested coverage for loss of documents, libel and slander, fraud and dishonesty, Trade Practices Act and Fair Trading breaches and FICS determinations up to the maximum jurisdictional limit.
- The Commonwealth Bank suggested that the scope of the arrangements envisaged in section 912B should be 'reduced' so that it required compensation arrangements for loss suffered because of fraud, defalcation, loss of funds entrusted to a licensee (prior to the issue of a financial product) due to insolvency or negligent advice.
- IFSA suggested that professional indemnity insurance should cover all successful claims against licensees in relation to activities covered by the licence, including negligence, fraud and dishonesty.

291. On the other hand:

- The SFE expressed the view that fraud or defalcation would be an appropriate starting point (with the possibility of broadening the range of conduct being explored in a second phase).
 - the Exchange expressed the view that to require compensation in relation to every breach of a licensee's obligations would impose very high costs.
- The ICAA stated that compensation should be required to cover losses caused to the consumer by negligence.
- NIBA suggested, in connection with insurance intermediaries, that compensation arrangements were appropriate where there had been a failure to enter into and complete transactions according to the client's instructions.
- Another submission suggested that the compensation regime should not extend to advising, making a market or discretionary trading, but instead should protect investors' property or funds which are lodged with a financial services licensee,

essentially in a quasi-trustee function, rather than protecting investors against all failures by the licensee to properly carry out its duties and obligations.

- The focus on property entrusted was also reflected in IBSA's submission.
- This emphasis leads to a compensation regime with a comparable coverage to that of the National Guarantee Fund — ie unauthorised transfer, deficiency on insolvency in property entrusted, unauthorised transfer.

292. As one would expect, the authors of submissions drew on their experience in the sectors they operate in and the compensation arrangements to which they are currently subject.

293. Thus ASFA suggested the introduction of a requirement for a superannuation fund trustee seeking an AFSL to hold trustee liability insurance as a means of meeting their section 912B obligations, and confined its submission to superannuation. It suggested that the scope and nature of the compensation for loss payments needs to be limited to those cases where breaches of the SIS or the FSR legislation have occurred and the fund or adviser is unable to make payments as a result of fraudulent behaviour.

294. Several, while expressing a view on the general desirability of compensation arrangements, sought exemption for APRA-regulated bodies, and at least one indicated that issuers (or at least insurers) should be exempt. Few specifically addressed obligations in respect of past and present representatives.

295. A difference of view was evident in the responses to the question whether different criteria or a different mechanism should apply depending on whether the financial service provider was solvent or unable to pay/insolvent. One view was that there should be consistent coverage whether or not a licensee was solvent. The other view put was that a different mechanism should apply and that the costs and limitations of that mechanism should be taken into account in determining its coverage.

Claimants

Issue 5

Who should be entitled to claim?

296. The answer provided in the vast majority of submissions which addressed this issue was 'retail' persons. Several expressed agreement with the reasons put forward in the CASAC paper for so limiting claimants, and that it was consistent with the Financial Services Reform Act amendments.

297. Other responses included:

- It should not matter if the client is retail or wholesale (ICAA);
- Both retail and wholesale clients should be entitled to claim, but the maximum payments should be capped (NIBA).

298. Other points made in this connection are:

- The suggestion that perhaps there should be a higher limit on the amount of compensation in relation to superannuation products;
- FSCPC stated that any person who can demonstrate that they have a beneficial interest in a dealing or transaction should also be allowed to claim as long as they would also meet the definition of retail client. The purpose of this suggestion was to assist beneficiaries of deceased estates.

299. No difficulties were expressed with the idea that those who were responsible for, or profited from, the financial difficulties of a licensee should not be entitled to claim.

Compensation requirements imposed on financial services licensees

Issue 6

What compensation requirements should be imposed on financial services licensees?

- (a) Should financial services licensees be required to have professional indemnity insurance? Are there other appropriate mechanisms which could be alternatives at the option of the licensee?
- (b) What should the mechanism adopted be required to cover?

300. It was generally agreed that since the losses in issue are the consequences of the conduct of financial services licensees (or their representatives) the primary obligation should rest on the licensee. This was so even if a wider statutory compensation scheme were proposed as a safety net.

301. The discussion in the submissions was about the mechanism — capital requirements, security bonds, professional indemnity insurance or some other device.

302. Several submissions referred to the capital backing of licensees, suggesting variously that:

- a minimum level of capital should be required for all licensees (and that consideration of a solvency threshold is desirable);
- asset requirements could restrict new entrants and hence choice for consumers.

303. The TCA expressed the view that licensees should be required to have adequate financial resources to underpin their operations, comprising a minimum level of capital, and professional indemnity insurance or another acceptable guarantee, commensurate with the nature and scale of the particular financial services business.

304. There was little support for the retention of the requirement for a security bond. However, the Commonwealth Bank suggested that security bonds should be retained for those situations where professional indemnity insurance is not available, and American Home Assurance suggested it might be required, in addition to professional indemnity insurance, where the licensee was not very secure.

305. There was general support for professional indemnity insurance to be the primary compensation mechanism although there was also:

- recognition of the increases in the cost and coverage of such insurance, and the difficulties being experienced by some in obtaining it;
- recognition that some alternatives would be appropriate;
- as indicated above, little agreement on what it should cover.

306. One submission raised the question of just what role such insurance should play and the degree to which the legislation should interfere with the normal commercial relationship between the insured and insurer.

307. In addition, there was a lack of clarity as to the respective roles of external dispute resolution schemes and compensation arrangements.

308. Alternatives suggested included industry co-insurance, pooled schemes or 'group insurance'. Proportionate liability and professional standards schemes were also raised in this context. These are also addressed in Chapter 3.

309. The discussion on Principal Issue 6(b) is summarised under Principal Issue 4 above.

310. ASIC also pointed to the other matters which would need to be addressed in this context: indemnity limits, reinstatements, 'deductibles' (excess), retroactive cover, exclusions, and how to ensure compliance and the effect of action of the insured. (See Chapters 3 and 5).

Difficulties with professional indemnity insurance

Issue 7(a)

What, if any, difficulties are being experienced in the financial services sector with the cost and availability of professional indemnity insurance? For example, is run-off cover available?

311. Submissions pointed to a number of difficulties with professional indemnity insurance from the licensee's point of view at the time these submissions were written, including the following:

- Would the required cover be available? And at what price?
 - It was argued that mandating coverage does not necessarily mean that it will be offered (or offered at a price licensees regard as reasonable), particularly in the current state of the market;
 - : reference has been made to the requirement in the *Insurance (Agents and Brokers) Act 1984* for run-off cover, a requirement which was never activated because it was thought that the market could not provide it;
- Is the premium based on an assessment of risk of the particular business, or even the claims experience in relation to like businesses (or is it based on products dealt with)?
- Rigidity in the terms of coverage of professional indemnity insurance policies — ie if a business cuts across several traditional segments of the market, then several policies may be required.
- More generally, there was concern about the availability of fraud and run-off cover, exclusions etc

312. A selection of the experience with obtaining professional indemnity insurance expressed in the submissions follows:

- SDIA reported that, while professional indemnity insurance is compulsory for Principal Members, premiums have risen by up to 500 per cent and excesses have risen by up to 300 per cent (typically \$150,000);
- The ASX has also reviewed participating organisations' insurance requirements. This has shown:
 - a 100 per cent increase in excesses for many stockbrokers (to \$100,000);

- a marked decline in the average level of professional indemnity insurance (not just on retail transactions) since September 2001 (in some cases, coverage has halved);

- The ICAA referred to:

- cases where premiums have increased by more than 1000 per cent;
- minimum increases for 2002/03 renewal period being 100-200 per cent, with more if high risk conduct, such as financial planning, is involved;
- additional activities being excluded from policies (or only included at prohibitive rates) and excesses increasing;

and concluded that this could mean that a significant proportion of the firm's activity could be uninsured;

- NIBA expressed the view that while the cost of professional indemnity insurance has increased significantly over the past 12 months, it still remains readily available to insurance brokers;

- the exception is brokers with poor claims experience or those that have had their licence suspended or cancelled;
- run-off cover is not automatically available through the NIBA professional indemnity insurance facility, but is available for individuals in the market place.

- The FPA referred to anecdotal evidence of premium increases of 30 per cent to 1000 per cent but indicated it was impossible to obtain evidence of the basis of the premiums and increases in excesses of between 50 per cent and 400 per cent.

Issue 7(b)

What, if any, difficulties have consumers had in being compensated from professional indemnity insurance policies?

313. The difficulties with professional indemnity insurance from the consumer's point of view which were expressed in the submissions include the following:

- How does anyone ensure that premiums have been paid and the policy is in force?
- What about misrepresentations by the insured, or if the licensee fails to notify the insurer as required by the policy?
- Is retroactive and run-off cover available?
- An insured may negate the value of the policy in a particular instance by a failure to notify the insurer of a claim.

- Professional indemnity policies usually do not cover fraud and dishonesty of the principal.
- An insurance policy may prevent the insured telling a client which insurer covers his business and the terms of the policy.
- There may be problems in joining the insurer in legal action.
- If the claim is not covered by an external dispute resolution scheme, then litigation (with its attendant costs) may be necessary.
- The width of exclusions and, in some cases, the insurer not being willing to allow licensees to pay the compensation and then make a claim on the policy.

314. The response of the FSCPC to the difficulties encountered by consumers in accessing professional indemnity insurance policies was to suggest:

- mandating minimum insurance requirements; and
- if the insurance industry is unwilling or unable to provide appropriate insurance for licensees, then the Government should consider organising a scheme for the licensees.

Market licensees

Issue 8

Should market licensees continue to be required to make compensation arrangements (as they have in the past and are in Part 7.5)?

- (a) If so, what changes to the current Part 7.5 should be made?
- (b) Is there justification for a consolidated scheme for financial services licensees who are market participants?

315. Unfortunately only six submissions responded to Issue 8:

- IBSA argued for the retention of the National Guarantee Fund for the purposes for which it was formed (subject to the proposed split into fidelity and clearing support components);
- The Commonwealth Bank argued that fidelity funds are important means of promoting confidence in the market. For this reason, it expressed the view that the National Guarantee Fund and the Sydney Futures Exchange fidelity fund should be retained in their current form and similar fidelity funds should be required for other financial markets;

- The SEGC argued in favour of 'compensation schemes' but it was not clear whether these were individual market schemes or more general schemes;
- FSCPC argued against the retention of market related schemes on the ground that market participants should be party to a broad based statutory scheme instead.
- Both ASIC and the SFE argued against the retention of the requirement for markets to make compensation arrangements:
 - The SFE argued that the existing obligation was an anomaly reflecting a failure of the FSR amendments to take account of the significance of the prior demutualisation of the exchanges that were in existence when the FSR amendments were enacted. It argued that a shareholder-owned market operator is a utility and not the same thing as the customers who use the utility. Further, it argued that it is those customers, to the extent that they engage in misconduct, who should bear the cost of providing for misconduct by fellow users of that utility.
 - ASIC also pointed out that in a demutualised environment, market operators are no longer 'proxies' for their participants. The Commission indicated that separate market compensation arrangements are not consistent with the FSRA theme of harmonised regulatory treatment and that this involves a regulatory bias. The need for a connection with a particular market, a question about such a requirement's consistency with newer models of financial markets and the possibility of complexity for clients.
 - : ASIC instead proposed a statutory scheme which would be available where the licensee was insolvent or unable to pay, and pointed to professional indemnity insurance and external dispute resolution schemes where the licensee is able to pay.

316. Only one submission responded to Principal Issue 8(a):

- the SEGC suggested that the overlap between schemes and lack of uniformity between different schemes would need to be addressed;
 - it also submitted that the National Guarantee Fund should continue to receive interest on the trust accounts held by participating organisations of the Australian Stock Exchange;
- the SFE, on the other hand, wished to discuss transitional arrangements when market operators were no longer required to have compensation arrangements;
 - the SFE anticipates that this would mean that all money in the fidelity funds would be excess and available for 'financial industry development' purposes with fewer controls than currently.

317. Only three submissions responded to Principal Issue 8(b) — whether there was justification for a consolidated scheme for financial services licensees who are market participants. In brief:

- The SFE opposed such a scheme on the grounds of cross-subsidisation and pointed out that ‘the existing funds have different owners whose property could not be compulsorily acquired except on just terms’.
- ASIC opposed a consolidated market scheme as not being consistent with the objective of harmonised regulatory treatment.
- One confidential submission favoured it on the ground of investor confusion and the inefficiency of multiple schemes, as mentioned by CASAC in its report.

Prescribed CS facility licensees

Issue 9

Should prescribed CS (clearing and settlement) facility licensees be required to have compensation arrangements in relation to unauthorised transfers/certificate cancellation or some wider conduct?

318. The term ‘prescribed CS facility licensees’ refers to those licensed CS facilities which are prescribed ie they have access to the provisions of Part 7.11 which facilitate the electronic transfer of legal title to financial products. This brings with it added risk of unauthorised transfer of certain financial products, there being no need to produce a certificate.

319. Only ASIC responded to this issue. The Commission’s response was ‘no’, taking the view that the objections requiring market licensees to have such arrangements apply equally to CS facilities.

A broad statutory scheme

Issue 10

Do the financial services industry and consumers consider that a broad statutory scheme is warranted?

Issue 11

If so:

- (a) Should it be available prior to insolvency or only on inability to pay/insolvency?
- (b) On what grounds should claims be paid?

320. Necessarily, at the stage of the debate when the Issues Paper was released this question was lacking in specificity — as to what conduct such a scheme might cover, and which services. This may well have generated greater concern than a tightly formulated proposal.

321. There was significant opposition from industry representative groups to the idea of a broad statutory scheme:

- AAPBS opposed it;
- American Home Assurance indicated it would not be the preferred model;
- ASFA argued that, given the avenues for redress in place, the creation of a funded compensation regime is unnecessary and potentially counter-productive. Any genuine gaps in the current compensation regime should be addressed through suitable renovation of those structures.
- NIBA did not support the introduction of such a scheme on the basis that the existing professional indemnity insurance arrangements for insurance brokers are working well;
- IFSA did not consider a broad statutory scheme warranted but recognised there may be a call for a more limited scheme in relation to client assets where the licensee is insolvent or unable to pay and the professional indemnity insurance requirement has failed.

322. On the other hand:

- FSCPC favoured such a scheme, providing 'consistent coverage' including in relation to market participants.
- ASIC supported the introduction of a statutory compensation scheme as a means of supplementing the role of mandatory (and fairly comprehensive) professional indemnity insurance;
 - in ASIC's view the statutory compensation scheme should only be available on insolvency or an inability to pay, and should probably be limited to protecting retail client assets:
 - : thus the scheme would cover situations where there was misuse or misapplication of client money or financial products or misuse or

misapplication of the licensee's (or representative's) authority over money or products where the client's property or authority had been given to the licensee/representative in the course of the latter's financial services business;

- ASIC's proposal for a compensation scheme does not include coverage of losses consequent on the collapse of a managed investment scheme;
- John Jordan favoured an external scheme only as a backstop, if the licensee failed to pay the initial order under his proposed scheme.

323. The ICAA indicated that it may be willing to consider the merits in having a broad statutory scheme that is designed to provide some financial coverage involving fraud or theft (ie a scheme comparable to Part 23 of SIS).

324. It should be noted that concerns about cross-subsidisation, and the possibility of a statutory scheme covering a wide range of conduct and hence imposing significant cost on industry were expressed in a number of the submissions on this point.

Exemptions/substitutes/concessional treatment — APRA-regulated bodies, etc

Issue 12

Should special provision be made for financial services licensees which are regulated by APRA, have high financial requirements or high capitalisation, or have the requisite connection with such a body?

325. A substantial number of submissions argued that their segment of the financial services industry should be treated as a special case:

- AAPBS argued that the problem which the compensation arrangements are intended to address 'is not particularly relevant to building societies and other ADIs';
 - amongst the reasons given were the existing requirement to comply with APRA's prudential requirements and have sufficient assets to satisfy successful claims, concern about cross-subsidisation, that there was no evidence of market failure or a lack of consumer confidence that would justify a statutory scheme, the requirement to join external dispute resolution schemes, the various avenues available for legal redress and that it would impose an additional cost to the industry;
- similarly, the National Credit Union Association argued that the problem was not relevant to credit unions and their deposit taking services because of the intense prudential regulation and they already have professional indemnity insurance;

- the submission also addressed misappropriation from a depositor's account, statutory priority for depositors and deposit insurance in the event of a failure;
- in like vein, CUSCAL argued that the prudential requirements imposed on authorised deposit-taking institutions minimise the likelihood of insolvency and maximise the availability of 'assets to meet proved claims' ie they meet the purpose of the compensation arrangements, according to the Issues Paper;
- the Commonwealth Bank also argued that APRA-regulated bodies should not be included in any statutory scheme given that insolvency risk is mitigated;
 - the Bank also argued that conglomerates including APRA-regulated bodies are low risk;
- A major general insurer argued that insurers should be exempt and referred to the recent general insurance reforms.
 - While acknowledging that APRA regulation does not guarantee that a body will not fail, the insurer stated that nonetheless both extensive and further requirements would just add further expense with no more 'guarantee' than APRA regulation;
- NIBA expressed the view that licensees who are APRA regulated bodies should be exempt but not those merely associated with an APRA regulated body.
- John Jordan expressed the view that APRA-regulated entities should not be subject to the scheme, as prudential requirements should include investor protection mechanisms. He concluded that any significant compensation payment ordered for a financial services breach may threaten prudential solvency and that this was a reason to leave it to APRA.
- The ICA also argued that authorised general insurers not have to have compensation arrangements, on a variety of grounds including APRA regulation and existing consumer protection mechanisms (including the Insurance Contracts Act and external dispute resolution schemes).
- Paul Gerrard expressed the view that there is minimal risk that an institutional dealer will have insufficient assets to compensate a consumer for misconduct. He suggested that it may be appropriate for ASIC to require the parent company to provide a guarantee but that further restrictions on these dealers would not provide additional benefit to consumers. On the other hand, he recognised that there would always be an element of risk when consumers rely on independent dealers, and that this is the natural consequence of maintaining a reasonable level of competition and consumer choice in the industry.
- The SEGC expressed the view that it may be appropriate that licensees regulated by APRA, those with high financial requirements or high capitalisation or having the requisite connection with such a body not to have professional indemnity insurance,

instead arranging self-insurance or making other compensation arrangements approved by ASIC in place of insurance.

- Another reason put forward for exempting insurers was that ‘compensation’ in this context is usually to reissue the product and handle the claim.

326. On the other hand, there were expressions of caution:

- the TCA pointed out that APRA policies mean that it should not be assumed that a bank would always come to the aid of a financially-troubled associate;
 - the TCA concluded that, given that APRA regulation does not and cannot preclude misconduct by a licensee, the Association did not feel that such licensees should be exempt from the standard compensation arrangements;
- ASIC has taken the view that the key consideration should be access to a level of liquid capital sufficient to meet claims, not whether the body is APRA-regulated. It therefore does not support a blanket exemption of APRA-regulated bodies from any mandatory professional indemnity insurance requirement, or from any statutory compensation scheme. It takes the view that arrangements, such as self-insurance and the provision of an indemnity by a related company, may be appropriate alternatives where the licensee or the related company can show it has an appropriate level of liquid capital reserves.
 - ASIC considered that large businesses should participate in any statutory compensation scheme because, apart from the remote possibility that they may become insolvent, these firms would benefit from the positive impact on consumer confidence that such a scheme could be expected to have. ASIC also referred to the contribution they would make to the viability and cost of the scheme and/or payment pools within it.

Relationship with external dispute resolution schemes

Issue 22

What is the appropriate relationship between compensation arrangements and external dispute resolution schemes?

327. A variety of responses was received to this issue, mainly focusing on the relationship between external dispute resolution schemes and any statutory compensation scheme.

328. ASIC sees external dispute resolution schemes as an important mechanism to mitigate a key limitation of insurance as a compensation mechanism; namely, the difficulties retail clients may experience in accessing compensation through insurance. By helping to overcome these access problems, the external dispute resolution system, in

effect, enhances the efficacy of professional indemnity insurance, as a mechanism for protecting retail clients against uncompensated loss. ASIC pointed out that if a statutory compensation scheme were confined to the situations where the licensee were insolvent or unable to pay claims, then the role of that scheme and the external dispute resolution scheme would be separate and complementary.

329. The Commonwealth Bank expressed the view that the paper had given alternative dispute resolution schemes insufficient attention and that internal and external dispute resolution should first be undertaken without the need for 'more interventionist measures' except perhaps in relation to insolvency risk.

330. In this connection we note that it was explicit at paragraph 10 of the Issues Paper that the review is not about the requirement for ASIC-approved external dispute resolution schemes. We do not see external dispute resolution schemes and compensation arrangements as alternatives.

331. The Financial Industry Complaints Service provided a description of its scheme, and examples where the scheme had been unable to assist the consumer.

Issues consequential on a statutory scheme

Operator of a statutory scheme

Issue 12

If a statutory scheme were warranted:

(a) Who should operate the scheme?

332. A range of views were expressed in response to this question:

- ASIC in conjunction with other industry regulators and bodies (ICAA);
- Industry (and there may need to be more than one industry scheme)(NIBA);
- External dispute resolution schemes, backed by a special unit of ASIC (John Jordan);
- A new body operating as an independent company governed by a board of equal members of industry and consumer directors with an independent chair (FSCPC);
 - FSCPC expressed the view that 'Rather than existing in legislation we support a mandatory requirement that licensees participate in the scheme and that the scheme be subject to approval and oversight by ASIC. '

- ASIC noted that this would need further consideration in the light of the role of the scheme. The Commission commented on the possibility of its workload varying considerably. Options for consideration included a self-funded body corporate under the ASIC Act, or a company limited by guarantee. In ASIC's view, the governing body of the scheme should include a balance of people with industry, consumer/investor, and corporate governance/public administration experience.

333. Any special governance and accounting requirements would have to be developed in the light of the decisions made on the operator of the scheme.

Industry-wide coverage?

Issue 14

Could the one scheme cover financial services in relation to all financial products and sectors of the industry?

334. Answers to this depend on the authors' assumptions as to the risks being covered and, in some cases, perhaps a confusion of the risk inherent in the product and the risk in the service (since it is only the latter which is under discussion). It also involves assumptions about how any such scheme would be funded.

335. Four who responded to this issue answered no. This appears to be on the basis that risk of consumer loss varies significantly between industry sectors and equity requires that a different approach be taken for the different risks involved, and a concern about cross-subsidisation. At least one submission argued that specific expertise is needed to address particular sectors.

336. FSCPC expressed the view that there would be a single scheme with sub-schemes possibly of different types of intermediaries, and further sub-schemes by issuers, or by sectors.

337. ASIC floated the possibility of a number of specific payment pools or contribution groups within the overarching framework of a single compensation scheme.

Future of National Guarantee Fund and fidelity funds

Issue 15

If market licensees no longer had to make compensation arrangements, what should happen to the funds in the National Guarantee Fund and the exchange fidelity funds?

338. Four responses were received to this question:

- IBSA suggested that the fidelity element of the National Guarantee Fund should be wound-up and the amounts returned to the current contributor base, if this is practically feasible;
 - the Association also suggested that National Guarantee Fund contributors could use their rebate to finance the levy necessary to create the new fund;
- similarly, FSCPC expressed the view that the SFE, Bendigo and Newcastle fidelity funds and 'a relevant portion' of the National Guarantee Fund should be applied to assist those market participants meet their obligation to the new broad scheme;
- SEGC suggested that the National Guarantee Fund should be used in a manner consistent with the purposes for which those funds are held by the SEGC;
 - funds for already approved financial industry development account projects should be set aside and it would also be appropriate for some funds to be set aside for future FIDA projects, and possibly payment from the National Guarantee Fund of the initial contribution of participating organisations to the new scheme, in lieu of the initial levies;
- the SFE expressed the view that all such funds should be considered excess and be available for 'financial industry development' purposes.

Funding of any statutory scheme

Issue 16

How should it be funded initially and in the longer run?

339. While more detailed consideration of this issue would be needed if it were decided to establish a statutory scheme, nine submissions addressed it. The themes evident in those submissions include:

- the need for levies to reflect risk;
- opposition on constitutional and equity grounds from the SEGC/ ASX to the use of the National Guarantee Fund as a basis of any new fund or for interim funding;
- the suggestion that funding be provided from interest on trust accounts, insurance, borrowings and levies;
- whether post-event funding would be practicable or equitable;
- two submissions sought capping of each licensee's liability to the fund, as well as capping of payments from the fund.

The operator's powers

What would be the appropriate powers of the operator?

340. Little of use could be said about this in the absence of decisions on some of the previous issues. Powers to levy, to hold and invest funds, to obtain information about the failed licensee or representative and its clients, qualified privilege and statutory protection against breach of confidentiality would have to be considered.

Measurement of damages

Issue 19

How should the loss be measured and should consequential loss be covered?

341. Only six submissions addressed this question, and some in only a cursory fashion.

- American Home Assurance suggested that only damages sufficient to put the client back in the position he enjoyed before the licensee breached the terms of its licence and caused the loss should be paid;
 - This line was supported by John Jordan who added reasonable interest, but expressed the view that consequential loss or opportunity cost could be fought over in court;
- NIBA suggested that compensation should be for the loss suffered, including any consequential loss by the client that would be awarded by a court;
- FSCPC stated that compensation should restore the consumer to the position he or she would have been in at the time the claim was settled had it not been for the misconduct. The Centre argued that the scheme should also have a discretion to make awards, and that interest and the cost of pursuing the claim should be payable;
- ASIC, pointing out correctly that this question is only relevant to a statutory scheme (and not to professional indemnity insurance), and on the basis that the scheme only related to loss of property, expressed the view that it should pay the value of the property lost, as at the date of the misconduct. It also favoured a discretion to the scheme manager, as the SEGC currently has, to pay a fair and reasonable sum to compensate the claimant for a pecuniary or other gain the claimant might have made but for the deprivation of its property.

Capping

Issue 20

Capping

- (a) Should there be capping of the amounts paid in response to claims?
- (b) If capping is accepted, what form would be appropriate?

342. First, as one submission pointed out, it is necessary to distinguish capping of claims (such as the external dispute resolution schemes impose) and capping of payments. The Issues Paper related only to the latter — capping of payments.

343. Secondly, there was general agreement that capping of payments was desirable (although one submission saw a restriction to retail clients as a cap in itself). The rationale usually was the need to keep costs at a reasonable level and maintain investor vigilance. The costs in this context are those of obtaining appropriate insurance as well as the cost of running any statutory compensation scheme. It also provides actuaries with a baseline on which to calculate the necessary size of any such fund.

344. While one submission recommended capping on the ground of consistency with the external dispute resolution schemes, it seems undesirable that they drive the ambit of any compensation requirements.

345. A variety of suggestions was received in response to Issue 20(b), depending at least in part on whether the author had insurance, a statutory scheme or some other solution in mind. The suggestions included:

- The cap should be on the amount paid per claim, rather than per insolvency, for example.
- The form should vary depending on the segment of the financial services industry in which the particular licensee was engaged.
- The cap should allow for full recovery of the external dispute resolution scheme determinations.
- The tiered capping system in the UK was supported in two submissions.
- One suggested that compensation should be paid in full for any compulsory component of any product, such as insurance and superannuation.
- The same submission suggested that dollar limits of any cap should be CPI indexed annually and subject to review every three years.

- A cap of \$500,000 was suggested as being consistent with the sophisticated investor test, and that the vast majority of claims to the SEGC to date would fall with it. It was also recommended as generous compared to some international schemes.
- That insurance brokers continue to be required to have professional indemnity equal to or more than 15 per cent of premiums collected with a minimum cover of \$1 million and a maximum cover of \$5 million.

Connection with Australia

Issue 21

What is the appropriate connection with Australia?

346. Few responded to this issue. One response was that it should not matter where the client was located. However, another submission suggested that claims in relation to professional indemnity insurance should not be restricted to Australian residents who are retail clients but that a more restrictive approach may be appropriate in relation to a mandatory statutory scheme.

347. ASIC suggested that it would be appropriate to allow a condition to be imposed on foreign financial service providers permitted to operate in Australia without an AFS licence, requiring that they have/belong to comparable compensation arrangements that are able to be accessed by their Australian-resident or Australian-located retail clients.

Excess funds in any statutory scheme

Issue 22

Should excess funds in a statutory scheme be available for financial industry development purposes, or should there be a mechanism to discourage the build up of such excess funds?

348. Nine responses were received to this issue.

349. The following suggestions were made:

- Only the SEGC/ASX wholeheartedly supported the current 'financial industry development' arrangements;
- The FSCPC indicated that the scheme should have a discretion either to manipulate levies or to make excess funds available for purposes consistent with the purposes of the fund – 'public benefit, investor protection purposes';

- John Jordan considered that excess could be applied in the interest of the scheme — for example, research into consumer behaviour;
- However, several others expressed the view that excess funds, if they ever arise, should be used to reduce levies payable to operate the scheme in future years.
- ASIC stated that, as far as possible, the costs imposed on industry by a compensation scheme should be no greater than is required to support a viable scheme. It is always open to industry associations to levy their members to pay for industry development projects.
- The SFE stated that there needs to be greater scope for operators of funds to avoid the build up of funds without the current degree of ministerial involvement and unduly restrictive tests.

Time limits

Issue 24

Should there be time limits for claiming and, if so, how should they be set?

350. Answers depended on the compensation mechanism each author had in mind.

351. Several suggested that the six year limitation period should apply and that the time limit in relation to professional indemnity insurance would be determined by statute. Another suggested that it would be determined by the external dispute resolution scheme in each case. A further submission indicated it would be reasonable to limit the fund to hearing claims three years from the time the claimant knew or should reasonably have known of all the relevant facts.

Level of detail

Issue 25

What is the appropriate level of detail in the legislation?

352. Again a variety of responses were received:

- That the requirements should be in regulations, rather than the Act.
- In relation to professional indemnity insurance, that the detail should be prescribed in regulations, with some flexibility remaining for ASIC.
- That if compensation arrangements are to include a statutory scheme, then the legislation should either provide a high level of detail about the terms of the scheme,

or a mechanism for these terms to be set out in detail in delegated legislation or administrative guidelines.

- That the scheme should be statutorily based, with the *Superannuation (Resolution of Complaints) Act 1993* providing a good basis.

B Alternative schemes

353. Several submissions proposed alternative schemes. These are summarised below.

APT strategy; Boutique Financial Planning

354. APT proposed that the current security bond be replaced by a requirement that all dealers must either:

- Be a member of a compensation trust (which is described below); or
- Receive exemption from ASIC on the grounds that their NTA is so large that membership of such a trust would be superfluous.

355. The compensation trust scheme involves:

- Each dealer would contribute to the trust in proportion to the number of proper authorities issued by the dealer.
- In the event of a claim, the trust would first apply the 'equity' in the trust of the dealer concerned and only when that was exhausted would the other dealers in the trust suffer any loss.
- The compensation trusts would be managed by the members in such manner as may be acceptable to ASIC.
- Dealers would be free to hold 'equity' in any such compensation trust that would accept them.
- It would be expected that dealers with similar risks would band together.
- If a dealer were unable to gain acceptance to any such fund, then it would either be forced to leave the industry or to create its own compensation fund and or meet the relevant net tangible asset requirements referred to above.
- The trusts would also assist in group purchasing of professional indemnity insurance.

356. Boutique Financial Planning proposed a similar scheme. It would involve giving licensees a choice as to compensation mechanism including the possibility of groups of, for

example, dealers setting up their own indemnity fund. This would reduce cross-subsidisation (because the dealers would decide who could join their particular fund).

John Jordan

357. John Jordan suggested the following scheme:

- All licensees would agree to be bound by external dispute resolution scheme decisions.
- An ASIC-approved external dispute resolution scheme or ASIC would be empowered to order a licensee to pay compensation to the consumer.
- Courts could order payments 'in scope', but damages should not be covered by the scheme.
- The licensee then would have a limited time to pay the consumer.
- If the amount were not paid, the scheme would pay the consumer (at the direction of the external dispute resolution scheme) and seek redress from the licensee.
- A licensee's failure to pay would be a significant licence breach, attracting disciplinary action;
- Licensees may be able to cover themselves by professional indemnity insurance.

358. The scheme is said to have three advantages:

- Early warning of potential licensee default;
- The licensees' professional indemnity insurance is on a more appropriate basis than the current non-commercial model used in the *Insurance (Agents and Brokers) Act 1984*;
- The consumer obtains settlement reasonably speedily.

WA Department of Consumer and Employment Protection

359. The WA Department of Consumer and Employment Protection favoured Option E in Chapter 11 of the Issues Paper. This option involves market operators being required to have compensation arrangements or a consolidated market compensation scheme, financial service providers being required to have, for example, professional indemnity insurance and a broad statutory scheme.

FPA

360. In its submission the FPA put a series of options and examined their merits. Very briefly, they were:

- professional standards model;
 - examples of this model are the New South Wales and Western Australian Professional Standards Acts which provide a mechanism for members of participating professional associations to limit certain aspects of their professional liability (ie capping) by registering a scheme with the Professional Standards Council;
 - the model involves measures to manage risk and the FPA states that there is evidence to suggest that scheme participants are a more acceptable risk to insurers (and are therefore enjoying reduced premiums);
- open market professional indemnity insurance cover;
- statutory indemnity/fidelity fund in the nature of the Solicitors Mutual Indemnity Fund;
 - the Solicitors Mutual Indemnity Fund pays the difference between the indemnity provided by an insurer under the solicitor's professional indemnity insurance and the amount of the claim;
 - it applies only limited risk weighting and provides run-off cover;
- security bond, acknowledging the significant weaknesses of this option;
- government owned insurance companies;
- government guarantee as in the case of long service leave and superannuation entitlements;
- government established underwriting pool for particular risks;
- amendments to the *Insurance Contracts Act 1984* to require insurance companies to charge premiums that take into account the prospective insured's risk management practices and claims history;
- fidelity levy as part of a scheme like Part 23 of the *Superannuation Industry (Supervision) Act 1993*. (This was also suggested by the ICAA.)

BROAD OPTIONS CONSIDERED

In brief, the problem is that financial services licensees do not always have assets to meet claims arising from clients' losses which result from misconduct in the course of providing financial services — for example, defrauding clients of their funds or financial products.

This is discussed in Chapter 3.

Appropriate regulatory form

Given the nature of the problem, self-regulation is not appropriate.

Quasi-regulation and co-regulation appear to depend on there being an industry body or several industry bodies covering the relevant field. This is not the case in the financial services sector. The problem outlined in the Issues Paper relates to financial services licensees handling a wide range of products and licensees are represented by a number of industry associations — for example, for financial planners, superannuation interests, building societies, trustee companies, etc. Expecting such a range of industry associations to come forward with a proposal which would provide a harmonised result across the sector is not realistic. This is shown by the wide variety of responses to the issues put in the Issues Paper released in September 2002.

We take the view that explicit government regulation is required to achieve a harmonised compensation regime enforceable by ASIC. Explicit government regulation is already in place for this purpose.

Other courses of action

If a requirement for compensation arrangements is maintained, it is desirable that information be available, giving clients a description of the compensation arrangements that are in place, what they cover and what they don't, and the minimum coverage. The aim is to ensure that consumers do not have false expectations as to what the arrangements cover.

Description of options

Obviously there are a multitude of possible solutions to the problem outlined above. Of these, six options are examined below.

Option 1

The first option is not to require any mechanisms for compensating clients of financial services licensees.

This would involve amendment of Chapter 7 of the *Corporations Act 2001* (the Corporations Act) to delete section 912B and Part 7.5. It would also require a decision on the future use of the consumer protection funds in the Australian Stock Exchange's National Guarantee Fund, and the use of money in the fidelity funds of other licensed financial markets.

Option 2

The second option is not to amend the relevant provisions of the Corporations Act.

This would leave the following provisions to operate:

- section 912B would require financial services licensees to have adequate compensation arrangements to cover loss incurred by retail clients as a result of a breach of the Chapter 7 obligations;
 - it would still be necessary for the finer points (for example, the size of claims which must be covered and alternatives to professional indemnity insurance) to be elaborated in regulations or by ASIC, as envisaged by the current wording of the section;
 - the effect of the current transitional regulations is that this provision is not currently in operation but it was planned to commence automatically on 11 March 2004 (Corporations Regulations 10.2.44);
- Part 7.5 requires market licensees to make compensation arrangements where the transactions of retail clients are executed on its market;
 - the National Guarantee Fund, which provides investor protection in relation to transactions on the Australian Stock Exchange, includes this function;
 - more flexible compensation arrangements are available to market licensees other than the Australian Stock Exchange;
 - : these market licensees can transition into the new arrangements now and must transition into them by 11 March 2004.

Option 3

Option 3 involves:

- requiring financial services licensees to have basic professional indemnity insurance¹⁹, with exemptions and alternatives;
- the establishment of a statutory fund covering losses of retail clients incurred when:
 - property entrusted to a financial services licensee which has since become insolvent (or is otherwise unable to pay) cannot be recovered (at least in the short term); or
 - property entrusted to a financial services licensee which has since become insolvent (or otherwise unable to pay), or over which the licensee had authority, cannot be recovered (at least in the short term);
- deleting the requirement on market operators to have compensation arrangements.

Option 4

Option 4 involves:

- requiring financial services licensees to have basic professional indemnity insurance, with exemptions and alternatives;
- the establishment of a statutory fund covering losses (subject to capping) of retail clients which occurred when the licensee was an intermediary and was insolvent or unable to pay;
 - the scheme would cover the return of client property held by the licensee or losses to retail clients arising from any improper conduct by the licensee, using the same eligibility criteria as would apply in disputes with solvent intermediaries;
 - : it would therefore provide for compensation for amounts that had been or could be awarded by an ASIC-approved dispute resolution body or a court;
 - : it would be limited to investments;
- deleting the requirement on market operators to have compensation arrangements.

Option 5

Option 5 involves:

- a requirement that financial services licensees have basic professional indemnity insurance or a substitute mechanism, with exemptions and alternatives;

¹⁹ With 'fidelity' or fraud insurance/policy extension.

- no statutory fund;
- fine-tuning amendments to Part 7.5.
 - for example, capping or otherwise limiting payments from the National Guarantee Fund and capping levies for the benefit of the Fund.

Option 6

Option 6 involves:

- omitting section 912B and not including any requirement to have professional indemnity insurance or a substitute arrangement;
- requiring all financial services licensees to satisfy a high solvency threshold;
- retention or omission of the market compensation requirements.

Impact analysis

Who is affected by the problem and who is likely to be affected by its proposed solution?

Consumers of financial services and the reputation of financial services licensees are affected by the problem.

Consumers of financial services, market licensees and financial services licensees are likely to be affected by its proposed solution.

Which groups are likely to experience these benefits and costs and what is likely to be the extent of their impact?

Option 1

How will Option 1 affect existing regulations and the roles of existing regulatory authorities?

Adoption of Option 1 would leave a definite gap in the consumer protection scheme which the *Financial Services Reform Act 2001* put in place. It would be criticised on this ground.

The expected impacts of option 1 as likely benefits or likely costs

Impact on Commonwealth government

Option 1 would save ASIC (and the Commonwealth government) a small amount because oversight of compliance with the relevant requirements in new Chapter 7 would not be needed. On the other hand, it may be seen as adversely affecting ASIC's role in relation to consumer protection in the financial services sector.

More generally, omission of the current mechanisms for compensation is unlikely to be publicly acceptable.

Impact on business

Those financial services licensees which do not have professional indemnity insurance policies (or acceptable alternatives) would save through not being obliged to pay premiums or make alternative arrangements. Those who do have such policies might save any additional premiums due for any additional cover.

Some market licensees may see benefit in Option 1 if it involved increased access to existing market-based funds for purposes which give them a commercial benefit.

It involves no restriction on competition.

Impact on consumers

Consumers would be adversely affected because the protection expected from the current requirements, and provided by the National Guarantee Fund and fidelity funds would no longer be available.

Option 2

How will Option 2 affect existing regulations and the roles of existing regulatory authorities?

Option 2 involves retention of the requirements in new Chapter 7, which was inserted by the *Financial Services Reform Act 2001*. It therefore does not affect existing regulations and the roles of existing regulatory authorities.

The expected impacts of option 2 as likely benefits or likely costs

Impact on Commonwealth government

There is no new financial impact on the Commonwealth government. The requirement to have professional indemnity insurance (or some acceptable substitute) would involve some regulatory costs, but only the same as currently anticipated.

ASIC would oversee compliance with the requirements. This is already factored into its budget.

Impact on business

The cost for financial services licensees is the financial cost of obtaining the professional indemnity insurance (or substitute) to satisfy the requirement. It does not, however, involve any additional cost to such licensees than they currently expect to be liable for, at least from 11 March 2004.

While most reputable businesses would, in any case, have professional indemnity insurance, it may not cover this range of risks. Further, it is not clear that professional indemnity is likely to be available to cover this range of risks.

The benefit for such licensees is that retail persons may be more comfortable approaching them for their services if they are aware that they have appropriate professional indemnity insurance.

It may be argued that this option involves a restriction on competition if a significant number of financial services licensees are not able to obtain the necessary insurance cover — for example, because the particular licensee was considered a bad risk. This comment applies to any option involving a requirement for professional indemnity insurance. However, each proposal requiring professional indemnity insurance involves the possibility of alternatives being acceptable.

The maintenance of the existing market compensation arrangements does not impose a significant cost on participating organisations or the market.

- There has, for example, been no need to levy for the benefit of the National Guarantee Fund because the Fund has grown through its own investment income and interest on trust accounts. Its administrative costs are paid from the Fund.
- Similarly, we are not aware that the fidelity fund requirements of old Chapter 7 imposed significant costs on the relevant exchanges or participating organisations.

Impact on consumers

Section 912B, if it commences as currently drafted and can be complied with, would provide a harmonised regime across the financial services sector. It would provide a definite improvement for consumers over the current arrangements applying to, for example, securities dealers (a security bond of \$20,000) and the clients of those financial service providers which previously were not required to undertake any measure which sought to ensure that assets were available to meet proved claims.

However, it is not clear that the professional indemnity insurance anticipated by section 912B as currently drafted is likely to be available.

The cost of obtaining the necessary professional indemnity insurance (or of funding, for example, alternatives) will, in the end, be borne by retail clients of financial services licensees.

Consumers undertaking transactions on financial markets would have a greater level of protection through the National Guarantee Fund and other market compensation arrangements than consumers undertaking the same transactions 'off-market'.

Option 3

How would Option 3 affect existing regulations and the roles of existing regulatory authorities?

Option 3 would involve a significant change to the existing legislative framework (to provide for the creation and maintenance of a statutory fund) and raises major issues

about who would administer it, and its relationship with ASIC and the external dispute resolution schemes.

The expected impacts of option 3 as likely benefits or likely costs

Impact on Government

The requirement to have professional indemnity insurance (or some acceptable substitute) would involve some regulatory costs, depending on the level of prescription of the requirement (eg whether it required insurance companies to report on specific events), but no greater than current section 912B.

ASIC would oversee compliance with these requirements. This is already factored into its budget.

Any statutory scheme involves some risk for the Government, if it is mismanaged or proves to be insufficient.

Impact on Business

We understand that basic professional indemnity is more likely to be available. In addition, exemptions and alternatives are anticipated.

The administration of a statutory fund would involve significant costs. Although it could presumably be funded by using interest on trust accounts in the longer term or an annual fee, it would also involve a power to levy licensees to provide an initial fund, and when the ongoing fund was low. Further, since financial services licensees currently have access to income on trust accounts, funding through using interest on trust accounts may also be seen as a cost on business.

The benefit for financial services licensees is that consumers would have greater assurance that they could recover funds and financial products handed over to financial services licensees in the event of the licensee becoming insolvent or unable to pay.

Market licensees would benefit to the extent, if any, that money currently included in the National Guarantee Fund and the fidelity funds of other exchanges would be available for purposes which benefited them commercially. Financial market licensees subject to Division 3 of Part 7.5 would save some administrative costs through not having to administer compensation arrangements.

It is difficult to see this option as anti-competitive.

Impact on Consumers

This would provide a measure of protection for retail clients prior to insolvency or an inability to pay through the requirement for professional indemnity insurance (or a substitute).

A statutory fund such as is proposed would provide a better level of protection after insolvency or an inability to pay than all except clients of stockbrokers on the ASX

currently enjoy. It would provide a harmonised level of protection across the financial services industry.

However, in relation to clients of ASX stockbrokers:

- retail clients would have a level of protection reduced from their current, particularly in relation to unauthorised transfer;
- wholesale clients would be disadvantaged because they would not have access to the National Guarantee Fund and would not be required to be covered by the professional indemnity insurance (except to the extent required by the business rules) or a statutory scheme.

It is expected that the cost of the new arrangements would ultimately be borne by consumers. Not all retail consumers may wish to pay the extra cost and it is conceivable that the additional cost for some may render the financial services beyond their means.

Option 4

The responses on Option 4 closely follow those in response to Option 3.

The major difference is the ambit of the proposed statutory scheme, and hence its cost. It covers far wider ground in relation to investments, but does not address losses from comparable financial services provided in relation to, for example, risk products such as insurance. It addresses only intermediaries (whereas many issuers will be required to be licensees and may well be providing advice).

It would involve a difficult assessment of risk because levies would need to be proportionate to the risk of payments from the scheme arising from that business.

Option 5

How will Option 5 affect existing regulations and the roles of existing regulatory authorities?

Option 5 adopts the current framework and would fit easily with the existing legislation and the current role of ASIC.

The expected impacts of option 5 as likely benefits or likely costs

Impact on Government

There is no new financial impact on the Commonwealth government. The requirement to have professional indemnity insurance (or some acceptable substitute) would involve some regulatory costs, depending on the level of prescription of the requirement (eg whether it required insurance companies to report on specific events), but only equivalent to the current section 912B.

ASIC would oversee compliance with the requirements. This would already be factored into its budget.

Impact on Business

There is a benefit for business in requiring compensation coverage which is likely to be available through basic professional indemnity insurance.

It also benefits financial services licensees in that it leaves them access to the income on trust accounts, rather than channelling those funds into a statutory fund, as Option 3 proposes.

Option 5 would not impose any additional costs on existing market licensees (including the ASX and SFE) and would assist in assessing the funds needed for the National Guarantee Fund (through the limitation on claimants and/or the size of the payment).

However, the retention of the requirement for all markets on which the transactions of retail clients are executed to have compensation arrangements:

- imposes a cost on some new market licensees (but no more than the current requirement);
- may be seen as inconsistent with some new market structures;
- creates a distinction between on and off-market transactions which may not be warranted.

This option raises the possibility of a benefit for banks that are seeking to become participating organisations of the ASX because it involves a cap on levies for the benefit of the National Guarantee Fund. (APRA has objected to banks becoming participating organisations because of the unlimited levy power).

We do not see Option 5 as anti-competitive.

Impact on Consumers

Option 5 would involve:

- generally an improvement in the protection offered to consumers of financial services prior to the *Financial Services Reform Act 2001*;
- however, in relation to clients of stockbrokers on the ASX, further consideration is necessary on the issue of restricting claimants to retail claimants/capping of payment.

This option would affect wholesale clients of participating organisations.

Option 6

How would Option 6 affect existing regulations and the roles of existing regulatory authorities?

Option 6 could, if required, be monitored by ASIC.

The expected impacts of option 6 as likely benefits or likely costs

Impact on Government

There would be significant costs involved in enforcing a solvency threshold for all financial services licensees above the capital requirements indicated in ASIC Policy Statement 166. It also could be seen as involving a government guarantee that licensees will not fail.

Impact on Business

Option 6 would form a significant hurdle for financial services licensees commencing business in a small way. It would also impose costs for those who could meet the requirements and would involve compliance costs for all licensees.

The option is likely to disadvantage financial services licensees in the 'small business' range and advantage those financial services licensees which are, or are associated with insurance companies, banks etc.

It is therefore anti-competitive.

Impact on Consumers

Adoption of this option would involve reduced choice of provider and increased costs. Financial services licensees could still become insolvent or unable to pay, with calls for Government assistance possible.

Conclusion and recommended option

Summary of the assessment of each option

In brief:

- Option 1:
 - would be an unwarranted reduction in consumer protection and is therefore unacceptable;
- Option 2:
 - the cover required by current section 912B may not be available;
 - it involves differential treatment of market and off-market transactions;
- Option 3:
 - provides an even level of protection for retail persons (with some reduction in protection for retail clients of ASX stockbrokers);

- but there is insufficient evidence of loss in the area the statutory fund would cover to make an assessment as to whether it could be justified ie of the costs and benefits involved;
- Option 4:
 - addresses the concerns that it is no longer appropriate to require market operators to make compensation arrangements but would not provide a harmonised outcome across the width of financial services regulated under new Chapter 7 (because it applies only in relation to investments), and regardless of whether the licensee concerned is an intermediary or an issuer;
 - instead it differentiates on the basis of the product;
 - again, there is insufficient evidence of loss in the area the statutory fund would cover to made an assessment as to whether it could be justified ie of the costs and benefits involved;
- Option 5
 - does not involve any guarantee, certainly not by the Government, that funds will in fact be available to meet proven claims;
 - does, however, provide a greater level of protection than many retail clients have enjoyed under the pre-FSR regimes;
 - provides greater flexibility than Option 2 through the possibility of exemptions;
 - involves an expectation of insurance which is likely to be available;
 - addresses some difficulties with the operation of the current market compensation arrangements;
- Option 6 is not acceptable because of the likely anti-competitive effect.
 - consumers are likely to see it as involving protection against insolvency of the financial services licensee.

What is the preferred option?

The recommended option is Option 5, which provides:

- an improved level of cover for many retail clients over pre-FSR regimes;
- a level of professional indemnity insurance which we understand will be available;

- flexibility by allowing for:
 - other mechanisms apart from professional indemnity insurance to be acceptable;
 - exemptions for those with high capitalisation and for insurers and authorised deposit-taking institutions regulated by APRA (and those licensees the relevant liabilities of which are guaranteed by such institutions);
- no significant additional cost to industry;
- retention of protection for retail clients in relation to market transactions.

The main assumptions that the conclusion rests upon

The main assumptions that the conclusion rests on are:

- consistently with the FSR regime, retail clients need some consumer protection device which may assist in the recovery of losses consequent on the wrongdoing of financial services licensees or their representatives;
- it would be inappropriate for the Government to guarantee compensation directly, or to hold out that the legislative scheme or the budget guarantees compensation;
 - we acknowledge that professional indemnity insurance coverage may sometimes fail;
- the burden of the mechanism should fall on those whose conduct is in issue, or those who are responsible as financial services licensees for those whose conduct is at fault;
- the establishment and maintenance of a statutory scheme would be a major alteration to the regulatory regime put in place by the *Financial Services Reform Act 2001*;
 - but there is insufficient evidence of loss currently suffered in relation to this area to begin to assess whether such a scheme would be justified;
- the retention of obligations on market licensees to have compensation arrangements imposes low (and in some cases, no) costs.

Why is this option preferred and others rejected?

While no option is perfect, we take the view that Option 5 is, on balance, preferable.

INSURANCE (AGENTS AND BROKERS) ACT 1984

9B Meaning of acceptable contracts of professional indemnity insurance

(1) An acceptable contract of professional indemnity insurance, in relation to liabilities that are prescribed for the purposes of a nominated provision, means a contract of insurance:

(a) that is accepted by ASIC; and

(b) that contains a clause indicating that the parties to the contract intend that any claim under the contract will be determined according to the law of a State or Territory specified in the contract; and

(c) under which the insured is indemnified to the extent required by the regulations in respect of the prescribed liabilities arising out of or in the course of the insured's business as an insurance intermediary.

(2) Regulations specifying the extent to which a person is to be indemnified under an acceptable contract of professional indemnity insurance may make provision for different amounts according to the date on which the contract is entered into or renewed.

(3) Despite section 28 of the *Insurance Contracts Act 1984*:

(a) a failure to comply with a duty of disclosure by a person seeking to enter into an acceptable contract of professional indemnity insurance; or

(b) a misrepresentation by such a person to an insurer before such a contract was entered into;

whether that failure or misrepresentation was fraudulent or not, is not a ground for the insurer to avoid the contract or to reduce its liability under the contract.

(4) An acceptable contract of professional indemnity insurance in respect of liabilities that are prescribed for the purposes of a nominated provision must provide that, despite the fact:

(a) that the person entering into the contract subsequently ceases to trade as an insurance intermediary; or

(b) that the contract is cancelled under subsection (5);

that person, or any other person who becomes responsible for the liabilities of that person, is to continue to be indemnified in relation to a claim:

(c) that is made in respect of a contract of insurance entered into by the insurance intermediary; and

(d) that gives rise to such a prescribed liability;

if that claim is made within the period after entry into that last-mentioned contract of insurance that is, at the time of entry into that contract, prescribed by regulations made for the purposes of this subsection.

(5) The insurer under an acceptable contract of professional indemnity insurance must not cancel the contract unless, at least 3 business days before the date of intended cancellation of the contract, ASIC is notified in writing by the insurer or by the agent of the insurer:

(a) of the insurer's intention to cancel the contract; and

(b) of the date of the intended cancellation of the contract; and

(c) of the reason for the intended cancellation of the contract.

Penalty: 150 penalty units.

(6) For the purposes of subsection (5), the following days do not count as business days:

(a) a Saturday or a Sunday;

(b) a day that is a public holiday or a bank holiday;

(i) in the Australian Capital Territory; and

(ii) if the insured is a natural person – in the place of residence of the insured; and

(iii) if the insured is a company – in the State or Territory in which the insured is incorporated; and

(iv) if the insured is a partnership or a body corporate other than a company – in the principal place of business of the insured.

(7) A provision in a contract of professional indemnity insurance has no effect if it purports to permit the contract to be cancelled by a person (the *premium funder*) who has entered into a loan agreement with the insured for the provision of all or a part of the premium payable under the contract if the insured is unable or unwilling to comply with the terms of the loan agreement.

(8) In this section:

nominated provision means:

(a) paragraph 19(1)(b); or

(b) subparagraph 31B(1)(a)(ii) or (b)(ii).

***CORPORATIONS ACT 2001* — SECT 912B**

COMPENSATION ARRANGEMENTS IF FINANCIAL SERVICES PROVIDED TO PERSONS AS RETAIL CLIENTS

- (1) If a financial services licensee provides a financial service to persons as retail clients, the licensee must have arrangements for compensating those persons for loss or damage suffered because of breaches of the relevant obligations under this Chapter by the licensee or its representatives. The arrangements must meet the requirements of subsection (2).
- (2) The arrangements must:
 - (a) if the regulations specify requirements that are applicable to all arrangements, or to arrangements of that kind – satisfy those requirements; or
 - (b) be approved in writing by ASIC.
- (3) Before approving arrangements under paragraph (2)(b), ASIC must have regard to:
 - (a) the financial services covered by the licence; and
 - (b) whether the arrangements will continue to cover persons after the licensee ceases carrying on the business of providing financial services, and the length of time for which that cover will continue; and
 - (c) any other matters that are prescribed by regulations made for the purposes of this paragraph.
- (4) Regulations made for the purposes of paragraph (3)(c) may, in particular, prescribe additional details in relation to the matters to which ASIC must have regard under paragraphs (3)(a) and (b).