ASIC

Australian Securities & Investments Commission

Submission to Treasury on compensation for loss in the financial services sector: issues and options

November 2002

What this submission is about

This submission presents the Australian Securities and Investments Commission response to *Compensation for Loss in the Financial Services Sector: Issues and Options* (the Paper), released by the Hon Ian Campbell, Parliamentary Secretary to the Treasurer, in September 2002.

This submission discusses each of the Principal and Secondary Issues in the order they are set out in the Paper, using the same numbering and Chapter headings as the Paper.

As the Government intends to release a detailed proposal about compensation arrangements in response to the Paper, ASIC anticipates making a further submission in response.

Glossary

AFS licence	Australian financial services licence
CASAC	Companies and Securities Advisory Committee
CS facility	Clearing and settlement facility
EDR scheme	External dispute resolution scheme
FSL	Financial services licensee
FSR Act	Financial Services Reform Act
IABA	Insurance (Agents and Brokers) Act 1984
PII	Professional indemnity insurance
the Paper	*Compensation for Loss in the Financial Services Sector: Issues and Options* (the Paper), released by Treasury in Sept 2002

Contents

Executive summary

Cross-references are to relevant Sections of the submission.

(a) ASIC believes that compensation arrangements in the financial services sector are justified: Section 2.

(b) The primary purpose of compensation arrangements is to ensure that assets are available to meet proven claims: Section 3.

(c) In ASIC's view, compensation arrangements should cover both solvent and insolvent financial services licensees, with different mechanisms and coverage criteria applying to each situation: Section 4. Compensation arrangements should only apply where the financial services provider is an Australian Financial Services (AFS) licence holder or their authorised representative: Section 4.

(d) Licensees should only be required to have compensation arrangements for their retail clients: Section 5.

(e) Licensees should have professional indemnity insurance (PII) as a general requirement. Equivalent alternative arrangements (eg self-insurance) may be appropriate in certain circumstances. PII coverage should be broad, covering the range of risks to which the licensee or its representatives might be exposed in dealing with their retail clients: Section 6.

(f) PII policies should also be endorsed to cover the determinations of approved external dispute resolution schemes to which the licensee belongs: Section 6, Section 22.

(g) ASIC does not see an ongoing role for security bonds as a compensation mechanism: Section 6.

(h) In ASIC's view, continuing to require financial market licensees to make compensation arrangements (currently under Part 7.5) is not justified. Similarly, we do not believe that a consolidated compensation scheme confined to FSLs that are market participants is consistent with the FSR Act objective of regulatory harmonisation: Section 8.

(i) As with markets licensees, ASIC does not believe that clearing and settlement facilities licensees should be required to make compensation arrangements: Section 9.

(j) Instead of current markets schemes, ASIC supports the introduction of a statutory compensation scheme covering retail clients of FSLs generally. Such a scheme would supplement the role of mandatory PII in limited circumstances: Section 10.

(k) The proposed statutory compensation scheme would only provide compensation where the licensee was insolvent or unable to pay claims or account for client property: Section 11.

(l) Coverage of the scheme would also be limited to protecting client funds and other property. It would not be appropriate, in our view, for a scheme intended as a limited safety net (supplementing a mandatory PII requirement) to provide an assurance of compensation for losses due to breaches of the licensee's or representative's obligations generally: Section 11.

(m) An FSL compensation scheme should also exclude coverage of losses due to misconduct in how a managed investment scheme is operated or managed: Section 11.

(n) In addition, there should be capping of the amounts able to be paid in response to claims on a statutory scheme: Section 20. There should also be time limits on claims: Section 24.

(o) ASIC would not support a blanket exemption of APRA-regulated bodies from compensation arrangement requirements: Section 4, Section 18.

(p) The EDR system is integral to the effective operation of compensation arrangements. In particular, EDR schemes play a critical role in terms of the accessibility of compensation where a claim has initially been rejected: Section 22.

Principal issues: general issues [PI 1 – 5]

Question 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? [PI 1]

ASIC response

1.1 ASIC is able to provide:

- data on financial services businesses that go into external administration
- figures on criminal and civil action initiated by ASIC against financial services providers
- qualitative information based on ASIC enforcement activities/experience.

1.2 We confine ourselves in this section to summarising the information and its limitations. Other sections of this submission discuss implications of the information.

Financial service providers that go into external administration

1.3 We have been able to generate some data on companies licensed or registered by ASIC (under pre-FSR Act legislative requirements) that have gone into external administration at some stage during the period of ASIC's legislative responsibility. For insurance intermediaries, the data dates from July 1998. For securities and futures dealers, the data covers roughly a ten-year period.[1]

1.4 The figures are as follows:

- Insurance brokers (general): 39
- Insurance brokers (life): 5
- Insurance brokers (foreign): 1
- Insurance agents: 2
- Securities dealers: 13

[1] Para 39 of the Paper states that only 3 securities dealers have gone into external administration. That figure, which is based on information previously provided to Treasury by ASIC, has been revised in the light of further investigation.

- Futures dealers and brokers: 4

It is interesting that, of the securities and futures dealers, all but one is recorded as having gone into external administration since July 2001.

1.5 ASIC cannot 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.

1.6 The extent of intermediary insolvency is relevant to whether a ‘safety net’ statutory compensation scheme where financial services providers are insolvent or unable to pay claims is justified. See Section 10 below.

Criminal and civil action initiated by ASIC

1.7 Paras 38 to 40 of the Paper summarise data from ASIC Annual Reports for 1999-2000 and 2000-01 on criminal prosecutions of investment advisers, and advisers banned from providing financial services either permanently or temporarily. For 2001-02:

- 4 financial advisers (ie proper authority holders) who cheated their clients were jailed; and
- 17 investment advisers (ie proper authority holders) were permanently banned. Criminal proceedings were initiated in respect of some of these matters. A further 18 advisers were banned for shorter periods.

1.8 During 2001-02, three dealers licenses were also revoked, including the licence of Saxby Bridge Financial Planning Pty Ltd.[2] In 2000-01, seven licences were revoked.

1.9 Paras 38 to 40 of the Paper summarise data from ASIC Annual Reports for 1999-2000 and 2000-01 on administrative action taken against insurance brokers. During 2001-02, six insurance brokers were deregistered, suspended or their registration was made subject to conditions.

ASIC enforcement experience

1.10 In the majority of cases where ASIC has taken 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. In some cases of fraud or other

[2] This licence revocation, and that of a related company ABS Securities Pty Ltd, are currently the subject of applications to the Administrative Appeals Tribunal by the companies concerned.

serious misconduct, ASIC has been able to obtain orders to have the proper authority holder's assets frozen, making them available for distribution to clients and other creditors.

1.11 However, 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 frequently occurs where the intermediary has continued to trade (illegally) after ceasing to be a proper authority holder. In these circumstances there will generally be no insurance to cover client losses resulting from fraud or the collapse of the intermediary’s business.

Question 2

Is requiring compensation arrangements in the financial services sector justified? [P1 2]

ASIC response

2.1 ASIC believes that requiring compensation arrangements for losses suffered as a consequence of conduct by financial services licensees or their representatives is justified.

2.2 We note the cogent general arguments favouring regulation to protect consumers of financial services in David Llewellyn's Paper, *The Economic Rationale for Financial Regulation*, to which the Paper refers. In this section, we discuss points favouring compensation arrangements specifically, as one possible form of regulation.

Community expectations

2.3 ASIC suggests that most financial services consumers would expect that the providers of those services (like legal, medical and other professional services) will be able to meet claims against them arising from the ordinary conduct of their business. This is not to say that most consumers/investors necessarily know about, or understand, professional indemnity insurance (PII). However, they do have a strong expectation that their funds will be safe. Similarly, it is quite common for trade and professional bodies that take funds on trust to be required to have ‘fidelity fund’ type arrangements.[3] Such arrangements may both reflect,

[3] Trade and professional groups whose clients are protected by compensation, guarantee or fidelity fund arrangements under various State laws include: solicitors, conveyancers,

and help create, expectations among financial services consumers that their funds taken/held on trust will be safe.

Consumer confidence

2.4 As noted in the Paper, a key argument for compensation arrangements is that (assuming they are adequately publicised) such arrangements have the potential to help maintain and enhance consumer/ investor confidence and therefore, participation in the financial marketplace. The confident participation of retail clients in the financial marketplace is a key objective of the financial services reform process (It is also one of ASIC's statutory aims).[4]

2.5 Where ordinary consumers are aware of their lack of information about the creditworthiness and integrity of financial services providers, they may be discouraged from using the services of such businesses altogether. Alternatively, they may over-rely on the services provided by entities associated with large financial institutions, at the expense of well-established and well-conducted smaller businesses. A limited assurance of the availability of compensation may help maintain and enhance consumer participation, including use of the services provided by a range of firms.

2.6 While such an assurance has the potential to create moral hazard this issue should not be overstated, in our view. Firstly, to the extent that consumers think they are protected (see previous point), the possibility of their acting without due diligence exists anyway. Secondly, the potential for moral hazard is likely to be greatest in relation to an unrestricted compensation scheme or fidelity fund.

2.7 The knowledge that a licensee has PII is unlikely of itself to induce consumers to take less care in selecting a financial adviser or product. Risky conduct by the financial services provider (in the knowledge that there is insurance) is also discouraged by the use of deductibles, the risk-weighting of premiums and the prospect that they may not be able to obtain insurance at all in the future if they have an excessive claims history.

2.8 For compensation schemes, the potential for moral hazard can be limited by designing the scheme in a certain way. Schemes that:

- require an element of self-insurance (by not covering the loss in full)

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property stock and business agents, travel agents, motor vehicle traders. See generally *Consumer Protection Law*, Goldring J. et al, 1998 (Federation Press) at pp. 399 – 400.

[4] See Subsection 1(2)(b) of the ASIC Act, which commits ASIC to promoting 'the confident and informed participation of investors and consumers in the financial system'.

- limit the range of circumstances in which loss can be recovered, and
- require the consumer to have first exhausted other avenues for redress

give the consumer incentives to exercise care.

Potentially devastating consequences

2.9 Account also needs to be taken of the potentially serious implications of uncompensated loss for the persons affected. In ASIC's experience, a significant portion of persons liable to suffer uncompensated loss due to representative misconduct will be retirees who face financial ruin if compensation is not available. The Paper makes an important further point in this context:

> There is the likelihood of the one financial services licensee dealing in, or providing advice about, a high percentage of an individual’s savings. This exacerbates the consequences of fraud or inappropriate advice, even if a widespread portfolio is being chosen. The likelihood is increasing with trends in the financial services industry. [para 74].

Question 3

What is the purpose of compensation arrangements which are required by legislation? [PI 3]

ASIC response

3.1 ASIC agrees with the view, in [para 106] of the Paper, that the primary purpose of compensation arrangements is to ensure that there are assets available to meet proven claims resulting from licensee or representative misconduct. The extent to which this assurance should be provided by regulation is considered below.

Question 4

In what circumstances should compensation arrangements be required in relation to a financial services licensee? [PI 4]

Should different criteria or a different mechanism apply depending on whether the financial service provider is solvent or unable to pay/insolvent?
[PI 4 (b)]

Should compensation arrangements relate only to the situation where the financial services licensee is unable to pay/insolvent? [PI 4 (c)]

ASIC response

Compensation arrangements should cover both solvency and insolvency situations with different mechanisms applying in each situation

4.1 In ASIC's view, compensation arrangements should be in place both where the licensee is solvent and where it is unable to pay/insolvent.

4.2 ASIC believes that, where the FSL is solvent, the appropriate mechanism for providing the assurance of assets to meet proven claims is professional indemnity insurance [PII] (or, in certain circumstances, alternative insurance-type arrangements, at the option of the licensee): see Section 6 below. Where the licensee is unable to pay, or insolvent, on the other hand, there is a role, in our view, for a minimum ‘safety net’ statutory compensation scheme: see Section 10 below.

Different criteria should apply depending on whether the licensee is solvent or insolvent/unable to pay

4.3 There would not appear to be a basis in principle for limiting the application of compensation to certain causes or circumstances of loss only. However, as the Paper notes:

> the balance between financial risk and consumer protection, and between the costs and benefits of any solution, needs to be kept firmly in mind… [para 98].

Giving appropriate weight to the cost of compensation arrangements is particularly important where, as with an insolvency compensation scheme mechanism, that cost is liable to be largely borne by innocent participants in a payment pool, and ultimately their clients, rather than the entity responsible for the misconduct that caused the loss.

4.4 Where the licensee is solvent, the objective, in our view, should be to provide a high level of assurance of compensation covering the broad range of losses that retail clients may suffer as a result of licensee or representative misconduct. What this might mean in terms of the coverage requirements for mandated PII (the proposed mechanism for providing compensation in these circumstances) is discussed in detail at Section 6 below. Broadly, however, licensees should be required to be insured generally against claims arising from breaches of all their/their representatives' legal obligations to clients; and coverage should extend to all financial products/financial services provided.

4.5 By contrast, the approach to coverage where the licensee is insolvent/unable to pay would appropriately be much more circumscribed, in our view. The scope of any proposed statutory compensation scheme is considered in detail at Section 10 below. In broad terms, again, the primary purpose of any scheme should be to protect client funds and other property if the licensee or representative is unable to account for the property (whether or not fraud is also established). In addition, it would not be viable or appropriate for a statutory compensation scheme to cover losses resulting from the loss of value or collapse of a managed investment scheme as a result of misconduct in how it is managed or operated. Again, this is discussed below at Section 10.

Unlicensed providers should not be covered

4.6 A statutory compensation scheme should not cover losses arising from the misconduct of unlicensed financial services providers. Extending compensation to clients of such providers may impose an unacceptable burden on licensees. It would not be consistent with the general approach of the FSR Act reforms. It would also have moral hazard implications. In ASIC's view, the message that retail clients should only deal with licensed providers must not be diluted.

4.7 In contrast to other information that financial services consumers require, information about whether a provider is licensed or an authorised representative is relatively easily to find by checking ASIC's registers. (A key challenge, of course, is to educate consumers to take this step before they obtain financial services.)

4.8 However, it may not always be easy for unsophisticated consumers to assess whether an authorised representative is acting within the scope of his/her authority from the licensee. Further, the ability to mislead and manipulate such consumers, once the client – representative relationship is established, will be greater. Therefore, 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).[5] This approach was taken in the UK with the newly established Financial Services Compensation Scheme [FSCS].[6]

[5] In effect, activities undertaken in apparent compliance with Part 7.7 and 7.8 would be covered. Activities otherwise exempt by section 917D would not be covered.

[6] Ch 6, *Relevant persons in default,* FCSC Handbook, at 6.2 *Who is a relevant person?*

Question 5

5. Who should be entitled to claim? [PI 5]

ASIC response

5.1 ASIC believes that compensation arrangements should only apply to retail clients of licensees. As [para 150] of the Paper notes, this is the approach proposed by the Companies and Securities Advisory Committee (CASAC) — as it then was — in its September 2001 Consultation Paper, *Retail Client Compensation in Financial Markets*. We agree with the reasoning supporting CASAC's view.[7] We understand that, although the current markets' schemes are not limited to retail clients, they tend not to be used by wholesale clients.

[7] See CASAC Consultation Paper, pp. 9 – 10

Principal issues: financial services licensees (FSLs) [PI 6 – 7]

Question 6

What compensation requirements should be imposed on financial services licensees?

Should financial services licensees be required to have Personal Idemnity Insurance (PII)? Are there other appropriate mechanisms which could be alternatives at the option of the licensee?

What should the mechanism be required to cover?

ASIC response

Imposing compensation requirements on licensees

6.1 ASIC supports the view that responsibility for providing compensation should rest, as far as possible, with the licensee, as the entity responsible for the conduct causing loss: see Paper, paras 158-160. Ensuring that the licensee bears the cost of compensation, where possible, is desirable, both from an equity perspective and as a way of providing incentives to encourage effective internal supervision of employees and representatives. Mandatory PII generally provides a viable and effective means of enforcing licensee responsibility.

6.2 In ASIC's view, PII should be seen as the primary compensation arrangement. Alternative arrangements at the option of the licensee may also be appropriate in certain circumstances: see Section 6.6 below. We do not see an ongoing role for security bonds: see Section 6.8 below.

The case for a PII requirement

6.3 The Paper sets out a number of advantages of PII as a compensation mechanism at para 174. We agree that these are key considerations, and would add the following:

- Most claims against FSLs or their representatives will be negligence-related. Mandatory PII cover would appear to be the only viable mechanism for ensuring the availability of funds to meet such claims.

As is discussed in Section 10 below, it is doubtful whether a statutory compensation scheme could viably extend to covering negligence claims.

- Amid increasing PII costs, some licensees (particularly, more marginal operators) are unlikely to insure, or obtain adequate cover, if they are not required to do so.[8] We understand that this is currently the situation for some financial services businesses. Typically, the assets of such businesses will be minimal due to their service-based nature. In addition, some firms may "run bare" to minimise the impact of insolvency on the owner's personal or family circumstances should a claim arise which cannot be met. Mandatory PII should provide a significant degree of protection for consumers against this possibility.
- Key industry groups have publicly endorsed the crucial consumer protection/public interest role of PII, among other things, in their recent submissions to the Senate's Economics Reference Committee's Review of Public Liability and Professional Indemnity Insurance.[9] Despite the current ‘hard’ market, abandoning compulsory PII for their members has not been suggested as a serious option by the major industry associations. (However, there is ongoing consideration of what specific coverage requirements can reasonably be imposed on members).[10]
- Apart from its consumer protection role, PII also plays a role in licensees’ risk management and, more generally, in promoting a stable and secure environment for financial services.

6.4 [Para 175] of the Paper also notes certain disadvantages of PII. In our view, these undoubted limitations do not constitute a case against requiring that licensees have PII. Rather, they point to the need to ensure, as far as possible, that the mechanism operates effectively: see *Making a PII requirement work effectively* at Section 6.18 below.

6.5 Arguably, they also point to a role for a ‘safety net’ statutory compensation scheme to complement PII in circumstances where (despite the PII requirement) licensees are unable to meet claims. The limitations of PII are further discussed in relation to the broad statutory compensation scheme option: see Section 10 below.

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[8] National Insurance Brokers Assoc recently stated that its members were 'alarmed' at the number of small businesses reportedly abandoning insurance. Under-insurance is also a major problem: PR, 2 Sept. 2002.

[9] See, in particular, submissions of the FPA, CPA and ICAA.

[10] See, for instance, changes to ICAA PI regulations of 30 August 2002.

Alternative arrangements at the licensee's option may be appropriate

6.6 It may be appropriate to allow a self-insurance option for at least part of its exposure, where a licensee is able to demonstrate a sufficiently high level of liquid assets. Similarly, the requirement might be satisfied where the licensee provides an indemnity or guarantee from a related organisation with an appropriate capital level. A licensee that is part of a conglomerate may well be covered by a group insurance policy. We suggest that any alternative mechanism should be subject to prudential regulation by APRA. (This would currently exclude the use of discretionary mutual funds as these are not APRA-regulated. We understand that APRA is currently considering the status of such funds.[11])

6.7 In ASIC's view, the key consideration in this context should be access to a level of liquid capital sufficient to meet claims, not whether the body is APRA-regulated. We would not support a blanket exemption of APRA-regulated bodies from any mandatory PII requirement.

Security bonds not supported

6.8 ASIC does not support an ongoing role for security bonds. We agree with Treasury's "preliminary view" that "surety bonds do not provide adequate protection or, if markedly increased, involve a possible impediment to becoming a financial services licensee and potentially a significant cost on business": para 169.

6.9 Our data indicates that there have been very few calls on bonds lodged by securities' dealers (perhaps indicating consumers' low level of awareness of the bonds). The data also indicates that, where claims are made, there may be multiple claimants, resulting in very low levels of compensation being received by claimants. Thus, since 1 Jan 1990, there have been only 131 claims made, of which 20 were withdrawn or refused, and 3 are currently under consideration. Of the 108 successful claims: 41 were against one particular company; 41 were against one individual; and, 17 were against another company. In each of these cases, claimants received only a few hundred dollars on average, each.

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[11] For a recent comment by APRA on discretionary mutual funds, see *APRA Speech – Regulatory Outlook Twelve Months On*, Tom Karp, 12 Sept. 2002, at p. 3.

Coverage of a PII requirement mechanism

Broad coverage proposed

6.10 In ASIC's view, licensees offering services to retail clients should be required to have PII covering the broad range of risks to which licensees and their representatives might be exposed, in dealing with their retail clients.

6.11 Thus, policies should cover the insured against liability incurred by, or loss arising from, a claim that is made as a result of a negligent act, error or omission in providing the licensee's or representative's services. This will generally include breach of contract. If not included in the basic cover, the policy should also include an extension for breach of the licensee's or representative's statutory obligations to its retail clients—including, but not limited to, breaches of Chapter 7, *Corporations Act*. There should also be extensions for claims by retail clients arising from fraudulent or dishonest conduct by employees of the licensee or its authorised representatives. Cover of legal costs should probably also be mandated, given that it appears to be increasingly common for these costs to be excluded from the standard cover.

6.12 In our view, licensees' policies should be endorsed to cover determinations of retail client claims by approved external dispute resolution (EDR) schemes to which the licensee belongs. This proposal is considered further below.

6.13 We note that a number of industry association representatives have drawn attention to the difficulties some of their members have recently experienced in obtaining PII cover for certain aspects of their work, eg providing advice on tax-effective products, agricultural investments etc.[12] While acknowledging these difficulties, we believe that, for PII to be effective, it would have to cover all financial services activities carried on by, and products dealt with by, licensees or representatives.

6.14 A further aspect is run-off cover. Given the 'claims made' nature of PII policies, unless a run-off cover extension is required, the licensee may have no cover for claims arising after they cease to be insured (because, for example, they close their business or become insolvent). Run-off cover would appear to be an essential component of an effective PII-based compensation mechanism. We believe that most stakeholders would accept this, at least in principle. A run-off requirement is a

[12] See, for instance, comments of FPA, CPA etc at 6.2, 6.6, 6.7, 6.12, 6.14-6.16, 6.24 of *A Review of Public Liability and Professional Indemnity Insurance, Senate Economics References Committee*, Oct 2002.

common feature of the mandatory PII regimes developed by industry associations, as well as Government.[13]

6.15 The real issues about run-off cover are likely to be about availability and cost; and, assuming reasonable availability, what the appropriate period of a cover requirement should be. This latter issue is a complex one. For instance, whether misconduct has occurred in many dealing activities is likely to emerge relatively soon after the misconduct. On the other hand, in the case of advice, it often takes a number of years before the client's claim becomes apparent or crystallises. To deal effectively with the latter scenario, an extended period of cover (seven years is a commonly used period)[14] would be required.

6.16 A range of other issues would also have to be dealt with by Regulations setting out the requirements of a mandatory PII regime. These include:

- what minimum indemnity limits would be required
- whether policies should have unlimited reinstatements and, if not, how many reinstatements would be appropriate
- the maximum deductible (excess) on claims
- what provision should be made for retroactive cover
- prohibiting certain exclusions which may have the effect of undermining the intended coverage
- other possible policy extensions.

6.17 ASIC notes that the Paper does not invite detailed submissions on the content of any mandatory PII requirement at this stage. The Government envisages that there will be a second stage of the Review during which 'a more detailed proposal' will be exposed for public comment: Paper, para 33. If a mandatory PII requirement forms part of this more detailed proposal, ASIC will offer further submissions on the above issues.

Making a PII requirement work effectively

6.18 For an insurance-based compensation regime to be effective there clearly needs to be a practicable way of ensuring that licensees are, and stay, insured at the required level. As [para 175] of the Paper notes, one of the disadvantages of PII as a compensation mechanism is this problem of ensuring compliance. In our view, a detailed proposal for a PII compensation regime should consider the compliance issue (as well as

[13] For instance, Rules of FPA, CPA and ICAA include run-off requirement.

[14] The Statute of Limitations period plus one year.

the specific coverage requirements noted above). Besides canvassing ASIC's role in this context, it would be appropriate to consider the potential involvement of *underwriters* in compliance monitoring. Underwriters might be required to notify ASIC within a defined period when a licensee's policy had lapsed or not been renewed, similar to the current requirement under the Insurance (Agents and Brokers) Act (IABA).[15] They might also be required to certify that policies meet the prescribed requirements.

6.19 Another disadvantage or limitation of PII noted in [para 175] of the Paper, is that the insured may act in ways that void the cover, by, for example, misrepresentations in the offer document, the making of admissions or failure to report claims. As is indicated, the issue of misrepresentation, at least, could be addressed by a provision (modelled on s9B(3), IABA), prohibiting the insurer from avoiding the contract of insurance, or reducing its liability under it, where there has been a failure to disclose or misrepresentation by the insured prior to entry into the contract. The viability of mandating a similar non-avoidance clause, as part of an FSR PII regime, could be further considered.

Coverage of External Dispute Resolution (EDR) scheme determinations

6.20 The effectiveness of PII as a compensation mechanism will also depend on the client's ability to access compensation when insurance is the source of the funds. In the absence of alternative mechanisms of redress, the client will generally have no option, should the licensee's insurer refuse to accept the claim, but to sue the insured. This will obviously involve cost and delay (often of years). The situation will be further complicated for the client should the licensee fail to join the insurer to the proceedings (for instance, because it does not have the financial capacity to defend the proceedings). Even where a claim is accepted, ASIC's experience is that there may be considerable delays before the client is paid.

6.21 As the Paper notes, however, the FSR requirement that licensees belong to one or more approved EDR schemes covering the range of their retail client activities helps reduce the problems of access to compensation associated with PII. By providing a reasonably prompt and low cost alternative to legal action for accessing compensation, the EDR system, in effect (to the extent of the schemes' jurisdiction) enhances the efficacy of PII as a mechanism for protecting retail clients against the possibility of uncompensated losses.

[15] Section 9B(5). This provision requires the insurer to notify ASIC of their intention to cancel the broker's PII policy.

6.22 This role would be further supported, in our view, if, as part of a mandatory PII regime, policies were required to be endorsed to cover all decisions of approved EDR schemes to which the FSL belongs. ASIC recommends this course of action if insurance-based compensation is introduced.

Option of requiring PII cover for specific Chapter 7 obligations only, not supported

6.23 The current wording of s912B of the Corporations Act, limits the requirement to have compensation arrangements to the situation where loss has resulted from a breach of a "relevant obligation" of Chapter 7. [Para 191] of the Paper notes that the Review does not assume that section 912B should remain unchanged. It raises the possibility that the section might refer, instead, either to the specific liability provisions of Chapter 7 or to another set of obligations.

6.24 As mentioned above, ASIC believes the broad range of civil liabilities should be covered by PII. We do not support mandated coverage that is limited to either the Chapter 7 obligations or the Chapter 7 liability provisions. This view is based on the following considerations:

- The specific obligations of Chapter 7 were developed in light of other statutory and general law obligations.
- Consistent with this, licensees are required to comply with ‘financial services laws’ as part of their General Obligations under s912A.[16] Financial services laws include obligations imposed by other Parts of the Act and obligations under other State and Federal laws.[17]
- There is no obvious policy rationale for providing regulatory assurances about the availability of insurance cover for losses resulting from breaches of some, but not all, licensee or representative legal obligations to clients.
- It is unclear what the impact of a requirement limited to Chapter 7 obligations or liability provisions would be on the provision of PII. Currently, polices normally either provide broad coverage for civil liabilities generally, or a more limited standard cover with the option of an extension for breaches of statutory obligations. If an approach limiting mandated coverage to Chapter 7 obligations or liability provisions were introduced, would a legislative incentive be given to developing policies that *just* provided cover for breach of those obligations? If so, would encouraging such narrowly framed policies be desirable?

[16] Section 912A(1)(c).

[17] See definition of "financial services law" at section 761A.

- Either of the approaches being considered would also have the potential to create problems for consumers in understanding how an insurance policy relates to their circumstances. These approaches might well also create disputes about policy coverage and perceptions that protection is arbitrary or legalistic where claims were not covered.

Question 7

What, if any, difficulties are being experienced by the financial services sector with the cost and availability of professional indemnity insurance? For example, is run-off cover available? [PI 7(a)]

What, if any, difficulties have consumers had in being compensated from professional indemnity insurance policies? [PI 7 (b)]

ASIC response

Financial services sector PII experience

7.1 ASIC is able to provide some limited comment on this issue on the basis of our role administering PII insurance requirements applying to some types of financial services providers.

ASIC's role in administering PII insurance

7.2 ASIC administers PII cover requirements imposed by the IABA for insurance brokers.[18] ASIC also administers the PII cover requirements imposed by current ASIC policy for responsible entities of managed investment schemes[19] under Part 5C of the Corporations Act 2001. (We also administer PII cover requirements for liquidators, through the registration process under s1282 of the Corporations Act 2001.)

[18] Subsection 19(1)(b) requires, as a condition of registration, that an insurance broker have an acceptable contract of PII within the meaning of section 9B of the Act and Regulations.

[19] Policy Statement 131 Managed Investments: Financial Requirements.

ASIC experience with PII availability for insurance brokers and responsible entities

7.3 Generally, industry feedback has been that PII premium costs have increased, particularly since the collapse of HIH. However, our experience has been that, in most cases, persons requiring PII cover have been able to obtain the cover they require to be licensed or registered by ASIC.

7.4 We have received only two applications from responsible entities for relief from the PII cover conditions in their licences. Both applicants subsequently withdrew their applications. We also received a small number of breach notifications and qualified audit reports for responsible entities, showing failure to hold appropriate PII cover.

7.5 Feedback from responsible entities shows that difficulties in obtaining PII stem from higher costs, a limited number of PII insurance providers, and limited capital availability. For new schemes starting up, insurers will often insist on reviewing the first prospectus before agreeing to provide cover.

7.6 ASIC has also received a small number of breach notifications and qualified audit reports for general insurance brokers showing failure to hold appropriate PII cover. Informal feedback from insurance brokers is that PII is available, but at a greater cost. Where brokers had difficulty in obtaining the necessary cover, there were often additional problems such as a poor claims record or other factors indicating that the broker may have breached the law.

7.7 ASIC has also noted that life insurance brokers who are also financial planners appear to be finding it more difficult to get PII cover. We are not sure whether this is because the life insurance or the financial planning side of the business is seen as high risk.

7.8 ASIC has also observed that excess levels are increasing, and, in a number of cases, that excesses are above the level of the IABA requirements.

7.9 Because of the difficulties noted above, it is generally taking entities longer to obtain the cover required. This may also explain the increase in the number of retroactive clauses (dealing with gaps in cover) that we are currently seeing in the PII Certificates of Currency.

Difficulties experienced by consumers

7.10 In the course of ASIC's enforcement activities, our enforcement staff have encountered situations where consumers have experienced considerable delays in obtaining compensation from the licensee's PII policy. In some cases, the insurer was unwilling to allow licensees to pay the compensation and then make a claim on the policy. The insurer's concern in these cases would appear to be that payment may be seen as an admission of liability. There are also difficulties with the width of some policy exclusions.

Principal issues: market licensees [PI 8 – 9]

Question 8

Should market licensees continue to be required to make compensation arrangements (as they have in the past and are currently under Part 7.5)? If so, what changes to the current Part 7.5 should be made? [PI 8, PI 8(a)]

Is there justification for a consolidated scheme for financial services licensees who are market participants? [PI 8 (b)]

ASIC response

Is there a continuing role for markets' compensation schemes?

8.1 In ASIC's view, continuing to require financial market licensees to make compensation arrangements covering the conduct of market participants (or someone for whose conduct the market participant is responsible) is not justified. We agree generally with the views set out in the CASAC Consultation Paper on this issue;[20] as well as the additional considerations noted in the Paper: [para 205]. While some of the disadvantages of the current arrangements, eg the differences in coverage between the National Guarantee Fund and the exchange fidelity funds, could be overcome, various other objections can be identified.

8.2 In a demutualised environment, market operators are no longer appropriately regarded as "proxies" for their participants. Arguably, the obligation to have compensation arrangements should fall directly on the FSL. (On the other hand, we see no objection to a situation where, to enhance business confidence, a market operator decides to maintain a compensation arrangement/scheme voluntarily.)

8.3 The markets' compensation arrangements are also open to objection as they are not consistent with the FSR Act theme of harmonised regulatory treatment. The arrangements currently apply to clients of market participants only. Unless comparable arrangements were also mandated for retail clients who do not invest directly, the situation will continue where direct investors are given greater regulatory assurance than, say, those who make additional contributions to their

[20] Consultation Paper, pp.3 – 7.

superannuation or purchase a managed investment product through a financial planner. It is not clear why this regulatory bias should continue.

8.4 Other objections include the fact, noted in the Paper, that the current market regimes require a connection to be established between the conduct causing loss and a particular market. [Para 199] states:

> This may create complexity for the client, if there is doubt as to which market his or her instruction was to be executed on, or whether it was to be executed on a market at all.

Even if, in practice, this issue currently only arises occasionally, the requirement of a connection with a particular market would appear to be rigid and, as [para 205] of the Paper notes, not readily adaptable to the newer models of financial markets covered by Part 7.2 of Chapter 7.

8.5 Instead of the market schemes, ASIC supports a statutory compensation scheme covering clients of FSLs generally, where the licensee is insolvent/unable to pay the claim. Apart from being confined to the insolvency/inability to pay context, such a scheme would appropriately also be limited in the circumstances of loss that it covered. See Section 10 below.

8.6 ASIC acknowledges that a statutory scheme confined to the situation where the licensee is insolvent or unable to pay, would provide less protection to clients of market participants than the current market schemes, which are not limited to insolvent licensees. However, this loss of protection needs to be seen in light of the role which the EDR system, in particular the Financial Industry Complaints Scheme, now plays in providing clients of stock brokers with accessible redress for most retail claims against solvent firms.

8.7 Indeed, it is arguable that, within the FSR framework, any compensation scheme arrangements should be limited to the situation where the licensee is insolvent/unable to pay, with a combination of mandatory PII and the EDR system providing the process for ensuring availability and accessibility of assets to meet claims where the licensee remains solvent. This is further discussed in Section 11 below.

A consolidated scheme for clients of market participants only?

8.8 As with the current markets schemes, this alternative is open to objection as it is not consistent with the objective of harmonised regulatory treatment.

Question 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?
[PI 9]

ASIC response

9.1 ASIC does not support the proposition that CS facilities should be required to have compensation arrangements. Generally, the objections to requiring market licensees to have such arrangements (see Section 8 above) apply equally to CS facilities.

9.2 Also, if such a requirement were introduced, it would only apply to the ASTC—currently the only prescribed CS facility with the capacity to effect transfers of title and, therefore, unauthorised transfers/certificate cancellations. (The only other apparently potential contender, SFECC/Austraclear, is not currently a prescribed CS facility.) Arguably, this would be inconsistent with the FSR Act objective of regulatory neutrality. Participants of other CS facilities, even if not able to effect unauthorised transfers of title, do have the capacity to engage in other unauthorised conduct through the CS facility. However, it is not proposed that other CS facility operators should be required to have compensation arrangements for such conduct.

9.3 In our view, within the FSR framework, the appropriate processes for claims against solvent licensed participants of a prescribed CS facility for unauthorised transfer or certificate cancellation, are a combination of mandatory PII and the EDR system. For claims against insolvent licensees that are or were participants of a prescribed CS facility, a statutory insolvency scheme would be the appropriate process. These processes would be strengthened by statutory warranties and indemnities relating to transfer in the Regulations under Part 7.11.

Principal issues: a broad statutory scheme? [PI 10 – 11]

Question 10

Do the financial services industry and consumers consider that a broad statutory scheme is warranted? [PI 10]

ASIC response

10.1 ASIC supports the introduction of a statutory compensation scheme as a means of supplementing the role of mandatory PII [see under PI 6(a) above] in providing compensation arrangements for retail clients. While such a scheme would be “broad” in the sense of applying to FSLs generally, we see it as playing a limited safety net role only. Specifically, in our view, a compensation scheme should only pay compensation when the FSL is either insolvent, or unable, or unlikely to be able, to meet claims against it: see Section 11 below. The causes of loss for which compensation should be payable should also be carefully circumscribed: see Section 11 below. In addition, the amount of compensation payable by the scheme on any claim should be capped: see Section 20 below.

10.2 The following points below support these views:

The need for insolvency protection

10.3 The likelihood of licensees, particularly smaller firms, becoming insolvent is real and may increase in an economic downturn. The increase in the number of licensed securities dealers that have gone into external administration in the last couple of years is worth noting in this context. There has also been a considerable number of insurance broker failures in recent years. See Section 1 above.

10.4 The fact that firms go into external administration does not mean that clients’ funds or property (which must be held on trust under Part 7.8, Div 2) will have been misappropriated. Nonetheless, it is reasonable to assume that this and other forms of misconduct are more likely to occur where a firm or its principals are under stress. In these circumstances, too, it is less likely, whatever the regulatory requirements, that appropriate insurance cover will be maintained.

10.5 While licensee failure leading to claims for uncompensated loss are expected to be relatively rare, the implications of a failure, when it occurs, may be considerable. For instance, during the period 1988-1993, almost all the 5,333 claims made on the National Guarantee Fund arose out of the insolvency of eight stockbrokers that became insolvent in the wake of the October 1987 market crash.[21]

10.6 Apart from the number of claims, account also needs to be taken of the potentially serious implications of uncompensated loss for the persons affected. As suggested, a significant portion of those persons are likely to be retirees who face financial ruin if compensation is not available.

The limitations of insurance cover as a compensation mechanism

10.7 Any PII requirement likely to be imposed on licensees will have to consider the cost and availability of cover and the broad range of financial services businesses for which cover will be required. Inevitably, a workable, reasonably affordable insurance regime—even a robust one—will leave some events/risks uncovered.

10.8 The extent to which a PII requirement will limit uncompensated loss will depend on the extent of compliance with the requirement, as well as on whether the insured acts in ways that void the contract of insurance or reduce the indemnity provided by it. These issues are discussed above in the context of a PII mechanism: Sections 6.18 – 6.19.

10.9 Other factors being equal, the less comprehensive the PII coverage requirements, and the less effective compliance with them, the greater the risk of licensee failure and the stronger the case for a compensation scheme safety net to protect financial services clients against licensee failure.

10.10 This said, however, no matter how prescriptive and detailed it may be, a PII requirement alone cannot provide a guarantee against licensee failure.

An insolvency scheme would provide direct access, as well as a source of funds

10.11 A statutory compensation scheme would provide a timely and assured means of providing compensation for licensee insolvency. In some circumstances, a client may be entitled to seek to recover their loss by making a claim in the insolvency; however, obtaining compensation could take many years and it may only be minimal. It may also be practically difficult for some retail clients to effectively pursue their

[21] Securities Exchanges Guarantee Corporation, Annual Report 2002, at p. 16.

claims against an insolvent licensee, especially where the licensee's insurer opposes the claim (if the policy is still operative). Again, there may also be an extended delay before any compensation is received.

10.12 A compensation scheme would resolve these issues for the claimant. If the claim were accepted, the client would be paid out and the scheme could pursue the claim in the insolvency under its right of subrogation. In this way, the compensation scheme would play a role analogous to that of the EDR system where the licensee remains solvent. (However, it is acknowledged that there are important differences in the way the two mechanisms work.)

An insolvency scheme would ensure ongoing comparability with overseas jurisdictions within the context of a harmonised regulatory regime

10. 13 As the comparison of international compensation schemes set out in Attachment D of the Paper indicates, insolvency compensation schemes exist in many overseas jurisdictions. For most of these schemes, coverage is limited to exchange participants; however, some jurisdictions (eg UK, Ireland, EC Directive) cover a broader range of financial services providers.[22]

10.14 The proposed insolvency scheme would ensure that Australia continues to have arrangements generally comparable with arrangements in other comparable jurisdictions. At the same time, these arrangements would be consistent with the FSR objective of a harmonised regulatory environment in that, unlike the current market schemes, they would not be restricted to protecting clients of market participants only.[23]

An insolvency scheme would ensure ongoing compliance with IOSCO principles

10.15 The International Organisation of Securities Commissions' *Objectives and Principles of Securities Regulation* (1998) contemplates that investors will have access to compensation (as well as mechanisms of redress) for the improper conduct of market participants: Clause 4.2.1 *Protection of Investors*. Clause 11.7 *Client Asset Protection* further states in part that:

> Regulators should recognise the benefits for investor protection and confidence in financial markets of effective mechanisms to protect client assets from the risk of loss and the insolvency of investment firms.

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[22] Paper, Attachment D: Comparison of International Compensation Schemes.

[23] See Section 9 above.

10.16 The proposed insolvency scheme would maintain Australia’s adherence to the IOSCO Principles.

Question 11(a)

If a broad statutory scheme were warranted, should it be available prior to insolvency or only on inability to pay/insolvency? [PI 11(a)]

ASIC response

11.1 In ASIC's view, any statutory scheme should be limited to situations where the FSL is unable to pay, including where the FSL is insolvent.

The "inability to pay" threshold

11.2 The Paper canvasses the option of allowing claims against the scheme where the licensee is unable to pay, even though insolvency proceedings as such may not have been initiated. The Paper notes that this option would give greater flexibility than a simple insolvency threshold; however, it would require “some definitive statement that the licensee is unable to pay (which may of itself have consequences for the licensee’s situation)": see paras 229-230.

11.3 ASIC supports this more flexible approach. The UK Financial Services Compensation Scheme, which adopts such an approach, provides appropriate criteria for determining how the inability to pay threshold might be determined.

11.4 Under the UK Scheme,[24] either the FSCS or the regulator, the Financial Services Authority, can determine that a person (ie a financial services business) is in default if the person is either:

- unable to satisfy protected claims against it; or
- unlikely to be able to satisfy protected claims against it.

A determination can be made where one or more of a number of proceedings have been commenced—for instance, a resolution of creditors has been passed, a liquidator has been appointed, orders have been made for the winding up or administration of the company etc. For an investment business, a determination can be made where the scheme is satisfied that the person against whom the claim is made cannot be contacted and there is no evidence that the person will be able to meet

[24] See Ch 6, *Relevant Persons in Default*, FSCS Handbook at 6.3 *When is a Relevant Person in Default?*

claims against it. So, in effect, the scheme will be able to deal with claims where the entity against whom the claim is made has ceased to operate, as well as where proceedings have been commenced.

Why a compensation scheme should be limited to the inability to pay situation

Where the licensee remains solvent, the compensation regime is appropriately constituted, within the FSR framework, by a combination of mandatory PII, the EDR system and the legal system.

11.5 If a compensation scheme had coverage in some circumstances where the FSL remained solvent, situations could arise where both the scheme and the relevant EDR process would be able to handle the same claim. (Currently, we note, there is some jurisdictional overlap between the National Guarantee Fund's jurisdiction and that of the Financial Industry Complaints Scheme.) Jurisdictional overlap of this kind is undesirable for a number of reasons, eg additional administrative costs, the potential for consumer confusion, the potential for inconsistent treatment of like cases.

11.6 These problems would not arise, however, if the availability of any statutory scheme were limited to the situation where the licensee was unable to pay the claim. In these circumstances, the EDR scheme will be largely irrelevant (unless the claim were covered by the licensee's PII policy). Generally, even if the financial services provider remained licensed and a member of the relevant scheme, there would be no point in the client making a complaint to it as there would be no source of funds to satisfy an award in the client's/claimant's favour.

11.7 It is ASIC's view that, within the FSR framework, where the FSL is solvent, a generally adequate compensation regime would involve a combination of mandatory PII (or equivalent alternative arrangements) [see Section 6 above], the EDR system and, where this were not available, the courts. The insurance requirement would cover the ability of licensees to meet claims; the relevant EDR scheme would provide an accessible avenue for redress, as an alternative to the courts, at least to the extent of its jurisdiction.

11.8 It is acknowledged that EDR schemes do not cover the full range of potential claims by retail clients. For instance, the current monetary limits on claims against stock brokers through FICS is $100,000—a figure that is obviously well below the level of many retail transactions. However, in ASIC's view, the issue of consumer access to compensation/redress where the licensee remains solvent is not something that should be addressed through a compensation scheme arrangement. Rather, it would be best addressed by extending the jurisdiction of the EDR schemes, where appropriate.

Most overseas investor compensation schemes only apply on inability to pay/insolvency

11.9 See Attachment D of the Paper. This issue is discussed in the preceding Section.

Cost considerations

11.10 A scheme limited to situations where the licensee is insolvent/ unable to pay would be less financially burdensome on other licensees in the payment pool than a scheme also providing cover where the licensee remains solvent. Other licensees may well resent a situation where they were required to fund overlapping EDR scheme and compensation scheme processes. (The importance of carefully circumscribing the costs of compensation mechanisms where those costs are not borne by the licensee responsible for the misconduct is discussed in Section 4.)

Question 11 (b)

If a broad statutory scheme were warranted, on what grounds should claims be paid? [PI 11 (b)]

ASIC response

Limited coverage proposed

11.11 ASIC's approach to this question is partly dependent on whether a PII requirement is mandated and, if so, how comprehensive it is in terms of coverage and ensuring compliance: see Section 6 above.

11.12 Assuming a reasonably comprehensive PII requirement is introduced, we believe that the role of any statutory scheme should probably be limited to protecting retail client assets. Thus, the scheme would cover situations where the licensee was insolvent/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

wherever the client's property or authority had been given to the licensee/representative in the course of the latter's business.

11.13 A number of considerations support this approach:

- The jurisdiction and operation of a statutory scheme needs to be carefully circumscribed, recognising the increased regulatory burden that would be imposed on licensees by such a scheme. A scheme limited to claims to protect client assets would be less likely to involve the complex legal and evidential issues applying, for instance, to negligent or wrongful advice claims. Apart from the cost of dealing with such claims, it may also be doubted whether a compensation scheme is an appropriate mechanism for dealing with them.
- If limited to asset protection, the scheme would have reasonably clear boundaries and be reasonably easy to explain to consumers. By contrast, a scheme that attempted to cover a broader range of circumstances of loss, without covering all civil liabilities, may create disputes about jurisdiction and consumer confusion.
- Interest on trust accounts held by licensees may be an appropriate source of ongoing funding for a compensation scheme that was focused on client asset protection.[25] See Section 15 below.
- Overseas investor compensation schemes generally only provide for losses of client securities or monies held. (However, the UK scheme is considerably broader: the investment sub-scheme covers all civil liabilities, not just loss of money or assets.) The jurisdiction of Part 7.5 markets' compensation arrangements is also quite narrow in terms of the range of claims covered. Typically, compensation schemes focus on addressing misappropriation of funds or property held on trust.

11.14 We would not support an additional requirement that fraudulent or dishonest conduct, or any other intentional element, must also be established. Requiring that fraud be proved is likely to add significantly to the costs of establishing claims. The relevant parties would inevitably resist fraud or dishonesty allegations. The key issue for the claimant is that their property has been lost—whether this has occurred as a result of a mistake or technical failure or fraud is, from the claimant's perspective, a secondary (if not irrelevant) matter.

11.15 The position ASIC has outlined assumes that an insolvency scheme is only a fall-back option and that a reasonable assurance of compensation will be provided by a PII regime. If, however, PII is not mandated, or there are very significant gaps in the cover provided, a different—more encompassing—approach to scheme coverage may be appropriate.

[25] As the IP notes, however, under the new Chapter 7 regime, this interest is retained by the licensee: Regs 7.8.02(7) and 7.8.05(3). These Regulations would obviously need to be amended if it was determined that interest on trust accounts should be used to fund a compensation scheme.

Excluding operational losses of registered schemes

11.16 The provision of a financial service under section 766A(1) of the *Act* includes: to operate a registered scheme: s776A(1)(d). This inclusion raises the following question, posed by the Paper:

Is it desirable, or consistent with the treatment of other financial products, that a responsible entity of a registered scheme be required to have compensation arrangements with respect to all aspects of operating the scheme. [para 125]

11.17 As previously noted, ASIC currently requires responsible entities to maintain PII and insurance against fraud by its officers under ASIC's Policy Statement 131 *Managed Investments: Financial Requirements*. This requirement covers, among other things, losses due to misconduct in operating a scheme. In ASIC's view, it would be appropriate for a PII requirement to continue under the FSR Act compensation arrangements. (We would note, however, that, if a managed investment scheme of any size collapsed as a result of misconduct, the level of compensation provided by compulsory indemnity insurance—limited as the indemnity would be—may be quite modest.)

11.18 On the other hand, we do not believe it would be appropriate or viable for an insolvency compensation scheme to cover losses consequent on the collapse of a managed investment scheme. Were it to do so, the failure of a large managed investment scheme could lead to very substantial claims and impose an unacceptable burden on innocent participants in the payment pool—and ultimately their clients. Further, as the Paper implies, coverage of operational losses of a managed investment scheme would be anomalous given that, because the mismanagement/failure of a superannuation fund is not covered by the AFS licensing regime,[26] the scheme would not cover losses resulting from the collapse of a superannuation fund.

[26] Regulation of the management of superannuation funds occurs under the *SIS Act*.

Subsidiary issues about statutory schemes [SI 12 – 17]

Question 12

12. Who should operate the scheme? [SI 12]

ASIC response

12.1 This issue would be the subject of further detailed consideration if it was decided to establish a scheme. At this stage, we would make the following preliminary observations only:

- Any scheme would need to be operated in a way that ensured its independence from the licensees and industry sectors whose conduct it covered.
- In its Consultation Paper, CASAC, as it then was, raised the possibility of having its proposed compensation scheme operated by an existing ASIC-approved EDR scheme. This would have avoided the cost of establishing a new infrastructure and would provide consumers with a single point of contact. However, for the reasons in [para 242] of the Paper, we do not believe that this would be a viable option. ASIC does not consider that any current EDR scheme has the capacity to manage a compensation scheme, in addition to its dispute resolution functions, at this time.
- The nature and extent of the demands likely to be made on the scheme's resources would be a key issue in determining how it should be operated. A scheme that was limited to situations where the licensee was insolvent or unable to pay claims (and further limited to certain types of claim) would be unlikely to have to deal with a large number of claims overall. There may be extended periods where few, if any, demands were made on it. On the other hand, the failure of even a single licensee may lead to multiple, even numerous, claims—so the volume of work from time to time may be considerable. Given this variability, a major challenge would be to devise a cost-effective structure for the scheme. This would very likely include a capacity to outsource claims-processing work if there were significant claims' activity.
- The option of establishing a company limited by guarantee as the scheme operator would mean considerable administrative costs. These may be difficult to justify, given the likely overall number of claims. A new body, without an existing administrative framework or links to a larger/higher profile organisation may also have problems attracting and retaining suitably qualified and experienced staff.

Other alternatives might be considered, including the possibility of establishing the scheme as a self-funded body corporate under the ASIC Act (like the Corporations and Markets Advisory Committee, previously CASAC), with scheme money/assets held under a trust and administrative costs coming out of the trust. Such an arrangement could help address administrative requirements (eg accounting, payroll, superannuation fund etc) in a cost-effective way.

Question 13

13. What special governance and accounting requirements would be appropriate? [S1 13]

ASIC response

13.1 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.[27] The inclusion of members who can effectively oversee the management/investment of the scheme's money/assets would be a priority. We believe that members should be required to act in the public interest. Part-time appointments would probably be appropriate given the scheme's (proposed) coverage limitations. ASIC's role in the governance of any scheme would need to be considered.

13.2 We believe that, as a "public interest" body with the power to raise and invest funds, a scheme operator should be expected to produce audited annual statements and to make these publicly available.

13.3 To the extent that the structure and coverage of a scheme affects its tax status, it should be ensured, as far as possible, that the scheme has tax-free status—similar to that currently enjoyed by the National Guarantee Fund and other market-based fidelity funds.

Other duties/requirements

13.4 In addition to governance and accounting requirements, other duties that might be imposed on the scheme operator could include:

- an obligation to publish accessible information about the operation of the scheme for claimants and potential claimants;

[27] The requirements for the governing bodies of the UK Financial Services Compensation Scheme and the Compensation Fund of the Hong Kong Securities and Futures Commission include public interest representatives.

- where a claim has been made by one or more clients of a licensee and the scheme becomes aware of other clients who may also have a claim, an obligation to advertise the fact that a particular client group may be eligible to make a claim on the scheme.

Question 14

14. Could the one scheme cover financial services in relation to all financial products and sectors of the industry? [SI 14]

ASIC response

14.1 This would appear to be primarily a question about how compensation arrangement liabilities should be allocated across the range of FSLs. Clearly, this would be a contested area if a compensation scheme is established. At this stage, ASIC does not seek to articulate views about the detailed 'architecture' of any scheme.

14.2 Responses to the CASAC review indicate that there is likely to be opposition from some industry quarters to arrangements that result in significant cross-subsidisation between, and even within, recognised industry segments. As a way of minimising cross-subsidisation, it may be appropriate to establish a number of specific payment pools or contribution groups within the overarching framework of a single compensation scheme. However, as the Paper highlights, determining a basis on which such contribution pools might be defined would be complex.

14.3 The issue of payment pool viability or sustainability would also need to be considered. Clearly, there would be no point in creating a situation where some payment pools were so narrow that the demands made on participants were unrealistic or impractical. Some degree of cross-subsidisation would appear to be inevitable, given the range of businesses operating in the financial services sector and their varying resources. (We note that insurance pools, in financial services and other areas, also involve a degree of cross-subsidisation.)

14.4 It may also be relevant to consider the fact that large product issuing institutions benefit from the existence of the many smaller firms providing advice about and recommending their products. It may not be unreasonable for these larger firms to contribute to the management of risks associated with smaller distribution-end firms as a way of helping to maintain consumer confidence in this distribution channel.

14.5 Finally, we would note that the coverage of the scheme, as we envisage it at least, is narrow. This also needs to be kept in mind in considering cross-subsidisation.

Question 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? [SI 15]

ASIC response

15.1 ASIC does not seek to comment on this issue.

Question 16

How should it be funded initially and in the longer run? [SI 16]

ASIC response

16.1 As with the related issue of how liabilities should be allocated across the range of FSLs (see Section 14), the issue of how a scheme should be funded may well be a contested one and would require further consultation. We offer the following initial observations:

- If an asset protection-focused scheme were decided upon, interest on licensees' trust accounts could be considered as an appropriate funding source (see Section 11). As the Paper notes, under the Regulations, this interest is currently retained by licensees.[28] An amendment to the relevant Regulation would be required.
- While post-event funding would be desirable, in terms of minimising cost, it is unlikely, in our view, that such an approach would be practicable for a scheme designed to cover a large number of licensees. An ongoing infrastructure/scheme manager would probably be essential.
- A ‘pay as you go’ approach (which minimises the possibility of fund assets building up) would nonetheless be desirable. An annual levy calculated on the size of trust account funds held, in anticipation of the level of claims in the forthcoming period, might be an option, with additional calls able to be made as required.

[28] *Corporations Regulations*, 7.8.02(7) and 7.8.05(3).

- It would be important to ensure that the scheme had sufficient liquidity to carry on day-to-day business efficiently and to ensure that eligible claims were paid on time. The scheme would probably need to have the capacity to borrow to guarantee this. There may also be a role for insurance in this context.

Question 17

What would be the appropriate powers of the operator? [SI 17]

ASIC response

17.1 The scheme operator would clearly require powers to levy, hold and invest funds and remunerate the persons involved in administering the scheme. The operator must be able to obtain sufficient information about any failed licensee or representative and its retail clients to allow it to assess claims. We agree that qualified privilege and statutory protection against breach of confidentiality would also be appropriate.

17.2 ASIC agrees with the view in the CASAC Consultation Paper that it would not be appropriate for the scheme operator to have prudential powers.

Secondary issues: other issues [SI 18 – 25]

Question 18

Should special provision be made for financial services licensees which are regulated by APRA, to have high financial requirements or high market capitalisation, or have the requisite connection with such a body? [SI 18]

ASIC response

18.1 ASIC's view on a mandatory insurance requirement is that alternative arrangements, including self-insurance and the provision of an indemnity by a related company, may be appropriate where the licensee or the related company can show it has an appropriate level of liquid capital reserves: see Sections 6.6 - 6.7. As noted, however, ASIC does not support the view that there should be a blanket exemption for APRA-regulated bodies.

18.2 ASIC would not support the exemption of large financial institutions, or distribution businesses owned by such entities, from participation in the funding of any statutory compensation scheme. As our response at Section 14 indicates, we believe that large businesses should participate because, apart from the admittedly remote possibility that they may themselves become insolvent, these firms would benefit from the positive impact on consumer confidence that such a scheme could be expected to have. Their participation would also obviously contribute to the viability and cost of the scheme and/or the payment pools within it.

Question 19

How should the loss be measured and should consequential loss be covered? [SI 19]

ASIC response

19.1 This question would not appear to relate to a mandatory PII insurance requirement. The quantum of any claim on a licensee's insurance would be determined by the insurance policy (including any relevant exclusions) and normal legal principles for the calculation of damages.

19.2 The grounds for claiming on a statutory scheme should probably be limited to loss of property (including money). Assuming this approach, the scheme should pay the value of the property lost, as at the date of the misconduct, subject to any cap on payments that may apply. (On capping, see Section 20 below). It would also be appropriate for the scheme manager to be given a discretion, similar to that given to the SEGC under Regulation 7.5.58, 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.

19.3 Further consideration of this issue would be required if the scheme covered a broader range of grounds.

19.4 ASIC supports the views in the Paper on the inappropriateness of requiring the scheme to account to the client for profits made as a result of the misuse of the client's assets/property. We also support the views on interest, costs and contributory negligence.

Question 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? [SI 20]

ASIC response

20.1 We assume that this question relates primarily to a statutory compensation scheme.

The issue of what amounts per claim and aggregate cover might be specified in the context of a mandatory PII regime is dealt with above: see Section 6. (The question may also have some relevance to a mutual insurance scheme; however, as noted at 6.6, ASIC does not support this option.)

20.2 We agree with the view expressed in the CASAC Consultation Paper that caps should be imposed on the maximum amount paid in response to claims. Capping is desirable, both from a cost-control perspective and as a constraint on the moral hazard potential of a compensation scheme. However, a minimum threshold on claims is not supported.

20.3 The appropriate form of capping, in our view, would be a cap on the amount that can be paid *per claim*. This is the approach taken by the UK Financial Services Compensation Scheme[29] and would appear to be fairer, from the claimant's point of view, than other options—for instance, a cap per licensee/intermediary or a cap per claimant (where the claimant has more than one claim).

20.4 While supporting a cap on the amount that can be paid per claim, we would not support an additional limitation based on the amount of the claim itself. In our view, there should be no such limitation. A compensation scheme should ensure that, where a claim is established, the claimant receives at least some form of recompense without having to give up their right to seek to recover the balance of their loss (for example, from the licensee's insurer) through the Courts or by some other means. In some cases, a compensation scheme payment would provide a potential litigant with financial resources not otherwise available to them to pursue legal action for the balance they are owed—thereby facilitating access to redress in such cases.

20.5 In our view, a scheme would appropriately cover most claims by retail clients within its jurisdiction. The UK's FSCS pays 100% of the first 30,000 pounds, and 90% of the next 20,000 pounds up to a limit of 48,000 pounds. The Compensation Fund of the Hong Kong Securities and Futures Commission will have a cap of $HK150,000 on claims (per investor).[30] These figures may provide some guidance in setting caps; however, investigation of the likely size of potential claims in this country would obviously be desirable.

Question 21

What is the appropriate connection with Australia? [SI 21]

21.1 In ASIC's view, the key issue here is whether the potential claimant is a client of an AFS licensee or its authorised representative. If they are, irrespective of whether they are resident or located in Australia, they should be:

[29] Ch 6, *Limits on the amount of Compensation Payable*, FSCS Handbook, at COMP 10. By contrast, it is proposed that the Compensation Fund of the Hong Kong Securities and Futures Commission will operate on a' per investor' cap basis: see Consultation Paper, Proposed New Investor Compensation Arrangements, March 2002 at www.hksfc.org.hk

[30] ibid.

- covered by the licensee's PII policy; and
- able to claim against any statutory scheme that may be established (assuming, of course, that their claim is within the scheme's jurisdiction).

21.2 Conversely, 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.

Question 22

What is the appropriate relationship between compensation arrangements and external dispute resolution [EDR] schemes? [SI 22]

ASIC response

Key aspects

22.1 ASIC's views about this issue are largely contained in our responses to a number of the preceding questions. The following points summarise our views:

- Although not reopened for consideration by the Review, the EDR system is integral to the effective operation of compensation arrangements.
- EDR schemes provide a reasonably prompt, low cost process, compared to legal action, for *accessing* compensation where a licensee is solvent (or insurance will cover the risk) and compensation has not been able to be obtained by directly approaching the licensee. Because of this, the EDR system has the potential 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 overcome these access problems, the EDR system, in effect, enhances the efficacy of PII, as a mechanism for protecting retail clients against uncompensated losses.
- The role of the EDR system in this last respect would be further enhanced if, as we propose in Sections 6.20 – 6.22, PII policies were required to be endorsed to cover awards and settlements of approved EDR schemes to which the FSL belongs.

- If, as we also propose, a statutory compensation scheme confined to situations where the FSL is insolvent/unable to pay claims were established, the role of that scheme and the role of the EDR system would be, for the most part, separate and complementary. Thus, the compensation scheme would provide, in the insolvency context, a means of accessing redress (as well a source of funds) that complements the role played by EDR where the FSL remained solvent.

Where an EDR scheme award is unable to be paid by the licensee

22.2 Notwithstanding the last dot point, some interaction between the EDR system and an insolvency compensation scheme will occur. In particular, situations will arise where an EDR scheme award is unpaid at the time of the financial service provider's collapse—indeed, the EDR award may have helped precipitate that collapse. This scenario raises the question of the circumstances in which, and the extent to which, an EDR scheme determination should be recognised, as regards both liability and quantum, by the compensation scheme. (We are assuming here that, for one reason or another, insurance will not be available to meet the determination.)

22.3 As the Paper notes, the basis of EDR determinations is wide, covering, typically, not only the full range of civil liability, but good industry practice and fairness in all the circumstances as well. An EDR scheme may also provide compensation, in certain circumstances, for detriment other than direct financial loss: see [para 299] of the Paper. Different caps on the amount a claimant can recover may also apply to the EDR scheme in question, compared to the compensation scheme.

22.4 Given these differences, we believe it would not be appropriate for a compensation scheme to compensate a claimant simply because an award had been made by an EDR scheme prior to the licensee’s collapse. The same considerations would apply to court decisions to the extent that those decisions were made on grounds going beyond the scope of the compensation scheme’s jurisdiction.

22.5 On the other hand, where the basis for the EDR scheme determination (and the quantum of the award) is consistent with the circumstances of loss covered by the compensation scheme, the compensation scheme should have the right, in ASIC’s view, to recognise the EDR scheme award and provide compensation accordingly, up to the limit of any relevant caps applying to the compensation scheme. In general, it would be desirable if this were the practice adopted—both from a consistency-of-decision-making and a resource-use perspective.

22.6 In ASIC's view, a scheme should also pay (up to the limit of any relevant caps) judgment debts owed to clients by subsequently collapsed licensees where the judgment is based on grounds that are within the scheme's jurisdiction.

22.7 Occasionally, the situation may also arise where the issue is not an entity's capacity, but its willingness, to pay an EDR scheme determination. This may occur, for instance, where ASIC has revoked the entity's licence. In these circumstances, concern about loss of scheme membership (and, with this, breach of licence conditions) will no longer act as a lever to force payment of the determination by the entity. Thus, the possibility of the client/complainant's loss going uncompensated may arise.

22.8 A requirement, such as we propose (see Section 6 above), that licensees' PII policies should be endorsed to cover EDR scheme determinations would reduce, but not eliminate, this possibility. Further consideration of this issue may be warranted.

Question 23

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? [SI 23]

ASIC response

23.1 In our view, 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. The build up of excess funds, as distinct from an appropriate 'buffer', should be avoided. The option would always be open to an industry association to levy its members to pay for industry development projects if that is what the association, and its members, chose to do. We do not see a case for legislatively underwriting the provision of money for industry development projects. A predominantly 'pay as you go' approach to the funding of a statutory scheme as proposed in Section 16 above, could minimise this possibility.

23.2 To the extent that a build up of funds did occur, the excess funds would most appropriately be devoted to investor/consumer education purposes, in our view.

Question 24

Should there be time limits for claiming and, if so, how should they be set? [SI 24]

ASIC response

24.1 ASIC believes that claims on a scheme should be subject to time limits. An approach based on the general contract law limitation period of six years from the date of the misconduct would be an appropriate one. The UK Financial Services Compensation Scheme adopts a six-year limitation period as the generally applicable limitation. However, the FSCS is given a discretion to disregard this limitation period, in the case of investment-related claims, where it considers it reasonable to do so.[31] A discretion of this kind might also be considered.

Question 25

25. What is the appropriate level of detail in the legislation? [SI 25]

ASIC response

25.1 On a compulsory insurance requirement, ASIC's view is that the Regulations should spell out, in considerable detail, minimum policy content requirements. Within such a framework, there may also be a role for ASIC to develop policy or guidance on the requirement.

25.2 If compensation arrangements are to include a statutory scheme, 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.

[31] See FSA Handbook, *Compensation*, at 8.2.3 - 8.2.4.