COMPENSATION

FOR LOSS IN THE

FINANCIAL SERVICES SECTOR

ISSUES AND OPTIONS

September 2002

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Comments

The Government is seeking comments from interested parties on the issues and options raised in this paper. Comments should be sent to:

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The closing date for submissions is 8 November 2002.

Copies of this document are available from the Info Access bookshops and on the Treasury website http://www.treasury.gov.au

It is envisaged that one or more meetings will be held during the consultation period to discuss the issues raised in this paper. If you are interested in attending, please notify Ms Smith.

Confidentiality

It will be assumed that submissions are not confidential and may be made publicly available. If you want your submission, or any part of it, to be treated as 'confidential', please indicate this clearly. 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.

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FOREWORD

I am pleased to release an issues and options paper on compensation for loss in the financial services sector. Only minor reforms were made to the market compensation provisions of Chapter 7 of the *Corporations Act 2001* in the *Financial Services Reform Act 2001.* However, we now have the opportunity to examine from first principles the broader issues involved in compensation arrangements for a failure in the provision of financial services.

The aim of this paper is to promote discussion of the basic issues — 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.

The ambit of the paper is wide — compensation for financial loss suffered by clients in connection with the provision of financial services. It therefore encompasses financial services in relation to all financial products — market-traded products, those traded outside formal markets and those for which there is no secondary market. It includes services in relation to financial products which are in the nature of investments as well as those which manage risk. However, it should be noted that the focus is on financial services — the paper does not consider loss caused by market fluctuations, or the failure of the institution which issued the product.

It poses many questions on which you are encouraged to respond. Appropriate policy cannot be formed in a vacuum. We need your views and experience to inform it. More specifically, it is only with your assistance on the costs and benefits of the various possible courses that we can, in due course, assess more detailed options.

I hope that a wide cross-section of the community will enter into this debate — by attending one of the meetings that Treasury is to conduct, or by sending in a submission. In this way we can work towards a compensation framework which is understandable and appropriate, to complement the reforms implemented through the *Financial Services Reform Act 2001*.

Senator the Hon Ian Campbell
Parliamentary Secretary to the Treasurer
Parliament House
Canberra

TABLE OF CONTENTS

FOREWORD III

TABLE OF CONTENTS V

ABBREVIATIONS AND TERMS USED X

OVERVIEW 1

Background 1

Structure of the paper 1

Introduction 1

The problem and 'Is requiring compensation arrangements the way to address it?' 2

The current compensation arrangements 2

How should the requirements for compensation arrangements be reformed? 2

Options and conclusion 2

Attachments 3

Procedure 3

PRINCIPAL ISSUES 4

Financial services licensees 4

Market licensees 5

A broad statutory scheme? 5

SECONDARY ISSUES 5

If a statutory scheme were warranted 5

Other issues 6

CHAPTER 1: INTRODUCTION 7

A: The compensation review 7

What is the purpose of this review? 7

What triggered the review? 7

What is the purpose of this paper? 8

What does this review address and what is outside its ambit? 8

B: Origins of the review 9

The Corporate Law Economic Reform Program, CLERP 6 and the *Financial Services Reform Act 2001* 9

Request to the Companies and Securities Advisory Committee (CASAC) 10

CASAC's Consultation Paper 11

Responses to CASAC's Consultation Paper 11

CASAC's interim report 11

Senator Campbell's announcement 11

C: This issues and options paper 12
D: The consultation process 12
CHAPTER 2: THE PROBLEM AND OBJECTIVE 15
A: What is the problem to be addressed? 15
Concepts: Financial services licensees, financial service, financial products 15
What is the nature and size of the problem? — Evidence of wrongdoing and losses 15
B: Why is government action needed to correct the problem? 18
What protection and redress is available (apart from compensation arrangements)? 18
Current avenues for redress — some limitations 19
C: What is the objective of government action? 20
D: Will compensation arrangements help to achieve this objective? 20
E: Should compensation arrangements be required by legislation? 21
Reasons for compensation arrangements 21
Is mandating compensation arrangements consistent with the role of regulation? 24
What about the 'moral hazard' involved in requiring compensation arrangements? 25
F: Conclusion 26
CHAPTER 3: CURRENT AUSTRALIAN COMPENSATION REQUIREMENTS 29
A: Description 29
B: Problems 30
CHAPTER 4: THE PURPOSE AND DESIGN OF COMPENSATION ARRANGEMENTS 31
A: What is the purpose of a compensation regime? 31
B: Designing a compensation regime 32
Ease of access 32
Simplicity for consumers 32
Administrative simplicity 33
CHAPTER 5: COVERAGE 35
A: The conduct 35
Financial service 35
Licensed/unlicensed 36
Possible acts or omissions causing loss 36
B: The cause of the loss 37
(i) Defalcation and fraud 37
(ii) Loss of property (including funds) entrusted to the licensee 37
(iii) Deficiency (on insolvency/inability to pay) in funds and financial products held on trust 38
(iv) Failure to enter into and complete transactions according to instructions 38
(v) All the specific obligations of the financial services licensee imposed by new Chapter 7 39
(vi) All the actions you could have taken against the licensee in his capacity as a licensee (on insolvency/inability to pay) 39

C: The claimants 40
Retail clients 40
Wholesale claimants? 41
Referral business and excluded claimants 41
D: Measure and nature of compensation 42
E: Mechanisms to provide compensation 42
CHAPTER 6: FINANCIAL SERVICES LICENSEES 43
A: Responsibility 43
B: Mechanisms 44
Surety bonds 44
Professional indemnity insurance 46
Other mechanisms? 48
Should all licensees be treated the same way in any requirement for compensation arrangements? 48
The current professional indemnity insurance market 48
C: What should the mechanism adopted be required to cover? 49
All the obligations of the financial service provider under new Chapter 7 50
Other possibilities 51
D: Conclusion 52
CHAPTER 7: MARKET LICENSEES 53
A: Should market licensees be required to make compensation arrangements? 53
History 53
An assessment of the general features of current Australian compensation funds 54
CASAC's view 56
Questioning the current requirements 56
B: If market licensees continue to be required to make compensation arrangements 58
C: A consolidated market scheme? 59
D: CS (clearing and settlement) facility licensees 59
CHAPTER 8: IS A BROAD STATUTORY SCHEME WARRANTED? 61
A: Is a broad statutory scheme warranted? 61
B: In what circumstances should a broad statutory scheme apply? 62
Solvency/insolvency/inability to pay 62
The grounds on which it would pay claims 63
C: The CASAC proposal 63
Responses to CASAC's Consultation Paper 65
D: Overseas schemes 65
CHAPTER 9: SUBSIDIARY ISSUES RELATING TO STATUTORY SCHEMES 69
A: Who would operate the scheme? 69
B: Reporting and governance issues 70
C: Would the one scheme cover all financial services and all financial products? 71
D: How would it be funded? 72

Initial funding....72
Ongoing funding....74

E: What should be its statutory powers? 75

CHAPTER 10: OTHER ISSUES 77

A: Treatment of APRA-regulated bodies and those with high financial requirements 77

B: Measure and nature of compensation 78
Consequential loss 79
Accounting for profits 80
Interest, costs, contributory negligence 80

C: Should there be capping of payments? 81

D: What form of capping is appropriate? 81

E: Subrogation 82
What will not be recovered through subrogation 83
Actions which prejudice subrogation 83

F: Connection with Australia 84

G: Relationship with external dispute resolution schemes 85
Requirement for licensees to be members of external dispute resolution schemes....85
Features of external dispute resolution schemes....85
Roles of external dispute resolution schemes and compensation arrangements....86

H: Excess funds 87

I: Should there be time limits for claiming? 88

J: Level of detail in the legislation 89

CHAPTER 11: OPTIONS 91

Option A 91

Option B 91

Option C 92

Option D 92

Option E 93

Option F 93

Option G 93

Option H 94

CHAPTER 12: CONCLUSION....95

ATTACHMENT A: OUTLINE OF FINANCIAL SERVICES LICENSING REGIME 97
A: Licensing of financial service providers 97
B: Financial service provider conduct and disclosure 98
ATTACHMENT B: CURRENT COMPENSATION MECHANISMS IN THE FINANCIAL SERVICES SECTOR IN AUSTRALIA 99
A: Requirements imposed on exchanges/financial markets 99
(i) Before the *Financial Services Reform Act 2001* 99
(ii) After the *Financial Services Reform Act 2001* 101
B: Requirements imposed on financial services providers 102
(i) Requirements before the *Financial Services Reform Act 2001* 102
(ii) Requirements after the *Financial Services Reform Act 2001* 104
ATTACHMENT C: THE ORIGINS OF THE NATIONAL GUARANTEE FUND 109
Sydney Stock Exchange 109
Melbourne Stock Exchange 109
The *Securities Industry Act 1975* 110
National Guarantee Fund — establishment 110
National Guarantee Fund — operation 111
ATTACHMENT D: COMPARISON OF INTERNATIONAL COMPENSATION SCHEMES 113
ATTACHMENT E: THE CURRENT PROFESSIONAL INDEMNITY INSURANCE MARKET 117

ABBREVIATIONS AND TERMS USED

APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ASIC Act	*Australian Securities and Investments Commission Act 2001*
ASX	Australian Stock Exchange Limited
broad statutory scheme	A compensation scheme established by statute in relation to a wide range of financial products, as distinct from the exchange fidelity funds/National Guarantee Fund
CASAC	Companies and Securities Advisory Committee (now renamed the Corporations and Markets Advisory Committee)
CASAC Consultation Paper	The Consultation Paper entitled *Retail Client Compensation in Financial Markets* dated Sept 2001 of the Companies and Securities Advisory Committee, available on www.camac.gov.au
client	The term 'client' is used in this paper to mean the client of an intermediary and a person acquiring a financial product from a product issuer where the circumstances are such as to require the issuer to be a financial services licensee
Corporations Act	*Corporations Act 2001*
defalcation	This is wider than dishonest dealings — see footnote 91
fidelity fund	In this context, a fund established by an exchange to pay claims arising from the conduct (for example, fraudulent conduct) of members/participants of the exchange and their staff.

financial product	This term includes securities, derivatives, units in managed investment schemes, superannuation and life and general insurance products, but does not include credit products. It is defined broadly in Division 3 of Part 7.1 of the new Chapter 7 of the Corporations Act, with specific inclusions and exclusions.
financial service	In brief, a person provides a financial service if they provide financial product advice, deal in a financial product, make a market for a financial product, operate a registered scheme or provide a custodial and depository service.[1]
financial service provider	A provider of financial services (whether licensed or not)
financial services licensee	A provider of financial services licensed under Part 7.6 of the new Chapter 7 of the Corporations Act
Financial Services Reform Act	*Financial Services Reform Act 2001*
Financial Services Reform regime	The regime for the licensing of financial markets, clearing and settlement facilities and financial service providers, product disclosure and other matters included in the new Chapter 7 of the Corporations Act which was substituted by the Financial Services Reform Act.
Insurance (Agents and Brokers) Act	*Insurance (Agents and Brokers) Act 1984*
intermediary	A person performing an intermediate role between the consumer and the product issuer. The person may be licensed in his own right or be an authorised representative.
market licensee	An entity licensed under Part 7.2 to operate a financial market
market operator	The operator of a financial market — for example, the Australian Stock Exchange Limited

1 Further details are to be found in Division 4 of Part 7.1 of the new Chapter 7.

National Guarantee Fund (NGF)	The National Guarantee Fund which performs investor protection and clearing guarantee functions for certain transactions by participating organisations of the Australian Stock Exchange
new Chapter 7	Chapter 7 of the Corporations Act 1 inserted by the Financial Services Reform Act
prescribed CS (clearing and settlement) facility	A licensed CS (clearing and settlement) facility (that is, licensed under Part 7.3 of the new Chapter 7) which is prescribed for the purpose of Division 4 of Part 7.11 (which facilitates electronic transfer of legal title to financial products)
retail client	This term is defined in section 761G by reference to particular financial products, price paid and asset/income tests. Small businesses, as defined in that section, are also retail clients.
run-off cover	Professional indemnity policies commonly provide cover only in relation to claims made or notified during the year for which the premium is paid. 'Run-off cover' is additional and provides cover in relation to events occurring during the year for which the premium is paid but where the claims are made or notified in later years, when the licensee has ceased to carry on financial services business (and therefore does not hold a professional indemnity insurance policy).
SEGC	Securities Exchanges Guarantee Corporation Limited which administers the National Guarantee Fund
subrogation	The substitution of one person or entity for another — the substituted person 'stands in the shoes of' the first person and gains the same rights as belonged to that person (for example, against a fraudulent financial services licensee)
surety bond	A guarantee by a person to pay an amount if another person fails to satisfy their own obligations
wholesale client	A person who is not a retail client (see above)

Note: references to particular sections and Parts in this paper are to sections and Parts of the Corporations Act, as amended by the Financial Services Reform Act, unless otherwise indicated.

OVERVIEW

Background

The purpose of this review is to consider compensation arrangements in the financial services sector, with the aim of ensuring that Australia has a comprehensible and efficient compensation regime, which provides appropriate protection for investors and does not impose an unjustified burden on participants in the sector. Any proposed changes arising from this review will need to meet with a broad consensus, and be consistent with the Australian regulatory regime, while taking due account of international models. Any such arrangements will need to be industry funded, not Government-funded.

The review is about losses suffered by clients as a consequence of the wrongdoing of financial services licensees (or their representatives) in the course of providing 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 caused by the insolvency of the issuer.

It thus opens for debate the ground covered by Part 7.5 and section 912B of the Corporations Act, as amended by the Financial Services Reform Act. Other aspects of the new Chapter 7 are not opened for discussion by this paper.

The review has been triggered by disquiet, expressed at a late stage of the consultation process on the Financial Services Reform Bill, with the currently required arrangements. However, its purpose is to consider the issues from first principles, not merely to focus on the problems that were then brought to our attention.

Structure of the paper

Introduction

The Introduction (Chapter 1) provides further background to the review (including the Corporate Law Economic Reform Program and the Companies and Securities Advisory Committee (CASAC) Consultation Paper).

The problem and 'Is requiring compensation arrangements the way to address it?'

Chapter 2 addresses the following preliminary issues:

- What is the problem to be addressed?
- Why is government action needed to correct the problem?
- What is the objective of government action?
- Will compensation help to achieve this objective?
- Should compensation arrangements be required by legislation?

The current compensation arrangements

Chapter 3 addresses briefly:

- What are the current compensation requirements?
- What are the problems with them?

How should the requirements for compensation arrangements be reformed?

Chapter 4 addresses the purpose and some issues connected with the design of compensation arrangements.

Chapters 5 to 10 address the following:

- In what circumstances should compensation be available and to whom? — Chapter 5
- The mechanisms available to provide compensation are examined separately:
  - those arranged by financial services licensees in Chapter 6
  - those made by market licensees in Chapter 7
  - and the question whether a broad statutory scheme is warranted is examined in Chapter 8.
- Subsidiary issues relating to statutory schemes are examined in Chapter 9 and further issues of wider relevance to compensation arrangements in Chapter 10.

Options and conclusion

High-level options and a conclusion are provided in Chapters 11 and 12 respectively.

Attachments

The financial services licensing regime is summarised in **Attachment A**, and the current compensation requirements on market operators and financial service providers in Australia are outlined in **Attachment B**.

Attachment C provides a brief description of the ancestry of the National Guarantee Fund. **Attachment D** summarises six international compensation schemes and a relevant European Community directive. Some background about the professional indemnity insurance market is provided in **Attachment E**.

The issues, spread throughout the paper, are reproduced together immediately after this summary, divided into principal issues (1-11) and secondary issues (12-25).

Procedure

It is likely that, in the light of the comments and submissions received during the exposure period of this paper, a more detailed proposal will be formulated and that this, in turn, will be exposed for public comment.

It is desirable that any legislative reform necessary to give effect to the outcome of this review be in place in good time before March 2004, the end of the Financial Services Reform transition period.

PRINCIPAL ISSUES

It would be appreciated if, in responding to these questions, you particularly address the costs and benefits of your suggestions to consumers, business, government and the community.

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? (page 18)

2 Is requiring compensation arrangements in the financial services sector justified? (page 27)

3 What is the purpose of compensation arrangements which are required by legislation? (page 31)

4 (a) In what circumstances should compensation arrangements be required in relation to a financial services licensee? (page 40)

(b) Should different criteria or a different mechanism apply depending on whether the financial service provider is solvent or unable to pay/insolvent? (page 40)

(c) Should compensation arrangements relate only to the situation where the financial services licensee is unable to pay/insolvent? (page 40)

5 Who should be entitled to claim? (page 42)

Financial services licensees

6 What compensation requirements should be imposed on financial services licensees? (page 48)

(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? (page 48)

(b) What should the mechanism adopted be required to cover? (page 51)

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? (page 49)

(b) What, if any, difficulties have consumers had in being compensated from professional indemnity insurance policies? (page 49)

Market licensees

8 Should market licensees continue to be required to make compensation arrangements (as they have in the past and are in Part 7.5)? (page 58)

(a) If so, what changes to the current Part 7.5 should be made? (page 58)

(b) Is there justification for a consolidated scheme for financial services licensees who are market participants? (page 59)

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? (page 60)

A broad statutory scheme?

10 Do the financial services industry and consumers consider that a broad statutory scheme is warranted? (page 62)

11 If so:

(a) should it be available prior to insolvency or only on inability to pay/insolvency? (page 63)

(b) on what grounds should claims be paid? (page 63)

SECONDARY ISSUES

If a statutory scheme were warranted

12 Who should operate the scheme? (page 70)

13 What special governance and accounting requirements would be appropriate? (page 71)

14 Could the one scheme cover financial services in relation to all financial products and sectors of the industry? (page 72)

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? (page 73)

16 How should it be funded initially and in the longer run? (page 75)

17 What would be the appropriate powers of the operator? (page 76)

Other issues

18 Should special provision be made for financial services licensees which are regulated by APRA, have high financial requirements or high market capitalisation, or have the requisite connection with such a body? (page 78)

19 How should the loss be measured and should consequential loss be covered? (page 80)

20 Capping:

(a) Should there be capping of the amounts paid in response to claims? (page 81)

(b) If capping is accepted, what form would be appropriate? (page 82)

21 What is the appropriate connection with Australia? (page 84)

22 What is the appropriate relationship between compensation arrangements and external dispute resolution schemes? (page 87)

23 Should excess funds in a statutory scheme be available for financial industry development purposes, or should there be mechanisms to discourage the build up of such excess funds? (page 88)

24 Should there be time limits for claiming and, if so, how should they be set? (page 89)

25 What is the appropriate level of detail in the legislation? (page 89)

CHAPTER 1: INTRODUCTION

The purpose of this Chapter is to introduce the reader to the compensation review.

It includes brief consideration of the purpose of the review, its ambit and origins, and proposed 'next steps'.

The structure of the discussion in the paper as a whole is included in the Overview.

A: The compensation review

What is the purpose of this review?

1. The purpose of this 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. Any proposed changes arising from this review will need to meet with a broad consensus, and be consistent with the Australian regulatory regime, while taking due account of international models.

2. By 'compensation arrangements', we mean mechanisms for providing the clients of financial services licensees with compensation for loss suffered as a result of, for example, a breach of the licensee's specific obligations under new Chapter 7. This review includes consideration of the rationale for compensation arrangements, the extent of the conduct that should be covered, the mechanisms to provide compensation and who should be eligible to claim it.

What triggered the review?

3. While not forming part of the Corporate Law Economic Reform Program, this review follows the enactment of the Financial Services Reform Act (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.

4. During consultation on the exposure draft of the Financial Services Reform Bill, some basic difficulties 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.

5. 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 in the expectation that a thorough review would be undertaken subsequently.

What is the purpose of this paper?

6. The purpose of this paper is to raise issues and options for discussion, to progress the review. It is not based on a Government 'position' and no option put currently has any Government endorsement.

What does this review address and what is outside its ambit?

7. The area of discussion in this paper is, 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.

8. The discussion is **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. It therefore does not cover:

- the loss of insurance cover if the insurance company which issued your policy becomes insolvent;
- any loss on the sale of interests purchased in a managed investment scheme due, for example, to the scheme being unable to sell the product it produced;
- any loss on the sale of a quoted investment caused by a drop in the market price;
- any loss which you, as an investor, may suffer if the superannuation fund in which you have invested is mismanaged or fails;

and it does not involve consideration of guaranteeing money placed on deposit with banks.[2]

2 Thus, the following Commonwealth legislation is not relevant to the current exercise because it relates to the safety of the financial product itself:
- Part 23 of the Superannuation Industry (Supervision) Act 1993;
- priority for depositors under subsection 13A(3) of the Banking Act 1959.

9. On the other hand, it is about losses suffered, for example:

- when a financial planner, or his representative, steals money which should have been held on trust on behalf of a client who has given instructions for the purchase of superannuation, securities or other financial products with that money;
- as a consequence of accepting a licensee's financial product advice which was not reasonable in the circumstances (for example, reasonable inquiries into the personal circumstances of the client had not been made);
- when the licensee (whether the supplying institution or an intermediary), while holding the purchase money, becomes insolvent before the financial product is issued or purchased; or
- as a consequence of the unauthorised transfer of securities.

10. In terms of legislative provisions:

- the review is about the area currently covered by section 912B (the obligation on financial services licensees to have compensation arrangements) and Part 7.5 of the new Chapter 7 (the obligation on market licensees to have compensation arrangements);
- it is not about:
  - the remainder of new Chapter 7, including the requirement for ASIC-approved external dispute resolution schemes;[3]
  - the order of priority in distributing assets on the winding up of a company.

11. Being within the area of discussion does not, of course, mean that the compensation arrangements eventually chosen will cover that particular situation. The appropriate coverage of compensation arrangements is a matter for discussion — see Chapter 5.

B: Origins of the review

The Corporate Law Economic Reform Program, CLERP 6 and the *Financial Services Reform Act 2001*

12. The Commonwealth Government initiated the Corporate Law Economic Reform Program (CLERP) in 1997.

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3 The relationship between compensation arrangements and external dispute resolution schemes is discussed at paragraphs 296 to 303.

13. The sixth paper in the CLERP series was entitled *Financial Markets and Investment Products* and was released in 1997. It was subsequently developed into a consultation paper entitled *Financial Products, Service Providers and Markets — an integrated framework*, and the Financial Services Reform Bill. This Bill was enacted as the *Financial Services Reform Act 2001* (the Financial Services Reform Act), which commenced on 11 March 2002. The Financial Services Reform Act amends the *Corporations Act 2001* (the Corporations Act) by inserting a new Chapter 7 which provides:

- uniform regulation of dealing and advising in relation to all financial products — including securities, derivatives, superannuation, life and general insurance, bank deposit products and foreign exchange (but not credit products);
- a harmonised financial product disclosure regime;
- harmonised regimes for the licensing of:
  - financial service providers (replacing the widely diverging regulatory arrangements which include the licensing of securities dealers and advisers, futures brokers and dealers, the registration of insurance brokers and foreign exchange dealers as well as the arrangements governing insurance agents); and
  - financial markets and clearing and settlement facilities.

14. Further details of the regime for the licensing of financial service providers under the new Chapter 7 are provided in **Attachment A**.

15. As indicated above, while wholesale reform of the market compensation requirements was not a part of CLERP 6, participants in the consultation sessions on the draft Financial Services Reform Bill raised basic questions about the compensation regime.

16. Since time did not allow a review of the area prior to the Bill's proposed introduction, only modest reforms were included in the relevant provisions. 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.[4]

Request to the Companies and Securities Advisory Committee (CASAC)

17. Following the introduction of the 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. The issues referred to the Committee included whether there was a need for compensation arrangements, as well as the structure and coverage of any such arrangements required by legislation.

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4 The second reading speech on 5 April 2001 — Hansard pages 26524-5.

CASAC's Consultation Paper

18. 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 intermediaries.[5] 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.

Responses to CASAC's Consultation Paper

19. The CASAC Consultation Paper received only limited circulation, given the time restraints for reporting. The nine responses received were mixed. A number of submissions supported the proposed scheme. On the other hand, some raised concerns about possible 'moral hazard', and the methods and implications of financing the scheme.

20. One asked whether there was evidence of such a lack of consumer confidence as to justify the scheme. Others asked whether the proposal was consistent with the recommendations in the Report of the Financial System Inquiry (the Wallis Committee) on risk management and financial safety, and the harmonised approach to regulation reflected in the Financial Services Reform Act.

21. The scope, in terms of the liabilities covered, was questioned and it was suggested that possible alternatives, such as reforming and improving the current schemes, should be considered.

CASAC's interim report

22. 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.

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

Senator Campbell's announcement

24. 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

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

financial services sector. Senator Campbell indicated that he had asked Treasury to prepare the issues paper in consultation with ASIC and CASAC,[6] with the aim of seeking industry feedback on the issues.[7] This process therefore subsumes the previous CASAC review.

C: This issues and options paper

25. This issues and options paper has been prepared in response to Senator Campbell's request. ASIC and the Corporations and Markets Advisory Committee have been consulted in its preparation, and it is now being released for public consultation.

26. The aim is to engage a wide cross-section of the public and industry in the debate, and to obtain the views of as many interested parties as possible.

27. Issues are highlighted throughout the paper and are reproduced together at the beginning of this paper. The inclusion of a particular issue should not be seen as implying that the Government has adopted a particular view on any of the preceding issues.

28. The structure of the discussion in the paper as a whole is included in the Overview.

D: The consultation process

29. As part of the consultation process, we envisage that one or more meetings will be held during the consultation period to discuss the issues raised in this paper.

30. In addition, we seek your written views. Information regarding submissions, including the deadline, is provided on the page of this paper immediately following the title page.

31. When making a submission, there is no need to address all the issues. You may decide that there are others, which we have not raised, or that only one segment of the paper interests you. However, if you take this approach you need to bear in mind that consideration of this subject must commence with the basic questions of justification for any compensation requirements, their purpose and the coverage of any scheme proposed.

32. You are encouraged to address, in your submission, the costs and benefits of possible solutions to consumers, business, Government and the community. Consumers should assess any proposed solution against their current compensation rights.

33. It is likely that, in the light of the comments and submissions received, a more detailed proposal will be formulated and that this, in turn, will be exposed for public comment. It is

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6 The Companies and Securities Advisory Committee was renamed the Corporations and Markets Advisory Committee with effect on 11 March 2002.

7 Senator Campbell's press release 008.

desirable that any legislative amendments required be enacted in good time before 10 March 2004, when the Financial Services Reform transition period ends.

CHAPTER 2: THE PROBLEM AND OBJECTIVE

This Chapter discusses the problem. It also considers whether government action is needed to correct it and the objective of government action.

A: What is the problem to be addressed?

34. Put at its most simple, 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.[8]

Concepts: Financial services licensees, financial service, financial products

35. A person who operates a financial services business in Australia must be licensed to do so under the new Chapter 7 (unless exempt) and, when licensed, is referred to as a financial services licensee.

36. The term 'financial service', which is used in paragraph 34, includes dealing and advising on financial products. It is explained further in paragraph 124.

37. At the heart of the definition of providing a financial service is the concept of 'financial product'. The term 'financial product' includes securities, derivatives, superannuation, general and life insurance policies (with certain limited exceptions) and deposit-taking facilities (but not credit products).[9]

What is the nature and size of the problem? — Evidence of wrongdoing and losses

Evidence from ASIC

38. In its annual reports ASIC reported that:

- in 1999-2000:
  - 8 investment advisers who had defrauded their clients were jailed following prosecutions brought by ASIC;

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8 The particular conduct which compensation arrangements should cover is discussed in Chapter 5.
9 See particularly sections 763A to 763D, and the explicit inclusions and exclusions in sections 764A and 765A.

      - the amounts involved ranged from $114,000 to $4 million;

  - 16 investment advisers were banned for life;

      - one adviser banned had been involved in unauthorised transactions worth $17 million;

  - the registration of 2 insurance brokers was cancelled;

- in 2000-01:

  - 5 investment advisers who had defrauded their clients were jailed following prosecutions brought by ASIC;

  - 17 people were banned for life from advising investors and another 13 advisers were banned for shorter periods of time;

      - one of the incidents triggering this action involved unauthorised investments resulting in client losses of more than $10 million;

  - 7 insurance brokers were deregistered or suspended.

39. ASIC's records indicate that the rate of insurance brokers going into external administration in recent years is significantly higher than for securities dealers. (Only three securities dealers have gone into external administration in the last 10 years.)

40. Action initiated by ASIC has, over the years, assisted in the recovery of significant funds. In one case of improper advice in 2000-01, ASIC's action resulted in payment of approximately $10.6 million by the principal to the clients.

Claims on the National Guarantee Fund

41. The second source of information is the Securities Exchanges Guarantee Corporation (SEGC) Annual Report for 2000-01.[10] This indicates that:

- the SEGC has received 5,554 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;

10 The SEGC administers the National Guarantee Fund — see Chapter 3 and Attachments B and C.

  - 95 per cent of claims received in the 5 years preceding the report were in relation to unauthorised transfers — typically involving fraud by a person who was not necessarily within the broker effecting the transfer;

- since the National Guarantee Fund was formed, $21.4 million has been paid from it in claims and $13.4 million recovered.

The potential impact on Australians

42. Virtually all adult Australians have financial products covered by the new Chapter 7, and hence an interest in the compensation arrangements required.

43. Statistics on the value of several types of financial products per household indicate that the value is significant and has risen in recent years:

- superannuation and life policies account for 20 per cent of household assets, with an increase of around 10 per cent per annum, on average over the five years to 2001;

- directly-held shares and investments in managed investment schemes account for around 9 per cent of household assets, with an increase of around 24 per cent per annum on average over the same period.[11]

44. It is estimated that 40 per cent of Australian adults have direct ownership of shares.[12] If this estimation is correct, then at least 5.7 million adults have an interest in the future of the current National Guarantee Fund as an investor protection fund, and any alternative to it which is proposed.

45. The number of financial service providers is also relevant: in 2000-01, ASIC recorded around 2,500 securities dealers and advisers (and about 37,500 authorised representatives) as well as around 1,200 insurance brokers and 190 futures brokers and advisers.[13]

The need for better evidence about the problem

46. In summary, despite indications above that the problem described in paragraph 34 is significant, at this stage the evidence we have of consumers of financial services suffering loss is patchy. We would therefore welcome any evidence you may have which will help us to form a more complete picture of the problem.

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11 The household balance sheet in Australia', Treasury *Economic Roundup* — Spring 2001.
12 According to the ASX *Shareownership Update* of November 2000.
13 ASIC Annual Report 2000-01 page 60.

Principal 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?

B: Why is government action needed to correct the problem?

What protection and redress is available (apart from compensation arrangements)?

47. It has been argued that, as with other products and services, the main protection for clients of financial services lies in a combination of competition, information disclosure, reputation and legal redress.[14]

48. It is not clear that competition and reputation alone will address the problem in paragraph 34.

49. Do information disclosure and legal redress do so? To answer this, it is necessary to examine the protection and avenues for redress provided to consumers of financial services by the law. These include:

- for bodies regulated by APRA and new entrants after 11 March 2002, the qualifications to become a financial services licensee, and, for all financial services licensees, the obligations flowing from being a licensee (see **Attachment A**), including:
  - the requirement to provide a Financial Services Guide and to be a member of an external dispute resolution scheme;
  - the requirements for handling client assets;[15]
- the other avenues for redress included in the new Chapter 7 — for example:
  - compensation orders in relation to financial services civil penalty provisions;[16]
  - civil action in relation to provision of the required disclosure document;[17]

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14 David Llewellyn, *The Economic Rationale for Financial Regulation*, Financial Services Authority Occasional Paper Series No. 1, page 36.
15 See Part 7.8.
16 Action is taken in a superior court under section 1317HA (or 1043L).
17 Under section 953B or 1022B.

- civil action for loss or damage consequential on contravention of the provisions relating to false or misleading statements, inducing a person to deal, dishonest conduct or misleading or deceptive conduct;[18]
- payment of money from 'frozen' accounts;[19]
- through the cooling-off provisions and provisions for choosing not to proceed with agreements with unlicensed persons, clients may be in a position to retreat from some inappropriate arrangements;[20]

■ the other mechanisms for redress which may be available including:

- private legal action — for example, in contract or tort;
- action under Part 2, Division 2 of the ASIC Act — for example, an action for damages under section 12GF or enforcement of the warranties implied by section 12ED;
- ASIC initiating a representative action under section 50 of the ASIC Act;
- making a claim in the insolvency of a financial services licensee, or taking action for the loss or damage against a director for insolvent trading;[21]

■ funds and property are held on trust by a financial services licensee and will not be available for the general creditors of the failed intermediary;[22]

- equity provides personal remedies for a breach of trust (compensation and account for profits) and remedies directed at the property (tracing, and recovery of the trust property or having a charge over it).[23]

Current avenues for redress — some limitations

50. Do these provide sufficient protection for clients? The avenues for redress summarised in paragraph 49 above do not guarantee that assets will be available to satisfy any judgment or determination a client obtains in relation to the financial services licensee's conduct as such. They may also involve significant cost to the claimant and delay in being paid.

51. Licensing schemes are not infallible. In general, they focus on characteristics at the time of application and, no matter how thorough, will allow some incompetent or fraudulent

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18 Under section 1041I.
19 Under section 983E.
20 See Division 5 of Part 7.9 and Division 11 of Part 7.6.
21 See Subdivision B, Division 4 of Part 5.7B.
22 See sections 981A, 981E, 981H, 984B and Corporations Regulation 7.8.07.
23 Also see Corporations Regulation 7.8.04.

operators to be licensed. Licence suspension or cancellation may occur only after a default or loss has been suffered.

52. Despite this, the very existence of a licensing regime may encourage consumers to assume a level of protection that the regulatory framework cannot guarantee.

53. Where the financial services licensee is insolvent, the avenues are more limited. If a winding up order has been made:

- those claimants with debts will be able to prove in the winding up but are unlikely to receive the full amount of their claim;
- claims for unliquidated damages or compensation, whether in tort, contract or another cause of action, can also be proved (the liquidator must make an estimate of the value of the claim, or refer the question of value to the court);
- unsecured creditors are prevented from enforcing debts directly against the company's property;
- proceedings against the company cannot be commenced or proceeded with except with leave of the court.

54. In addition, a failing financial services licensee may not comply with its obligations, for example to keep its client money in a trust account, and tracing the funds or financial products held on trust, where the remedy is available, will be expensive.

C: What is the objective of government action?

55. The objective is to ensure that consumers, particularly retail consumers, of financial services have appropriate remedies so that they maintain confidence in the financial marketplace and continue to participate in it.

D: Will compensation arrangements help to achieve this objective?

56. If the current avenues for redress and ensuring adequate funds to pay proved claims are considered insufficient, are compensation arrangements the only response? Are there alternatives that should be considered?

57. The following alternatives to the compensation arrangements proposed by CASAC were put in submissions to the Committee:

- applicants for a financial services licence should satisfy a high solvency threshold, with mechanisms to ensure that those persons continue to satisfy it once they have been licensed;

- there should be a strong regulatory focus on reducing the possibility of intermediaries becoming insolvent, rather than reliance on a compensation scheme.

58. While the first appears to be a means of achieving the second, its adoption could have an adverse effect on the entry of small financial service providers into the sector. Both suggestions may be seen as implying that the Government guarantees the solvency of financial services licensees. Obviously, solvency cannot be guaranteed; yet the suggested alternatives do not address what happens on insolvency. Adoption of the proposals would, however, involve ASIC in prudential regulation and impose increased costs on industry.

E: Should compensation arrangements be required by legislation?

59. What is so special about financial services that further regulatory interference in the market is warranted? Generally, the consumer probably has greater difficulty assessing services being purchased, than goods. Looking at services generally, what distinguishes financial services?

Reasons for compensation arrangements

60. The following have been put forward in various contexts as reasons for requiring compensation arrangements.

Providing for retirement — consumer confidence

61. In the light of the expected increase in the proportion of retired persons to the working population in the years to come, Australian governments have sought to encourage reduced dependence by retirees on the age pension through superannuation initiatives. While a minimum level of superannuation is now mandatory, households may also choose to change their spending patterns in anticipation of their future needs by increasing the proportion of their assets in superannuation and other investments. Owning shares has also been encouraged by the major privatisations of recent years.

62. It is desirable that investors continue to have confidence in the financial services licensees through whom such products are purchased and sold.

Contagion

63. Financial service providers linked to banks or insurance companies provide a wide range of financial services. The possibility of such a provider providing poor service or failing financially may have implications for confidence in the related banking and insurance group. Compensation arrangements in relation to financial services may assist with this confidence. However, in practice, if such a licensee breaches significant obligations to clients

or deprives them of property, there is significant and immediate pressure on the relevant bank or insurance group to right the wrongs done as soon as possible.

Incomplete information — assessment of risk

64. In particular cases, the consumer will have incomplete information about the financial services they are obtaining and the creditworthiness of the financial service provider. If they are aware of that lack of information (and the risk entailed in not having it) and are averse to taking such risks, then they may not obtain the financial service.

65. For example, in the United Kingdom, there is evidence that suggests that part of the reason for the substantial fall in the sales of life assurance and personal pension products in 1994 and 1995 was the lack of consumer confidence in the industry following a series of scandals and hazardous selling practices.[24]

66. Alternatively, they may not be aware of the lack, or the extent of the lack, of information.

67. In addition, for many, financial services may not be used frequently and hence the consumer has little experience or ability to learn from experience. This is particularly so in relation to major investment decisions such as superannuation.

68. Even if the risk involved could be assessed, some insurance policies, for example, are entered into for the benefit of third parties who are not in a position to make such an assessment.

69. Further, the complexity of financial products increases the probability that financially unsophisticated consumers can misunderstand or be misled about the nature of the products, particularly their obligations and risks.

70. Finally, it is difficult to verify any advice being given by a financial services licensee and faults frequently cannot be rectified.

71. It is arguable that a compensation framework provides an independent assurance to consumers about the terms on which financial services are offered and their quality. On the other hand, it has been argued that the problems of incomplete information and the assessment of risk in purchasing financial products is no greater than in the purchase of, say, a horse or a car.

24 David Llewellyn, *op cit*, page 26.

Court action

72. If easily accessible, compensation arrangements may provide a cheaper, easier and quicker avenue for redress than the range of legal action outlined in paragraph 49, a number of which require action in a superior court.

73. On insolvency, many of the remedies referred to in that paragraph cease to be available, and any compensation arrangements provide both the route for determining the claim and the source of funds.

Financial ruin

74. There is a 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. This likelihood is increasing with trends in the financial services industry.[25]

75. While this point relates particularly to investments, there is a comparable point to be made in relation to insurance — in the case of at least some insurance (for example, building, life and disability), there is a distinct possibility of the individual suffering substantial financial loss by being encouraged to purchase a product which does not fit the risk or by the licensee failing to execute the transaction as instructed.

76. Further, the same licensee may provide both investment and insurance advice to the one client.

Consistency with the Financial System Inquiry

77. The Financial System Inquiry (the Wallis Committee) recommended the development of a single set of requirements for investment sales and advice including 'financial resources or insurance in cases of fraud or incompetence'.[26]

Keeping boards honest

78. It has been argued that a wide range of investors helps to keep the board of a company aware of its duties and the expectations of shareholders. It is only with compensation arrangements in place that retail investors will continue to have confidence to so invest and continue to perform this function.

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25 Similarly, in the case of uncertificated 'CHESS' securities, the broker may well have authority over all or a substantial proportion of a client's securities.

26 Financial System Inquiry (the Wallis Committee) Final Report (March 1997) Recommendation 15, pages 274-5.

Imperfections in the financial services market which are not removed by competition

79. From another perspective, inefficiencies in the performance of a market (in this case, the financial services market) can give rise to less than ideal outcomes. These inefficiencies can include the difficulty of obtaining information, buyers of services not having access to the same information as is available to sellers, and the behaviour that can arise in response to unequal access to information.

80. Other factors affecting the market may include events outside the financial services market that cannot necessarily be controlled or predicted but impact upon the delivery and price of services.

81. All of the above can add to the cost and risk to buyers and sellers in the market. Compensation can seek to address some of these inefficiencies by directly reducing the level of risk experienced by buyers and providing appropriate incentives for financial service providers to manage their risks prudently.

International comparisons

82. While not of itself a justification for mandating compensation arrangements, compensation regimes in various overseas countries lead to expectations of comparable protection in Australia.

Is mandating compensation arrangements consistent with the role of regulation?

83. From the discussion above, it appears that there are reasons to require compensation arrangements but that does not of itself necessitate regulatory intervention.

84. Regulation is necessary only to the extent that markets may fail, and then only where it can be demonstrated that the benefits of intervention outweigh the costs.[27]

85. The Wallis Committee concluded that:

> 'the government should not provide an absolute guarantee in any area of the financial system (just as it does not do so in other areas). Primary responsibility should remain with those who make financial promises. It would be inequitable for the government to underwrite some financial promises but not other promises made by participants in the broader economy.'[28]

86. The Committee expressed the view that the intensity of financial safety regulation should be proportional to the intensity of financial promises, the most intense being payment services.

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27 Only a detailed proposal can be assessed in this way. It is anticipated that a cost/benefit analysis will be made of the proposal formulated following this consultation process.

28 Financial System Inquiry (the Wallis Committee) Final Report (March 1997), page 191.

87. Even where regulation is justified, it is not the role of regulation to eliminate risk in the financial services sector (or elsewhere). Instead, the spectrum of risk should be preserved for reasons of economic efficiency.

What about the 'moral hazard' involved in requiring compensation arrangements?

88. The phrase 'moral hazard' refers to the notion that financial services licensees and clients will take less care because compensation for losses caused by the conduct which is the subject of the arrangements will be assured. Arguably, it could even induce consumers to gravitate towards risky licensees.

89. This may be justified in the situation where the consumer has reason to suspect a particular licensee — for example, one whose prices are much lower than the 'market rate' — but didn't inquire.

90. However, 'moral hazard' implies that the ordinary, retail consumer has access to, and is in a position to assess, information relating to, for example, the financial position of the licensee, or the competence and trustworthiness of particular staff members. It also assumes that the consumer is aware of the compensation arrangements.

91. Some schemes seek to address this aspect of 'moral hazard' by:

- ensuring that, say, 90 per cent of the loss of the retail consumer (up to a nominated cap) is paid — so-called 'co-insurance';
- excluding those likely to be 'in the know' (such as associates and close family of the wrongdoer) from obtaining compensation (the market compensation arrangements in the Corporations Act provide for this).

92. It is also desirable that the limitations of the scheme be well understood.

93. The notion of 'moral hazard' also applies to financial services licensees. Where consumers suffer loss which is covered by compensation arrangements, the cost of the consumers' losses is borne by the wider financial services industry. This possibility may encourage licensees to behave badly. On the other hand, licensees presumably wish to retain their licences and maintain profitability. Other remedies in the Corporations Act (such as liability for insolvent trading, which can apply to directors) and, ultimately, subrogation of the compensation provider to the rights of the client against the licensee may also influence licensees.

94. Mandating any compensation arrangements involves additional potential risk for the Commonwealth Government (and the taxpayer). Calls for government assistance can be expected if:

- professional indemnity insurance is required by legislation but the insurance proves not to be available, or only at a cost considered exorbitant by industry; or
- an approach involving a compensation fund is adopted and the fund, at some later stage, is mismanaged or proves to be inadequate.

F: Conclusion

95. In summary, while the arguments above do not lead to a particular model of compensation arrangements (let alone the details of that model), they indicate that, among other things:

- consumers do not always have all the relevant information, and are not always in a position to assess the information or the worth of the particular financial service;
- consumers can suffer severe financial hardship through losses suffered as a consequence of the conduct of financial services licensees;
- this affects consumer confidence in obtaining financial advice and undertaking transactions in financial products;
- consumers expect the level of comfort provided by a compensation regime and may be prepared to pay the additional cost.

96. There therefore appears to be a justification for requiring compensation arrangements for losses suffered as a consequence of conduct[29] of financial services licensees.

97. The ambit and structure of the compensation model adopted (including the conduct covered) will be influenced by the experience of misconduct and financial failure in the jurisdiction, the values held and the perceived tolerance in the community for risk of financial loss.

98. However, the balance between financial risk and consumer protection, and between the costs and benefits of any proposed solution, need to be kept firmly in mind, especially in the light of the new measures included in the Financial Services Reform Act (and further ASIC licensing requirements) to promote consumer protection.

99. There is always the danger that schemes will be formulated by a government wishing to 'do something' about a course of conduct or insolvency in which the public has a real concern. This can be seen in the brief description of the origins of the National Guarantee Fund in **Attachment C**. The aim of this review is to avoid such a situation by attempting to trigger a debate of the issues now.

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29 Just what conduct of financial services licensees should be covered is considered in Chapter 5.

Principal issue 2

Is requiring compensation arrangements in the financial services sector justified?

CHAPTER 3: CURRENT AUSTRALIAN COMPENSATION REQUIREMENTS

The purpose of this Chapter is to provide an outline of the current compensation requirements and problems with them.

A more detailed description of the requirements for compensation arrangements before and after the commencement of the Financial Services Reform Act is to be found in **Attachment B**.

A: Description

100. The requirements for compensation arrangements included in the new Chapter 7 are:

- financial services licensees which provide financial services to persons as retail clients must have arrangements for compensating them for loss suffered because of breaches of the relevant obligations under new Chapter 7 by the licensee or its representatives;[30]
- The Australian Stock Exchange's National Guarantee Fund will continue to pay claims made by clients of participating organisations of the Exchange in the same circumstances as before the commencement of the Financial Services Reform Act;[31]
  - these circumstances are breach of the 'contract guarantee', unauthorised transfer, incorrect certificate cancellation and insolvency;
- other market licensees will, when they transition fully into the new regime, have access to the more flexible requirements for compensation arrangements provided in the new Chapter 7;[32]
  - these compensation arrangements are required to cover defalcation and fraud.

101. A more complete description of the requirements on financial service providers and market operators, both before and after the commencement of the Financial Services Reform Act, is provided in **Attachment B**.

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30 Section 912B.
31 Division 4 of Part 7.5 (and the relevant Corporations Regulations).
32 Division 3 of Part 7.5.

B: Problems

102. As indicated in paragraph 4, the criticisms made during the exposure period of the Financial Services Reform Bill related particularly to the continuing requirement for market licensees to have compensation arrangements and the perceived overlap between this requirement and the requirement in section 912B for financial services licensees to have compensation arrangements.

103. The circumstances were not such that any comprehensive criticism of the regime was provided.

104. In brief, some of the problems with the compensation requirements in the new Chapter 7 are:

- how does the cover required by section 912B fit with the market compensation arrangements?
  - the market compensation arrangements tend to be concerned with the protection of assets entrusted to the licensee, while section 912B focuses on breach of an obligation under the new Chapter 7;
- should market licensees be required to continue to have compensation arrangements?
  - if so:
    - : what circumstances should such compensation arrangements be required to cover?
    - : should the arrangements cover the entirety of the financial services business of market participants, or should they allocate responsibility between markets, and be limited to on-market transactions?
    - : should the same requirements apply to all market licensees? (currently the National Guarantee Fund provisions are significantly different);
  - if not, what should be done with the existing compensation funds?
- is the current ambit of section 912B appropriate?

105. However, the purpose of this review is not just to address the identified problems, but to revisit the whole compensation regime. The following chapters therefore take a wider approach than simply trying to cure identified problems.

CHAPTER 4: THE PURPOSE AND DESIGN OF COMPENSATION ARRANGEMENTS

This Chapter addresses the purpose of compensation arrangements and some issues relating to their design (for example, simplicity).

The purpose of such arrangements needs to be considered from the perspective of those who will have to contribute to the fund required to make the payments, as well as the perspective of the consumer.

A: What is the purpose of a compensation regime?

106. What is the purpose of compensation arrangements required by legislation? One possible answer is that the purpose of such arrangements is to ensure that there are assets to meet appropriate proved claims against financial services licensees who have caused loss in the course of providing financial services so that consumers continue to have confidence in the market and continue to participate in it.

Principal issue 3

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

107. The emphasis here is on compensation arrangements 'required by legislation' — that is, it is not a question of what professional indemnity insurance a wise financial service provider would choose, or what a professional association may require of its members.

108. Consideration of the purpose of required compensation arrangements is closely linked to consideration of the circumstances in which compensation would be payable. This in turn will be influenced by the mechanism chosen and the limitations of that mechanism (for example, the terms on which professional indemnity insurance is available).

109. Nevertheless, it is appropriate to consider first the situations in which compensation should be payable and therefore the next chapter focuses on this subject. This is followed by consideration of how the available mechanisms can or should cover the identified area.

B: Designing a compensation regime

110. In consulting on proposed changes to the UK compensation scheme,[33] the UK Financial Services Authority indicated that the compensation arrangements should be:

- transparent in their structure and operation;
- easily accessible to claimants and potential claimants;
- fair in their application to both claimants and contributors;
- efficient and responsive in operation; and
- simple and cost effective.

111. There are two points in this list which deserve consideration now — ease of access and simplicity.

Ease of access

112. To put substantial weight on accessibility at this stage of the discussion may deny consideration of compensation mechanisms which do not of themselves involve a neutral process for deciding claims, such as is provided by the SEGC in relation to the National Guarantee Fund. It also leads to difficulty in distinguishing the role of external dispute resolution mechanisms from that of compensation arrangements (at least during solvency).

113. It appears preferable to focus on compensation arrangements providing funds to meet proved claims, while not losing sight of the consumers' interest in gaining access to it.

Simplicity for consumers

114. Simplicity in the terms of a compensation regime will assist consumers to understand its coverage, and its limitations.

Variety of services and variety of products

115. The Financial Services Reform regime provides a harmonised regulatory regime across the range of financial services. However, any compensation arrangements need to be flexible to fit the range of financial services businesses. Thus, if professional indemnity insurance is generally required of financial services licensees who provide financial services to retail clients, the specific requirements (for example, type and level of cover) may differ depending on the type of work undertaken by the licensee.

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33 Financial Services Authority CP 5 *Consumer Compensation*, December 1997, page 8.

116. The need to recognise differences raises a series of questions:

- is there any justification for treating separately services in relation to any particular financial product or set of financial products (for example, 'investment products')?
  - In this context there is a need to distinguish risk associated with the product, and risk associated with the service. A volatile, risky product sold to relatively sophisticated retail clients may result in few claims.
- Should financial services in relation to superannuation products be treated separately, or even be the only subject of the compensation requirements?

117. We return to this issue in the context of any broad statutory fund in paragraphs 245-249.

Solvency/insolvency

118. Simplicity for the consumer was one of the reasons why CASAC favoured compensation for the same events both before and after insolvency.

119. However, going into external administration is a watershed in the life of any company and its creditors. It is not clear that it should necessarily be different for clients claiming against the licensee.

120. If you consider that compensation arrangements should be required both after the licensee has become insolvent (or unable to pay), and before that time, then should the arrangements cover the same conduct?

Administrative simplicity

121. There is another aspect of simplicity — simplicity in administration, which reduces administrative costs and increases certainty.

122. Costs will be increased where the scheme necessitates complex investigations or where judgments on complex factual situations are required. Grounds for claiming which involve establishing that the licensee had a particular mental state (for example, intention or recklessness) will also cause difficulties for the claimant and increased costs for the compensation provider.

123. In contrast, where claims are easily provable the compensation provider will have a valid right of subrogation and its claims are likely to be accepted by a liquidator.

CHAPTER 5: COVERAGE

The purpose of this Chapter is to consider the conduct of financial services licensees which should be covered by compensation arrangements, the particular occasions causing loss and who should be entitled to claim.

Put another way, in what circumstances should the law require the pooling of clients' risk, with the consequent risk of requiring innocent financial services licensees to contribute?

You may wish to consider separately the situations when a licensee is solvent and able to pay claims, and when it is insolvent or unable to pay.

A: The conduct

Financial service

124. What conduct should be the subject of compensation arrangements for the financial services sector? The starting point is the phrase 'provides a financial service'.[34] This encompasses:

- providing financial product advice;
- dealing in a financial product;
- making a market for a financial product;
- operating a registered scheme;
- providing a custodian or depository service; and
- conduct of a kind prescribed by any regulations made for the purposes of paragraph 766A(1)(f).

125. This description triggers a series of questions:

- Should compensation be required in relation to all these activities?

34 Section 766A.

- Should compensation arrangements extend to advising?
- In what, if any, circumstances should making a market trigger the need for compensation arrangements?
- 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?
- To what extent should compensation arrangements apply in relation to operating a custodial and depository service?
  - In this case there is no distinction between the financial service and the financial product.
- Should such arrangements be required in relation to the compliance of financial services licensees who are issuers with the product disclosure requirements (as well as the conduct of issuers, such as advising, which is comparable to that undertaken by intermediaries and which has triggered the requirement for a financial services licence)?
- Should compensation arrangements extend to licensees' conduct of discretionary trading accounts?

Licensed/unlicensed

126. Should compensation arrangements be limited to the conduct of financial services licensees and their representatives, and not include unlicensed providers of financial services?

127. 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)?

Possible acts or omissions causing loss

128. There is a range of circumstances within the ambit of 'providing a financial service' in which the conduct of the financial services licensee may cause loss to the client. They include:

- giving personal advice without a reasonable basis for the advice;
- false, misleading or deceptive conduct;
- failing to execute the client's instructions;

- failing to return to a client when requested any money or property belonging to the client that has been entrusted to the licensee;
- unauthorised transfer of a financial product belonging to the client;
- a licensee becoming insolvent, particularly where there is a deficiency in trust property.

B: The cause of the loss

129. Some of the possible grounds for claiming are discussed below. A number are not mutually exclusive. You are encouraged to comment on their appropriateness and suggest others.

130. For the sake of simplicity, this paper has been written as if all wrongdoing is by the licensee itself. There will obviously be occasions on which the conduct causing loss is that of the representative for whose relevant conduct the licensee is responsible under new Chapter 7.

(i) Defalcation and fraud

131. This would provide compensation for losses in respect of financial products or funds entrusted to a financial services licensee for the purpose of a dealing where defalcation or fraud is proved. It is the basic criterion for the current fidelity funds held by the stock markets (other than the ASX) and the Sydney Futures Exchange.

132. Note that:

- intention must be proved, including in the event of a deficiency on insolvency or unauthorised transfer, before the claim will be paid;
- there is uncertainty about the meaning of 'defalcation' (see footnote 91).

(ii) Loss of property (including funds) entrusted to the licensee

133. An alternative is to focus on the loss of property (whether financial products or funds) entrusted to a licensee without the need to prove intention or fault. Examples are:

- money is entrusted to the licensee for the purchase of a financial product but the licensee does not arrange for the purchase of the product nor repay the funds;
- financial products are held on behalf of the client pending sale but the licensee does not account for the proceeds nor return the financial products;
- unauthorised transfer of financial products and share certificates wrongly cancelled;

- this is discussed further at paragraphs 216 to 222.

Taking this one step further:

- unauthorised transfer of funds from client accounts with authorised deposit-taking institutions to which the financial services licensee has access.

(iii) Deficiency (on insolvency/inability to pay) in funds and financial products held on trust

134. This closely follows the ground for claiming described in (ii) above but would apply on insolvency or an inability to pay claims. It is shown separately because it is the area covered by a number of the overseas statutory schemes — see **Attachment D**.

(iv) Failure to enter into and complete transactions according to instructions

135. This would involve putting the client in the same position as if the financial service provider had carried out the client's instruction for purchase or sale.

136. The argument in favour of this concept forming a basis for a compensation regime is that it is more appropriate for, for example, insurance than the models described in (ii) and (iii) above.

137. The problem relates to consequential loss. In the case of a failure to execute a securities transaction, this may involve loss of capital gain, dividends or a bonus issue. This may be significant, but consider the following scenarios in the context of failure to execute an instruction to arrange insurance cover:

- a financial services licensee takes a client's money and leads him or her to believe on reasonable grounds that insurance cover has been arranged, but fails to execute:
  - instructions to obtain a disability policy;
    - : the client has a heart attack, cannot work and cannot get further cover;
  - or instructions to obtain a policy covering a house and its contents;
    - : and the house subsequently burns down uninsured.

138. This provides greater protection for consumers, at greater cost to industry, than the models described in (ii) and (iii) above.

139. Two notes of caution in considering this model:

- The CASAC Consultation Paper (which considered a scheme relating to securities, derivatives and units in managed investment schemes) recommended that return of

property should not extend to 'opportunity' or 'consequential pecuniary' loss.[35] The argument was that to cover these might significantly increase the cost and assessment requirements of the scheme.

- The 'contract guarantee' in Subdivision 4.3 of Part 7.5 of the Corporations Regulations provides a ground for claiming against the National Guarantee Fund where the transaction has been entered into but not completed – this is not the same as ground (iv).

(v) All the specific obligations of the financial services licensee imposed by new Chapter 7

140. Compensation arrangements in these circumstances cover losses consequential on the financial services licensee failing to comply with the specific obligations imposed by new Chapter 7.

141. The extent of this requirement, and issues associated with current section 912B, are examined further in Chapter 6 of this paper.

(vi) All the actions you could have taken against the licensee in his capacity as a licensee (on insolvency/inability to pay)

142. This is based on the model proposed for discussion in the CASAC Consultation Paper.

143. Allowable claims would include not only return of property but also claims relating to improper acts or omissions in the provision of financial services by firms now in default. It therefore covers claims in tort (for example, negligence), contract, statutory liability and the grounds on which an external dispute resolution scheme might have made a determination, where the conduct causing loss was the provision of financial services by the financial services licensee. This is on the basis that the grounds on which retail clients may lawfully claim against licensees in relation to their investments should be the same whether the licensee is solvent, or not.

144. It is inappropriate for financial services compensation arrangements to provide compensation to clients in relation to the obligations of a financial services licensee in its other roles — for example, as a company which has issued shares to the consumer, as the trustee of a superannuation scheme in which the consumer has invested or as the occupier of premises.

145. According to the CASAC Consultation Paper, its proposed model would complement the investor protection required by other provisions of the new Chapter 7 — that is, the compensation arrangements required by section 912B and the requirement for ASIC-approved external dispute resolution procedures.

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35 See CASAC Consultation paper, page 11.

146. The arguments against the breadth of this model are:

- the cost to the industry as a whole and whether the pooling of risk in such a spectrum of circumstances is justified:
- the complexity of the investigations and decisions which the scheme operator would be required to make:
  - the scheme administrator would be required to judge a case of the factual complexity of the recent matter of Ali v Hartley Poynton;[36]
  - this problem, however, is not limited to this model;
- all other legal action against a financial services licensee is affected by a winding up order — should claims by clients of the financial service licensee be treated differently?

147. The relationship of compensation arrangements and external dispute resolution scheme determinations is addressed in paragraphs 296 to 303. This discussion raises the question whether compensation arrangements should be required to cover the determinations of all approved external dispute resolution schemes.

Principal issue 4

(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?

C: The claimants

Retail clients

148. Should only retail clients have access to the scheme[37] or should all (barring, for example, those connected with the wrongdoers or who have profited from the wrongdoing) be entitled to make claims but the payments be limited to a cap appropriate for retail clients?

36 Ali v Hartley Poynton, Victorian Supreme Court, Smith, J., 16 April 2002.

149. Adopting the former course means that financial services licensees which only have wholesale clients would have no obligation to have compensation arrangements.

150. Further reasons for limiting the scheme to retail clients are described by CASAC.[38] They are:

- wholesale clients may be better able than retail clients to assess the risk of dealing with particular intermediaries, or have a greater capacity to reduce risk either by diversifying their activities among several intermediaries or by obtaining insurance, if available, to cover any consequences to them of the insolvency of an intermediary;
- caps on compensation may still allow many retail clients to recover all or most of any eligible losses, whereas wholesale clients may only recover an insignificant proportion of those losses unless the caps were set very high;
- limiting the scheme to retail clients may substantially reduce the cost of the scheme and/or increase funds available to compensate those clients.

Wholesale claimants?

151. On the other hand, we note that the National Guarantee Fund currently includes no requirement that a claimant be retail.

152. If wholesale clients remain entitled to claim, should their claims be judged against the same criteria as retail clients, some of those criteria, or different criteria altogether? Should they, for example, only be entitled to claim against compensation arrangements for loss of property entrusted to a financial services licensee?

Referral business and excluded claimants

153. There are two further issues related to the question of who should be entitled to claim:

- treatment of 'referral business', where the retail client's instructions are, for example, passed by a financial planner to a stockbroker;
  - in these circumstances, the financial planner (wholesale) may be treated as the client of the stockbroker, leaving the retail client with no remedy under the compensation arrangements for a wrong caused by the stockbroker;

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37 The Financial System Inquiry (the Wallis Committee) Final Report (at pages 280-281) recommended an additional layer of consumer protection for retail transactions, and that financial protections (such as fidelity funds) should be suitable only for retail persons.

38 See CASAC Consultation Paper, pages 9-10.

(an analogous situation may exist where a client seeks the issue of a financial product through an intermediary, but the issuer fails after receipt of the funds and before issue of the product);

- defining excluded claimants — that is, those with a connection with the failed financial service provider or have had responsibility for, or profited from, the financial difficulties of the relevant financial service provider.

Principal issue 5

Who should be entitled to claim?

D: Measure and nature of compensation

154. The discussion above relates to the circumstances in which compensation should be payable and to whom. The further questions about how to measure the loss for the purpose of calculating compensation (for example, whether consequential loss should always be provided) and what type of compensation should be provided (for example, financial products or their value in cash) are discussed at paragraphs 270 to 278.

E: Mechanisms to provide compensation

155. While there are a variety of mechanisms through which compensation can be provided, they generally fall into three categories — those arranged by financial services licensees, those arranged by market licensees and statutory schemes.

156. These three possible avenues (and issues particular to each of them) are therefore examined separately — financial services licensees in Chapter 6 and market licensees in Chapter 7. The questions whether a broad statutory scheme is warranted and if so, its structure, are examined in Chapters 8 and 9.

CHAPTER 6: FINANCIAL SERVICES LICENSEES

The purpose of this Chapter is to discuss whether financial services licensees should be made responsible for, and pay for, compensation relevant to their own and their representatives misconduct.

It also explores the advantages and disadvantages of surety bonds and professional indemnity insurance, and asks whether there are other mechanisms which should be considered.

Finally, it asks what risks should the required mechanisms cover.

A: Responsibility

157. As indicated above, the subject of this paper is loss suffered by clients as the result of financial services licensees' breach of their legal obligations as licensees or where licensees have deprived clients of funds or financial products.[39] The actor in this context is the financial services licensee (or its representative, for whose relevant conduct it is responsible).

158. It therefore follows that, all other things being equal, the obligation to make the compensation arrangements should be on the financial service provider (the principal).

159. This would also provide an incentive to behave if the premium or other payment due reflects accurately the risk involved in covering a particular licensee.

160. The **advantages** of such an approach are:

- it imposes liability on the body responsible for the regulated conduct;
  - if the risk involved in the particular operations and the cost to the financial services licensee are aligned, cross-subsidisation will be minimised;
- it underlines the message that the main responsibility for risk management lies with internal supervision. External regulation is not an alternative to robust and effective internal supervision processes and responsibilities;[40]

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39 The extent of the licensee's conduct giving rise to a compensable claim is discussed in Chapter 5.
40 David Llewellyn, *op. cit.*, page 51.

- it is consistent with the approach of the Financial Services Reform Act of a harmonised regime applying across the financial services sector, while allowing for variations to take account of different products and ways of doing business.

161. The **difficulties** with such a conclusion are:

- any problems inherent in or currently being experienced with the available mechanisms;
- the degree to which 'confidence in the market' (particularly if this is construed as the formal market or clearing and settlement facility) is the justification for requiring compensation arrangements.
  - It is arguable that all who benefit from such confidence should contribute. This may lead to the conclusion that some obligation should rest on the market operator or, perhaps in the context of uncertificated financial products, the prescribed CS (clearing and settlement) facility.

B: Mechanisms

162. There are several devices which can be used to make financial services licensees primarily responsible for compensation arrangements:

- surety bonds;
- professional indemnity insurance;
- other means.

163. Each would involve a measure of discipline on the licensee because it would form a requirement for the continuation of the licence. The merits of each mechanism are considered briefly below.

Surety bonds[41]

164. Securities dealers and advisers, under the pre-Financial Services Reform regime, were required to lodge a $20,000 surety bond with ASIC (see **Attachment B**).

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41 This segment of the paper draws on points made by Paul Latimer in his article 'Compensation of Investors for Failure of a Securities Industry Licensee', Company and Securities Law Journal Vol. 15, pages 495-503 (November 1997).

165. ASIC can apply the bond 'to compensate a person who has suffered pecuniary loss due to the failure of the licensee or an agent of the licensee to carry on business under the licence adequately and properly'.[42]

166. Approximately 2,000 bonds are held by ASIC. Usually fewer than 10 bonds per year are called on, although the number of claimants for the one bond varies from one to 40.

167. The **advantages** of a surety bond requirement are:

- the client has ready access to the funds through ASIC, and access to review mechanisms in relation to ASIC's decisions;
- they are limited in the range of risks covered by the relevant legislative provisions, not the terms of an insurance contract;
- at least while solvent, it is the individual licensee which faces the loss.

168. The **disadvantages** of the current surety bond requirement are:

- they provide a very limited source of compensation following any significant losses covered by it (and, in this situation depending on the security provided, the provider of the bond may be 'out of pocket', rather than the ex-licensee);
  - the current Australian bond, $20,000, is too small for many events in which compensation is sought — it is not proportional to the risk, the size of the business or the funds held on behalf of clients;
  - investors frequently receive only a few cents in the dollar;
  - it thus provides little compensation, and probably its potential loss provides little deterrence;
- a substantial bond may prove an impediment to those wanting to start in the financial services sector in a small way;
- it is not clear that the existence of security bonds under the current Corporations Act is widely known;
- administration of the bond imposes some costs on ASIC, such as ensuring lodgment and assessing claims;
  - overwhelmingly, ASIC does not handle the funds — instead performance bonds/bank guarantees are used — although the bank may require deposit of the actual amount;

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[42] Corporations Regulation 7.3.04(1) prior to the Financial Services Reforms.

- the threshold question of who can claim on the deposit is considered by one commentator to be unclear currently – for example, is negligence covered?[43]
- the claimant will be left to private legal action (with its legal costs) or external dispute resolution to the extent that his claim is unpaid (and if it is worthwhile).

169. Noting the disadvantages above, we have taken the 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.

Professional indemnity insurance

What is professional indemnity insurance?

170. Traditionally, professional indemnity/professional liability insurance covered a professional against liability in respect of loss caused by his negligence to other persons, including clients.

171. While the traditional policy was confined to negligence, the 'professional indemnity' policy in recent years has evolved to a broader range of civil liability and is available to a wider range of occupations. Depending on the wording, the policy may extend the basic negligence cover to a claim arising from a breach of contract, tort and statute (such as misleading and deceptive conduct provisions in the corporations legislation).[44]

172. Extensions could include loss of documents, dishonesty of employees, retroactive cover, run-off cover and legal defence costs.

173. The circumstances in which professional indemnity insurance is currently required in the financial services sector are described in **Attachment B** of this paper.

What are the advantages and disadvantages of professional indemnity insurance as a means of providing compensation?

174. The **advantages** are:

- insurance is considered more effective and efficient than surety bonds;
- it provides substantial funds to pay accepted claims and greater certainty that they will be available (in defined circumstances);

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43 Paul Latimer, *op. cit.*, page 498.

44 Rick Welsh, *Professional Risk — traps for the unwary* at Clayton Utz Risky Business II, 2-3 March 1999.

- access could be following a direct approach to the licensee, court action (or the threat of it) or following an external dispute resolution determination;

- provided it is risk-weighted, the burden falls on those responsible for the relevant conduct;

- professional indemnity insurance is standard business practice and most licensees are expected to have it, whatever the regulatory requirements (although the exact coverage will vary);

- it does not involve the establishment of new infrastructure and the cost of running it;

- it assists in discipline to the extent that it involves surveillance provided by insurers, and to the extent that the insurer makes a rational assessment of the risk inherent in the business of the particular licensee.

175. The **disadvantages** are:

- it requires prescription as to the coverage, the minimum level of coverage, the excess etc provided by the policy which will suffice for regulatory purposes;

  - this may be by regulations (as in the case of the Insurance (Agents and Brokers) Act) or by a combination of regulation and discretion to the regulator (as in paragraph 912B(2)(b)); and

  - regulatory oversight is then necessary to ensure that the cover has been obtained and maintained, and that the policy does not have inappropriate limitations and exclusions;

    : a contract of professional indemnity required to be held by insurance brokers needs to be accepted by ASIC[45] — would such a requirement be justified more generally?

- there may be difficulty in the regulator or client establishing that cover is in place and not voided by, for example, misrepresentation,[46] admissions to the claimant or failure to report a claim;

- while the client's rights are against the insured, the processing of claims and payment of successful claimants is dependent on the insurance company, and any decision it makes to contest the claim;

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45 Section 9B of the Insurance (Agents and Brokers) Act.

46 Misrepresentation can be addressed in the relevant legislation- see s 9B(3) of Insurance (Agents and Brokers) Act.

- if litigation results, there is likely to be an imbalance in the resources and expertise of the claimant and the insurer;
- however, if the claim is within external dispute resolution limits and the professional indemnity policy covers determinations of the scheme, then access is facilitated.

Other mechanisms?

176. Are there other mechanisms which should be considered as alternatives to professional indemnity insurance or surety bonds? An industry fidelity fund has been suggested as one alternative. If there are appropriate alternatives, should financial services licensees be allowed to choose which suits their circumstances?

177. Relevant in this context is the question whether membership of a market compensation arrangement would, to some extent, satisfy the obligation on a financial services licensee to have compensation arrangements.

Should all licensees be treated the same way in any requirement for compensation arrangements?

178. Should APRA-regulated bodies, those with high financial requirements imposed by other means or those with high market capitalisation be treated differently in any requirement for compensation arrangements?

179. This is discussed in paragraphs 265 to 269 below.

Principal 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) (See below) What should the mechanism be required to cover?

The current professional indemnity insurance market

180. Before the Government develops policy in this area, we need further information about the current state of the market for professional indemnity insurance in the financial services sector.

181. The issues on which we would like your views and experience include the following:

- reinstatement of cover, excesses and the availability of 'run off' cover;
- the availability of coverage for fraud of licensees and their representatives, legal expenses and cover for licensees licensed to engage in a range of activities cutting across established segments of the financial services sector;
- whether insurers provide cover in respect of determinations of external dispute resolution schemes.

182. You may be aware of other issues of relevance. If so, we would appreciate your advice.

183. Some background on the current state of the professional indemnity insurance market is provided in **Attachment E**.

184. We also need to understand whether clients have had difficulty obtaining the benefit of such policies.

Principal 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?

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

C: What should the mechanism adopted be required to cover?

185. The next question is 'What should the mechanism adopted be required to cover?' You need to consider this in the light of your answer to Principal Issue 4.

186. Some possibilities are discussed below. You may wish to suggest others.

All the obligations of the financial service provider under new Chapter 7

Current coverage of section 912B

187. The answer currently provided in section 912B,[47] inserted by the Financial Services Reform Act, is loss or damage suffered because of breaches of the relevant obligations under new Chapter 7 by the licensee or its representatives.

188. This therefore encompasses, for example, loss suffered by a retail client:

- which is caused by advice given by the licensee without a reasonable basis;
- who has sought to return a product in accordance with the cooling-off provisions but the licensee has refused to comply with those provisions;
- who has paid money to a licensee for the purchase of a financial product but the licensee has not dealt with it in accordance with Division 2 of Part 7.8 (for example, it has not been paid into a trust account, as required);
- as a consequence of the failure by a licensee to issue a complying product disclosure statement.

189. Section 912B requires licensees to have compensation arrangements for losses suffered by retail clients as a consequence of breaches of the relevant obligations under 'this Chapter' (that is, the new Chapter 7). In drafting the Bill, it was not the intention that this be read as requiring the compensation arrangements to cover compliance with other 'financial services laws', one of the general obligations included in section 912A.[48]

190. Treasury officers envisaged that the details of the compensation arrangements required to meet section 912B would be prescribed by regulations but that ASIC would determine the amount of the cover in the light of the extent and nature of the financial services business carried on by the relevant licensee. Thus, in the case of general insurance brokers, the amount specified might be lower because premiums received by such a broker are deemed to have been received by the insurer. It was also envisaged that ASIC could review the amounts determined in the light of experience, but it was not envisaged that ASIC would consider the position of licensees individually in making determinations under this provision.

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47 Section 912B will, in effect, commence on 11 March 2004.

48 This reading has been suggested because one of the general obligations on financial services licensees in section 912A is to comply with 'financial services laws' (a term which is defined in section 761A to include other relevant Commonwealth, State and Territory legislation).

Questions about section 912B

191. This review does not assume that section 912B should remain unchanged. The following issues arise in this context:

- Should section 912B refer instead to:
  - specific obligations in Chapter 7?
  - specific liability provisions in Chapter 7?
  - some other set of obligations?
- Should section 912B cover conduct in contravention of Part 7.9 (product disclosure) by financial services licensees?
  - clearly this is distinct from conduct of an intermediary, or comparable conduct (for example, advice or receipt of purchase money pending issue of a product) by an issuer.

Other possibilities

192. Although this issue can easily become a discussion in greater detail than is appropriate for this paper, the following models are worth considering:

- The Technical Committee of the International Organisation of Securities Commissions[49] suggested fraud, faulty execution, loss of documents or unauthorised trading by the firm's employees;
- under the UK requirements,[50] with limited exceptions, 'Personal Investment Firms' are required to have adequate professional indemnity insurance cover for all the business activities which it carries on, or for which it is responsible;
  - the policy must cover negligence, legal defence costs, libel and slander, loss of documents, Ombudsman awards and representatives' conduct.

Principal issue 6(b)

What should the mechanism adopted be required to cover?

49 The IOSCO Technical Committee, in a paper dated August 1996 entitled *Client Asset Protection*, discusses briefly the advantages and disadvantages of compensation schemes and insurance. See www.iosco.org.

50 The separate UK Financial Services Compensation Scheme is summarised in Attachment E.

D: Conclusion

193. You need to consider whether the compensation arrangements which depend on financial services licensees are sufficient to meet your answer to Principal Issues 3 and 4. If not, are you suggesting a complementary market scheme or a broad statutory scheme?

CHAPTER 7: MARKET LICENSEES

The purposes of this Chapter are:

- to ask whether market licensees should be required to make compensation arrangements;
- to assess the various compensation arrangements required of market operators and to question the current requirements;
- to ask, if market licensees are to continue to be required to have compensation arrangements, what shape should they take;
- to raise the question whether consolidated market arrangements are justified; and
- to ask whether any obligation to make compensation arrangements on prescribed clearing and settlement facilities (through which uncertificated financial products are transferred) is justified.

A: Should market licensees be required to make compensation arrangements?

History

194. It can be seen from the summary of the origins of the National Guarantee Fund in **Attachment C** that, at least in the case of the Sydney Stock Exchange, the decision to establish a fidelity fund was made as a means of protecting its reputation and discouraging regulation following the collapse of a broking firm.

195. Fidelity funds were subsequently required in several jurisdictions by legislation in 1970 and 1975 and in all jurisdictions by the *Securities Industry Act 1980* and its successors. The National Guarantee Fund was created in 1987 from the amalgamation of a proportion of the fidelity funds of the capital city exchanges. The relevant provisions were re-enacted in 1989, amended in 1990-94, re-enacted in 2001, and retained in substance in the Financial Services Reform legislation.

An assessment of the general features of current Australian compensation funds

196. The ASX's National Guarantee Fund and other Australian exchanges' fidelity funds fall under this heading.

197. The **advantages** of these funds are:

- they probably provide the greatest certainty for the consumer in relation to the particular conduct covered (see **Attachment B**);
- they can be used in combination with surety bonds and professional indemnity insurance;
  - thus the SEGC, having paid a claim, is subrogated to the claimant's rights against the financial services licensee (backed by its professional indemnity insurance);
- compensation fund managers may well be better placed than retail clients to get to the bottom of an issue through obtaining documents and dealing with the licensee, if solvent, or its lawyer;
- in the case of the National Guarantee Fund, funds in excess of the required minimum are made available for securities industry/financial services industry development purposes;
  - a total of over $110 million has been paid out of the NGF for this purpose since its establishment.

198. We also note that the International Organisation of Securities Commissions' *Objectives and Principles of Securities Regulation* contemplate that investors in securities markets will have access to compensation for improper behaviour.[51]

199. The **disadvantages** of requiring these arrangements are:

- the current exchange-based funds in Australia relate particularly to the protection of assets, and do not cover advice;
  - there is, of course, an issue (discussed in Chapter 5) as to the appropriateness of requiring a compensation scheme to cover additional risk, such as negligent advice;
- putting aside its clearing guarantee functions, the National Guarantee Fund coverage in relation to investor protection is significantly different from that required of other fidelity funds;
  - is this justified?

51 See para 4.2.1 of the Objectives which are on IOSCO's website – see www.iosco.org.

- to make them comparable would involve additional costs on participants in other markets, or reducing the level of protection currently provided by the National Guarantee Fund;

- if individual financial markets are required to have such a scheme, how do the schemes interact in the cases where a participant is a member of several financial markets;

  - 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;

- requiring financial markets to have compensation arrangements may impose a cost on them;

  - however, the National Guarantee Fund currently costs the ASX and ASX participating organisations nothing to maintain or administer;

    - on the contrary, as indicated above, the National Guarantee Fund has provided over $110 million for 'securities industry development' purposes since its establishment — for example research, investor education and improvements to the automated trading system;

  - it is not clear that the requirement on other financial markets to have compensation arrangements imposes an onerous burden;

- compensation arrangements made by the market operator may remove the element of personal responsibility from the licensee;

  - however, in most cases the scheme operator will, when it pays the claim, be subrogated to the rights of the claimant — that is, the scheme operator acquires the rights of the claimant and will take action against the licensee (and its professional indemnity insurer);

  - the scheme operator may also seek to prove in the licensee's insolvency;

- compensation arrangements under Division 3 of Part 7.5 involve some regulatory costs in that they must be approved.

200. In summary, market compensation arrangements, while potentially covering the same events as a professional indemnity insurance policy, offer greater comfort to the client by providing both a decision-making process and a source of funds. This is provided to all clients of stockbrokers in the case of the National Guarantee Fund, and, in the case of markets other than the ASX, to retail clients (once the market transitions into the new Chapter 7 compensation regime).

CASAC's view

201. CASAC concluded that the compensation arrangements in new Chapter 7 of the Corporations Act:

> 'can create inconsistencies and administrative complexities in awarding compensation, given that eligibility under a scheme operated by a particular market operator is based on establishing a connection between the actions of insolvent financial service providers and that market. It can also create possible overlapping sources of client compensation between financial market operator schemes and intermediary schemes. The existence of multiple schemes can result in investor confusion, forum shopping, potential inequality and fragmentation of avenues of redress.'[52]

202. The difficulties are indicated by the relevant provisions of Part 7.5[53] which seek to establish the necessary connection with a particular market. In the absence of such a connection, the client is left to rely on the section 912B compensation arrangements. (An alternative would be to require the market compensation scheme to cover eligible claims arising from the whole of a participant's securities business, for example.)

203. CASAC considered[54] that the Financial Services Reform compensation arrangements could be confusing for retail clients, particularly if a client had to seek compensation from several different schemes in the event that the insolvent intermediary traded on that client's behalf in various markets. It could also create inequalities, to the detriment of investors if different eligibility and recovery criteria applied in different markets.

204. Further, CASAC pointed to:[55]

- increased regulatory responsibilities and costs, given the requirement for the regulator to assess the compensation scheme of each financial market operator;
- the inefficiency of having several compensation schemes administered separately.

Questioning the current requirements

205. There are further arguments against requiring market licensees to maintain compensation arrangements:

- if the purpose of establishing a fidelity fund is to retain confidence in a market, it should be left as a matter for the business judgment of the market operator whether or not to have compensation arrangements, rather than being mandatory;

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52 CASAC Consultation Paper page 4.
53 Section 885C (the losses to be covered) and section 885D (certain losses that are not Division 3 losses).
54 CASAC Consultation Paper, page 6.
55 CASAC Consultation Paper, page 6.

- separate compensation arrangements for exchange-traded financial products cannot be justified, given the purpose of the Financial Services Reform Act as providing harmonious regulation;
- the requirement is a relic of a previous era and does not fit the range of financial markets (including markets which do not fit the traditional exchange model) which will be regulated under Part 7.2 of new Chapter 7.

206. While there are difficulties with the current market compensation requirements, there are also reasons to consider retention of market-based compensation arrangements including:

- Government policy is that a market operator must supervise the relevant conduct of its participants. This is reflected in the provisions of the new Chapter 7 relating to the obligations on market licensees.[56]
  - Requiring the market operator to have compensation arrangements which would apply in relation to its participants' conduct as intermediaries in relation to retail clients would appear consistent with this supervisory role.
- The special position the ASX has in the Australian financial marketplace and the increasing participation of the Australian population, particularly retail persons, as direct investors.

207. Retail investors on the ASX may wish to consider whether alternative proposed compensation arrangements will provide comparable protection. We note that while there has been only one stockbroker insolvency since 1993, there has been an increased number of claims against the National Guarantee Fund for unauthorised transfer.

208. If market operators were no longer required to make compensation arrangements, and the element of the National Guarantee Fund attributable to clearing house support were paid out,[57] there would be no further function for the National Guarantee Fund and it would presumably no longer provide funds for the financial services development account. This leads to the question what would be done with the remaining funds — see secondary issue 15. It is likely that the exchanges would oppose them being used as the basis of any statutory fund of broad application — see paragraphs 250 to 254.

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56 Part 7.2.
57 Under section 891A.

Principal 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)?

B: If market licensees continue to be required to make compensation arrangements

209. If the obligation to make compensation arrangements were to continue to be imposed on market licensees, what changes from the current Part 7.5 would be appropriate? — for example:

- On what grounds should claims be paid?
  - should they be the same across all financial markets? If so, should they be based on the National Guarantee Fund criteria, the current fidelity fund criteria or some other basis?
  - if they relate only to property entrusted to the financial services licensee, should this protection extend to authority a financial services licensee has over property of an investor (for example, broker sponsored uncertificated holdings and authority over client bank accounts)? Is this consistent with the treatment of unauthorised transfers of other holdings (including issuer sponsored holdings)?
- Should the arrangements only relate to on-market transactions (rather than all transactions by market participants, whether on- or off-market, that must be 'reported' to a market operator, for example)?
- Should the arrangements cover wholesale clients (as the National Guarantee Fund does)?
- How should responsibility be divided where a licensee is a participant on several markets? Is this, in practice, a real problem?

210. A number of other issues of relevance here are discussed in Chapter 10. They include subrogation and capping.

Principal issue 8(a)

If market licensees are to continue to be required to have compensation arrangements, what changes to the current Part 7.5 should be made?

C: A consolidated market scheme?

211. A cross-section of international schemes are summarised in **Attachment D** and some conclusions reached from consideration of these schemes included at paragraphs 239 to 240.

212. Consideration of the various international schemes leads to the question whether a consolidated market scheme would be justified. This would involve amalgamating the existing market arrangements into a single statutory scheme.

213. On the one hand, this would address the issue of responsibility where the licensee participates on several markets and may assist in resolving what to do with the existing National Guarantee Fund and SFE fidelity fund. In addition, if sufficiently similar to the current arrangements, it would provide an assurance of continuity for clients of market participants and it would provide a scheme comprehensible to overseas investors.

214. On the other, such a scheme treats clients of market participants or transactions undertaken on formal markets as requiring a higher level of protection. While they have been treated this way for some time, without further argument it would appear to be inconsistent with the theme in the Financial Services Reform Act of harmonised regulatory treatment across the financial services sector. Further, depending on the governance and structure of such a scheme, it may be seen as involving Government assumption of responsibility more properly borne by market licensees.

215. It also involves many of the issues of any broad statutory scheme — see Chapters 8 and 9.

Principal issue 8(b)

Is there justification for a consolidated scheme for financial services licensees who are market participants?

D: CS (clearing and settlement) facility licensees

216. In the context of secondary sales, financial services licensees hold (or have authority over) financial products and the money of clients largely for the purpose of settlement. With developments in this area, some licensees will offer services in relation to clearing or settlement and may not be participants on a licensed market.

217. Unauthorised transfer is relevant to certificated and uncertificated securities. It is particularly relevant in relation to uncertificated securities transferred through a prescribed CS (clearing and settlement) facility under Division 4 of Part 7.11. In this case, the mechanism is solely within the control of the CS (clearing and settlement) facility licensee,

not the market operator. Indeed, the relevant transaction may have been entered into off-market.

218. Currently, there is only one clearing house with this capacity — the ASX Settlement and Transfer Corporation Pty Limited, which was the 'Securities Clearing House' of Chapter 7 of the Corporations Act prior to the commencement of the Financial Services Reform Act.

219. Compensation for losses arising from contravention of the Securities Clearing House rules regarding cancellation of certificates, and unauthorised transfer of securities was provided by the National Guarantee Fund,[58] and continues to be available under new Chapter 7.[59] (This protection does not require conscious wrongdoing on the part of the Exchange participant — the fraud may be perpetrated by another.)

220. However, the new Chapter 7 includes the capacity for other clearing and settlement facilities to be prescribed for this purpose and hence also to facilitate the electronic transfer of legal title.

221. As indicated above, there have been an increasing number of claims against the National Guarantee Fund on the ground of unauthorised transfer since 1997. In addition, there is clearly a need to maintain confidence in uncertificated systems.

222. On the other hand, traditionally clearing houses have not supervised the conduct of participants except to the extent that it relates to risk to the facility.

Principal 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?

58 Divisions 7 and 7A of Part 7.10 of Chapter 7 prior to the Financial Services Reform Act.
59 See Division 4 of Part 7.5 and relevant Corporations Regulations.

CHAPTER 8: IS A BROAD STATUTORY SCHEME WARRANTED?

The purpose of this Chapter is to ask whether a broad statutory compensation scheme is warranted and, if so, what should it cover and how should it be structured.

A: Is a broad statutory scheme warranted?

223. Our tentative conclusion from the discussion above is that:

- requiring compensation arrangements through legislation is justified;
- the primary responsibility for making relevant compensation arrangements should be on the financial services licensee.

224. A conservative questioner might ask:

- Does any proved inadequacy in the compensation mechanisms under consideration, particularly in insolvency, justify establishing and operating a broad statutory scheme?
- Should the need for a broad statutory compensation scheme be deferred until a considered evaluation of the effects of the Financial Services Reform regime (including a revised section 912B) can be made?

225. The **advantages** of a broad statutory scheme are:

- it could provide harmonised compensation arrangements across the financial services sector;
- depending on the scheme adopted, it would provide simplicity and clarity for clients suffering loss;
- a compensation fund manager may well have better resources than the retail client to get to the bottom of an issue, obtain documents and deal with the licensee's insurer and lawyer.

226. The **disadvantages** of such a scheme are:

- depending on the structure and coverage, it could be a further significant cost to the industry;

- depending on the manner of funding it, there is the likelihood of cross-subsidisation — for example, of the poorly managed or fraudulent by large, well-managed firms, of one activity by another (eg advising by dealing), or one sector of the industry to another;
- if it applies prior to insolvency, it may take some responsibility away from the financial services licensee (except to the extent that the funding mechanism reflects the risk of individual licensees to the scheme, and the exercise of subrogation).

Principal issue 10

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

B: In what circumstances should a broad statutory scheme apply?

Solvency/insolvency/inability to pay

227. The options would appear to be to provide for payment in certain specified situations when the financial services licensee:

- was solvent, and on insolvency;
- became unable to pay **or** was insolvent;
- was insolvent.

228. The argument against covering situations prior to insolvency is that the client has other avenues of redress at this point and there are presumably assets to satisfy successful claims (including the mechanisms required under section 912B).

229. The overseas statutory schemes overwhelmingly address the situation where the financial service provider is unable to pay or insolvent. This was followed by CASAC[60] which proposed immediate payment to claimants (within the caps), even where there is some likelihood of an eventual return to those claimants in the insolvency.

230. The second option provides a measure of flexibility over the third in that insolvency is not necessary. However, it may leave the client in some uncertainty as to whether the scheme is available in a given situation and requires some definitive statement that the

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60 See CASAC Consultation Paper, page 12.

licensee is unable to pay (which may of itself have consequences on the licensee's financial situation).

Principal issue 11

If a broad statutory scheme is warranted, when should it be available?

(a) Should it be available prior to insolvency? or only on inability to pay/insolvency?

The grounds on which it would pay claims

231. In brief, the grounds on which compensation could be available include losses as a result of the licensee's defalcation and fraud, losses of property (including funds) entrusted to the licensee, deficiency on insolvency, failure to enter into and complete transactions as instructed, or some other breach a relevant obligation. These are discussed in Chapter 5 of this paper.

232. It should be noted that the cost of administering compensation arrangements rises in proportion to the complexity of the investigation and decisions to be made by the scheme operator. The issue of administrative complexity is discussed at paragraphs 121 to 123.

Principal issue 11

(b) On what grounds should claims be paid?

C: The CASAC proposal

233. The Companies and Securities Advisory Committee (CASAC) issued in September 2001 a Consultation Paper that proposed for discussion a scheme to compensate retail clients of insolvent financial services licensees who were intermediaries.[61] 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;
- be operated by an independent body, with appropriate powers and duties;

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

- compensate retail clients of financial services licensees who were intermediaries and that were insolvent or unable to pay, even where there was a chance of eventual recovery in an insolvency;
- use the same eligibility criteria as apply in disputes with solvent intermediaries;
  - thus the scheme would provide for the return of client property, and compensation for any other amounts that had been or could be awarded by an ASIC-approved dispute resolution body or a court;
  - it could cover all investment matters including a fully discretionary securities/derivatives trading account or unauthorised transfers, but not an outright loan;
  - the Committee anticipated that this scheme would complement the requirements for external dispute resolution arrangements and the requirement for compensation arrangements in section 912B;
- be subject to compensation caps and to time limits on making claims;
- be funded by levies on financial services licensees dealing (as intermediaries) in investments on behalf of retail clients; and
- include transitional arrangements to deal with funds currently held by the National Guarantee Fund and the Sydney Futures Exchange.

234. The model which the Committee proposed for discussion:

- involves omission of the requirements in Part 7.5 on financial markets (including exchanges) to have compensation arrangements (the National Guarantee Fund would be dismantled);
- relates only to securities, derivatives and interests in managed investment schemes;
  - the Committee indicated that the proposed scheme could provide a model for compensation schemes for deposits, superannuation and insurance but that separate schemes or eligibility rules would be needed and could be a matter for future review;
- assumes the continuation of the requirement in section 912B for financial services licensees to have compensation arrangements and that these arrangements would cover the broad range of claims;
  - the Committee indicated that it was up to ASIC to develop its policy on the compensation arrangements required under section 912B.

Responses to CASAC's Consultation Paper

235. CASAC received nine responses to the consultation paper (of which seven were in writing). A number of submissions supported the proposed scheme, one expressing the view that it would:

- simplify compensation arrangements, providing certainty and uniformity and avoiding overlapping and duplication, with the resulting efficiencies benefiting retail investors;
- be consistent with international developments;
- provide broad insolvency protection for investors and place primary responsibility for compensation directly on financial service providers rather than market operators.

236. Some other submissions raised concerns about possible 'moral hazard' and the methods and implications of financing the scheme. Was there evidence of such a lack of consumer confidence as to justify the scheme? Why was the UK model (which differs significantly from the US and Canadian models) being adopted?

237. It was also suggested that CASAC should only develop its compensation scheme in the light of ASIC's financial licensing requirements and that detailed justification was needed to move away from the recommendations on risk management and financial safety of the Financial System Inquiry (the Wallis Committee).

238. There was opposition in two submissions to the possibility of compensation for negligent advice and several asked whether the separate treatment of investments (as distinct from superannuation, insurance and deposit products) was consistent with the Financial Services Reform Act. One submission sought a regulation impact statement, while another suggested a discussion of possible alternatives, such as reforming and improving the current schemes.

D: Overseas schemes

239. Review of the overseas schemes (summarised in **Attachment D**) indicates:

- they generally only apply on inability to pay/insolvency (for example, the United States Securities Investor Protection Corporation, Canadian Investor Protection Fund, the Irish Investor Compensation Company Limited, the UK Financial Services Compensation Fund);

  - however, the proposed Hong Kong Investor Compensation arrangements would also apply in wider circumstances[62] but is limited to exchange traded products;

- they generally provide for compensation for losses of client securities or money held by the intermediary (eg Ireland, Hong Kong, Canada, United States);

  - the exception in this regard is the UK scheme which covers not only the return of property but also claims relating to improper acts or omissions by investment firms in default;

- they relate to various classes of investments (but not the range of financial products addressed under new Chapter 7):

  - the Hong Kong scheme covers securities and commodity dealers and margin financiers;

  - the US scheme relates to securities and cash held in connection with securities transactions;

  - the Canadian scheme relates to securities, cash balances and certain other property in connection with securities or futures business;

  - the Irish scheme includes shares, units in collective investment schemes, futures, options and life and general insurance policies;

  - the UK scheme relates to stocks and shares, unit trusts, futures and options, personal pension plans and long term insurance policies such as endowments. (The UK Financial Services Compensation Scheme provides separately for claims in relation to protected deposits and protected contracts of insurance.)

- they variously apply to retail or all clients, and the compensation is capped;

- they generally cover intermediaries (not issuers);

- they provide a safety net but jurisdictions frequently also require professional indemnity insurance/surety bonds.

240. It should be noted that several of these schemes are market-related, although separately administered. Further details of the schemes in the UK, US and Canada were summarised by CASAC and are available on www.camac.gov.au.

62 Any breach of trust, defalcation, fraud or misfeasance by the intermediary or any person employed by the intermediary.

241. Both the model CASAC proposed for discussion and some of the overseas schemes give rise to the question whether a statutory scheme limited to market participants or market transactions is warranted. This is discussed at paragraphs 212 to 215.

CHAPTER 9: SUBSIDIARY ISSUES RELATING TO STATUTORY SCHEMES

The purpose of this Chapter is to discuss a number of issues that would be relevant to the construction of a broad statutory scheme. These include who should operate the scheme and its funding. (A number of these issues apply equally to exchange-related compensation funds.)

The inclusion of this section should not be viewed as indicating that the Government has decided that any statutory scheme is warranted. If that decision were reached, then each of these issues would have to be examined in greater detail.

A: Who would operate the scheme?

242. The possibilities considered in the CASAC Consultation Paper[63] are:

- licensed market operators;
- clearing and settlement facility licensees;
- intermediaries collectively (for example, through a mutual entity of which all intermediaries are members);
  - it is very difficult to conceive of all intermediaries, let alone all financial services licensees, voluntarily forming such a body;
- an 'independent entity' that operates the scheme in accordance with legislative criteria and/or regulations;
  - for example, an existing ASIC-approved external dispute resolution scheme operator.

This proposed solution has the advantage of avoiding the need for a new and costly administrative structure, and the CASAC Consultation Paper suggests it would provide retail clients with access to the one entity that could deal with their investment complaints against an intermediary, whether solvent or insolvent.

63 See CASAC Consultation Paper, pages 8-9.

However:

- the criteria to be applied, and the nature of the decision to be made by the external dispute resolution operator would change on insolvency;
- there are a number of external dispute resolution schemes based on different segments of the financial services sector;
- a financial services licensee may be required to be a member of more than one scheme;
- it would appear inappropriate to choose one such scheme to operate any statutory compensation fund (and requiring financial services licensees to be members of a particular private body may raise competition issues).

To provide for a series of external dispute resolution scheme operators to operate any statutory compensation scheme would involve administrative difficulties — for example, who would have the power to levy, and ensuring consistent administration.

One suggestion, which has been made to meet these concerns, is to give the levy power and the power to make rules and set the policy to a statutory agency that would delegate the day-to-day decision-making functions to the individual external dispute resolution schemes.

243. The SEGC has also been suggested, again with the aim of avoiding the need to create a new apparatus. However, it is a wholly owned subsidiary of the Australian Stock Exchange with a very specific current role.

Secondary issue 12

If a statutory scheme were warranted, who should operate the scheme?

B: Reporting and governance issues

244. If a statutory scheme is considered warranted, there are obviously a large number of reporting and governance issues. Their treatment will, in part, depend on the nature of the scheme operator. They include:

- Should there be any special reporting requirements, bearing in mind any power to levy to provide a compensation fund (see below) and holding such funds?

- How would its governing body be constituted?
  - it has been suggested that it would be necessary to include persons with investor experience and appropriate corporate governance/public administration experience in addition to financial services representatives;
  - one submission to CASAC suggested that practitioner representatives would provide practical day-to-day experience, knowledge and insight as well as a sense of responsibility for and commitment to effective regulation;
    - : it would, however, be unfortunate if such members saw their role as representatives of a particular group or industry sector, rather than as upholding the wider public interest;
  - should the market operators be involved?
- What appeal rights are appropriate?

Secondary issue 13

If a statutory scheme were warranted, what special governance and accounting requirements would be appropriate?

C: Would the one scheme cover all financial services and all financial products?

245. The aim of the Financial Services Reform regime is to provide a harmonised regulatory regime across the range of the financial services.

246. Whether the compensation regime should apply to all financial services is a separate issue and is discussed at paragraphs 124 and 125.

247. Whatever the range of financial services decided on, this does not mean that there should not be variations within the scheme to accommodate the different ways that business is done across the financial services industry, the different risks involved, or the recognised segments of the industry.

248. Issues in this context include:

- should financial service licensees who are intermediaries be treated in a different manner to those who are issuers?

- should financial services licensees who are market participants be put into a separate sub-scheme?
  - one submission to CASAC suggested a network of sub-schemes for groups such as ASX participating organisations, SFE members, financial planners etc.
  - alternatively ASX participating organisations and members of other exchanges could remain under their current compensation regimes, and the statutory scheme only apply to other financial services licensees;
- should any scheme be limited to on-market transactions, as one submission to CASAC suggested?

249. However, any proposal relating to sub-schemes needs to recognise that:

- any financial services licensee may be offering a wide range of products;
- there will ultimately be difficulties about categorising particular products;
- the focus should be on the service (and the comparability of the service), rather than on the financial product;
- division in accordance with recognised segments of the industry may not address concerns about cross-subsidisation;
  - even though a particular financial product is risky, this does not necessarily mean that provision of a financial service in relation to it is high-risk conduct. Instead, it may be that particular conduct (such as advising) is the source of more claims than, say, execution-only transactions.

Secondary issue 14

If a statutory scheme were warranted, could the one scheme cover financial services in relation to all financial products and sectors of the industry?

D: How would it be funded?[64]

Initial funding

250. How would the scheme initially be funded?

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64 See CASAC Consultation Paper, pages 17-20.

251. The CASAC Consultation Paper[65] stated: 'Transitional arrangements could deal with the transfer of appropriate funds currently held by the National Guarantee Fund and the SFE to the new Scheme. A substantial transfer could benefit intermediaries by reducing their immediate or foreseeable levies, as well as providing immediately available funds on commencement of the Scheme.'

252. In response to the CASAC suggestion, various concerns were raised in two submissions about applying the National Guarantee Fund to support the scheme during the transitional period :

- appropriating National Guarantee Fund trust money may be unconstitutional as an acquisition of property on other than just terms;
- the proposal may delay or prevent the ASX's intended application for the clearing guarantee element of the Fund;
- the proposal does not take sufficient account of the National Guarantee Fund's role in protecting wholesale investors or providing funds for projects relating to the development of the securities industry;
- the bodies that are to provide the clearing guarantee and the securities industry development account have a higher claim on National Guarantee Fund funds than the proposed scheme, which should be funded by industry;
- funds from the National Guarantee Fund could be used to benefit persons who cannot claim on, and have not contributed to, the National Guarantee Fund, and would involve cross-subsidisation;
- payment from the National Guarantee Fund may not be necessary to ensure adequate funding for the Scheme, given that claims can only be made in the event of an intermediary's insolvency and such insolvencies are infrequent.

253. A different view may be taken if the statutory scheme were limited to market transactions or market participants.

254. Another submission to CASAC expressed the view that the transitional arrangements should cover transfer of technology, personnel, procedures and expertise as well as funds, to ensure a seamless and reliable handover.

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65 See CASAC Consultation Paper, page 20.

Secondary issue 15

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

Ongoing funding

255. Ongoing funding could be provided by some combination of the following:

- interest on trust accounts held by financial services licensees (although this interest is retained by the licensee under the new Chapter 7 regime[66]);
- insurance;
- borrowings;
- levies (which would be in addition to the fees currently payable to ASIC and the levies due to APRA).

256. In the case of levies, further issues arise:

- the levy could be on transactions, on licensees according to their gross revenue from acting on behalf of retail clients or all clients, or be based on the number of employees and representatives providing financial services;
- should licensees be divided into classes, with different levies set depending on risk (including the level of prudential supervision)?
  - The problem is to match risk in the financial services provided by a particular licensee to the scheme on the one hand, and the rate of the levy on that licensee.
- should market licensees also be required to contribute, given that they would benefit from the scheme?
- if market licensees are no longer required to have compensation arrangements, then should the levy payable by market participants be paid instead from the relevant current market compensation fund?

257. Licensees could be levied as and when required, or on a more regular basis with the purpose of creating a reserve and minimising unexpected calls.

66 Corporations Regulations 7.8.02(7) and 7.8.05(3).

258. One submission to CASAC suggested that it may be appropriate to use some or all of the levies collected to purchase insurance rather than being invested by the Scheme operator. This would 'outsource' the funding of the Scheme and may obviate the need for the Scheme to build up sufficient funds to cover a 'one year in fifty claim' on the financial failure of a major intermediary or to unduly cap claims in a period of stress.

259. Note that the Government expects any such scheme to be totally industry-funded.

Secondary issue 16

If a statutory scheme were warranted, how should it be funded initially and in the longer run?

E: What should be its statutory powers?[67]

260. Should the operator have any prudential powers? The CASAC Consultation Paper discussed this possibility, and came to the conclusion that it was not appropriate.

261. Further, submissions to CASAC made the following points:

- the exchanges and clearing houses already have prudential powers and it is not necessary for the Scheme operator also to have these;
- ASIC already has relevant powers and in general has exercised them effectively. There is no need for a further layer of regulation on financial intermediaries.

262. There is also the question of the non-prudential powers of the scheme operator.

263. CASAC expressed the view that the scheme operator would need:

- sufficient powers to perform its duties — for example;
  - to ensure that intermediaries contributed to the scheme;
  - to invest any surplus;
  - to obtain information from relevant persons and/or enter into information sharing agreements with relevant regulators to gain access to sufficient information regarding any failed intermediary and its client accounts;
- qualified privilege and protection for breach of confidentiality;

67 See CASAC Consultation Paper, page 16.

- power to transfer client accounts of an insolvent intermediary to another intermediary and to close out open positions in derivatives contracts, 'though exercise of these powers should be co-ordinated with comparable powers of liquidators, financial market operators and regulators'.

264. While the first two dot points above appear unexceptional, the power in the third would need careful consideration before adoption. The current roles of clearing houses, external administrators and receivers need to be respected.

Secondary issue 17

If a statutory scheme were warranted, what would be the appropriate powers of the operator?

CHAPTER 10: OTHER ISSUES

The purpose of this Chapter is to address some of the many issues that may be considered subsidiary or consequential in the design of compensation arrangements. These include the treatment of APRA-regulated bodies, limitations on payments (capping) and the required connection with Australia.

These issues are not only of relevance to any broad statutory scheme.

A: Treatment of APRA-regulated bodies and those with high financial requirements

265. If standard compensation arrangements such as professional indemnity insurance are required, should all financial services licensees be required to have them?

266. Financial services licensees which are regulated by APRA would appear to be in a special position and it may be that the standard requirement for compensation arrangements are inappropriate.[68]

267. Should such licensees be allowed to 'self-insure' (that is, to set aside particular funds for the purpose), or make other arrangements approved by ASIC in place of professional indemnity insurance, if that is required? Should such bodies be exempt from any requirement for professional indemnity insurance or, indeed, any compensation arrangements? Are different approaches appropriate for different types of body regulated by APRA?

268. Should the following be treated the same way:

- other licensees which are subject to high financial requirements?
- licensees with high market capitalisation?
- licensees with the requisite connection with bodies which are APRA-regulated, have high financial requirements or high market capitalisation?

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68 It should be noted that, if this argument is accepted, in combination with section 14 of the Insurance (Agents and Brokers) Act/section 985B of the new Chapter 7 (which provides that payment to an insurance intermediary of a premium is a discharge of the insured's liability to the insurer) the area of conduct of insurance intermediaries under discussion in the context of compensation requirements will be limited.

269. We note that:

- no prudential regulator can guarantee that a body under its supervision will not fail;
- while APRA is concerned about the financial soundness of prudentially regulated bodies, those bodies can still, for example, fail to comply with new Chapter 7, to execute the orders of clients or to acknowledge that an officer has defrauded a client.

Secondary issue 18

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

B: Measure and nature of compensation

270. The appropriate measure and nature of compensation will depend on the grounds for claiming which the compensation arrangements provide.

271. Looking briefly at the possible grounds for claiming discussed in Chapter 5:

(i) Defalcation or fraudulent loss of funds and property entrusted to a financial services licensee

(ii) Loss of property (including funds) entrusted to the licensee without the need to prove fault

There are several possible approaches in this context:

- to restore the financial product or funds to the claimants—this is consistent with the notion that the purpose is to put the claimant in the same position as prior to the financial services licensee's wrongful conduct:
  - : if this approach is taken, then, if the loss is of financial products, the aim would be to restore those products;
  - : if the financial products are not available, then their value (as at the date of the wrongdoing) would be payable;
- an alternative approach would be always to pay the value of the proved claim, as at the date of the wrongdoing.

(iii) Failure to enter into and complete transactions according to instructions

The object in this case is to put the claimant in the same position as if the financial services licensee had executed and completed the transaction according to instructions.

- For example, in the case of securities, compensation would be in the form of the securities instructed to be purchased (if available), or the amount which the seller would have received if the sale instructed had in fact been executed, plus any immediately consequential loss (such as dividends).
- In the case of, for example, an insurance contract, the issue becomes more difficult:
  - : it would be inappropriate to empower the scheme operator to require an insurance company to issue a policy it no longer writes; further, the client may have suffered significant consequential loss (for example, if the house burned down uninsured).

(iv) All the obligations of the financial service provider under new Chapter 7

Where the obligation has a related liability provision in new Chapter 7,[69] then the measure of damages is likely to be indicated in that provision.

However, where the claim relates to a provision without a related liability provision, then the compensation requirements would need to provide instructions.

(v) All the actions you could have taken against the failed licensee in its capacity as a licensee

This puts the scheme operator in the invidious position of judging enormously complex situations and then deciding on the measure of damages in accordance with the usual rules in comparable court actions in tort and contract, under a relevant statute or the rules of an external dispute resolution scheme. This, however, is not a problem limited to this model.

272. In any case, the payment will be subject to any cap set — see paragraphs 279 to 281.

Consequential loss

273. There are several options in relation to paying claimants for consequential loss including:

- not paying consequential loss;

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69 For example, section 953B.

- In relation to claims for the return of client property (in the case of securities and units in managed investment schemes) or recognition of contractual rights (in the case of derivatives), the CASAC Consultation Paper suggests that recovery of consequential pecuniary loss is not appropriate,[70] on the basis that these losses might significantly increase the cost and assessment requirements of the scheme;

■ providing a discretion for the compensation administrator;

- as in the case of the provisions governing the National Guarantee Fund, which provide the SEGC (the scheme administrator) with a discretion to pay certain consequential loss in cases of unauthorised transfer.[71]

Accounting for profits

274. It is inappropriate for a compensation scheme to account to the client for profits made by the licensee from misuse of the clients' assets/property.

275. In trust law, seeking compensation with interest is an alternative to requiring the trustee to account for the profits (the first being based on disavowal of the trustee's conduct, while accounting for profits is based on adoption of the trustee's conduct). A claimant cannot seek both.

276. The claim for compensation of a person who has recovered from the wrongdoer on either ground should, to that extent, be reduced.

Interest, costs, contributory negligence

277. Interest should be payable on any cash compensation payable (excluding amounts attributable to the costs of making the claim) calculated from the date of entitlement to make the claim until the date of payment. The cost of pursuing the claim should also be recoverable.

278. Where appropriate, any contributory conduct of the claimant or the claimant's failure to mitigate the loss should be taken into account.

Secondary issue 19

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

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70 See CASAC Consultation Paper, page 11.
71 Corporations Regulation 7.5.58.

C: Should there be capping of payments?

279. This question has two limbs:

- where the scheme provides that any person (whether retail or wholesale) can claim against the fund;
  - in this case limiting payments (capping) will assist in any actuarial assessment of the amount required in the fund;
- where only retail persons can claim;
  - is it appropriate to cap payments? or should such payments be uncapped?

280. The CASAC Consultation Paper[72] suggested that caps would help keep costs within reasonable bounds and reduce investor expectations. It indicated that a cap, if sufficiently liberal, might ensure that most retail claimants recover all or a significant portion of the funds due to them.

281. Another question in this context is whether there should be a minimum threshold for claims. While this could reduce the number of small claims, CASAC pointed out that it could also discriminate against the retail investors who have very limited funds.

Secondary issue 20

(a) Should there be capping of the amounts paid in response to claims?

D: What form of capping is appropriate?

282. If the view is taken that capping should be imposed, then the following questions arise:[73]

- what is the appropriate cap?
  - one submission in response to the CASAC paper indicated that any caps should be sufficiently high to ensure that virtually all claims by retail clients can be met, given the increasing number of inexperienced retail clients with large lump sums of superannuation to invest, which may represent their life savings;

72 See CASAC Consultation Paper, pages 12-13.
73 See CASAC Consultation Paper, pages 13-14.

  - the UK model provides for payment of 100 per cent of the claim up to a certain amount, followed by declining percentages up to further specified limits;
    - an alternative is a fixed percentage of each allowable claim;
  - caps can be calculated per insolvent intermediary, as a percentage of the available compensation funds, on the amount which can be paid in a particular period or per client per event;[74]
- should it be the same for all grounds on which claims can be made? and for services in relation to all financial products?
- how should multiple accounts relating to the one family or group of companies be treated for capping purposes?
  - if a client transacts in the name of a spouse, family trust or controlled companies, should each be treated as a separate client for capping purposes?
  - the CASAC Consultation Paper suggests that treating each of these persons or entities as a separate client would give an advantage to those persons who transact in the greatest number of capacities;
  - one submission to CASAC opposed this on the basis that it is unrealistic to assume that one spouse is a mere nominee of the other or that children do not act independently of their parents.

Secondary issue 20

(b) If capping were accepted, what form of capping would be appropriate?

E: Subrogation[75]

283. Generally, claimants who accept compensation are required to assign, or are deemed to have assigned, their relevant rights against the licensee to the scheme operator. This is obviously appropriate, at least to the extent of the payment made by the scheme operator to the client.

284. Taking this one step further, a scheme may require subrogation of all rights against the licensee so that the scheme operator can take a class action for all the claims of affected retail persons (with any surplus (over administrative costs) being paid to the successful claimants).

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74 See CASAC Consultation Paper, pages 13-14.
75 See CASAC Consultation Paper, pages 14-15.

285. Clearly, retail claimants should not be financially disadvantaged by subrogating their rights in return for compensation, nor should the scheme profit from exercise of subrogation rights.

286. Subrogation implies it is a scheme of first resort. An alternative, which may be considered appropriate to a pre-insolvency situation, is to require the claimant to take all reasonable steps before claiming from the fund.

What will not be recovered through subrogation

287. There are, however, limitations on how much can be recovered through subrogation:

- where the grounds to be established to make a claim involve complex investigations and decisions for the scheme operator, there will be an increase in the administrative costs which will not be recovered through subrogation;
- there may be situations where it may not be worth pursuing an ex-licensee (for example, where it has assets of little value, and no valid professional indemnity insurance policy).

Actions which prejudice subrogation[76]

288. It is clearly undesirable to allow the possibility of compensation being required to be paid in relation to a claim where the retail client has already been paid out by another entity and the scheme operator's rights to subrogation have been prejudiced.

289. The solution adopted in relation to the National Guarantee Fund is to provide the SEGC, which administers the Fund, with a discretion to reduce the payment:

- where the claimant has received a benefit from a third party to whom they have assigned rights and remedies in relation to the loss; and
- to the extent that the claimant has, without the SEGC's consent, adversely affected the SEGC's rights of subrogation.[77]

290. The CASAC proposal gives a wider discretion to the scheme operator — any action by a claimant that prejudices the subrogation rights of the scheme against the intermediary should permit the scheme operator to reject or reduce the claim.

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76 See CASAC Consultation Paper, page 15.
77 Corporations Regulation 7.5.75(2).

F: Connection with Australia

291. What is the appropriate connection with Australia? Just how far should an Australian compensation scheme spread? The questions in this connection include the following:

- should clients or purchasers who are resident overseas have access to Australian compensation arrangements?
- what if the licensee has no place of business in Australia?

292. CASAC[78] proposed that its scheme apply to any retail client, wherever located, who had dealt directly with an Australian intermediary, wherever located, in relation to any investments on any Australian exchange or 'over the counter' market. The Committee considered that this would help to promote Australian financial markets to overseas retail investors, who would be protected in their dealings with Australian intermediaries through a compensation scheme that compares favourably with the more limited coverage of overseas schemes.

293. CASAC also considered there was an issue whether the nexus should extend to Australian intermediaries trading on an overseas exchange or 'over the counter' market.

294. One submission to CASAC agreed with the Consultation Paper that the scheme, if it could be extended to foreign clients of local intermediaries without imposing an excessive cost on those intermediaries, could enhance Australia's competitive position in global markets.

295. Another submission expressed the view that the necessary connection with the Australian market may depend on what protection key overseas compensation arrangements offer to Australian investors when they deal directly through an overseas intermediary, or via an Australian intermediary who then uses an overseas agent.

Secondary issue 21

What is the appropriate connection with Australia?

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78 See CASAC Consultation Paper, page 10.

G: Relationship with external dispute resolution schemes

Requirement for licensees to be members of external dispute resolution schemes

296. Subsection 912A(2) of the Corporations Act requires financial services licensees who deal with retail clients to have a 'dispute resolution system'. A dispute resolution system consists of:

- internal dispute resolution procedures; and
- membership of one or more external dispute resolution schemes that are approved by ASIC.

297. The Corporations Regulations set out the bases against which ASIC will approve external dispute resolution schemes.[79] ASIC has also released policy statements setting out how it will administer the external dispute resolution provisions.[80]

298. The existence of a requirement for each licensee to be a member of one or more external dispute resolution schemes is relevant to the context in which any compensation arrangements will operate.

Features of external dispute resolution schemes

299. Some features of the coverage of external dispute resolution schemes, which are relevant in this context, are:

- Monetary Limits
  - Different external dispute resolution schemes currently operate different monetary claims limits. These range, for example, from $250,000 for complaints about life insurance to $100,000 for complaints about investment advice. The existence of these limits means that the external dispute resolution schemes do not provide a mechanism for assisting retail clients with larger claims.
- The determinations
  - The basis of the determinations is wider than strict legal liability. Complaints are generally determined by reference to the law, good industry practice and fairness in all the circumstances.
  - A determination will often take the form of an order that a firm compensate a consumer for direct loss or damage caused by that licensee. Some schemes also

79 Corporations Regulations 7.6.02.
80 ASIC Policy Statements 139 and 165.

provide for a variety of other non-monetary determinations (depending on the circumstances of the complaint). For example, under the Insurance Brokers' Dispute Facility, an insurance broker may be directed to perform a specific service, implement rectification procedures or publish corrective advertising.

- Enforcement of decisions.
  - Members of external dispute resolution schemes are contractually bound to comply with a decision of that scheme, including an order that the firm pay an amount in compensation to a retail client. However, the leverage of the external dispute resolution scheme over the member firm will be reduced where that firm is prepared to surrender its licence, rather than meet a claim, or is no longer a member of the particular scheme.
- Solvency and insolvency
  - We see no, or very little, role for external dispute resolution schemes once a licensee has become insolvent.
  - Intermediaries typically rely on professional indemnity insurance that is 'endorsed' to meet external dispute resolution monetary awards made against them depending on the amount awarded and the amount of the excess. In the absence of effective 'run-off' cover, the payment of compensation to a complainant where the licensee has later become insolvent is not guaranteed.
- Other jurisdictional limitations
  - In practice all of the external dispute resolution schemes have limits on the types of complaints they deal with.

300. External dispute resolution schemes generally have a discretion about whether to deal with a particular complaint under their Rules and broadly expressed powers to consider complaints about member licensees. However, a complaint that involves an allegation of fraud, for example, may be declined by a scheme if it determines that testing of the evidence and/or cross-examination of the parties is necessary to reach a decision, and that the matter should more appropriately be dealt with in a court.

Roles of external dispute resolution schemes and compensation arrangements

301. This leads to consideration of the respective roles of external dispute resolution schemes and compensation arrangements. In our view, the primary purpose of compensation arrangements is to ensure there are assets to meet proved claims (that meet the criteria). The primary purpose of external dispute resolution schemes is to determine disputes between licensees and clients where the scheme criteria are met. Such schemes cannot provide certainty that the licensee will pay an amount awarded in circumstances

where the licensee is prepared to surrender its licence or otherwise becomes insolvent. This means that, in their primary roles, there is no capacity for conflict between external dispute resolution schemes and compensation arrangements.

302. It is only in considering access to compensation that you may see the possibility of conflict, duplication or choice. Ways of accessing compensation arrangements will depend on the nature of those arrangements and their coverage. It may be via a court judgment, an external dispute resolution determination or a direct approach to the compensation scheme operator. Following a winding up order, there will not be the same choice of access routes, as explained in paragraph 53.

303. The relationship between external dispute resolution schemes and compensation arrangements thus raises the following issues:

- What is the appropriate relationship between such schemes and arrangements?
- Should clients be required to use an external dispute resolution scheme (if available) before claiming against a compensation fund where the financial services licensee is solvent?
- Should compensation arrangements be required to cover all external dispute resolution determinations that are not complied with (for example, because of incapacity to pay)?
  - Your answer to this should be considered in the context of Principal Issue 4.
  - Could this lead to inequitable outcomes, given the different coverage of the various schemes?

Secondary issue 22

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

H: Excess funds

304. Prior to the commencement of the Financial Services Reform Act, Chapter 7 made provision for excess funds in the National Guarantee Fund to be used for 'securities industry development' purposes.[81] The new Chapter 7 makes provision for excess funds in the

81 Division 5 of Part 7.10.

National Guarantee Fund and other fidelity funds to be used for 'financial services industry development' purposes.[82]

305. If a new compensation regime involved compensation funds (whether held by markets or others), then should provisions allowing for excess payments to be made for financial services education and other appropriate development purposes be retained?

306. The CASAC Consultation Paper[83] suggested that levies should be reduced or suspended to avoid this situation and that the operator should be entitled to invest excess funds. However, it concluded that 'To use the excess funds for any other purpose would only be justifiable if it directly or indirectly promoted the investor protection goals of the Scheme.'

307. One submission to CASAC supported the proposal that the Scheme operator should be entitled to invest excess funds to increase the revenue available to the Scheme (though it also considered that excess funds should be able to be used for educational purposes).

Secondary issue 23

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

I: Should there be time limits for claiming?

308. Should there be a limit on the time within which one could claim? If so, what should it be and when should it commence?

309. The CASAC Consultation Paper[84] suggests three months from notification to 'all remaining retail clients'; but in the case of formal liquidation, CASAC suggests that claims made to the liquidator and passed on to the scheme operator would be subject to time limits on creditors making claims in a liquidation.

310. This assumes an ability to identify all clients. In the absence of this capacity (for example, through poor records), the time limit would need to provide for publication of notices in newspapers and sufficient time to prepare and lodge claims after this.

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82 Section 892G and Corporations Regulations 7.5.86-92.
83 See CASAC Consultation Paper, page 19.
84 See CASAC Consultation Paper, page 14.

Secondary issue 24

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

J: Level of detail in the legislation

311. In designing any mandatory compensation arrangements, regardless of the mechanism chosen, there is a question about the level of detail to be included in the relevant legislation and the extent to which the detail should be left to be resolved by other means. Those means include being prescribed in regulations, set by ASIC or left for the scheme operator to decide in, for example, disallowable instruments or rules requiring approval.

312. The current solution reflected in section 912B is to set the general requirement in the legislation but to require that the arrangements must satisfy any regulations in place or be approved in writing by ASIC. The factors that ASIC must have regard to are also specified. They include the financial services being provided and 'run-off' cover.

313. Similarly, the obligation on those market licensees which are not covered by the National Guarantee Fund to have compensation arrangements sets out the issues to be addressed but leaves the detail to be set by market rules (which need to be approved as part of the compensation arrangements).[85]

Secondary issue 25

What is the appropriate level of detail in the legislation?

85 Section 885B.

Chapter 11: Options

The purpose of this Chapter is to provide some high-level options for consideration.

When public reaction to the issues raised in the preceding Chapters of this paper has been assessed, more detailed options can be prepared.

Option A

- No compensation arrangements required

314. This option involves no additional obligations or costs on industry and no regulatory costs in enforcing them. It would allow for self-regulation or industry codes, and the use of compensation arrangements by particular financial services licensees, market licensees or segments of the industry as a marketing tool. It involves dismantling the National Guarantee Funds and exchange fidelity funds.

315. However, particularly in the light of the current compensation arrangements, it may not be acceptable to the Government and the public.

Option B

- Financial service providers be required to have, for example, professional indemnity insurance
- No obligation on market operators
- No statutory scheme

316. This option is simple and brings home the responsibility to financial services licensees. It leaves market licensees to decide whether they wish to provide compensation arrangements and does not require the establishment and maintenance of a new statutory scheme.

317. However, its disadvantages include:

- any difficulties being experienced in obtaining the necessary insurance;
- any difficulties clients have in pursuing their claims;

- any absences of expected cover when claims are made, particularly on insolvency; and
- any reduction in cover for clients of market participants following the dismantling of the National Guarantee Fund and the exchange fidelity funds.

Option C

- Obligation on financial service providers to have, for example, professional indemnity insurance
- Statutory scheme
- No obligation on market operators

318. This option would potentially provide for a harmonised scheme across the financial services sector and impose responsibility on financial services licensees. It avoids any problems involved in multiple market operators having multiple schemes. However, it involves establishing and funding a statutory scheme, and deciding the future of the National Guarantee Fund.

319. The relationship between the two layers of this option would work much as the current arrangements do — that is, having paid the claim, the scheme operator is subrogated to the rights of the claimant and is likely to claim from the licensee which is backed by professional indemnity insurance.

Option D

- Market operators to have compensation arrangements
- Financial service providers to have, for example, professional indemnity insurance
- No broad statutory scheme

320. This option encompasses both the 'do-nothing' approach, and various degrees of reforming the current requirements. It requires no structural change as it does not require the establishment and maintenance of a statutory scheme. Instead it allows for refining the current arrangements. A variation of this option would be to provide a consolidated market compensation scheme.

321. The relationship between the two mechanisms included in this option would work much as the current arrangements do. (Currently the exchanges require that participating organisations have professional indemnity insurance.) The division of responsibility between market licensees (and the question of market responsibility for a particular transaction) could be based on rules regarding linkage of the transaction with the particular market (as Part 7.5 attempts).

Option E

- Market operators to have compensation arrangements or a consolidated market compensation scheme
- Financial service providers to have, for example, professional indemnity insurance
- Broad statutory scheme

322. This option involves a multiplicity of avenues for the consumer. It would necessitate the careful division of responsibility between the market schemes and the broad statutory scheme — for example:

- all financial services (or securities) business of stockbrokers could be covered by the market scheme and not covered by the broad scheme;
- alternatively, the obligation on market licensees could be limited to providing compensation arrangements for wholesale clients.

323. The result is that it may involve different results for the consumer depending on whether the transaction is market-related or not. The professional indemnity insurance would be accessible by all relevant scheme operators.

Option F

- Market operators be required to have compensation arrangements or a consolidated market compensation scheme
- No obligation on financial service providers
- No broad statutory scheme

324. Adoption of this option would not prevent market operators or industry associations requiring professional indemnity insurance.

325. It would, however, provide no cover in relation to conduct unrelated to formal markets. It does not impose responsibility on the financial services licensee. Market operators would not welcome it and it involves the existing distinctions between market-related and other transactions (and possibly between the ASX and other markets).

Option G

- Statutory scheme
- No obligations on market operators

- No obligation on financial service providers

326. This option is simple but it involves establishing and maintaining a statutory scheme. In addition, it is not clear that it imposes suitable responsibility on the financial services licensees or that it should be considered in the absence of evidence regarding the availability, cost and adequacy of professional indemnity insurance and other mechanisms which may be required for financial services licensees.

Option H

- No obligation on financial service providers
- Market operator to have compensation arrangements or a consolidated market compensation scheme
- Statutory scheme

327. Again, it is not clear that this brings home responsibility to individual licensees appropriately. Further, problems regarding which transaction falls within which scheme and differences between current market schemes would need to be addressed.

CHAPTER 12: CONCLUSION

328. This paper has been written to promote discussion of the many issues surrounding the subject of compensation for loss in the financial services sector. The purpose is to initiate discussion of such issues as the justification for compensation arrangements, their purpose and on whom responsibility should be imposed for making them. Even where this paper indicates a tentative conclusion, you should feel free to challenge it.

329. Market licensees and, to varying extents, financial service providers have been required to have compensation arrangements before the Financial Services Reform Act applied to them. That Act made only modest reforms to the requirements applying to market licensees. However, it also introduced a general requirement that financial services licensees who provide financial services to retail clients have arrangements for compensating persons for loss or damage suffered because of breaches of the relevant obligations under Chapter 7. The purpose of this review is to re-examine these requirements. As is indicated, this involves a multitude of issues on which your contribution is sought.

330. Any broad statutory scheme would be a major change for Australia and needs careful consideration — Is it warranted? If so, how should it be structured and funded, and what claims would it cover? Is there a justification for a statutory scheme limited to market transactions or market participants? What obligations to make compensation arrangements should be imposed on financial services licensees and how do they relate to any market or broad statutory scheme?

331. The financial services industry is still adjusting to the Financial Services Reform regime, which commenced on 11 March 2002. Adjustment will continue over the next two years while financial service providers transition from their current regulatory regimes into the Financial Services Reform regime. Further changes and any further regulatory burdens must be justified, their impact on business large and small considered, and the wide range of services and products covered by the new regime carefully assessed.

332. Our hope is that participants in the industry will bring to the debate of the significant issues raised in this paper their individual experience and knowledge, while taking account of the wider context. There is a need for a balanced approach amongst the competing priorities in this exercise. Both the costs and benefits of any proposed scheme need to be taken into account, as do the range of financial services that can be subject to compensation arrangements, and the incentives on the financial service provider to behave and on consumers to make whatever checks they can.

333. 'Consumer protection' cannot be considered in isolation. As indicated in subsection 1(1) of the *Australian Securities and Investments Commission Act 2001*, one of the aims of ASIC is to promote the confident and informed participation of investors and

consumers in the financial system, while at the same time paying due regard to costs, efficiency and the development of the economy. That sentiment applies equally in relation to this review.

ATTACHMENT A: OUTLINE OF FINANCIAL SERVICES LICENSING REGIME

A: Licensing of financial service providers

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.

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.

A number of criteria will have to be satisfied in order to obtain an Australian financial services licence including:

- adequate financial resources for the performance of the proposed activities;
- competence, skills and experience to provide the relevant services; and
- adequate systems for training and supervision of representatives.[86]

Licences are also subject to licence conditions, imposed by the regulations or by ASIC.

A licence is required where services are provided to either wholesale or retail clients. Additional obligations are placed on licensees who offer services to retail clients. These include having in place adequate arrangements for compensating clients for losses suffered.

Licences may cover all financial services in relation to all financial products or a subset of services and products.

Licensees may authorise natural persons or corporate representatives to act on their behalf.

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86 Under the Financial Services Reform transitional provisions, entities providing financial services before the regime commenced on 11 March 2002 will have up to two years to obtain an Australian financial services licence covering the provision of those services. Under the transitional provisions, licensees under the previous Chapters 7 and 8 and registered insurance brokers are entitled to be granted an Australian financial services licence, and ASIC must grant them a licence. When considering applications for an Australian financial services licence from other entities, such as new entrants after 11 March 2002 or bodies regulated by APRA, ASIC must consider the application against the statutory criteria.

Authorised representatives are able to act for more than one licensee with the written consent of each licensee (cross-endorsement).

B: Financial service provider conduct and disclosure

Minimum standards of conduct apply 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 requirements.

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

ATTACHMENT B: CURRENT COMPENSATION MECHANISMS IN THE FINANCIAL SERVICES SECTOR IN AUSTRALIA

This attachment provides a summary of the Australian requirements for financial markets and financial service providers to have compensation arrangements, both before and after application of the Financial Services Reform regime.

A: Requirements imposed on exchanges/financial markets

(i) Before the *Financial Services Reform Act 2001*

(a) The Australian Stock Exchange Limited and the National Guarantee Fund

The National Guarantee Fund, established in 1987,[87] provides a clearing guarantee[88] and investor protection in relation to transactions on the Australian Stock Exchange (ASX). Its origins are summarised in Attachment C.

The situations in which clients of a stockbroker may claim on the National Guarantee Fund are:[89]

- where the broker has failed to complete a sale or purchase of securities entered into on the ASX's equities and debt market or where those transactions are required to be reported to the ASX by the stockbroker ('contract guarantee');
- an unauthorised transfer of securities;
- contravention by a stockbroker of the certificate cancellation provisions (which relate to the ASX's uncertificated securities system);
- where a person has entrusted property to a stockbroker who subsequently becomes insolvent and therefore cannot meet its obligations to that person.

Only the head of claim relating to insolvency involves a 'cap'. It is 14 per cent of the minimum amount of the National Guarantee Fund — that is, $11.2 million. In relation to any of the other grounds for claiming, there is no limit on the payment, if the head of claim is satisfied.

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87 By the *Australian Stock Exchange and National Guarantee Fund Act 1987*.
88 This aspect of its functions is outside the scope of this paper.
89 Subdivisions 4.3, 4.7, 4.8 and 4.9 of Part 7.5 of the Corporations Regulations.

There is no requirement that the claimant be 'retail'. All who satisfy the requirements are equally entitled to claim.

The National Guarantee Fund holds about $160 million and is administered by the Securities Exchanges Guarantee Corporation Limited, a subsidiary of the ASX. The basis of the fund was a proportion of the fidelity funds previously held by the capital city exchanges. To this has been added interest from broker accounts and investment income. While the power exists, no levies have been imposed to support the Fund. Payments have been made from the Fund for claims, administration and securities industry development purposes.

The relevant provisions were Part 7.10 of the *Corporations Act 2001*.

(b) Other stock exchanges, and futures exchanges

Other stock exchanges (in practice, Newcastle and Bendigo), and futures exchanges are required to have a fidelity fund.[90] Such a fund, on which clients of stock/futures brokers may claim, is required to cover only defalcation[91] and fraud of money and other property held in connection with the broker's business of dealing in securities/futures contracts. In addition, there is a discretion to pay an official receiver or trustee in bankruptcy/liquidator in cases of insolvency.

Claims are capped at $500,000 per broker. These schemes extend to brokers that have ceased to participate on the relevant exchange.

They do not, however, provide any guarantee that losses of clients following insolvency, when the risk to the client is most acute, will be covered.

The relevant provisions were Parts 7.9 and 8.6 of the *Corporations Act 2001*.

The grounds for claiming against the National Guarantee Fund have differed from those required under this heading since its establishment in 1987. At the time of its introduction, attention was drawn to the Fund's benefits as a 'no fault' scheme, over certain other professional schemes. This means that it is easier for the claimant to gain access to it because they do not have to prove, for example, fraud.

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90 See 'Abbreviations and terms used' above.

91 'Defalcation' is not defined in the legislation. However, Gibbs CJ, Wilson and Dawson JJ indicated in Daly v Sydney Stock Exchange Ltd (1986) 160 CLR 371 that 'defalcation' in the comparable provision in the *Securities Industry Act 1975* (NSW) was not limited to dishonest dealings. A person who had suffered loss as a result of a failure to account for funds entrusted to a firm as trustee should be able to recover from the fund even if the failure was due, eg to negligence, rather than dishonesty.

(ii) After the *Financial Services Reform Act 2001*

(a) The Australian Stock Exchange Limited and the National Guarantee Fund

The function of the National Guarantee Fund, and the grounds for claiming against it, remain, with few changes in the short term.

However, the Financial Services Reform Act[92] empowers the Minister to direct the payment out of the fund the element referable to clearing guarantee (leaving the Fund with only its 'investor protection' functions).

To facilitate any future changes in ASX procedure, the grounds for claiming have been moved into the Corporations Regulations.[93]

The relevant provisions are Division 4 of Part 7.5 of the amended Corporations Act, and Division 4 of Part 7.5 of the Corporations Regulations.

(b) Other financial markets

A number of changes were made to the requirements for compensation arrangements for financial markets other than the ASX on which the trades of retail clients are executed.[94] The new provisions:

- require coverage only for retail clients (whereas the previous provisions did not distinguish between wholesale and retail clients);
- tie the loss to a transaction on the market, not to the firm's business of dealing in securities or futures contracts (as the previous provisions did);
- do not require a fidelity fund, instead anticipating that a range of mechanisms would be acceptable, and it is up to the market operator as to how these are funded.

However, the new arrangements still only require coverage for loss arising from fraud or defalcation (although greater coverage can be provided at the discretion of the market operator).

'Run-off' provision is still required and caps are anticipated. In addition, the provisions give greater flexibility to the market operator to design the scheme that then must be approved by the Minister.

Market licensees other than the ASX remain subject to the compensation requirements that applied prior to the commencement of the Financial Services Reform Act. They will be

92 Section 891A.
93 See Part 7.5 of the Corporations Regulations, especially Division 4.
94 Division 3 of Part 7.5.

subject to the compensation requirements in the new Chapter 7 when their transition period ends.

The new Chapter 7 also includes a power to exempt a person or class of persons, or market or class of financial market from the compensation requirements or to modify them in their application to a particular person or class.[95] It was anticipated that this power may be used where:

- a particular market was nearing the end of its transition period (and hence obliged to change its compensation arrangements to fit the new Chapter 7); and
- meanwhile the Government had announced it would, following the review, implement an inconsistent compensation regime.

The compensation requirements for market licensees which are described above relate only to risk associated with the conduct of brokers, not any risk arising from the market licensee's conduct or that of any of its employees in conducting that market. There is no separate requirement for compensation arrangements to be made by clearing and settlement facilities.

B: Requirements imposed on financial services providers

(i) Requirements before the *Financial Services Reform Act 2001*

As indicated above, the Financial Services Reform Act provides for a harmonised licensing regime for financial services providers who were previously regulated under a series of Commonwealth Acts, each with their own requirements.

The following points summarise the compensation arrangements and financial requirements applying to some individual segments of the industry before they transition into the Financial Services Reform licensing regime.

- **Securities dealers and advisers** :
  - are required under the Corporations Act[96] to provide a security bond of $20,000 to ASIC;
    - : this is used to compensate persons (whether retail or wholesale) who have suffered 'pecuniary loss due to the failure of the licensee, or an agent or employee of the licensee, to carry on business under the licence adequately and properly';[97]

95 See section 893A.
96 See paragraph 786(2)(d) and Corporations Regulation 7.3.03.
97 Corporations Regulation 7.3.04, prior to the Financial Services Reform amendments.

- in addition, ASIC imposes financial conditions, including net tangible assets and surplus liquid fund requirements.

The requirements imposed by the Australian Stock Exchange on its participants are also relevant.

- responsible entities of **registered schemes**:
  - ASIC Policy Statement 131 *Managed Investments: Financial Requirements* requires, as a licensing condition, that responsible entities maintain appropriate professional indemnity insurance and insurance against fraud. This should cover claims up to, in aggregate $5 million, or the value of scheme assets, whichever is less, unless it is demonstrated to ASIC that such insurance is not reasonably obtainable. This Policy Statement also requires certain levels of net tangible assets.
- operators of **investor directed portfolio services**:
  - ASIC Policy Statement 148 *Investor Directed Portfolio Services* requires persons operating Investor Directed Portfolio Services to maintain appropriate professional indemnity insurance and insurance against fraud of officers and agents. It also requires certain levels of net tangible assets — when acting as the custodian of assets, the operator must have net tangible assets of at least $5m.
- Under the Insurance (Agents and Brokers) Act,[98] **insurance brokers** are required to have 'acceptable' professional indemnity insurance.
  - To be acceptable, the contract must:
    - : be accepted by ASIC;
    - : cover liabilities incurred as a result of a breach of professional duty by the broker in the course of carrying on business as an insurance intermediary up to an amount specified in the regulations;
    - : include a local jurisdiction clause.[99]
  - The amount of any excess is limited and the insurer is prevented from avoiding the contract or reducing liability under it on the ground of non-disclosure by the broker.
  - It is an offence for the insurer to cancel the policy without giving ASIC three days written notice including the reason.

Bodies regulated by APRA have been subject to capital and solvency requirements:

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98 See section 9B and the Regulations.
99 We understand that the requirement for 'run-off cover' in effect never commenced.

- in the case of **authorised deposit-taking institutions**:
  - APRA sets stringent capital adequacy requirements under the *Banking Act 1959*;
  - its prudential standards also address, among other things, liquidity, credit quality and large exposures.
- in the case of **insurance companies**:
  - the general insurance industry has been governed by the *Insurance Act 1973* which includes a capital requirement and prescribes a solvency margin;
  - new prudential standards issued by APRA relate to minimum capital requirements and a Liability Valuation Standard;
  - a regime that is similar in structure applies to life insurers.

(ii) Requirements after the *Financial Services Reform Act 2001*

The purpose of this section of the paper is to summarise the requirement on financial services licensees (those who have transitioned into the new Chapter 7 regime) to have compensation arrangements (section 912B), relevant transitional arrangements and ASIC Policy Statements.

The new regime for licensing financial service providers is described briefly in **Attachment A**.

Section 912B — compensation arrangements

A financial services licensee that provides financial services to retail clients must have arrangements for compensating those persons for loss or damage suffered because of breaches of the obligations imposed by new Chapter 7 on the licensee and its representatives (section 912B). The arrangements must be in accordance with the regulations or be approved in writing by ASIC.

Thus a wider range of financial service providers are required to have compensation arrangements than were required to do so prior to the Financial Services Reform Act — for example, insurance companies.

Section 912B is discussed further in Chapter 6 of this paper.

The new Chapter 7 of the Corporations Act also imposes a separate requirement on financial services licensees and product issuers, who provide services to retail clients, to be a member of one or more external dispute resolution schemes approved by ASIC.[100]

Transitional arrangements

The transitional regulations provide that section 912B does not apply in relation to a financial services licensee for the period of 2 years commencing on 11 March 2002[101] (the commencement of the Financial Services Reform Act).

However, the requirements under the Insurance (Agents and Brokers) Act for persons carrying on business as an insurance broker, or as a foreign insurance agent, to have acceptable professional indemnity insurance will continue to apply during the two year transitional period to:

- persons who remain under the Insurance (Agents and Brokers) Act; and
- those who hold Australian financial services licences authorising them to carry on such an insurance business.[102]

Similarly, securities dealers while they remain regulated under Part 7.3 of the previous Chapter 7, will continue to be required to have a security bond with ASIC.

In accordance with Corporations Regulation 10.2.45, ASIC has indicated[103] that it will continue, during the transitional period, to impose the 'approved security requirements' to those which would have been required to be licensed under Part 7.3 of the previous Chapter 7 and provide financial services to retail clients.

ASIC 'Pro Forma 209': Australian Financial Services Licence Conditions

ASIC has indicated in 'Pro Forma 209' that a condition relating to 'Professional Indemnity Compensation Requirements' may be imposed on financial services licensees. It will be imposed having regard to the transitional arrangements for compensation, depending on the role the licensee plays in providing financial services or in individual circumstances where ASIC requires the licensee to have professional indemnity arrangements in place.

The two scenarios included in 'Pro Forma 209' which are given to provide guidance on the type of conditions that will be imposed are:

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100 Subsections 912A(1)(g) and (2)(b), and subsections 1017G(1) and (2)(b).
101 See Corporations Regulation 10.2.44(1).
102 See Corporations Regulation 10.2.44(2).
103 ASIC Policy Statement 167.39.

(a) Where the licensee is authorised to operate a registered managed investment scheme in the capacity of a Responsible Entity and/or operate an Investor Directed Portfolio Service as an operator of such service, the following conditions will be imposed:

The licensee must maintain an insurance policy covering professional indemnity and fraud by officers that:

- is adequate having regard to the nature of the activities carried out by the licensee under the licence; and
- covers claims amounting in aggregate to whichever is the lesser of:
  - $5 million; or
  - the sum of the value of all scheme property of all Investor Directed Portfolio Services for which it is the operator and registered schemes for which it is the responsible entity.

(b) Where the licensee is required to have professional indemnity requirements in place as a result of individual circumstances, the following condition may be imposed:

The licensee must where so required by the ASIC in writing, maintain a policy of professional indemnity insurance which conforms with the specifications set out in that notice.

ASIC Policy Statement 166 — Licensing: Financial requirements

ASIC Policy Statement 166 applies to holders of Australian financial services licences other than those which are regulated by APRA. It indicates various financial requirements, depending on the particular class of licensee.[104] ASIC is not a prudential regulator and takes the view that this policy statement is not intended to ensure that a licensee will meet its financial commitments (including to clients and market counterparties).

The purpose of these requirements is not to provide compensation. ASIC states that it imposes the financial requirements to help ensure that:

- the licensee has sufficient financial resources to conduct its financial services business in compliance with the Corporations Act;
- there is a financial buffer that decreases the risk of a disorderly or non-compliant wind-up if the business fails; and

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104 Thus:
- responsible entities of registered schemes, Investor Directed Portfolio Services operators and custodial or depository service providers will be required to have net tangible assets of up to $5 million;
- market makers and underwriters will be required to have $50,000 to $100 million;
- foreign exchange dealers will be required to have $10 million 'tier one capital'.

- there are incentives for the owners of the business to comply through risk of financial loss.

ATTACHMENT C: THE ORIGINS OF THE NATIONAL GUARANTEE FUND

The National Guarantee Fund, formed in 1987, is the successor to the separate fidelity funds of the State stock exchanges. The aim of this attachment is to provide a brief summary of its ancestry.[105]

Sydney Stock Exchange

After three large failures of Stock Exchange members, the New South Wales Legislative Assembly in December 1936 pressed the then Premier to investigate the establishment of a government-supervised fund to reimburse clients of failed brokers.

However, the then Chairman of the Sydney Stock Exchange, Mr E.G. Blackmore grasped the public sentiment and determined that the Exchange must establish its own guarantee fund without delay thereby maintaining the right to regulate itself. Members expressed their approval of the guarantee fund at a general meeting in May 1937.

The fidelity fund was brought under government regulation by the *Securities Industry Act 1970*. The relevant provisions were carried over into the *Securities Industry Act 1975* (see below).

Melbourne Stock Exchange

Following the unexpected collapse of a broking firm in June 1937, the then Chairman of the Melbourne Stock Exchange seriously considered setting up a fidelity fund. There was also pressure on the Victorian Government to introduce legislation that would require the stock exchange to establish a fidelity fund. Eventually the Melbourne Stock Exchange and the Victorian Government rejected the need for a fidelity fund and addressed the issue by introducing accounting reforms which required brokers to set up client trust accounts that were overseen by government regulators.

The Melbourne Stock Exchange established its fidelity fund after the Victorian Government introduced the Securities Industries Act in 1970 which required the stock exchange to

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105 This summary draws on *The Bull, the Bear and the Kangaroo The History of the Sydney Stock Exchange*, by Stephen Salsbury and Kay Sweeney, Allen & Unwin, Sydney, 1988; *A Century of Change the First Hundred Years of the Stock Exchange of Melbourne* by Graeme Adamson, Currey O'Neil, Melbourne, 1984; *The Brisbane Stock Exchange 1884-1984* by AL Lougheed, Brisbane Stock Exchange, Brisbane, 1984 and *Miners and Millionaires The first One Hundred Years of the People, Markets and Companies of the Stock Exchange in Perth, 1889-1989* by Graeme Adamson, Australian Stock Exchange (Perth) Limited, Perth, 1989.

establish a fidelity fund to compensate for losses from any defalcation committed by an Exchange member or his employee.

(The Perth Stock Exchange established its fidelity fund in 1968 during the nickel boom; while the Brisbane Stock Exchange established its fidelity fund in 1971.)

The *Securities Industry Act 1975*

The States that were parties to the Interstate Corporate Affairs Agreement enacted the *Securities Industry Act 1975* (the 1975 Act) which required each stock exchange to establish a fidelity fund. In the case of exchanges that did not have a fund established under the 1970 Act, an amount of $100,000 was required.

The 1975 Act required that:

- a person could only be admitted as a member of a stock exchange if he had made a contribution to the fidelity fund of the stock exchange of not less than $500;
- the fidelity fund of a stock exchange be applied to compensate persons who suffered pecuniary loss by reason of a defalcation, or fraudulent misuse of money, securities or of other property by a member of the exchange (or its employees) where that property had been received in connection with the firm's business of dealing in securities.

In addition, the fidelity fund of a stock exchange could be applied to pay an official receiver or a trustee the amount required to make up or reduce the total deficiency arising because the available assets of a bankrupt member were insufficient to satisfy the debts arising from dealings in securities that have been proved in the bankruptcy. The 1975 Act limited payments out of the exchange's fidelity fund at $500,000 per member (for each type of claim). However, the exchanges had the power to increase this amount by a notice published in the Gazette.

The Act also provided that the stock exchange could impose a levy on each contributor if the fidelity fund became insufficient.

These provisions were largely replicated in the subsequent *Securities Industry Act 1980* (which applied in all States and Territories by virtue of the Co-operative Scheme which existed through the 1980s). They are the ancestors of the provisions in Parts 7.9 and 8.6 of the *Corporations Act 1989*, and the *Corporations Act 2001* prior to the commencement of the Financial Services Reform Act.

National Guarantee Fund — establishment

The National Guarantee Fund was established in 1987 by the *Australian Stock Exchange and National Guarantee Fund Act 1987*, which amended the *Securities Industry Act 1980*.

The 1987 Act provided legislative support:

- for a reorganisation of the stock exchanges in Australia to establish a single national stock exchange; and
- to create a national guarantee fund consisting of a portion of the pooled assets of the existing fidelity funds operated by the separate capital city exchanges;
  - the remainder was used to acquire the assets of the state stock exchanges and to finance innovations including the move to screen trading.

The Hon Lionel Bowen MP, in the second reading speech on 18 February 1987, stated:

> 'The 1986 Australian Shareownership survey conducted by the [Australian Associated Stock Exchanges] indicated that almost 90 per cent of adult Australians do not own shares. One of the major reasons given by those surveyed was that they preferred safer, less risky, investments. The contract guarantee and insolvency protection afforded by the National Guarantee Fund may serve to alleviate some of these concerns. The no-fault contract guarantees will ensure that where a party to a securities transaction does not complete his obligations, those obligations will be met by the National Guarantee Fund. This no fault system of contract guarantees contrasts with claims against existing fidelity funds under the provisions of Part IX of the *Securities Industry Act 1980* where defalcation or fraudulent misuse of property is required to establish a claim. Direct access to the National Guarantee Fund for compensation in respect of a dealer insolvency also contrasts with existing fidelity fund provisions which allow for compensation via formal Bankruptcy Act mechanisms.'[106]

National Guarantee Fund — operation

The initial grounds for claiming against the National Guarantee Fund provided a 'contract guarantee' relating to reportable transactions and for loss where a broker became insolvent and therefore could not meet its obligations in respect of property entrusted to it in connection with its securities business. Additional grounds were subsequently included. The current grounds for claiming and other aspects of its operations are summarised in **Attachment B**.

106 Hansard, House of Representatives, 18 February 1987, page 269.

Attachment D: Comparison of international compensation schemes

	UK	Canada	USA	Australia
Name	The Financial Services Compensation Scheme Ltd, which is accountable to the Financial Services Authority, replaced 8 existing schemes in December 2001.	Canadian Investor Protection Fund — a trust established by the Bourse de Montreal, the Toronto Stock Exchange, the Canadian Venture Exchange and the Investment Dealers Assn of Canada in 1969.	Securities Investor Protection Corporation (SIPC) established by the Securities Investor Protection Act 1970. (There is no requirement for compensation schemes in futures markets but some have funds.)	The Corporations Act provides for 1. National Guarantee Fund (NGF) — the ASX 2. Other exchanges to have compensation arrangements, for example, fidelity funds.
Transactions covered	Investments — that is, stocks and shares, unit trusts, futures and options, personal pension plans and long-term policies. (Other subschemes address deposit-taking and insurance.)	Covers losses of stocks, mutual funds, options, futures bonds, treasury bills, cash balances and certain other property in connection with securities or futures business.	Generally, broker-dealers registered with the SEC must be members of the scheme.	Depending on the head of claim, exchange-related or property held in connection with the member's securities/futures business.
Claimants	Retail and small business.	Not restricted to retail customers.	Retail and wholesale.	Retail and wholesale.
Losses covered	Return of investments and money, and loss arising from bad investment advice or poor investment management but only where the authorised firm is unable to meet claims.	Only losses arising from insolvency of a scheme member.	Provides for return of securities or cash lodged with a member firm on insolvency.	NGF: contract guarantee; unauthorised transfer; certificate cancellation; insolvency. Other: defalcation or fraud.
Cap; fund size	Cap: In investment business, 100 per cent of the first £30,000 is paid and 90 per cent of the next £20,000 to a cap of £48,000. Fund size: there is no reserve fund.	Cap: Maximum claim of C$1m (reduced to the extent that any deposit insurance entitlements are available). Fund size: C$190 million (2001).	Cap: $500,000 per customer, but cash claims are limited to $100,000. Fund size: over US$1.18 billion (2001).	NGF cap: the only limit is 14 per cent of the minimum fund size per insolvency. NGF Fund size: A$160 million Other cap: $500,000 per participant SFE Fidelity Funds: A$18.5 million (2001).

	UK	Canada	USA	Australia
Source of funds	Compulsory levies on the relevant group of authorised firms on a 'pay as you go' basis.	Assessment of members (on gross revenue and capital deficiencies), interest earned and lines of credit with 2 major Canadian banks.	Member assessments and income from investments in government bonds, bank lines of credit and, if necessary, a loan through the SEC.	NGF: state exchange fidelity funds, plus earnings; provision for levies and borrowing. Other: member contributions, provision for levies.
Claims experience	£44.9 million was paid to investors in 2001-02 (largely in relation to pension review cases).	Defined losses covered by the Fund over 33 years have been C$36 million.	Over 31 years, 433,000 claimants paid using available assets of failed brokerage firms of over US$13.6 billion, and US$370 million from the Fund.	NGF: 5,554 claims ($21.37 million paid and $13.37 million recovered) since 1988, mainly in 1988-91. Since 1993, one insolvency but more unauthorised transfer claims. SFE: 3 claims.

	Hong Kong	Singapore	Ireland	European Community Directive 97/9/EC
Name	Investor Compensation Fund, administered by the Securities and Futures Commission, is replacing 3 previous schemes. (The material below is taken from consultation papers.)	Part XI of the Securities and Futures Act 2001 requires each securities exchange and each futures exchange to establish, keep and administer a fidelity fund.	Investor Compensation Company Limited administers the scheme that commenced in 1998. (The Irish Stock Exchange is one of three shareholders.)	Not applicable.
Transactions covered	All securities, commodity dealers and margin financiers who receive and hold client securities and/or money whether or not they are exchange participants. However, the cause of action must relate to securities listed or traded on the stock exchange or futures contracts traded on the futures exchange.	Dealing in securities or trading of a futures contract.	Shares, units in collective schemes, futures and options, and life and general insurance policies. The scheme only relates to firms authorised to provide investment services, such as regulated investment firms, stockbrokers, insurance brokers and agents.	Those carrying on 'investment services business', defined to include execution of orders, managing portfolios of investments on a client by client basis and underwriting. Instruments covered: securities, units in collective investment schemes, financial futures contracts, FRAs, interest rate, currency and equity swaps, options and money market instruments.
Claimants	Retail.	Retail.	Private persons and smaller companies.	Member States may exclude wholesale investors and those with certain connections with the investment firm.
Losses covered	On bankruptcy or winding up of the covered intermediary, or any breach of trust, defalcation, fraud or misfeasance committed by the intermediary or any person employed by it.	Loss because of defalcation committed by members of the exchanges and bankruptcy of such members.	Return of investments and money when a firm is unable to meet its obligations due to its financial circumstances.	Return of investments and money when a firm is unable to meet its obligations due to its financial circumstances.
Cap; fund size	Cap: HK$150,000. Fund size: to be HK$1 billion.	Cap: 'prescribed amount'. Fund size: securities exchange fund S$30.6 million; futures exchange fund S$20 million (2001).	Cap: The lesser of 20,000 ECU or 90 per cent of the loss.	The minimum is the lesser of 20,000 ECU or 90 per cent of the loss.

	Hong Kong	Singapore	Ireland	European Community Directive 97/9/EC
Source of funds	Transfer of assets from existing compensation funds and levies on stock and futures exchange transactions.	Levies.	Levies on authorised firms.	Not addressed.
Claims experience	Varied with level of defaults. In 1998, one of the previous funds made payments of over HK$450 million to 6,419 claimants (after a cap per investor had been imposed).	Not available.	About 2,900 claims arising from three failures.	Not applicable.

ATTACHMENT E: THE CURRENT PROFESSIONAL INDEMNITY INSURANCE MARKET

The Australian Competition and Consumer Commission (ACCC) has issued an *Insurance Industry Market Pricing Review* (March 2002).[107] This report provides valuable information on the current state of the general insurance market in Australia. The Government has asked the ACCC to continue to update its report and provide analysis of the competitiveness of the public liability and professional indemnity sectors of the market.

The ACCC noted in its report that the general insurance industry as a whole had had a low return on equity over the past nine years. Recent performance and outlook for professional indemnity insurance was for a return of less than minus 5 per cent.

The significant increase in premiums during the year to March 2002 was seen as being related to the shift by insurers from establishing targets for business growth (as measured by premium volume) to setting targets for return on equity. It also related to the realisation that recent low returns on capital had occurred, in the case of professional indemnity insurance through a combination of:

- inadequate premium rates;
- a realisation of the extent of past losses as liability provisions are increased to reflect emerging claims experience; and
- the liquidation of the HIH Group potentially removing a barrier to price increases;
  - the HIH Group controlled 35 per cent of industry-wide gross written premiums for professional indemnity insurance, as at 30 June 2000.

In addition:

- recent APRA Prudential Standards impose risk-based minimum capital requirements on insurers. This involves increased capital requirements on insurers underwriting professional indemnity insurance, compared to domestic classes of business, such as motor vehicle insurance;
- some other insurers, such as Suncorp Metway and St Paul, have withdrawn from the market, and there is likely to be a limit on the capacity of remaining insurers to write professional indemnity insurance;

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107 The ACCC website is www.accc.gov.au.

- claims arising from the 11 September 2001 terrorist attacks may have reduced insurers' capacity to underwrite business and affected the reinsurance market.

The ACCC report discusses the cycles and shocks involved in general insurance pricing and concludes that the cause of sudden swings in premium rates is unpredictable and can be expected to continue to occur.

Professional indemnity insurance is one of the smallest classes of insurance, representing 3 per cent of total gross written premiums in Australia and less than 1 per cent of policies written. However, in 2000-01, it accounted for 8 per cent of the outstanding claims liability.

The responses of insurance companies to the questionnaire, which informed the ACCC report, indicate an average increase in premiums of 27 per cent. The reasons quoted were 'to achieve profitability' and deterioration in experience.

The report concludes that significant further increases could occur for professional indemnity insurance but the actual increases will depend on how insurers react to a series of relevant issues — for example:

- any increases in the cost of claims, and reinsurance costs;
- whether the number of insurance companies offering professional indemnity insurance diminishes leaving the remaining insurers relatively free to set the market (at least until excessive premiums attract other insurers back).

The low premium base enjoyed by policyholders in recent years, in conjunction with the losses incurred in relation to professional indemnity insurance, mean significant percentage increases in premiums by those insurers remaining in this sector of the market.

While this may be seen as part of a natural cycle in the insurance sector, concern has been expressed by segments of the financial services industry as to whether the increases in premiums being experienced reflect a valid assessment of the risk inherent in the particular business.

In an environment where there are fewer insurers offering professional indemnity insurance, the power of individuals and industry associations to negotiate the cover considered suitable for that segment of the financial services industry is reduced and the likelihood of exclusions being imposed by insurers may increase.