COMPENSATION AND INSURANCE ARRANGEMENTS FOR AFS LICENSEES

Background

Section 912B of the *Corporations Act* 2001 requires financial services licensees that provide financial services to retail clients to have compensation arrangements in place. These arrangements must be approved by the Australian Securities & Investments Commission (**ASIC**) or satisfy the requirements set out in the Corporations Regulations. In 2002, ASIC 'turned off' the requirement to comply with section 912B as a result of various factors, although there were some transitional compensation arrangements. The requirement has now been turned back on. Corporations Regulation (7.6.02AAA) made in July 2007 provided that from 1 July 2008 compensation arrangements for most licensees would be provided by way of adequate professional indemnity insurance. In March 2008 ASIC released Regulatory Guide 126 which sets out what ASIC regards as the minimum requirements of 'adequate' professional indemnity insurance. These will come into effect on 1 January 2010. Because of market constraints less rigorous requirements will apply until then.

The requirements

Regulation 7.6.02AAA requires most AFS licensees to have 'adequate' professional indemnity (**PI**) insurance. The Regulation makes the licensee responsible for assessing what is adequate professional indemnity insurance, but provides that regard must be had to:

1 the licensee's membership of an external dispute resolution scheme; and

2 relevant considerations in relation to the financial services business carried on by the licensee, including the volume of business, the number and kind of clients, the kind of business and the number of representatives of the licensee.

The Regulation provides that certain licensees are exempt from the compensation requirements. This applies to general insurance companies, life insurance companies and authorised deposit taking institutions regulated by APRA.

ASIC's view of adequate PI insurance

ASIC states that whether a PI insurance policy is adequate depends on the amount of the cover, the scope of the cover, whether the terms, conditions and exclusions of the cover undermine the overall effect, and whether the licensee has sufficient financial resources to enable the PI insurance policy to work in practice.

While saying it is for individual licensees to determine what is 'adequate' for them, ASIC regards the following as the minimum requirements of an 'adequate' PI insurance policy:

1 it must have a limit of at least $2 million for any one claim and in the aggregate for licensees with total revenue from financial services provided to retail clients of $2 million or less, and for others a limit approximately equal to expected revenue from retail clients up to a maximum of $20 million;

2 it must cover loss or damage suffered by retail clients because of breaches of Chapter 7 of the Corporations Act;

3 it must not exclude various things, including EDR scheme awards, loss caused by conduct of representatives generally or by fraud or dishonesty by directors, employees or other representatives;

4 it must cover breaches by both the licensee and all its representatives (either under the policy or separately covered by a policy under which the licensee has a right of indemnity);

5 it must include at least one automatic reinstatement (unless the limit of cover is at least twice the minimum);

6 defence costs must be in addition to the minimum limit, or the level of cover must be sufficiently increased to take into account these costs;

7 it must provide retroactive cover if the licensee had an immediately previous PI policy to the earlier of the retroactive date specified in the immediately previous PI insurance policy or the commencement date of the first PI insurance policy in the series of continuous policies;

8 it must continue to provide cover for a period of time after the licensee ceases business (eg run-off cover) for as long a period as is reasonably practicable but at least a year.

Transitional arrangements

During the consultation period with industry and stakeholders, it became apparent that there was currently no insurance product on the market which provided cover that satisfies these minimum standards and requirements. ASIC has responded to this feedback by introducing transitional arrangements which sets lower minimum requirements until 1 January 2010, by which time ASIC expects the market to have developed products that meet its preferred minimum requirements.

Based on what ASIC understands is currently commercially available, ASIC proposes the following minimum policy features for the transitional period:

- the policy is provided by an insurer regulated by APRA or operating under an exemption under the *Insurance Act* 1973;
- the policy has a limit of indemnity of at least $2 million or higher based on revenue (as in point 1 above);
- the policy must indemnify the licensee against liability for loss or damage suffered by retail clients because of breaches of Chapter 7 of the *Corporations Act* by the licensee or its representatives (as in point 2 above);
- the policy must not exclude various things, including liability under EDR scheme awards, liability caused by the conduct of representatives generally or by fraud and dishonesty by directors, employees or other representatives, or claims arising from instances that have been notified to ASIC (as in point 3 above);
- defence costs must be in addition to the minimum limit or the level of cover must be increased to take into account these costs (as in point 6 above);
- if the licensee had an immediately previous PI insurance policy, the policy must provide retroactive cover (as in point 7 above).Issues

ASIC has responded to the gap between its requirements and the availability of products on the market by introducing transitional arrangements that will cover licensees for a two year implementation period. The question remains as to whether the market will be able and willing to respond to these requirements, and whether such products will become available during the transition period. The new requirements present an opportunity for insurers to design and offer a product that satisfies these requirements, but much will depend on whether insurers can do so and still meet the indemnity guidelines. If a suitable product is not available in the market, ASIC may face pressure from the industry and stakeholders to modify its requirements before 1 January 2010.

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