



Compliance Update

Client Compensation

AFS licensees who provide services to retail clients are obliged to maintain compensation arrangements. New compensation requirements were released in November 2007.¹

From 1 July 2008, unless they are exempt, licensees must hold "adequate" professional indemnity insurance.

Adequacy standards for the scope and extent of cover required have been prescribed. (See Features of Adequate PI Insurance Cover below for full details of the standard.)

For existing licensees, there is a 2 year implementation period which works as follows:

- Recognising that it is not possible to obtain insurance which meets the minimum standard as at 1 January 2008, ASIC has prescribed a lesser standard of cover which will apply for 2 years. (See Implementation Period below for details of the lower standard).
- Until 1 January 2010, it is adequate for existing licensees to have PI insurance based on what is available in the market now, provided it meets the Implementation Period standard. However:
 - If you had PI insurance in place before 1 December 2007 that does not meet the Implementation Period standard, you must obtain a policy that does comply when your policy comes up for renewal.
 - If your policy does not come up for renewal in sufficient time to comply by 1 July 2008, you must take reasonable steps to comply as soon as possible after that, so that you have insurance that meets the Implementation Period standard no later than 31 December 2008.
- By 1 January 2010, all licensees will need to have Adequate PI Insurance, i.e. which meets the higher standard.

For new licensees, the requirements apply after 1 January 2008, i.e. they must have insurance that meets the Implementation Period standard from that date and Adequate PI insurance thereafter.

During the implementation period, ASIC will work with industry to encourage the development of products or solutions that will achieve this higher standard.

Assessing the Adequacy of Insurance

When considering if the insurance cover is adequate, the licensee will need to consider:

- The maximum liability that could result from claims heard by the licensee's EDR scheme;
- The nature, scale and complexity of 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 (including authorised representatives) the licensee has;
- The businesses' other financial resources;
- The amount and scope of cover and the terms and exclusions (See Features of Adequate PI Insurance Cover below for full details of these requirements)

Financial Adequacy

¹ These are set out in detail in RG 126: Compensation and insurance arrangements for AFS licensees

Licensees must assess what financial resources are required to cover any excess and gaps in cover due to exclusions in the policy and to ensure that they have the financial resources available.

Licensees must be able to demonstrate that they have the financial resources available. They must retain a record of their assessment which shows how the financial resources were calculated using capital, cash flow, overdraft or support from a parent company.

Annual Review of PI Insurance

Licensees must review their PI insurance arrangements (or other compensation arrangements) at least annually to ensure that they continue to be adequate and if there are any major changes in their business.

The process for doing so is:

Step	Activity
Step 1 - Assess the business	Review your business, taking into account any proposed changes to the business. Review your claims history (if any) and risk management procedures.
Step 2 - Assess your potential liability	Determine the maximum liability that is realistically likely to arise. ASIC considers that this will involve making a reasonable estimate of the following: <ul style="list-style-type: none"> • The maximum exposure to a single client (worst loss scenario per client); • The number of claims that could arise from a single event (potential for multiple claims); and • The number of claims that might be expected during the policy period.
Step 3 - Approach insurers / brokers	Ask insurers or insurance brokers for a list of key policy features, exclusions and available extensions (based on full disclosure of your assessment in Steps 1 and 2).
Step 4 - Assess amount and scope of cover including policy exclusions	Consider whether the amount and scope of cover are adequate. It should at least meet the minimum requirements. Review the policy features using the questions in the table below. Identify any gaps in cover.
Step 5 - Consider financial resources	Check that you have the financial resources to pay the excess on the estimated number of claims and cover any gaps and legal costs (if necessary). Consider how you will cover these claims. (e.g. through capital, cash flow, overdraft, support). Retain records of the assessment.

Features of Adequate PI Insurance Cover

The table below lists the minimum requirements for adequate PI insurance cover.

Policy Feature	Minimum requirements	Factors to consider
Approved Insurer	The policy must be with an insurer regulated by APRA (and can be an APRA regulated DOFI). It cannot be with a discretionary mutual fund.	If it is a group policy or provided under a group master scheme, the insurance will still need to be adequate for each individual licensee.

Policy Feature	Minimum requirements	Factors to consider
Amount of cover	<p>Licensees with total revenue² of \$2 million or less - Limit of at least \$2 million for any one claim and in the aggregate.</p> <p>Licensees with total revenue greater than \$2 million - minimum cover should be approximately equal to actual or expected revenue from retail clients, up to a capped minimum of \$20 million.</p> <p>Revenue may be calculated based on the financial year ended prior to taking out the insurance policy and reassessed on each policy renewal. For new licensees, or if a licensee believes revenue is likely to substantially change, the licensee should make an estimate of expected revenue.</p> <p>Some licensees will require a higher aggregate limit of indemnity in order for the insurance cover to be adequate. Licensees must retain records of how they determined what amount was adequate for them.</p>	<p>Is the level of indemnity adequate to cover claims brought both inside and outside of an EDR scheme?</p> <p>Does the policy cover claims made by wholesale clients or claims that fall outside the scope of s912B? If so, this might reduce the amount of cover available for claims that fall within s912B and licensees might need to increase the amount of cover accordingly.</p> <p>Does the business carry a higher risk of claims (e.g. does it give advice on higher risk products) or is it exposed to a higher volume of claims and therefore requires a larger amount of PI insurance cover?</p> <p>Have weaknesses been identified in your compliance systems, such as a high number of claims or high-risk products/practices, which might mean a higher level of cover is required?</p>
Scope of cover	<p>The policy must cover liability for loss or damage suffered by retail clients caused by (taking into account insuring clauses and exclusions):</p> <ul style="list-style-type: none"> • Breaches of obligations under Chapter 7 of the Corporations Act by both the licensee and its representatives (including authorised representatives); • Conduct of the licensee and its representatives (including authorised representatives); • Legitimate switching cases where a client is being switched from a fun or product that is not on an approved product list to another that is on such a list; • Fraud/dishonesty/infidelity by the licensee (except sole traders) and its directors, employees and representatives (including authorised representatives); • Claims for misrepresentations about services; • EDR scheme awards; • Claims arising from incidents that have been notified to ASIC (e.g. through a breach report on the basis that, by making the notification, the licensee has admitted liability and as a result the insurance policy will not cover the claim). 	<p>Approved Product Lists</p> <p>Licensees should review the product list on a regular basis and inform the insurer if there are other products that should be included on the product list.</p> <p>ASIC considers that this is a key area of potential retail client loss and encourages licensees to endeavour to get cover generally for exposure to claims arising from acts outside their approved product list as part of their overall risk management strategy. If such policies are not reasonably commercially available, ASIC expects licensees to set aside sufficient financial resources to cover this risk.</p> <p>EDR</p> <p>Does the policy cover agreed decisions reached through the EDR scheme conciliation process?</p> <p>Do lower sub-limits apply to EDR scheme awards and how are claims aggregated for the purpose of these limits?</p> <p>Licensees will be effectively self-insuring to cover claims outside these limits.</p> <p>Note: The policy may include a form prohibiting the licensee from admitting liability but it cannot prevent the licensee from reporting the breach to ASIC.</p>
Persons covered	<p>The policy must cover the licensee and all of its representatives (including authorised representatives) (either under the policy or separately covered by a policy under which</p>	<p>If there are many representatives (including authorised representatives) and/or they are geographically dispersed, the limit of indemnity might need to be higher to</p>

² Revenue has the same meaning in this context as in AASB 118

Policy Feature	Minimum requirements	Factors to consider
	the licensee has a right of indemnity).	manage this risk.
Automatic reinstatement	The policy must include at least one automatic reinstatement.	This is not required where the limit is at least twice the minimum cover.
Excess / deductibles	The excess/deductible must be at a level that the business can confidently sustain as an uninsured loss.	A business with a lower cash flow available to meet claims might require a larger amount of cover and/or cover with a lower excess. If there is a limited asset base available to meet claims, a policy with a lower excess might be preferable. If a PI insurance policy has a significant excess or deductible in proportion to the limit of indemnity, it may not be adequate. However, if the licensee can demonstrate that for other reasons (e.g. other financial resources, systems and controls in place) their arrangements are adequate overall, they may wish to apply to have this kind of arrangement considered as an alternative arrangement.
Legal costs	Defence costs must be 'in addition' to the minimum aggregate claim limit or the level of cover must be sufficiently increased to take into account these costs.	As at December 2006, legal costs for a court action were generally between 30%–50% of a claim and a typical defence cost on a claim against a financial planner was between \$4,000–\$5,000 for a small claim, but could be up to \$20,000. The conditions of the PI insurance market change from time to time. ³
Retroactive cover	If the licensee had a previous PI insurance policy, the policy must provide retroactive cover to the earlier of the retroactive date in the immediately previous policy or the commencement date of the first PI insurance policy in a series of continuous policies.	

Implementation Period

During the implementation period PI insurance is required to be a combination of:

- Minimum policy features – which are based on ASIC's understanding of what is commercially available - see Implementation Period Standard below;
- Analysis of the business, risk management systems and the insurance cover to identify gaps in cover;
- Additional financial resources to cover gaps in a licensee's policy; and
- Steps taken to improve the arrangements over time.

According to ASIC, insurance that complies with the superseded Insurance (Agents and Brokers) Act 1984 is adequate PI insurance for insurance brokers during this period.

Licensees who have an insurance policy in place before 1 December 2007 that does not meet the Implementation Period Standard and does not come up for renewal in sufficient time to comply by 1 July 2008 must take reasonable steps to obtain insurance that meets the Implementation Period Standard as soon as possible thereafter (but no later than 31 December 2008).

They must take reasonable steps to obtain that kind of policy by 1 July 2008 (e.g. by applying to an insurance broker) and keep records to show that they have assessed what additional financial resources are needed (i.e. to cover gaps or shortfalls in their policy).

³ PII Market Report

Implementation Period Standard

Policy Feature	Minimum requirements
Approved insurer	Same as the new adequacy standard – see above
Amount of cover	Same as the new adequacy standard – see above
Defence costs	Same as the new adequacy standard – see above
Scope of cover	<p>The insurance must cover liability for loss or damage suffered by retail clients as a result of (taking into account insuring clauses and exclusions):</p> <ul style="list-style-type: none"> • Breaches of Chapter 7 of the Corporations Act by both the licensee and its representatives (including authorised representatives); • The conduct of the licensee and representatives (including authorised representatives) generally; • EDR scheme awards; • Fraud and dishonesty by directors, employees and other representatives (but not for sole traders); and • Claims arising from incidents that have been notified to ASIC (e.g. through a breach report on the basis that, by making the notification, the licensee has admitted liability and as a result the insurance policy will not cover the claim).
Excess / deductible	Same as the new adequacy standard – see above
Retroactive cover	Same as the new adequacy standard – see above
Automatic reinstatement	The insurance must have at least one automatic reinstatement.

Financial resources – During the implementation period, licensees should assess if any financial resources are required to cover the excess and any gaps in cover and must retain records of this assessment. If the excess is significant relevant to the limit of indemnity, licensees should seek approval from ASIC as an alternative arrangement as we consider this kind of arrangement to be effectively self-insurance rather than PI insurance.

Disclosure

Details about compensation arrangements are required to be disclosed in the licensee's (and any authorised representative's) FSG as from 1 July 2008.

The FSG should disclose that the licensee has PI insurance in place (or that alternative arrangements have been approved by ASIC) and explain whether it will cover work done for the licensee for employees after they cease to work for the licensee.

This disclosure must not be misleading – ASIC suggests that the words “compensation” or “adequate insurance” are not used without a full explanation of what they mean and any limitations.

Alternative Arrangements

Licensees can apply to ASIC for approval of alternative compensation arrangements.

An application to ASIC should address the following issues:

- Which licensees will be covered by the arrangements (e.g. do the arrangements cover a group of related licensees or an industry sector?);
- How the arrangements meet the criteria for assessing adequate PI insurance;
- Any benefits, risks or costs to retail clients arising from the licensees using these arrangements as opposed to PI insurance; and
- Any circumstances particular to the licensee or the industry sector which make these arrangements more appropriate than PI insurance.

The alternative arrangements must provide no less protection than adequate PI insurance. ASIC will generally ask for an expert's report (e.g. actuarial report) demonstrating that this is the case to be submitted with the application.

In assessing the application, ASIC will have regard to the nature of the financial services covered, whether the arrangements provide cover after the licensee ceases the business and, if so, for how long. It will also take into account the factors used to assess the adequacy of PI insurance and the degree to which the arrangements are provided on arm's length terms.

Renewing PI insurance

Licensees should appoint a person to be responsible for assessing the adequacy of their PI insurance and arranging renewal.

It is advisable to apply early for renewal of professional indemnity insurance. In hard insurance markets, it is not only considerably more expensive, but harder to get. It could take some time to fully canvass the market. Diarise to commence the renewal process at least 3-4 months prior to expiry of the professional indemnity policy.

Notification to ASIC

Changes to the details of a licensee's professional indemnity insurance should be notified to ASIC using FS20. If the insurance is renewed on the same terms with the same insurer there is no need to notify.

Exemptions

General and life insurance companies and authorised deposit taking institutions regulated by APRA do not have to comply with the compensation arrangement. Neither do any licensees who are related to these entities and who have a guarantee from the entity which has been approved by ASIC.

<p>To discuss your compliance needs, contact</p> <p>Claire Wivell Plater T: 02 8353 6604 E: clairew@goldseal.com.au</p>	<p>Disclaimer This eAdvice has been prepared for Gold Seal's clients. It contains general information about compliance issues. It is not tailored to the individual circumstances of any recipient and is not a substitute for obtaining specific advice about the compliance issues that arise in your business.</p>	<p>About Gold Seal Gold Seal is a leading provider of a compliance, risk management, human resource, training, education, services to insurance intermediaries.</p> <p>© Gold Seal 2007 If you would like to reproduce this publication, please contact Claire Wivell Plater on 02 8353 6604 or email clairew@goldseal.com.au</p>
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