



ASIC

Australian Securities & Investments Commission

REGULATORY GUIDE 126

Compensation and insurance arrangements for AFS licensees

December 2010

About this guide

This guide is for Australian financial services (AFS) licensees and their representatives, advisers and insurers.

It sets out how ASIC administers the compensation requirements under s912B of the *Corporations Act 2001* (Corporations Act).

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Document history

This version was issued on 20 December 2010 and is based on legislation and regulations as at 20 December 2010.

Previous versions:

- Superseded Regulatory Guide 126, issued 27 November 2007, reissued 28 March 2008 and 26 October 2009

Disclaimer

This guide does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

Examples in this guide are purely for illustration; they are not exhaustive and are not intended to impose or imply particular rules or requirements.

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A Overview

Key points

If you provide financial services to retail clients, you must have arrangements for compensating those clients for breaches of Ch 7 of the Corporations Act. The primary way to comply with this obligation is to have professional indemnity (PI) insurance cover.

We administer the PI insurance framework so that, as far as possible, it reduces the risk that retail clients go uncompensated where a licensee has insufficient financial resources to meet claims by retail clients.

To achieve this, we aim to raise the standard of available PI insurance cover for licensees. However, PI insurance is not a guarantee that compensation will be paid if there is a claim.

The compensation requirements

RG 126.1 Under s912B of the *Corporations Act 2001* (Corporations Act), Australian financial services (AFS) licensees must have arrangements for compensating retail clients for losses they suffer as a result of a breach by the licensee or its representatives of their obligations in Ch 7 of the Corporations Act.

RG 126.2 These arrangements must:

- (a) satisfy the requirements in the Corporations Regulations 2001 (Corporations Regulations), which are that licensees must obtain PI insurance cover that is adequate, considering the nature of the licensee's business and its potential liability for compensation claims (reg 7.6.02AAA); or
- (b) be approved by us as alternative arrangements.

Section C of this guide sets out what we regard as the minimum requirements for adequate PI insurance. Section D provides information about when we will approve alternative arrangements.

RG 126.3 The Corporations Regulations also provide exemptions from the requirements for some licensees that are regulated by the Australian Prudential Regulation Authority (APRA) or are related to an entity regulated by APRA (reg 7.06.02AAA(3)): see Section E.

RG 126.4 In this guide, the requirements in the Corporations Act and Corporations Regulations are referred to as the 'compensation requirements'.

Our general approach

Our objective

- RG 126.5 Our objective in administering the compensation requirements is to reduce the risk that a retail client's losses (due to breaches of Ch 7 for which a licensee is responsible) cannot be compensated by a licensee because of a lack of financial resources (referred to in this guide as the 'policy objective').

What this means for licensees and consumers

- RG 126.6 Our approach to administering the compensation requirements means that all licensees that provide financial services to retail clients need to have PI insurance that meets the minimum standards in Section C, unless an exemption applies.
- RG 126.7 It is important, however, to recognise the limitations of PI insurance as a consumer protection mechanism.
- RG 126.8 PI insurance is not designed to protect consumers directly and is not a guarantee that compensation will be paid. It is designed to protect the insured (i.e. the licensee) against the risk of financial losses arising from poor quality services (e.g. poor advice or execution of services) and other misconduct by a financial services provider (e.g. fraud by its representatives).
- RG 126.9 The insurance is not intended to cover product failure or general investment losses, claims for loss solely as a result of the failure (e.g. insolvency) of a product issuer or where a return on a financial product has not met expectations. Nor is it intended to underwrite the products of a product issuer.
- RG 126.10 We recognise that the PI insurance that is currently available in the market is unlikely to provide a source of funds where a licensee has become insolvent before the claim was brought. Ideally, insurance policies would continue to cover the licensee after it has become insolvent or otherwise ceased business, but we understand that this insurance cover is generally not available in the current market to the average licensee. We also recognise that insurers may exclude some areas of cover in policies for risk management reasons.

Complying with the compensation requirements

RG 126.11 Table 1 sets out what you must do to meet the minimum PI insurance requirements.

Table 1: What you must do to comply

| | What you must do | When |
|--|---|--|
| New licensees | <p>If you are applying for an AFS licence, you will need to confirm in your application that you have:</p> <ul style="list-style-type: none"> • adequate PI insurance cover in place; or • a process to ensure that you will have adequate PI insurance cover in place when your AFS licence takes effect. <p>We will ask questions about your proposed compensation arrangements, including:</p> <ul style="list-style-type: none"> • the insurer and the type and level of PI insurance cover you have (or will have) in place; • the scope of the cover; and • whether the policy meets the minimum standards (see Section C). <p>You must also provide ASIC with a certificate of currency of the PI insurance policy before your licence will be granted.</p> | <p>When you apply for your AFS licence.</p> <p>You will need to have the insurance cover in place by the date your licence commences.</p> |
| Existing licensees | <p>You must have PI insurance cover that complies with the standards set out in Section C, unless an exemption applies or you have alternative arrangements in place that we have approved.</p> | <p>Since 1 January 2010.</p> |
| Alternative arrangements (we may approve alternative arrangements to PI insurance) | <p>You must lodge an application addressing the issues set out in Section D.</p> | <p>When you want to have alternative arrangements to PI insurance.</p> <p>You should allow enough time:</p> <ul style="list-style-type: none"> • for your application to be assessed; and • to obtain the required PI insurance if your arrangements are not approved. |
| Exempt licensees (some licensees are exempt) | <p>Some licensees can rely on an exemption under the Corporations Regulations: see Section E.</p> <p>If required, you must lodge an application for approval of a guarantee.</p> | |

Licensees with specific PI insurance requirements

- RG 126.12 The following groups of licensees are subject to specific PI insurance requirements as a condition of their AFS licence:
- (a) investor directed portfolio service (IDPS) operators: see Regulatory Guide 148 *Investor directed portfolio services* (RG 148) at RG 148.27; and
 - (b) managed discretionary account (MDA) service operators: see Class Order [CO 04/194] *Managed discretionary accounts* and Regulatory Guide 179 *Managed discretionary account services* (RG 179) at RG 179.59.

If you fall within either of these groups, you will need to ensure that the cover you hold meets these specific requirements.

- RG 126.13 Additionally, specific insurance requirements may apply to licensees who are also market participants. These requirements are set out in the ASIC market integrity rules. Licensees that are also market participants should refer to the ASIC market integrity rules as relevant to them to ensure they are meeting all their obligations.

Note: See Regulatory Guide 214 *Guidance on ASIC Market integrity rules for ASX and ASX 24 markets* (RG 214) and Regulatory Guide 215 *Guidance on ASIC market integrity rules for APX, IMB, NSXA and SIM VSE markets* (RG 215) for further detail on the market integrity rules that apply to domestic licensed markets.

- RG 126.14 Some other regulatory regimes also require licensees to hold PI insurance cover. For example, some superannuation trustees are obliged to hold PI insurance under APRA's Registrable Superannuation Entity (RSE) licence regime. As their existing cover has been obtained under a different regime with different objectives, such licensees still need to consider whether their existing cover is adequate for the purposes of the Corporations Act.

Discharge of security bonds

- RG 126.15 Under previous transitional compensation arrangements, some licensees were required to:
- (a) lodge and maintain a security bond with ASIC; or
 - (b) have PI insurance under the repealed *Insurance (Agents and Brokers) Act 1984*.
- RG 126.16 However, provided that you have PI insurance or ASIC-approved alternative arrangements in place, you may apply to us to have your security bonds discharged and returned: reg 7.6.02AA(4).

RG 126.17 For information on how to apply to have your security bond released, see Section F.

Disclosure in FSGs

RG 126.18 You must include a statement in your Financial Services Guide (FSG) and the FSG of your representatives about the kind of compensation arrangements you have in place and whether these arrangements comply with s912B: see reg 7.7.03A and Section G of this guide.

B Our general approach

Key points

Our objective in administering the compensation requirements is to reduce the risk that a retail client's losses cannot be compensated by a licensee because of a lack of financial resources. However, the compensation requirements are not a mechanism for providing compensation directly to consumers.

The following key principles guide our approach:

- 'adequate' means fit for achieving the policy objective;
- licensees are responsible for determining what is adequate in their circumstances; and
- an element of adequacy is the type of insurance that is practically available at any given time.

Policy objective

RG 126.19 When it introduced the regulations, the Australian Government described the objective of the compensation requirements as to:

reduce the risk that compensation claims to retail clients cannot be met by the relevant licensees due to the lack of available financial resources.

Regulation Impact Statement *Compensation arrangements for financial services licensees* (April 2007), p. 7.

RG 126.20 Our policy objective is to administer the compensation requirements to maximise their potential to meet this objective.

RG 126.21 In any industry, from time to time clients might suffer loss due to inappropriate advice or other misconduct by a service provider. Individual service providers or firms might not have sufficient resources to meet claims arising from these losses. In the financial services industry, there needs to be a mechanism to ensure that funds are likely to be available where retail clients suffer loss due to breaches by AFS licensees or their representatives of their obligations under the legislation.

RG 126.22 The compensation requirements are not a mechanism for providing compensation directly to consumers. Rather, they are a means of reducing the risk that a licensee cannot pay claims because of insufficient financial resources.

RG 126.23 The compensation requirements are *not intended to cover*:

- (a) product failure or general investment losses;

- (b) all possible consumer losses relating to financial services;
- (c) claims for loss solely as a result of the failure (e.g. through insolvency) of a product issuer (i.e. it is not intended to underwrite the products of a product issuer); or
- (d) a return on a financial product that has not met expectations.

Key principles

RG 126.24 Table 2 sets out the key principles that guide our administration of the compensation requirements.

Table 2: Key principles

| | |
|--|--|
| Principle 1: Fit to achieve the policy objective | 'Adequate' means the compensation arrangements are fit for achieving the policy objective. |
| Principle 2: Responsibility of licensee to assess | It is the basic responsibility of licensees to determine what is adequate for them. |
| Principle 3: Practical availability | An element of adequacy is what is practically available at any given time. |

Principle 1: Fit to achieve the policy objective

RG 126.25 PI insurance is designed to protect the insured (in this case, the licensee) against certain risks; it is not designed to protect consumers and is not a guarantee that compensation will be paid. PI insurance is a way of reinforcing a licensee's ability to meet any consumer losses caused by negligence or a breach of duty by the licensee or its representatives by making funds available to the licensee under the terms of the insurance policy. Consumers generally have no direct right of access to these insurance policies.

RG 126.26 The Corporations Regulations require:

- (a) licensees to have PI insurance that is *adequate*, considering certain factors of their business and potential liability; and
- (b) ASIC to assess applications for alternative arrangements against the same factors.

RG 126.27 The concept of what is 'adequate' is an important area for our guidance. We will consider whether compensation arrangements are adequate with reference to the policy objective—that is, whether the compensation arrangements reduce the risk that a retail client's losses (due to breaches of

Ch 7 for which a licensee is responsible) cannot be compensated by the licensee due to the lack of financial resources.

- RG 126.28 In Section C, we set out what we consider to be ‘adequate’ PI insurance, being cover that we consider would be fit to achieve the policy objective, given the nature of PI insurance.

Principle 2: Responsibility of licensee to assess

- RG 126.29 We consider that compliance with the compensation requirements is part of your overall risk management processes and your obligation in s912A to provide financial services ‘efficiently, honestly and fairly’.
- RG 126.30 The Corporations Regulations reflect the fact that different licensees will have very different businesses and risks, which will affect what compensation arrangements are adequate for them. Therefore we consider that you should undertake your own analysis of what is adequate for you.
- RG 126.31 Minimum standards set by relevant industry and professional bodies might provide a guide. However, compliance with these standards does not necessarily mean that a licensee meets the requirements under the Corporations Act.
- RG 126.32 You might find it helpful to engage external consultants, actuaries, brokers or advisers to undertake a risk assessment of your business and provide advice on the amount and type of cover that you should obtain.

Principle 3: Practical availability

- RG 126.33 We consider that one of the elements of adequacy is what is practically available at any given time.
- RG 126.34 The nature and extent of coverage of PI insurance is limited by what the PI insurance market will provide, and the market is subject to fluctuations. This can have a material impact on the scope and effectiveness of PI insurance cover. There may be times in the future where PI insurance is also less freely available (e.g. during a future ‘hard’ insurance market). These limitations mean that insurance cover that achieves the policy objective may not always be available.
- RG 126.35 Through our consultation and research we have considered and will continue to consider what standard of PI insurance is currently available for licensees in the market.
- RG 126.36 In 2006, we commissioned a report into the market for PI insurance for AFS licensees: see *Compensation arrangements for financial services licensees—Research into the professional indemnity insurance market* (REP 107).

Note: See also Consultation Paper 87 *Compensation and insurance arrangements for AFS licensees* (CP 87). *Report on submissions to CP 87 Compensation and insurance arrangements for AFS licensees* (REP 112) highlights key issues from submissions to CP 87 and our response.

- RG 126.37 REP 107 considered common types of claims against licensees and identified that the main cause of loss to licensees is claims relating to advice, including administrative errors and inappropriate advice. Other key areas of loss include:
- (a) representatives acting outside the approved product list;
 - (b) advisers switching a client from one fund or product to another without explaining the risks and benefits; and
 - (c) fraud and misappropriation of client money.
- RG 126.38 We are concerned about possible limitations in the ability of PI insurance to provide a source of compensation if a licensee becomes insolvent or ceases business. We understand PI insurance generally operates on a ‘claims made’ basis and only covers claims notified within the policy period. A licensee in financial difficulties might fail to notify claims promptly or might fail to maintain its PI insurance.
- RG 126.39 Because most advice claims are ‘long tail’ (i.e. claims arise two to seven years after the advice), there is a risk that the licensee might have retired or been wound up, and the period for notifying claims to the insurer passed, before the client realises they have suffered a loss. An insolvent entity is also unlikely to be in a position to continue to renew the policy for a further period.
- RG 126.40 We understand from industry feedback that there is no market at present for automatic run-off cover and it can generally only be obtained for orderly run downs (e.g. members’ voluntary liquidations) for a period of 12 months, where ideally seven years of run-off cover would be desirable. Accordingly, we do not currently require licensees to obtain automatic run-off cover. We will continue to monitor the availability of automatic run-off cover and may reassess our position if automatic run-off cover becomes available.

C Adequate PI insurance cover

Key points

Whether a PI insurance policy is adequate depends on several factors:

- the amount of the cover;
- the scope of the cover;
- whether the terms and conditions of the cover undermine the overall effect (e.g. by excluding cover for key aspects of the licensee's business); and
- whether the licensee has sufficient financial resources to enable the PI insurance policy to work in practice.

Based on these factors, you should assess what is adequate PI insurance to meet your obligations under s912B and obtain such cover.

What is 'adequate'?

RG 126.41 The Corporations Regulations require you to hold PI insurance that is *adequate*, considering:

- (a) your liability for claims brought through your external dispute resolution (EDR) scheme in s912A(2)(b) (see reg 7.6.02AAA(1)(a)); and

Note: You should take into account 'the maximum liability that has, realistically, some potential to arise' in connection with any particular claim against you and all claims for which you could be found liable: reg 7.6.02AAA(1)(a).

- (b) the nature of the financial services business carried on by you, including:

- (i) the volume of business;
- (ii) the number and kind of clients;
- (iii) the kind or kinds of business; and
- (iv) the number of representatives (see reg 7.6.02AAA(1)(b)).

Note: Explanatory Statement: Select Legislative Instrument 2007 No. 197 (Explanatory Statement to the Regulation) explains that reg 7.6.02AAA(1)(b) should capture liability for claims brought outside EDR schemes (e.g. through the courts).

RG 126.42 This is not an exhaustive list of the factors that you need to take into account in assessing what PI insurance cover is adequate in your circumstances.

Amount of cover

- RG 126.43 To be adequate overall, a PI insurance policy must have an adequate amount of cover. To be adequate, the limit of indemnity under the policy should cover a reasonable estimate of retail clients' potential losses.

Scope of cover

- RG 126.44 Section 912B requires that the insurance must cover loss or damage suffered by retail clients due to breaches of obligations under Ch 7 by the licensee and its representatives. This obligation extends to all financial services covered by Ch 7. Losses caused by negligent, fraudulent or dishonest conduct that amounts to a breach of Ch 7 and gives rise to liability to retail clients must be covered.

Note: For example, a licensee may have liability to retail clients under s953B, 953C, 991A, 1022B, 1022C or 1041I.

Terms and exclusions

- RG 126.45 If exclusions in a PI insurance policy undermine the policy objective, it is hard to see how the cover can be adequate. This applies especially to exclusions that relate directly to the minimum scope of cover described above.
- RG 126.46 Of special concern are exclusions that mean cover is not available for breaches of obligations under Ch 7 (by a licensee or its representatives) for services (most often advice) that relate to moving a client from products that are outside the licensee's approved product list to products that are on the licensee's approved product list.

Financial resources

- RG 126.47 Financial resources are a necessary part of PI insurance and therefore a factor in determining the adequacy of PI insurance. The Corporations Regulations require licensees to assess adequacy based on an estimate of claims that may be made against the licensee and other relevant factors of their business. One of these factors is whether a licensee has the financial resources to make the PI insurance work in practice.
- RG 126.48 There is generally an excess on insurance policies and those insured need to consider how they will cover the excess. You must assess what financial resources are required (to cover the excess and gaps in cover due to various exclusions) and ensure you have such financial resources available. You should be able to demonstrate to yourself, and to us if necessary, that you have such financial resources available.

- RG 126.49 You must retain records of this assessment. These records should indicate how the financial resources were calculated using either capital, cash flow, overdraft or support from a parent company.

Note: See Regulatory Guide 166 *Licensing: Financial requirements* (RG 166) for guidance on measuring financial resources.

Assessing adequacy

- RG 126.50 As discussed above, whether a particular PI insurance policy is adequate for you depends on all the facts and circumstances—including the nature, scale and complexity of your business, and your other financial resources. Therefore, it is up to you to determine what is adequate PI insurance for you to meet your obligations under s912B and obtain such PI insurance.
- RG 126.51 Table 3 gives guidance on the processes we think you should go through to determine what is adequate PI insurance for you. However, we will not ‘approve’ your PI insurance arrangements.
- RG 126.52 You should also have a process of ongoing assessment of your PI insurance to ensure it remains adequate.

Initial assessment

- RG 126.53 If you are applying for an AFS licence, we suggest that you use the assessment process in Table 3 to determine what will be adequate PI insurance for you.

Table 3: Initial assessment process

| | | |
|---|---|---|
| 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 potential liability | Determine ‘the maximum liability that has, realistically, some potential to arise’. We suggest you do this by making a reasonable estimate of the following factors: <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. | See RG 126.43 and Table 4 |
| 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). | See RG 126.58–RG 126.59 about authorised insurers |

| | | |
|---|--|-------------------------------------|
| Step 4: Assess amount of cover | Consider whether the amount of cover is adequate. It should at least meet our minimum requirements. | See RG 126.43 and Table 4 |
| Step 5: Assess scope of cover | Consider whether the scope of cover is adequate. | See RG 126.44 and Table 4 |
| Step 6: Review policy terms and exclusions | Review the policy features using the questions in Table 4. Identify any gaps in cover. | See RG 126.45–RG 126.46 and Table 4 |
| Step 7: 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 and retain records of the assessment (e.g. through capital, cash flow, overdraft, support). | See RG 126.47–RG 126.49 and Table 4 |

What the policy should cover

RG 126.54 Table 4 sets out our view on the features a PI insurance policy should have in order for it to be ‘adequate’. We have included what we consider are the minimum requirements for these features, and some factors you should consider when determining what is adequate depending on your business and individual circumstances.

Table 4: Features of adequate PI insurance cover

| Policy feature | Minimum requirements and factors to consider |
|------------------------|--|
| Amount of cover | <p>Minimum requirement: We consider that, to be adequate, a PI insurance policy 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. For licensees with total revenue from financial services provided to retail clients greater than \$2 million, minimum cover should be approximately equal to actual or expected revenue from financial services provided to retail clients (up to a maximum limit of \$20 million).</p> <p>Note 1: Revenue has the same meaning in this context as in AASB 118 <i>Revenue</i>.</p> <p>Note 2: For the purposes of this minimum requirement, a licensee’s revenue should be calculated including the revenue any authorised representatives receive from providing financial services to retail clients.</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 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>Note: REP 107 suggests that, as at December 2006, most licensees will need a minimum cover of \$2 million. This is likely to be adequate for smaller licensees, but might not be for larger licensees.</p> |

| Policy feature | Minimum requirements and factors to consider |
|----------------|--|
| | <p>Factors to consider:</p> <ul style="list-style-type: none"> • Is the level of indemnity adequate to cover claims brought both inside and outside of an EDR scheme? <p style="margin-left: 40px;">Note: The regulation prescribes EDR scheme membership as a key factor in assessing the adequacy of PI insurance arrangements. However, an estimate of claims under the EDR scheme might not always provide an accurate guide to a licensee's potential liability, as claims could be brought outside the EDR schemes, such as through the courts.</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. • 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? • 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? |
| Scope of cover | <p>Minimum requirement: The policy must indemnify the licensee against liability for loss or damage suffered by retail clients because of breaches of Ch 7 of the Corporations Act by the licensee or its representatives. This includes liability:</p> <ul style="list-style-type: none"> • for fraud or dishonesty by directors, employees and other representatives of the licensee (although fraud cover is not required for sole traders); and • under EDR scheme awards. <p style="margin-left: 40px;">Note 1: The policy need not explicitly refer to 'breaches of Ch 7' or 'EDR scheme awards'. However, the policy must have the effect of providing cover for breaches of the relevant obligations under Ch 7 and EDR scheme awards.</p> <p style="margin-left: 40px;">Note 2: The policy must be a contract of PI insurance. This means it must cover negligence, fraud and other misconduct (relating to retail clients) ordinarily covered by a contract of PI insurance.</p> |
| Exclusions | <p>Minimum requirement: The policy must <i>not</i> have the effect of excluding:</p> <ul style="list-style-type: none"> • EDR scheme awards; • loss caused by the conduct of representatives generally; • fraud and dishonesty by directors, employees and other representatives (although fraud cover is not required for sole traders); • claims for misrepresentations about services; • claims arising from incidents that have been notified to ASIC (e.g. through a breach report on the basis that, by merely making the notification, the licensee has admitted liability and as a result the insurance policy will not cover the claim); or • awards by state boards and specialist tribunals for claims against trustee companies (as defined in s601RAB of the Corporations Act) in relation to their role as guardians and administrators of estates. <p style="margin-left: 40px;">Note 1: A policy may include a term prohibiting the licensee from admitting liability for any claim, loss or demand provided that it does not prevent the licensee from reporting breaches to ASIC as required under s912D.</p> <p style="margin-left: 40px;">Note 2: Under the Corporations Amendment Regulations 2010 (No. 3) trustee companies remain subject to relevant state and territory laws on matters relating to their role as guardians and administrators of estates.</p> |

| Policy feature | Minimum requirements and factors to consider |
|---------------------------------|---|
| Persons covered | <p>Minimum requirement: The policy must cover the acts of the licensee and all of its representatives (either under the policy or separately covered by a policy under which the licensee has a right of indemnity).</p> <p>Note 1: Licensees need to take into account all of their representatives (i.e. not just authorised representatives) when considering the type and extent of cover that will be adequate. A client will generally have the same remedies against the licensee as it has against its representatives.</p> <p>Note 2: The licensee's policy does not need to indemnify the licensee for acts of its representatives if such acts are adequately covered by the representatives' own PI insurance cover and the licensee has a contractual right to be indemnified by its representatives.</p> <p>Factors to consider:</p> <ul style="list-style-type: none"> • Are there many representatives and are they geographically dispersed? If so, the limit of indemnity might need to be higher to manage this risk. <p>Note: In our experience, the greater the number of representatives that are working for a licensee, and the more geographically dispersed they are, the greater the potential for client losses to occur. The number and distribution of representatives might affect the licensee's ability to adequately supervise its representatives and a licensee with a greater number of representatives is likely to provide services to a greater number of clients.</p> |
| Automatic reinstatements | <p>Minimum requirement: The policy must include at least one automatic reinstatement.</p> <p>Note 1: Automatic reinstatement means that if the limit of the policy is exhausted before the end of the policy period, the limit of indemnity is reinstated for the balance of the period to cover any new claims that might arise. This is important, as licensees must ensure their PI insurance cover is adequate at all times.</p> <p>Note 2: Automatic reinstatement is not necessary where the limit is at least twice the minimum amount of cover referred to above.</p> |
| Excess/deductibles | <p>Factors to consider:</p> <ul style="list-style-type: none"> • Is the excess at a level that the business can confidently sustain as an uninsured loss, taking into account the licensee's financial resources? <p>Note 1: 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. We understand from REP 107 that currently available PI insurance policies generally have an excess. Therefore we consider that whether a licensee has sufficient cash flow to meet the excess for a reasonable estimate of claims is a relevant consideration in determining whether a PI insurance policy is adequate for that licensee.</p> <p>Note 2: 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) that their arrangements are adequate overall, they may wish to apply to have this kind of arrangement considered as an alternative arrangement.</p> |
| Legal costs | <p>Minimum requirement: 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.</p> <p>Note: REP 107 suggests that, as at December 2006, legal costs for a court action were generally between 30% and 50% of a claim and a typical defence cost on a claim against a financial planner was between \$4,000 and \$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. This is an example only.</p> |

| Policy feature | Minimum requirements and factors to consider |
|------------------------------------|---|
| EDR scheme awards | <p>Minimum requirement: The policy must cover EDR scheme awards.</p> <p>Factors to consider:</p> <ul style="list-style-type: none"> • Does the policy cover agreed decisions reached through the EDR scheme conciliation process? (If not, you will be effectively self-insuring to cover any conciliated agreements through your EDR scheme.) • Do lower sub-limits apply to EDR scheme awards and how are claims aggregated for the purpose of these limits? Again, you will be effectively self-insuring to cover claims outside these limits. <p>Note: A policy will not be inadequate merely because it contains a lower sub-limit on the amount that can be claimed as a result of an EDR scheme award.</p> |
| Fraud/dishonesty/infidelity | <p>Minimum requirement: The policy must cover fraud/dishonesty/infidelity by directors, employees and other representatives of the licensee (although fraud cover is not required for sole traders).</p> |
| Approved product list | <p>Minimum requirement: The policy must be able to cover legitimate switching cases where a client is being switched from a fund or product that is not on an approved product list to another fund or product that is on an approved product list.</p> <p>Factors to consider:</p> <ul style="list-style-type: none"> • 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. • 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 moving a client from a product that is not on an approved product list to a product that is on an approved product list as part of their overall risk management strategy. |
| Retroactive cover | <p>Minimum requirement: If the licensee had an immediately previous PI insurance policy, the policy must provide retroactive cover to the earlier of:</p> <ul style="list-style-type: none"> • 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. |
| 'Run-off' cover | <p>Not required: For the avoidance of doubt, the policy is not required to include automatic run-off cover as it is not currently available in the market. We will continue to monitor the availability of automatic run-off cover and may reassess our position should automatic run-off cover become available.</p> |

Ongoing assessment

RG 126.55 We expect you to review your PI insurance or other compensation arrangements at least annually to ensure they continue to be adequate (e.g. when your existing policy is due for renewal). You should also review the adequacy of your compensation arrangements in light of any major changes in your business (e.g. if you start providing new services or products or engage more representatives).

RG 126.56 From time to time, we may ask you to provide a copy of your PI insurance policy or a certificate of currency and other information relating to your

compensation arrangements. For example, we may ask for these documents when conducting a compliance review.

Compliance systems

RG 126.57 We expect you to ensure that a senior officer or manager is accountable for ensuring that your PI insurance policy is renewed when required, that premiums are paid on time and that your policy or other compensation arrangements continue to be adequate. You will need to make provision in your dispute resolution systems for ensuring that claims that are brought to your attention are promptly notified to insurers.

Which entities can provide the cover?

RG 126.58 Generally, the cover needs to be obtained from an insurer regulated by APRA, or operating under an exemption under the *Insurance Act 1973*.

RG 126.59 Under the *Financial Sector Legislation Amendment (Discretionary Mutual Funds and Direct Offshore Foreign Insurers) Act 2007*, all direct offshore foreign insurers have to be authorised under the *Insurance Act 1973*, unless they can rely on an exemption. You can obtain PI insurance provided by an APRA-regulated direct offshore foreign insurer. However, not all direct offshore foreign insurers are regulated by APRA.

Distinction between PI insurance and alternative arrangements

RG 126.60 If a contract of insurance is not labelled 'PI insurance' specifically but has the same broad effect as PI insurance, we will consider whether the cover provided is adequate in substance to meet the policy objective.

RG 126.61 For example, you may consider that the following arrangements fall within the category of PI insurance:

- (a) some types of trustee liability insurance held by superannuation trustees;
- (b) group insurance, where a small number of associated licensees are covered by one policy; and

Note: You will still need to consider whether the insurance is adequate for each individual licensee. For example, the limit of indemnity will need to be appropriately higher. A minimum cover of \$2 million would be insufficient.

- (c) a PI insurance policy provided under a group master scheme.

RG 126.62 Because the Corporations Regulations require licensees to obtain a contract of PI insurance, membership of a discretionary mutual fund would not satisfy the requirements. If you believe that membership of a discretionary mutual fund would provide no less protection than adequate PI insurance, you can submit an application for approval of this membership as an alternative arrangement: see Section D.

D Alternative arrangements

Key points

You can apply to us for approval of alternative compensation arrangements under s912B(2)(b): see RG 126.63–RG 126.66.

We will assess applications for approval of alternative arrangements on a case-by-case basis: see RG 126.67–RG 126.71.

Existing compensation arrangements must remain in place while new alternative arrangements are assessed: see RG 126.72.

How to apply for approval

- RG 126.63 You will need to lodge an application with us if you are an existing licensee and you wish to apply for approval of alternative arrangements. If you are a new licensee, you can apply for approval (if you choose to do so) as part of your licence application process.
- RG 126.64 Your application to us for approval of alternative arrangements should address the following issues:
- (a) which licensees will be covered by the arrangements (e.g. do the arrangements cover a group of related licensees or an industry sector?);
 - (b) how the arrangements meet the criteria for assessing adequate PI insurance under the Corporations Regulations (see Section C);
 - (c) any benefits, risks or costs to retail clients arising from the licensees using these arrangements as opposed to PI insurance; and
 - (d) any circumstances particular to the licensee or the industry sector which make these arrangements more appropriate than PI insurance.
- RG 126.65 We will generally ask for an expert report (e.g. actuarial report) to be submitted with the application to assess whether the arrangements give no less protection than PI insurance.
- RG 126.66 Applications for alternative arrangements should be made in writing and sent to applications@asic.gov.au.

How we will assess applications

- RG 126.67 We will assess each application on its merits. We will give priority to group applications (e.g. for an industry sector or sub-sector).

- RG 126.68 We will only approve arrangements that give no less protection than adequate PI insurance. We recognise that some alternative arrangements may in fact provide more protection than PI insurance.
- RG 126.69 Under s912B(3), we are required to consider:
- (a) the nature of the financial services covered; and
 - (b) whether the arrangements provide cover after the licensee ceases the business and, if so, for how long.
- RG 126.70 In approving alternative arrangements, we must take into account the factors used to assess adequacy of PI insurance in reg 7.6.02AAA(1). This means that any alternative arrangements must also be adequate considering:
- (a) the licensee's membership of an EDR scheme or schemes, taking into account the maximum liability that has, realistically, some potential to arise;
 - (b) the volume of business;
 - (c) the number and kind of clients;
 - (d) the kind or kinds of business; and
 - (e) the number of representatives.
- RG 126.71 An important feature of PI insurance is that it is provided by a third party, which offers some security that the arrangements will be enforceable in the event of fraud by agents or officers of the licensee. Therefore, one factor that we will consider in assessing alternative arrangements is the degree to which the arrangements are provided on arm's length terms.

Example: Industry compensation fund

Alternative arrangements proposed by an industry body may be approved by ASIC. For example, an industry body's members might wish to set up a compensation fund supported by compulsory levies of members.

This could be in addition to PI insurance (i.e. to compensate clients where a member's insurance is inadequate or they cease trading or become insolvent) or instead of PI insurance. Approval of a fund would depend on the amount of compensation that would be available for clients and the circumstances in which the fund would compensate clients.

We encourage industry bodies to consider whether an alternative arrangement is appropriate for their members and we are keen to discuss any such arrangements further with them.

Compensation arrangements during the assessment process

RG 126.72 It will take time to assess alternatives submitted to us for approval. If you are applying for approval of alternative arrangements, you should:

- (a) continue to hold any PI insurance you have previously obtained; or
- (b) keep in place any other ASIC-approved alternative arrangements you have previously implemented.

Discharge of security bonds

RG 126.73 If you have alternative arrangements approved by us, you can apply for release of any existing security bonds: see RG 126.83–RG 126.84.

E Exemptions

Key points

Certain licensees that are APRA-regulated are exempt from the compensation requirements under the Corporations Regulations.

Licensees that are related to these entities are also exempt if they have a guarantee from the APRA-regulated entity and the guarantee has been approved by ASIC.

Licensees that are exempt under reg 7.6.02AAA(1)

- RG 126.74 The Corporations Regulations provide that certain licensees are exempt from the compensation requirements: reg 7.6.02AAA(1). This applies to general insurance companies, life insurance companies and authorised deposit-taking institutions regulated by APRA as defined in reg 7.6.02AAA(3).

Related licensees

- RG 126.75 Licensees that are related to these APRA-regulated entities are also exempt where they have a guarantee from the APRA-regulated entity that has been approved by us: reg 7.6.02AAA(3).
- RG 126.76 If you wish to apply for approval of a guarantee, you will need to lodge an application with us. In deciding whether to approve a guarantee, we will consider the same factors as outlined in Section C for adequate PI insurance.
- RG 126.77 We understand that APRA-regulated entities are permitted to give guarantees that are limited in time and amount and we have no in-principle objection to such limits in guarantees put to us for approval (assuming, of course, that the limits are appropriate).
- RG 126.78 Applications for approval of a guarantee should be made in writing and sent to applications@asic.gov.au.

Discharge of security bonds

- RG 126.79 We have the discretion to discharge security bonds to licensees that are exempt under reg 7.6.02AAA(1) (i.e. general insurance companies, life insurance companies and authorised deposit-taking institutions regulated by APRA). These licensees do not need to apply to ASIC for the release of any existing security bonds.
- RG 126.80 Related licensees with a guarantee that has been approved by ASIC must apply for release of any existing security bonds: see RG 126.83–RG 126.84.

F Discharge of security bonds

Key points

Some licensees were required to lodge and maintain a security bond with ASIC.

Provided that these licensees have PI insurance or an ASIC-approved alternative arrangement in place, they may apply to have their security bonds released.

Security bonds

RG 126.81 Under previous transitional compensation arrangements, some licensees were required to:

- (a) lodge and maintain a security bond with ASIC; or
- (b) have PI insurance under the repealed *Insurance (Agents and Brokers) Act 1984*.

Note: See reg 7.6.02AA and Pro Forma 209 *Australian financial services licence conditions* (PF 209).

RG 126.82 However, provided that you have PI insurance or ASIC-approved alternative arrangements in place, you may apply to ASIC to have your security bonds discharged and returned: reg 7.6.02AA(4).

How to apply to have your security bond released

RG 126.83 To have a security bond released, you should:

- (a) publish a notice in a daily newspaper of general circulation in Australia, following the wording of Form 702 *Application for discharge of security* but replacing, in point 1, the words ‘dealers/investment advisers licence’ with the words ‘Australian financial services licence’; and
- (b) three months after publication, lodge with us:
 - (i) a copy of Form FS20 *Change of details for an Australian financial services licence* (see the guide attached to the form for the current fee and lodgement address);
 - (ii) an original or photocopy of the newspaper advertisement, clearly showing the date of publication; and

- (iii) a statement that, to the best of your knowledge, no person has, or is likely to have, a claim against you for pecuniary loss due to your failure, or the failure of your agents or employees, to carry on business under the licence adequately or properly, and that compensation arrangements are in place that are adequate to cover claims to which the security bond could otherwise apply.

We will release the security bond three months after publication of the notice, if there have not been any claims made against it.

RG 126.84 In making the certifications described in RG 126.83(b)(iii), you can take into account your own financial resources (e.g. if you cannot obtain retroactive insurance cover for potential claims against the security bond).

G Disclosure in FSGs

Key points

Under regs 7.7.03A and 7.7.06B you must include a statement in your FSG and the FSG of your representatives about the kind of compensation arrangements you have in place and whether these arrangements comply with s912B.

We can take action against misleading disclosure.

Licensees with PI insurance

- RG 126.85 If you have PI insurance, in your FSG and the FSG of your representatives you should:
- (a) disclose that you have PI insurance in place; and
 - (b) explain whether the insurance will cover claims in relation to the conduct of representatives/employees who no longer work for you (but who did at the time of the relevant conduct).

Licensees with alternative arrangements

- RG 126.86 If you are a licensee with alternative arrangements, in your FSG and the FSG of your representatives you should:
- (a) disclose that you have alternative arrangements to PI insurance that are approved by ASIC; and
 - (b) explain whether the alternative arrangements will cover claims made in relation to the conduct of representatives/employees who no longer work for you (but who did at the time of the relevant conduct).

Licensees that are exempt

- RG 126.87 The Explanatory Statement to the Regulation suggests that, to provide clarity, exempt and related licensees might also wish to provide appropriate disclosure about their compensation arrangements in their FSGs (p. 5).
- RG 126.88 You should disclose that you are exempt from the requirement as you are regulated by APRA or have an ASIC-approved guarantee from the APRA-regulated entity.

Action against misleading disclosure

RG 126.89 We may take action if we believe that disclosure about compensation arrangements is misleading. Disclosing that PI insurance is in place (or alternative arrangements to PI insurance that are approved by ASIC) is unlikely to be misleading. However, references made to 'compensation' or 'adequate insurance' may be misleading to consumers unless there is a full explanation of what those terms mean and any limitations that relate to them. You should therefore be careful if you choose to refer to these terms in your FSG. For example, some of the limitations are set out at RG 126.34–RG 126.40.

Key terms

| Term | Meaning in this document |
|----------------------------|---|
| AASB 118 | Australian Accounting Standards Board, Accounting Standard AASB 118 <i>Revenue</i> published July 2004. A copy is available at www.aasb.com.au |
| AFS licence | An Australian financial services licence under s913B of the Corporations Act that authorises a person who carries out a financial services business to provide financial services <p>Note: This is a definition contained in s761A of the Corporations Act.</p> |
| AFS licensee (or licensee) | A person who holds an Australian financial services licence under s913B of the Corporations Act <p>Note: This is a definition contained in s761A of the Corporations Act.</p> |
| APRA | Australian Prudential Regulation Authority |
| ASIC | Australian Securities and Investments Commission |
| automatic reinstatement | If the limit of the policy is exhausted before the end of the policy period, upon payment of a new premium by the insured, the limit of indemnity is reinstated for the balance of the period to cover any new claims that may arise. The number of automatic reinstatements refers to the number of times the limit of indemnity may be reinstated |
| Ch 7 (for example) | A chapter of the Corporations Act (in this example numbered 7) |
| [CO 04/194] (for example) | An ASIC class order (in this example numbered 04/194) |
| compensation requirements | The requirements in s912B of the Corporations Act and reg 7.6.02AAA of the Corporations Regulations |
| Corporations Act | <i>Corporations Act 2001</i> , including regulations made for the purposes of that Act |
| Corporations Regulations | Corporations Regulations 2001 |
| deductible or excess | The first part of a loss, which is borne by the insured. The insured is responsible for the loss up to the deductible amount and the insurer pays the remainder of the loss, up to the policy limit |
| EDR scheme | An external dispute resolution scheme approved by ASIC under s912A(2)(b) and 1017G(2)(b) of the Corporations Act |
| exclusion | A provision of an insurance policy that precludes coverage in particular circumstances |

| Term | Meaning in this document |
|--|---|
| Explanatory Statement to the Regulation | The Explanatory Statement: Select Legislative Instrument 2007 No. 197 |
| financial product | Generally a facility through which, or through the acquisition of which, a person does one or more of the following: <ul style="list-style-type: none"> • makes a financial investment (see s763B); • manages financial risk (see s763C); • makes non-cash payments (see s763D) <p>Note: See Div 3 of Pt 7.1 of the Corporations Act for the exact definition.</p> |
| financial service | Has the meaning given in Div 4 of Pt 7.1 of the Corporations Act |
| Financial Services Guide (FSG) | A document that must be given to a retail client in relation to the provision of a financial service in accordance with Div 2 of Pt 7.7 of the Corporations Act <p>Note: See s761A of the Corporations Act for the exact definition.</p> |
| market integrity rules | Rules made by ASIC, under s798G, for trading on domestic licensed markets |
| policy objective | As defined in RG 126.5 |
| product list | A list of products, agreed between the insurer and the insured and covered by the policy, for which the licensee and its representatives provide financial services |
| professional indemnity insurance (or PI insurance) | Liability insurance that covers loss arising from an error, omission or negligent act occurring in conduct of the holder's professional business |
| reg 7.6.02AA (for example) | A regulation of the Corporations Regulations (in this example numbered 7.6.02AA) |
| Registrable Superannuation Entity licence (or RSE licence) | Has the meaning given in the <i>Superannuation Industry (Supervision) Act 1993</i> |
| related entity | Has the meaning given under the Corporations Act for bodies corporate |
| representative | Has the meaning given in s910A of the Corporations Act |
| retail client | A client as defined under s761G of the Corporations Act and Div 2 of Pt 7.1 of the Corporations Regulations |
| retroactive cover | Where a 'claims-made' policy extends cover into the past to cover a period of time before the policy was obtained (up to the retroactive date) |

| Term | Meaning in this document |
|----------------------|--|
| retroactive date | A date in a 'claims made' policy on or after which acts or omissions are covered |
| revenue | As defined in AASB 118 |
| RG 166 (for example) | An ASIC regulatory guide (in this example numbered 166) |
| run-off cover | Cover for claims made after the insurance policy has ended that have arisen from the acts or omissions of the insured during the period of insurance cover. The cover is negotiated upfront at the commencement of the PI insurance policy, rather than separately |
| s912B (for example) | A section of the Corporations Act (in this example numbered 912B) |
| self-insurance | Setting aside a calculated amount of money to form a source of compensation for potential claims |
| trustee company | Has the meaning given in s601RAB of the Corporations Act |

Related information

Headnotes

adequate professional indemnity insurance; Australian financial services (AFS) licence; authorised insurer; compensation arrangements; direct offshore foreign insurer; duty to act efficiently, honestly and fairly; financial services; external dispute resolution (EDR) scheme; Financial Services Guide (FSG); professional indemnity insurance; retail clients; representatives; risk management; security bond

Class orders and pro formas

[CO 04/194] *Managed discretionary accounts*

PF 209 *Australian financial services licence conditions*

Regulatory guides

RG 148 *Investor directed portfolio services*

RG 166 *Licensing: Financial requirements*

RG 179 *Managed discretionary account services*

RG 214 *Guidance on ASIC Market integrity rules for ASX and ASX 24 markets*

RG 215 *Guidance on ASIC market integrity rules for APX, IMB, NSXA and SIM VSE markets*

Legislation

Corporations Act, Ch 7 Pt 7.6 Div 3, s601RAB, 912A, 912A(2)(b), 912B, 912B(2)(b), 912B(3), 912D, 953B, 953C, 991A, 1022B, 1022C, 1041I

Corporations Regulations, regs 7.6.02AA, 7.6.02AA(4), 7.6.02AAA, 7.6.02AAA(1), 7.6.02AAA(1)(a), 7.6.02AAA(1)(b), 7.6.02AAA(3), 7.7.03A

Insurance Act 1973

Insurance (Agents and Brokers) Act 1984 (superseded)

Financial Sector Legislation Amendment (Discretionary Mutual Funds and Direct Offshore Foreign Insurers) Act 2007

Consultation papers and reports

CP 87 Compensation and insurance arrangements for AFS licensees

CP 139 Compensation and insurance arrangements for trustee companies providing traditional services

*REP 107 Compensation arrangements for financial services licensees—
Research into the professional indemnity insurance market*

REP 112 Report on submissions to CP 87 Compensation and insurance arrangements for AFS licensees

ASIC forms

702 Application for discharge of security

FS20 Change of details for an Australian financial services licence