



**ASIC**

Australian Securities & Investments Commission

## REGULATORY GUIDE 126

# Compensation and insurance arrangements for AFS licensees

October 2009

### **About this guide**

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

It sets out how ASIC will administer the compensation requirements under s912B of the *Corporations Act 2001* (Cth) (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 update was issued on 23 October 2009 and is based on legislation and regulations as at 23 October 2009.

Previous versions:

- Superseded Regulatory Guide 126, issued 28 March 2008
- Superseded Regulatory Guide 126, issued 27 November 2007

## 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 Chapter 7. The primary way to comply with this obligation is to have professional indemnity (PI) insurance cover.

ASIC will 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 over time 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.

ASIC will take a staged approach to administering the requirements so that licensees are required to have a higher standard of PI insurance after a two-year implementation period. This gives industry time to develop insurance products to meet this higher standard. For the avoidance of doubt, licensees are not required to obtain automatic run-off cover from 1 January 2010.

During the implementation period, we will consider it to be adequate for licensees to have a standard of PI insurance that is based on what is available in the market, but that still achieves important improvements in the standard of compensation arrangements generally available to retail clients.

### The compensation requirements

- RG 126.1 Under s912B of the Corporations Act, 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 Chapter 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 having regard to the nature of the licensee's business and its potential liability for compensation claims (reg 7.6.02AAA); or
  - (b) be approved by ASIC as alternative arrangements.
- RG 126.3 The Corporations Regulations also provide exemptions from the requirements for some licensees that are regulated by APRA or related to an entity regulated by APRA (reg 7.06.02AAA(3)).

- RG 126.4 In this guide, the requirements in the Corporations Act and Regulations are referred to as the ‘compensation requirements’

## Our general approach

### Our objective

- RG 126.5 ASIC will administer the compensation requirements to maximise their potential to achieve the objective of reducing the risk that a retail client’s losses (due to breaches for which a licensee is responsible) cannot be compensated by the licensee because of lack of financial resources (referred to in this guide as the ‘policy objective’).
- RG 126.6 The requirements for licensees to have PI insurance cover will improve the standard of compensation arrangements currently in place in the industry. The extent to which it does so depends on what is currently available in the insurance market. We aim to encourage the development of PI insurance products that will deliver a high standard of protection. In the meantime, we want licensees to have the highest standard of PI insurance cover that is reasonably commercially available in the current market place.

### Our approach

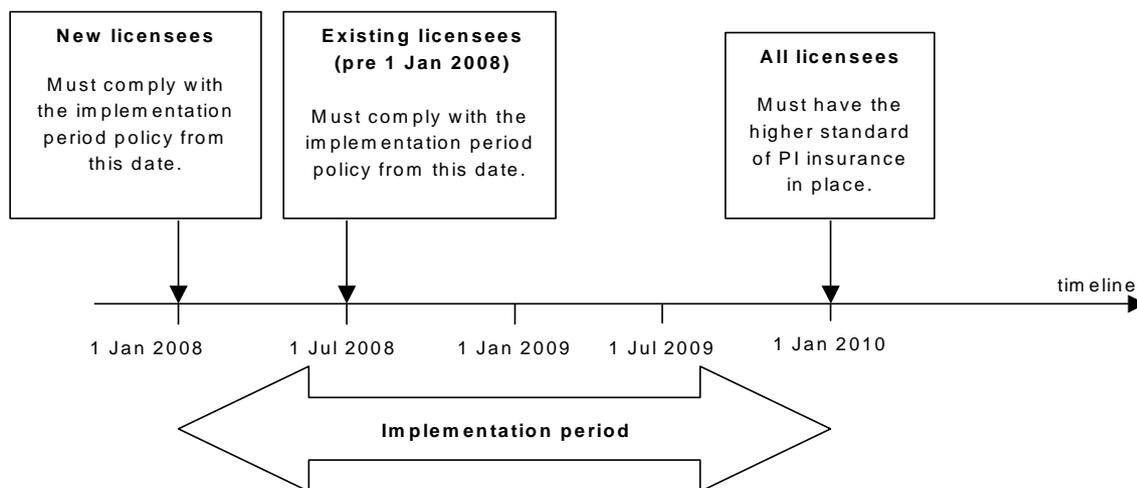
- RG 126.7 To achieve this objective, we will take a staged approach to administering these requirements:
- (a) For an implementation period of two years after the requirements commenced on 1 January 2008, we consider it to be adequate for licensees to have PI insurance based on what is available in the market, provided it meets some minimum standards.
  - (b) At the end of the two-year implementation period, we will expect licensees to have PI insurance that reliably delivers on all aspects of the policy objective (for the avoidance of doubt, licensees are not required to obtain automatic run-off cover from 1 January 2010).
- Note: previously automatic run-off cover was required to be obtained by 1 January 2010, but we have removed this requirement because automatic run-off cover is not currently available in the market.
- RG 126.8 During the implementation period, we will work with industry to encourage the development of products or solutions that will achieve this higher standard.
- RG 126.9 Our policy originally required licensees to obtain automatic run-off cover from 1 January 2010. We understand from industry that automatic run-off cover is currently not available in the market for licensees. Accordingly, we no longer require licensees to obtain automatic run-off cover from 1 January

2010. We will continue to monitor the availability of automatic run-off cover and may reassess our position should automatic run-off cover become available.

### What this means for licensees

- RG 126.10 During the implementation period, licensees will need to have PI insurance that complies with the minimum standards we described for implementation period policy in Section D. During the implementation period, we will consider this to be adequate.
- RG 126.11 After the implementation period, licensees must have PI insurance that complies with the standards in Section C (for the avoidance of doubt, licensees are not required to obtain automatic run-off cover from 1 January 2010).
- RG 126.12 Figure 1 illustrates this two-stage approach and when licensees will need to comply.

**Figure 1: Timeline for licensees to comply**



### What this means for consumers

- RG 126.13 The approach ASIC has adopted to administering the compensation requirements means that all licensees need to have PI insurance that meets some minimum standards from the commencement of the compensation requirements. This means consumers will have greater protection against loss than they did before the commencement of the compensation requirements.
- RG 126.14 But it is important to recognise the limitations of PI insurance as a consumer protection mechanism.

- RG 126.15 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 126.16 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 that has not met expectations. Nor is it intended to underwrite the products of a product issuer.
- RG 126.17 Currently available insurance 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 currently available policies for risk management reasons.
- RG 126.18 We will encourage the development of products that provide insurance cover in these areas by setting a higher standard that we will require licensees to meet after the implementation period.

## What you must do

- RG 126.19 Table 1 sets out what licensees must do to comply with the compensation requirements.

**Table 1: What licensees must do to comply**

	What you must do	When
<b>New licensees</b> (Your licence commences from 1 January 2008)	<b>Stage 1:</b> Confirm in your licence application that: <ul style="list-style-type: none"> <li>• you have PI insurance cover that complies with the implementation period policy in Section D; or</li> <li>• you have a process in place to ensure that you will have this cover when the licence takes effect.</li> </ul>	When you apply for your AFS licence.  You will need to have the insurance cover in place by the date your licence commences.
	<b>Stage 2:</b> Obtain insurance cover that complies with the standard set out in Section C (for the avoidance of doubt, licensees are not required to obtain automatic run-off cover).	By 1 January 2010.

	What you must do	When
<b>Existing licensees</b> (Your licence commenced before 1 January 2008)	<p><b>Stage 1:</b> Obtain an insurance policy that complies with the implementation period policy in Section D by 1 July 2008.</p> <p>If you had PI insurance in place before 1 December 2007 that did not meet the requirements in Section D, you were required to obtain a policy that did comply when your policy came up for renewal.</p> <p>If your policy did not come up for renewal in sufficient time to comply by 1 July 2008, we expected you to take reasonable steps to comply as soon as possible thereafter.</p> <p><b>Stage 2:</b> Obtain insurance cover that complies with the standard set out in Section C (for the avoidance of doubt, licensees are not required to obtain automatic run-off cover).</p>	<p>Depending on your situation:</p> <ul style="list-style-type: none"> <li>• by 1 July 2008; or</li> <li>• no later than 31 December 2008.</li> </ul> <p>By 1 January 2010.</p>
<b>Alternative arrangements</b> (ASIC may approve alternative arrangements to PI insurance)	<p>Lodge an application addressing the issues set out in Section E.</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"> <li>• for your application to be assessed; and</li> <li>• to obtain the required PI insurance if your arrangements are not approved.</li> </ul>
<b>Exempt licensee</b> (Some licensees are exempt)	<p>Some licensees can rely on an exemption under the Corporations Regulations: see Section F.</p> <p>If required, lodge an application for approval of a guarantee.</p>	

## Disclosure in FSGs

- RG 126.20 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.

## If you cannot comply

- RG 126.21 If you cannot obtain adequate PI insurance cover, are not exempt and have not obtained our approval for an alternative arrangement by the commencement of the compensation requirements, you might need to cease operating as a licensee.

## B Our general approach

### Key points

ASIC will administer the compensation requirements to maximise their potential to achieve the objective of reducing the risk that licensees cannot meet claims for compensation due to insufficient financial resources. The compensation requirements are not a mechanism for providing compensation directly to consumers.

These 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 what insurance is practically available at any given time.

We recognise that market limitations and the timetable for implementing the compensation requirements may mean that insurance cover that meets the policy objective is not readily available for all AFS licensees immediately.

We will therefore adopt a staged approach to administering the compensation requirements with a view to encouraging the development of insurance products that fulfil this purpose during the implementation period.

### Policy objective

RG 126.22 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',  
*Compensation Arrangements for Financial Services Licensees, Regulation Impact Statement, April 2007 p. 7.*

RG 126.23 ASIC's policy objective is to administer the compensation requirements to maximise their potential to meet this objective.

RG 126.24 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 126.25 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 126.26 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 126.27 Table 2 sets out the key principles that will guide our administration of the compensation requirements.

**Table 2: Key principles**

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

## Principle 1: Fit to achieve the policy objective

- RG 126.28 PI insurance is designed to protect the insured (e.g. 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 126.29 The Corporations Regulations require:
- (a) licensees to have PI insurance that is *adequate*, having regard to certain factors of their business and potential liability; and
  - (b) ASIC to assess applications for alternative arrangements against the same factors.

- RG 126.30 The concept of what is ‘adequate’ is an important area for ASIC 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 for which a licensee is responsible) cannot be compensated by the licensee due to the lack of financial resources.
- RG 126.31 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 126.32 We consider that compliance with the compensation requirements is part of a licensee’s overall risk management processes and its obligation in s912A to provide the financial services ‘efficiently, honestly and fairly’.
- RG 126.33 The Corporations Regulations reflect the fact that different licensees will have very different businesses and risks, which will impact on what compensation arrangements are adequate for them. Therefore we consider that licensees should undertake their own analysis of what is adequate for them.
- RG 126.34 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 126.35 Some licensees might find it helpful to engage external consultants, actuaries, brokers or advisers to undertake a risk assessment of their business and provide advice on the amount and type of cover that they should obtain.

## Principle 3: Practical availability

- RG 126.36 We consider that one of the elements of adequacy is what is practically available at any given time.
- RG 126.37 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 126.38 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. We have based our implementation period policy on this analysis: see Section D.

RG 126.39 In developing this guide, we commissioned a report into the market for PI insurance for AFS licensees: see REP 107 *Compensation arrangements for financial services licensees Research into the professional indemnity insurance market* (the PII Market Report).

Note: See also Consultation Paper 87 *Compensation and insurance arrangements for AFS licensees* (CP 87). REP 112 *Report on submissions to CP 87 Compensation and insurance arrangements for AFS licensees* highlights key issues from submissions to CP 87 and ASIC's response. All these documents are available on ASIC's website at [www.asic.gov.au](http://www.asic.gov.au).

RG 126.40 The PII Market Report 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 126.41 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 126.42 Because most advice claims are 'long tail' (i.e. claims arise 2 to 7 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 126.43 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 7 years of run-off cover would be desirable. Accordingly, we have removed the requirement to obtain automatic run-off cover from 1 January 2010. We will continue to monitor the availability of automatic run-off cover and may reassess our position if automatic run-off cover becomes available.

## Implementation period

- RG 126.44 When any new regulation is introduced, there will necessarily be a period of adjustment. Particularly in relation to PI insurance, we understand that insurance policies are generally written for one-year periods and time will be required for new policies or products to be developed and agreed.
- RG 126.45 Due to the compressed timeframe for implementation of the compensation requirements, we anticipate that there will be unique implementation issues involved during the initial implementation period (i.e. the first two years to 31 December 2009).
- RG 126.46 Therefore during the implementation period, where a licensee has an insurance policy that complies with the standards outlined in Section D, we will consider this to be adequate.

## Working with industry

- RG 126.47 We will work with industry during the implementation period to encourage the development of new products to help PI insurance fulfil the purpose of the policy objective.
- RG 126.48 We encourage relevant industry and professional bodies to:
- (a) provide guidance on the compensation requirements to their members; and
  - (b) consider what standard PI insurance policies and other measures they can develop to assist their members.
- RG 126.49 Industry bodies might also consider facilitating group compensation arrangements (e.g. a group insurance scheme or a compensation fund supported by levies from members). ASIC may consider such proposals as alternative arrangements under s912B(2)(b): see Section E. We encourage such bodies to approach us with any potential solutions they develop.
- RG 126.50 We encourage the insurance industry to respond to the opportunity created by mandatory PI insurance cover to develop new products that will help PI insurance fulfil the purpose of the compensation requirements.
- RG 126.51 We also expect that licensees will work actively (alone or collectively) to encourage insurers to meet the demand for PI insurance products that are consistent with the compensation requirements. This includes exploring the possibility of developing standardised policies that can cover licensees in the same industry or industry sector.

## 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, licensees should assess what is adequate PI insurance to meet their obligations under s912B and obtain such cover.

### What is 'adequate'?

RG 126.52 The Corporations Regulations require licensees to hold PI insurance that is *adequate*, having regard to:

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

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

- (b) the nature of the financial services business carried on by the licensee, 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: The Explanatory Statement to 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 126.53 This is not an exhaustive list of the factors that licensees need to take into account in assessing what PI insurance cover is adequate in their circumstances.

### **Amount of cover**

- RG 126.54 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 126.55 Section 912B requires that the insurance must cover loss or damage suffered by retail clients due to breaches of obligations under Chapter 7 by the licensee and its representatives. This obligation extends to all financial services covered by Chapter 7. Losses caused by negligent, fraudulent or dishonest conduct that amounts to a breach of Chapter 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 126.56 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 126.57 Of special concern are exclusions that mean cover is not available for breaches of obligations under Chapter 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 126.58 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 126.59 We understand that there is generally an excess on insurance policies and all insureds need to consider how they will cover the excess. Licensees are required to assess what financial resources are required (to cover the excess and gaps in cover due to various exclusions) and to ensure they have such financial resources available. Licensees should be able to demonstrate to themselves, and to us if necessary, that they have such financial resources available.

RG 126.60 Licensees 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 126.61 As discussed above, whether a particular PI insurance policy is adequate for a particular licensee depends on all of the facts and circumstances, including the nature, scale and complexity of the licensee's business, and their other financial resources. Therefore, it is up to each licensee to determine what is adequate PI insurance for them to meet their obligations under s912B and obtain such PI insurance.

RG 126.62 Table 3 gives guidance on the processes we think licensees should go through to determine what is adequate PI insurance for them. However, ASIC will not 'approve' a licensee's PI insurance arrangements.

RG 126.63 Even if licensees already have PI insurance cover in place, they should review their operations to assess what type and amount of cover they need. This involves licensees both:

- (a) undertaking an initial assessment of their business; and
- (b) having a process of ongoing assessment.

### Initial assessment

RG 126.64 We suggest that licensees use the assessment process in Table 3 to determine what will be adequate PI insurance for them.

**Table 3: Initial assessment process**

<b>Step 1: Assess the business</b>	Review your business, taking into account any proposed changes to the business. Review your claims history (if any) and risk management procedures.
<b>Step 2: Assess potential liability</b>	<p>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:</p> <ul style="list-style-type: none"> <li>• the maximum exposure to a single client ('worst loss scenario' per client);</li> <li>• the number of claims that could arise from a single event (potential for multiple claims); and</li> <li>• the number of claims that might be expected during the policy period.</li> </ul> <p style="text-align: right;">See RG 126.52</p>

<b>Step 3: Approach insurers/brokers</b>	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 126.68–RG 126.70 about authorised insurers
<b>Step 4: Assess amount of cover</b>	Consider whether the amount of cover is adequate. It should at least meet our minimum requirements.	See RG 126.54 and Table 4
<b>Step 5: Assess scope of cover</b>	Consider whether the scope of cover is adequate.	See RG 126.55 and Table 4
<b>Step 6: Review policy terms and exclusions</b>	Review the policy features using the questions in Table 4. Identify any gaps in cover.	See RG 126.56–RG 126.57 and Table 4
<b>Step 7: Consider financial resources</b>	<p>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).</p> <p>Consider how you will cover these claims and retain records of the assessment (e.g. through capital, cash flow, overdraft, support).</p>	See RG 126.58–RG 126.60 and Table 4

### Ongoing assessment

- RG 126.65 We expect that licensees will review their PI insurance or other compensation arrangements at least annually to ensure they continue to be adequate (e.g. when their existing policy is due for renewal). Licensees should also review the adequacy of their compensation arrangements in light of any major changes in their business (e.g. if they start providing new services or products or engage more representatives).
- RG 126.66 From time to time, we may ask a licensee to provide a copy of their PI insurance policy or a certificate of currency and other information relating to their compensation arrangements. For example, we may ask for these documents when conducting a compliance review of a licensee.

### Compliance systems

- RG 126.67 We expect licensees will ensure that a senior officer or manager is accountable for ensuring that their PI insurance policy is renewed when required, that premiums are paid on time and that their policy or other compensation arrangements continue to be adequate. Licensees will need to make provision in their dispute resolution systems for ensuring that claims that are brought to their attention are promptly notified to insurers.

## Authorised insurers

- RG 126.68 Generally, the cover needs to be from an insurer regulated by APRA, or operating under an exemption, under the *Insurance Act 1973*.
- RG 126.69 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. Licensees could then obtain PI insurance provided by an APRA-regulated direct offshore foreign insurer.
- RG 126.70 Currently not all direct offshore foreign insurers are regulated by APRA. We recognise that some existing licensees who were not required to meet the compensation requirements until 1 July 2008 might have been able to obtain insurance from a non-APRA-regulated foreign insurer before that date. However, licensees should be aware that if their insurer does not become regulated by APRA and they cannot rely on an exemption, they will need to change insurers after 1 July 2008.

## Distinction between PI insurance and alternative arrangements

- RG 126.71 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 126.72 For example, licensees 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: Licensees will still need to consider that 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 126.73 Because the Corporations Regulations require licensees to obtain a contract of PI insurance, membership of a discretionary mutual fund would not satisfy the requirements. Licensees who believe that membership of a discretionary mutual fund would provide no less protection than adequate PI insurance can submit an application for approval of this membership as an alternative arrangement: see Section E.

## What the policy should cover

RG 126.74 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 licensees should consider when determining what is adequate depending on their business and individual circumstances.

**Table 4: Features of adequate PI insurance cover**

Policy feature	Minimum requirements and factors to consider
<p><b>Amount of cover</b></p>	<p><b>Minimum requirement:</b> 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.</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: The PII Market Report suggests that 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> <p><b>Factors to consider:</b></p> <ul style="list-style-type: none"> <li>• Is the level of indemnity adequate to cover claims brought both inside and outside of an EDR scheme?           <p>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> </li> <li>• 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.</li> <li>• 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?</li> <li>• 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?</li> </ul>

Policy feature	Minimum requirements and factors to consider
<b>Scope of cover</b>	<p><b>Minimum requirement:</b> 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. This includes liability:</p> <ul style="list-style-type: none"> <li>• for fraud or dishonesty by directors, employees and other representatives of the licensee (although fraud cover is not required for sole traders); and</li> <li>• under EDR scheme awards.</li> </ul> <p>Note 1: The policy need not explicitly refer to 'breaches of Chapter 7' or 'EDR scheme awards'. However, the policy must have the effect of providing cover for breaches of the relevant obligations under Chapter 7 and EDR scheme awards.</p> <p>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>
<b>Exclusions</b>	<p><b>Minimum requirement:</b> The policy must <i>not</i> have the effect of excluding:</p> <ul style="list-style-type: none"> <li>• EDR scheme awards;</li> <li>• loss caused by the conduct of representatives generally;</li> <li>• fraud and dishonesty by directors, employees and other representatives (although fraud cover is not required for sole traders);</li> <li>• claims for misrepresentations about services; and</li> <li>• 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).</li> </ul> <p>Note: 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>
<b>Persons covered</b>	<p><b>Minimum requirement:</b> 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><b>Factors to consider:</b></p> <ul style="list-style-type: none"> <li>• Are there many representatives and are they geographically dispersed? If so, the limit of indemnity might need to be higher to manage this risk.</li> </ul> <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>
<b>Automatic reinstatements</b>	<p><b>Minimum requirement:</b> 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>

Policy feature	Minimum requirements and factors to consider
<b>Excess / deductibles</b>	<p><b>Factors to consider:</b></p> <ul style="list-style-type: none"> <li>• Is the excess at a level that the business can confidently sustain as an uninsured loss taking into account the licensee's financial resources?</li> </ul> <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 the PII Market Report 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>
<b>Legal costs</b>	<p><b>Minimum requirement:</b> Defence costs must be 'in addition' to the minimum limit <b>or</b> the level of cover must be sufficiently increased to take into account these costs.</p> <p>Note: The PII Market Report suggests that, 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. This is an example only.</p>
<b>EDR scheme awards</b>	<p><b>Minimum requirement:</b> The policy must cover EDR scheme awards.</p> <p><b>Factors to consider:</b></p> <ul style="list-style-type: none"> <li>• Does the policy cover agreed decisions reached through the EDR scheme conciliation process? (If not, the licensee will be effectively self-insuring to cover any conciliated agreements through its EDR scheme.)</li> <li>• Do lower sub-limits apply to EDR scheme awards and how are claims aggregated for the purpose of these limits? Again, licensees will be effectively self-insuring to cover claims outside these limits.</li> </ul> <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>
<b>Fraud / dishonesty / infidelity</b>	<p><b>Minimum requirement:</b> 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>
<b>Approved product list</b>	<p><b>Minimum requirement:</b> 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><b>Factors to consider:</b></p> <ul style="list-style-type: none"> <li>• 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.</li> <li>• 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.</li> </ul>

Policy feature	Minimum requirements and factors to consider
<b>Retroactive cover</b>	<b>Minimum requirement:</b> If the licensee had an immediately previous PI insurance policy, the policy must provide retroactive cover to the earlier of: <ul style="list-style-type: none"><li>• the retroactive date specified in the immediately previous PI insurance policy; or</li><li>• the commencement date of the first PI insurance policy in the series of continuous policies.</li></ul>
<b>'Run-off' cover</b>	<b>Not required:</b> 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.

## D Implementation period

### Key points

We recognise that it will take time to develop PI insurance policies that meet the policy objective.

Therefore, during the implementation period, if a licensee has a PI insurance policy that complies with our implementation period policy, we will consider this to be adequate.

The implementation period will run for the first two years of the new regime (i.e. from 1 January 2008 to 31 December 2009).

### Need for an implementation period

RG 126.75 From consultation and research, we understand that PI insurance policies that meet the policy objective and cover all consumer losses falling within the scope of the obligation under s912B might not be commercially available to all licensees. Commercially available policies might also include significant exclusions that undermine the effectiveness of the policy cover.

Note: The PII Market Report's key findings included that:

- (a) there are currently no policies available that are explicitly based on the obligation for AFS licensees to hold PI insurance; and
- (b) current policies might not cover the full range of breaches under the Corporations Act (e.g. there is generally no cover available for fraud by a sole trader licensee or for representatives acting outside the scope of an 'approved product list').

RG 126.76 We also understand that insurance policies are written for one-year periods and standard policies are settled by insurers even further in advance, and that insurance premiums may be higher initially while insurers gain experience in pricing the risks.

RG 126.77 Because it will take time to develop new products that are tailored to this market and that meet the policy objective, we believe that an implementation period of the first two years of the new regime (i.e. from 1 January 2008 to 31 December 2009) is appropriate. During the implementation period, we will work with industry to help develop PI insurance products that are adequate to meet the policy objective.

## Implementation period policy

- RG 126.78 We acknowledge that, in practice, PI insurance during the implementation period will be a combination of:
- (a) minimum policy features based on what we understand is currently commercially available (referred to in this guide as the ‘implementation period policy’, see Table 5);
  - (b) analysis of the business, risk management systems and the insurance cover to identify gaps in cover;
  - (c) additional financial resources of licensees to cover gaps in their policy; and
  - (d) steps taken to improve the arrangements over time.

**Table 5: Implementation period policy**

Policy feature	Requirement
<b>Authorised insurer</b>	From 1 July 2008, the insurance must be provided by an insurer regulated by APRA or operating under an exemption under the <i>Insurance Act 1973</i> : see RG 126.68–RG 126.70.
<b>Amount of cover</b>	<p>The insurance must have a limit of indemnity of at least \$2 million or higher based on revenue: see Table 4. 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 (up to a maximum limit of \$20 million).</p> <p>Note: Revenue has the same meaning here as in AASB 118. Revenue should be calculated based on the financial year ended previous to taking out the insurance cover and reassessed on each policy renewal. For new licensees, or if a licensee believes revenue based on the previous financial year 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. For example, if the policy also covers claims made by wholesale clients or claims that fall outside the scope of s912B, licensees might need to increase the overall amount of cover so that there is adequate cover available for claims that fall within s912B. Licensees must retain records of how they determined what amount was adequate for them.</p> <p>The insurance must have at least one automatic reinstatement, unless the limit of indemnity is at least twice the minimum limit referred to above.</p> <p>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>

Policy feature	Requirement
<b>Scope of cover</b>	<p>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. This includes liability:</p> <ul style="list-style-type: none"> <li>• for fraud or dishonesty by directors, employees and other representatives of the licensee (although fraud cover is not required for sole traders); and</li> <li>• under EDR scheme awards.</li> </ul> <p>Note 1: The policy need not explicitly refer to 'breaches of Chapter 7' or 'EDR scheme awards'. However, the policy must have the effect of providing cover for breaches of the relevant obligations under Chapter 7 and EDR scheme awards.</p> <p>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>
<b>Terms and exclusions</b>	<p>The policy must <i>not</i> have the effect of excluding:</p> <ul style="list-style-type: none"> <li>• EDR scheme awards;</li> <li>• loss caused by the conduct of representatives generally;</li> <li>• fraud and dishonesty by directors, employees and other representatives (although fraud cover is not required for sole traders); or</li> <li>• 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).</li> </ul> <p>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"> <li>• the retroactive date specified in the immediately previous PI insurance policy; or</li> <li>• the commencement date of the first PI insurance policy in the series of continuous policies.</li> </ul>
<b>Excess / deductibles</b>	<p>The excess / deductible must be at a level that the business can confidently sustain as an uninsured loss.</p> <p>Licensees should assess if any financial resources are required (to cover excess and any gaps in cover).</p> <p>Licensees must retain records of this assessment.</p> <p>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.</p>

#### Notes on Table 5

Note 1: Implementation period policies do not have to provide cover for moving a client from a product that is not on an approved product list to a product that is on an approved product list.

Note 2: Some of the concepts contained in Table 5 are more fully explained in Table 4.

## Licensees with other forms of PI insurance

RG 126.79 We consider that insurance that complies with the superseded *Insurance (Agents and Brokers) Act 1984* is adequate PI insurance for insurance brokers during the implementation period.

- RG 126.80 The following groups of licensees are currently required to hold PI insurance as a condition of their AFS licence:
- (a) responsible entities of managed investment schemes (see Regulatory Guide 167 *Licensing: Discretionary powers* (RG 167) at RG 167.40);  
Note: See also Regulatory Guide 133 *Managed Investments: Scheme property arrangements* (RG 133) at RG 133.20.
  - (b) investor directed portfolio service (IDPS) operators (see Regulatory Guide 167 *Licensing: Discretionary powers* (RG 167) at RG 167.40); and  
Note: See also Regulatory Guide 148 *Investor directed portfolio services* (RG 148) at RG 148.27.
  - (c) operators of managed discretionary account (MDA) services.  
Note: See Class Order CO 04/194 *Managed discretionary accounts* and Regulatory Guide 179 *Managed discretionary account services* (RG 179) at RG 179.59.
- RG 126.81 We expect licensees who fall within these groups to have *at least* the cover that is required under our existing policies mentioned above. Therefore, these existing requirements will continue to apply to these licensees.
- RG 126.82 Some other regulatory regimes require licensees to hold PI insurance cover. For example, some superannuation trustees are obliged to hold PI insurance under APRA's RSE licence regime. As their existing cover was 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 126.83 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 126.84 ASIC has the discretion to discharge any security bond and return it to the licensee where it has PI insurance or ASIC-approved alternative arrangements in place.
- RG 126.85 Licensees with security bonds should lodge a certification with ASIC in the prescribed form stating that compensation arrangements are in place that are adequate to cover claims to which the security bond could otherwise apply.

- RG 126.86 Licensees can take into account their own financial resources in making this certification (e.g. if they cannot obtain retroactive insurance cover for potential claims against the security bond).

## **New licensees**

- RG 126.87 Applicants for an AFS licence that is expected to commence on or after 1 January 2008 will need to confirm in their application that they have:
- (a) adequate PI insurance cover in place; or
  - (b) a process to ensure that they will have adequate PI insurance cover in place when their AFS licence takes effect.
- RG 126.88 We will ask questions about the applicant's proposed compensation arrangements, including:
- (a) the insurer and the type and level of PI insurance cover they have (or will have) in place;
  - (b) the scope of the cover; and
  - (c) whether the policy meets the requirements of our implementation period policy (see Table 5 in Section D).
- RG 126.89 Applicants must also provide ASIC with a certificate of currency of the PI insurance policy before their licence will be granted.

## E Alternative arrangements

### Key points

Licensees can apply to ASIC for approval of alternative compensation arrangements under s912B(2)(b): see RG 126.90–RG 126.94.

We will assess applications for approval of alternative arrangements on a case-by-case basis: see RG 126.95–RG 126.99.

Existing compensation arrangements must remain in place while new alternative arrangements are assessed: see RG 126.100–RG 126.101.

### How to apply for approval

- RG 126.90 Existing licensees who wish to apply for approval of alternative arrangements will need to lodge an application. New licensees can apply for approval, if they choose to do so, as part of the licence application process.
- RG 126.91 An application to ASIC 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 126.92 We will generally ask for an expert's report (e.g. actuarial report) to be submitted with the application to assess whether the arrangements give no less protection than PI insurance.
- RG 126.93 Licensees who wish to maintain arrangements that were already in place before the compensation requirements commenced must address the same criteria as for new arrangements. However, licensees who currently rely on a security bond will not receive approval to continue those arrangements.
- RG 126.94 Applications should be made in writing and sent to [applications@asic.gov.au](mailto:applications@asic.gov.au).

## How we will assess applications

- RG 126.95 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 126.96 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 126.97 Under s912B(3), ASIC is required to have regard to:
- (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 126.98 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 having regard to:
- (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 126.99 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 126.100 It will take time to assess alternatives submitted to us for approval. Licensees applying for approval of alternative arrangements should:

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

## **Discharge of security bonds**

RG 126.101 Licensees who have alternative arrangements approved by ASIC can apply for release of any existing security bonds: see RG 126.83–RG 126.86.

## F Exemptions

### Key points

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

Licensees who 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 who are exempt under reg 7.6.02AAA(1)

- RG 126.102 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 126.103 Licensees who 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 ASIC: reg 7.6.02AAA(3).
- RG 126.104 Licensees wishing to apply for approval of a guarantee will need to lodge an application. In deciding whether to approve a guarantee, we will consider the same factors as outlined in Section C for adequate PI insurance.
- RG 126.105 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 126.106 Applications for approval of a guarantee should be made in writing and sent to [applications@asic.gov.au](mailto:applications@asic.gov.au).

### Discharge of security bonds

- RG 126.107 ASIC has the discretion to discharge security bonds to licensees who 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 126.108 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 126.86.

## G Disclosure in FSGs

### Key points

Under regs 7.7.03A and 7.7.06B licensees must include a statement in their Financial Services Guide (FSG) and the FSG of their representatives about the kind of compensation arrangements they have in place and whether these arrangements comply with s912B.

ASIC can take action against misleading disclosure.

### Licensees with PI insurance

- RG 126.109 In their FSG and the FSG of their representatives, licensees with PI insurance should:
- (a) disclose that they 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 the licensee (but who did at the time of the relevant conduct).

### Licensees with alternative arrangements

- RG 126.110 In their FSG and the FSG of their representatives, licensees with alternative arrangements should:
- (a) disclose that they 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 the licensee (but who did at the time of the relevant conduct).

### Licensees who are exempt

- RG 126.111 The Explanatory Statement to the Corporations Regulations 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 126.112 Licensees should disclose that they are exempt from the requirement as they are regulated by APRA or have an ASIC-approved guarantee from the APRA-regulated entity.

## Action against misleading disclosure

RG 126.113 ASIC 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 if references are made to ‘compensation’ or ‘adequate insurance’ that may be misleading to consumers unless there is a full explanation of what those terms mean and any limitations that relate to them. AFS licensees should therefore be careful if they choose to refer to these terms in their FSG. For example, some of the limitations are set out at RG 126.37–RG 126.43.

## 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 <a href="http://www.aasb.com.au">www.aasb.com.au</a>
AFS licence	An Australian financial services licence under s913B that authorises a person who carries out a financial services business to provide financial services Note: This is a definition contained in s761A.
AFS licensee or licensee	The holder of an AFS licence
APRA	The Australian Prudential Regulation Authority
ASIC	The 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
automatic run-off cover	Cover for claims made after the insurance policy has ended which 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
compensation requirements	The requirements in s912B of the Corporations Act and reg 7.6.02AAA of the Corporations Regulations
Corporations Act	The <i>Corporations Act 2001</i> (Cth)
Corporations Regulations	The 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: see s912A(2)(b) and 1017G(2)(b) of the Corporations Act
exclusion	A provision of an insurance policy that precludes coverage in particular circumstances
Explanatory Statement to the Regulation	The Explanatory Statement to Legislative Instrument 2007 No 197

Term	Meaning in this document
financial product	<p>Generally a facility through which, or through the acquisition of which, a person does one or more of the following:</p> <ul style="list-style-type: none"> <li>(a) makes a financial investment (see s763B)</li> <li>(b) manages financial risk (see s763C)</li> <li>(c) makes non-cash payments (see s763D)</li> </ul> <p>Note: See Div 3 of Part 7.1 for the exact definition.</p>
financial service	Has the meaning given in Pt 7.1 Div 4 of the Corporations Act
FSG or Financial Services Guide	<p>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 Part 7.7 of the Corporations Act</p> <p>Note: See s761A for the exact definition.</p>
implementation period	The period from 1 January 2008 to 31 December 2009 during which ASIC will accept PI insurance that complies with Section D as adequate. This is intended to provide time for industry to develop PI insurance policies which meet the policy objective
implementation period policy	The policy in Table 5 of Section D
PII Market Report	The report commissioned by ASIC into the market for PI insurance: see REP 107 <i>Compensation Arrangements for Financial Services Licensees—Research into the Professional Indemnity Insurance Market</i> (December 2006) at <a href="http://www/asic.gov.au/reports">www/asic.gov.au/reports</a>
policy objective	As defined in RG 126.5
product list	A list of products in relation to which the licensee and its representatives provide financial services that is agreed between the insurer and the insured and covered by the policy
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
RG 164 (for example)	An ASIC regulatory guide (in this example numbered 164)
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 Chapter 7 Part 7.1 Div 2 of the Corporations Regulations

<b>Term</b>	<b>Meaning in this document</b>
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)
retroactive date	A date in a 'claims made' policy on or after which acts or omissions are covered
RSE licence	Has the meaning given in the <i>Superannuation Industry (Supervision) Act 1993</i>
revenue	As defined in AASB 118
self-insurance	Setting aside a calculated amount of money to form a source of compensation for potential claims

## Related information

### Headnotes

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

### Class orders and pro formas

CO 04/194 *Managed discretionary accounts*

PF 209 *Australian financial services licence conditions*

### Regulatory guides

RG 1–3 *AFS Licensing Kit*

RG 104 *Licensing: Meeting the general obligations*

RG 133 *Managed investments: Scheme property arrangements*

RG 148 *Investor directed portfolio services*

RG 165 *Licensing: Internal and external dispute resolution*

RG 166 *Licensing: Financial requirements*

RG 167 *Licensing: Discretionary Powers*

RG 179 *Managed discretionary account services*

### Legislation

*Corporations Act 2001* Chapter 7 Part 7.6 Div 3 s912A(1), 912B, regulations 7.6.02AA, 7.6.02AAA, 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*

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

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

### **Media and information releases**

IR 07-39 *ASIC consults on compensation and insurance requirements for  
AFS licensees*

IR 07-52 *ASIC releases guidance on compensation and insurance  
arrangements for AFS licensees*

### **ASIC forms**

FS20 *Change of details for an Australian financial services licence*