

# **Review of compensation arrangements for consumers of financial services**

Future of financial advice

© Commonwealth of Australia 2011

ISBN 978-0-642-74683-2

### **Ownership of intellectual property rights in this publication**

Unless otherwise noted, copyright (and any other intellectual property rights, if any) in this publication is owned by the Commonwealth of Australia (referred to below as the Commonwealth).

### **Creative Commons licence**

With the exception of the Coat of Arms (see below) and the Treasury logo and all tables within Chapters 1, 2, 3, 4 and Attachment B, as well as the material in paragraph 2.33, this publication is licensed under a Creative Commons [Attribution 3.0 Australia](http://creativecommons.org/licenses/by/3.0/au/) Licence.



Creative Commons Attribution 3.0 Australia Licence is a standard form license agreement that allows you to copy, distribute, transmit and adapt this publication provided that you attribute the work. A summary of the licence terms is available from <http://creativecommons.org/licenses/by/3.0/au/deed.en>. The full licence terms are available from <http://creativecommons.org/licenses/by/3.0/au/legalcode>.

The Commonwealth's preference is that you attribute this publication (and any material sourced from it) using the following wording:

Source: Licensed from the Commonwealth of Australia under a Creative Commons [Attribution 3.0 Australia](http://creativecommons.org/licenses/by/3.0/au/) Licence.

The Commonwealth of Australia does not necessarily endorse the content of this publication.

### **Use of the Coat of Arms**

The terms under which the Coat of Arms can be used are set out on the It's an Honour website (see [www.itsanhonour.gov.au](http://www.itsanhonour.gov.au)).

STATUTORY COMPENSATION REVIEW  
FUTURE OF FINANCIAL ADVICE

**RICHARD ST. JOHN**

PO Box 6295  
Kingston ACT 2604

Telephone: 03 8611 1325

Mobile: 0418 568 066

Email: [futureofadvice@treasury.gov.au](mailto:futureofadvice@treasury.gov.au)

<http://futureofadvice.treasury.gov.au>

The then Minister for Financial Services, Superannuation and Corporate Law, the Hon Chris Bowen MP, engaged me to review and report to the Government on the need for, and costs and benefits of, a statutory compensation scheme for financial services.

The review is being undertaken in the context of the Government's response to the report of the Parliamentary Joint Committee on Corporations and Financial Services *Inquiry into financial products and services in Australia*. Recommendation 10 of the report was '... that the Government investigate the costs and benefits of different models of a statutory last resort compensation fund for investors'.

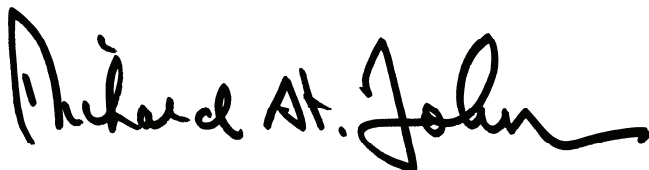
The review is an element of a broader package of changes for financial advice announced by the Government on 26 April 2010.

This consultation paper is a step towards the preparation of my recommendations to Government. It reflects initial research in which I have been assisted by a review secretariat in the Department of the Treasury and the outcome of preliminary consultations I have had with industry participants, regulators and other interested parties.

In releasing this paper, I draw attention to a number of issues on which comment is invited. These are raised at the end of Chapters 2 to 5. I am also seeking reactions to the preliminary observations I have made in Chapter 5. These observations are a pointer to issues I see as relevant to the review, but respondents should feel free to address other issues as well.

I intend to continue the consultation process in the period following the release of this paper and leading up to my preparation of recommendations to the Government.

I express my appreciation to the individuals and bodies who have already provided views or contributed information to the review including ASIC and FOS for their assistance.





# Contents

- Consultation process..... ix**
- Outline of paper..... xi**
- Chapter 1: Introduction and background..... 1**
  - Terms of reference ..... 1
  - Relevant concepts and issues of scope ..... 2
    - Financial services ..... 3
    - Financial services industry ..... 3
    - Retail clients ..... 5
    - Obligations on licensees ..... 6
    - Financial loss in absence of misconduct..... 7
  - Basis of financial services regulation ..... 7
  - Licensing regime for financial service providers..... 9
  - Context of compensation arrangements ..... 12
  - Future of Financial Advice reforms..... 14
- Chapter 2: Current compensation arrangements ..... 17**
  - Arrangements under s912B of the Corporations Act..... 18
    - Exemptions from compensation arrangements..... 20
    - Alternative arrangements ..... 20
    - Coverage of representatives ..... 20
    - Disclosure of compensation arrangements..... 21
  - Insurance as a basis for compensation ..... 21
    - Run-off cover ..... 23
    - Insurance provider..... 23
  - ASIC administration of insurance requirement..... 23
  - Grounds for compensation claims..... 24
  - Avenues for consumer redress ..... 26
    - Alternative dispute resolution mechanisms ..... 27
    - EDR scheme awards and professional indemnity insurance ..... 32
  - Other financial sector compensation arrangements ..... 34
    - Compensation regime for financial markets ..... 34
    - Financial Claims Scheme for depositors and policyholders..... 37
    - Compensation arrangements for superannuation funds ..... 38
    - Compensation arrangements for credit providers ..... 39
  - Issues of interest ..... 41

|   |           |
|---|-----------|
| <b>Chapter 3: Compensation arrangements in practice</b> .....   | <b>45</b> |
| Market for professional indemnity insurance.....                | 46        |
| Supply of professional indemnity insurance.....                 | 47        |
| Demand for professional indemnity insurance.....                | 47        |
| Access to insurance cover by licensees.....                     | 47        |
| Cost of professional indemnity insurance.....                   | 49        |
| Trends in insurance claims.....                                 | 50        |
| Insurance as a means of compensation.....                       | 52        |
| Benefits of professional indemnity insurance.....               | 52        |
| Limitations of professional indemnity insurance.....            | 52        |
| Consequences where insurance not available.....                 | 56        |
| Inability of retail clients to recover compensation.....        | 57        |
| Westpoint.....  | 58        |
| Storm Financial.....  | 60        |
| Other corporate collapses.....                                  | 60        |
| Issues of interest.....   | 62        |
| <b>Chapter 4: Comparison with other arrangements</b> .....      | <b>63</b> |
| UK compensation arrangements.....                               | 66        |
| Operation of UK arrangements.....                               | 69        |
| New prudential requirements.....                                | 69        |
| Proposed changes to UK regulatory architecture.....             | 70        |
| Schemes in other countries.....                                 | 71        |
| Operation of schemes in Canada, USA and EU.....                 | 72        |
| Compensation schemes in other industry sectors.....             | 72        |
| Professional indemnity insurance schemes.....                   | 73        |
| Issues of interest.....   | 74        |
| <b>Chapter 5: Observations and issues</b> .....                 | <b>75</b> |
| Introduction.....   | 77        |
| Consumer protection relatively well developed.....              | 78        |
| Focus on fallback compensation arrangements.....                | 79        |
| Mandate for fallback arrangements.....                          | 79        |
| Implementation of fallback arrangements.....                    | 80        |
| Eligible claims by retail clients.....                          | 80        |
| Compensation for licensee misconduct not investment losses..... | 81        |
| Insurance not a guarantee of compensation.....                  | 82        |
| Consequences where insurance does not respond.....              | 83        |
| Nub of the problem.....   | 83        |
| Possible remedial measures.....                                 | 84        |
| Protection of consumers at the outset.....                      | 85        |
| Enhancement of insurance cover.....                             | 86        |
| More focus on financial adequacy of licensees.....              | 91        |
| A last resort scheme for compensation.....                      | 93        |
| Issues in relation to any scheme.....                           | 93        |
| PFS/FOS scheme proposal.....                                    | 95        |
| Other considerations.....                                       | 96        |

**Attachment A: Relevant Corporations Regulations..... 99**

**Attachment B: Investor compensation arrangements in the European Union,  
Canada and the United States of America ..... 101**

**Glossary ..... 107**





## **Consultation process**

This consultation paper provides information, frames issues and raises questions on the need for, and costs and benefits of, a statutory compensation scheme for clients who suffer damage or incur loss as a result of misconduct by persons with whom they have dealt in the financial services sector. It was prepared as part of a review being conducted by Richard St. John. The paper reflects the initial research and preliminary consultation with industry participants and other stakeholders.

The reviewer invites feedback and comments from interested parties on the issues outlined in this paper. The information obtained through this process will inform and assist him in reaching views and making recommendations to the Government on whether changes are required to the current compensation arrangements.

Electronic lodgment of submissions is preferred, with documents submitted in a Word or RTF format. An additional PDF version may also be submitted.

All information (including name and address details) contained in submissions will be made available to the public on the Treasury website unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information in a separate attachment marked 'in confidence'. Legal requirements, such as those imposed by the *Freedom of Information Act 1982*, may affect the confidentiality of your submission.

Submissions may also be lodged by post.

***Closing date for submissions: Wednesday, 1 June 2011***

### ***Details for making submissions***

***Email: [futureofadvice@treasury.gov.au](mailto:futureofadvice@treasury.gov.au)***

Mail: Statutory Compensation Review  
PO Box 6295  
Kingston ACT 2604

### ***Enquiries***

Email: [futureofadvice@treasury.gov.au](mailto:futureofadvice@treasury.gov.au)

Telephone: Francesca Kibria (02) 6263 3253

Media Enquiries: [medialiaison@treasury.gov.au](mailto:medialiaison@treasury.gov.au)



## **Outline of paper**

- This paper provides information, frames issues and raises questions on the need for, and costs and benefits of, a statutory compensation scheme.
- Chapter 1 deals with the context and scope of the review. It also provides background on the overall regulatory framework for financial services and the regulatory philosophy on which it is based.
- Chapter 2 describes the current compensation arrangements within that regulatory framework.
- Chapter 3 addresses the operation of those compensation arrangements in practice.
- Chapter 4 provides a comparison with compensation arrangements in other countries and industry sectors.
- Chapter 5 provides some preliminary observations and draws out issues for further consideration.
- Attachment A sets out relevant regulations.
- Attachment B provides a summary of compensation arrangements in the EU, Canada and USA.

