

## Chapter 5: Observations and issues

This chapter provides preliminary observations and comments based on information gathered so far and initial consultation with a number of interested parties. These observations and comments are put forward with a view to drawing out the questions that seem to arise and providing shape to emerging issues as a basis for further consultation. They do not represent concluded views in any way. Respondents are encouraged to correct or supplement any of the information provided, to comment on issues raised or suggest other relevant avenues of inquiry. In brief:

- There is a relatively well developed regime for the protection of consumers in the financial services sector including a licensing regime for providers of those services, the imposition of statutory conduct and disclosure obligations upon licensed providers and rights of redress for consumers.
- Retail clients of financial services have additional protection in the form of a low cost alternative system for dispute resolution and arrangements to provide them with some assurance about recovery of compensation for loss or damage attributable to licensee misconduct.
- There are already statutory compensation schemes in place to provide consumers with last resort protection in sensitive areas such as in certain dealings with stockbrokers, authorised deposit-taking institutions and general insurers.
- The focus of the review is on the adequacy of the default arrangements for the protection of consumers in circumstances where they do not have recourse to those existing last resort arrangements.
- The default arrangements stem from a legislative declaration that financial service licensees who deal with retail clients should have arrangements for compensating those clients for loss or damage attributable to a licensee's breach of its statutory obligations.
- Following the implementation of the default arrangements, most licensees are required to hold professional indemnity insurance cover that is adequate for their business. Other licensees are exempt from any such requirement on the basis of their apparent financial strength and ability to meet claims for compensation from their own resources.
- The current default arrangements provide a measure of assurance but no guarantee that retail clients will be able to recover compensation to which they may be entitled.
- Professional indemnity insurance assists licensees in paying compensation that may be awarded to a client, but it is not a direct mechanism for the compensation of clients. It provides a valuable buffer but, under current arrangements, limited assurance that a licensee will be able to compensate a client. In some cases a policy will no longer be in force or it may not respond to a particular claim or provide sufficient cover.

- The risk for a client, where a licensee does not have recourse to insurance to cover the client's claim, is that the licensee may have stopped trading, become insolvent or have insufficient assets.
- There is an apparent shortfall in the delivery of compensation under current arrangements. Cases have arisen where retail clients have not been able to recover compensation to which they are entitled. While it is not easy to quantify the problem, clients have missed out on substantial recoveries and in any case the consequences for individuals can be harsh.
- Any move to provide further protection for retail clients could include measures to reduce the incidence of cases where clients suffer loss or damage from inappropriate licensee advice or conduct. This might be through improvements in professional standards for financial advisers on the one hand, and efforts to improve the financial literacy of consumers on the other.
- Mechanisms to enhance the effectiveness of professional indemnity insurance in underpinning the compensation arrangements could also be considered. This might include:
  - a tighter approach to the administration of the requirement for professional indemnity insurance;
  - the promotion of standard professional indemnity insurance cover including to deal with claims after licensees cease to trade; and
  - improved disclosure of insurance arrangements and facilitation of third party rights.
- The ultimate risk for clients in recovering compensation stems from a licensee's creditworthiness. This raises the question whether more attention should be given to the adequacy of licensees' financial resources.
- Beyond measures of this kind, or in conjunction with them, a further option would be to introduce a scheme to provide retail clients with last resort recourse to compensation to which they are entitled. There is a model for a comprehensive scheme of this kind in the United Kingdom, but not it seems elsewhere.
- In designing such a scheme, key issues would include:
  - the liability standard for eligible claims;
  - circumstances in which a claim can be brought;
  - capping of claims;
  - relationship to current compensation arrangements including existing statutory schemes;
  - relationship to EDR schemes and legal system;

- funding arrangements;
  - authority for scheme;
  - governance arrangements; and
  - process for systemic improvements.
- In assessing the costs and benefits of such a scheme, or other measures to strengthen compensation arrangements, it is relevant to consider:
    - the degree of harm suffered by retail clients under current arrangements;
    - the impact of that harm on confidence in financial markets and consumer participation in those markets;
    - the effects on wider regulatory settings and market impacts; and
    - the effects on barriers to entry in the financial services sector and on the cost of provision of those services.
  - Current compensation arrangements do not purport to deal with loss or damage suffered by consumers from investment failures other than as a result of licensee misconduct. In practice this line may be somewhat blurred in dealing with loss from the failure of a product issuer for example. The line between non-compensable investment loss and compensable loss from licensee misconduct, and the implications of any cross-over between the two in practice, need to be kept in mind in considering possible new measures.
  - A balance will have to be made between the effectiveness of any enhanced compensation arrangements in protecting consumers and promoting confidence in the financial services sector, and their impact on the cost and supply of financial services to retail clients and the overall efficiency of the sector.

## **Introduction**

5.1 The review is directed to the adequacy of compensation arrangements for the protection of consumers in the financial services sector. The arrangements in question aim to provide some assurance that retail clients will be able to obtain compensation to which they may become entitled from financial service providers with whom they deal.

5.2 The assumption and management of risk and trade-offs between risk and reward are inherent for those who participate or invest in financial markets, services or products. The regulatory framework imposes standards of conduct and disclosure on the providers of financial services and offers remedies for those who suffer loss or damage where those standards are not met. It does not however generally seek to eliminate risk for those participants.

5.3 The regulatory regime already provides an additional level of protection for retail participants on the basis presumably that they are likely to be less well informed or able to take care of their own interests than wholesale participants. The high cost — in economic, social and human terms — that can ensue for individuals who suffer loss in the financial markets becomes readily apparent in the aftermath of the failure of financial products or institutions. There is a heavy toll on individual lives and families where for example they lose their life savings or retirement nest egg through unwise or inappropriate investment.

5.4 These issues are pronounced in circumstances where, as has been the case for some years now, individuals are encouraged to participate in the financial markets and, through superannuation, to take more responsibility for their own future financial security. The experience of such investors, and any sense of grievance where they feel let down by participants on whom they rely, can be expected to affect overall confidence in the financial services sector.

5.5 The case for a statutory compensation scheme needs to be considered within the existing framework of measures for the protection of consumers and the overall regulatory scheme for financial services.

5.6 The challenge is to strike a balance between measures for the protection of retail participants, weighing the benefits and costs of those measures including their impact on the costs of and supply of financial services, and the overall efficiency and effectiveness of the relevant markets.

### ***Consumer protection relatively well developed***

5.7 There is already a fairly well developed regime for the protection of consumers in the financial services sector. The provision of a low cost alternative dispute resolution system, and arrangements to provide some assurance that consumers will be able to obtain compensation for loss or damage to which they may be entitled, go beyond the level of protection generally available to consumers of goods and services in other sectors.

5.8 The regulatory framework includes significant components directed to the protection of consumers and, in particular, of retail clients who deal with providers of financial services. Consideration of these components, their rationale and the way they fit together provides a starting point.

5.9 Providers of financial services are required to be licensed and are subjected to standards that govern their conduct towards clients and their disclosure of information to clients. Those licensees who provide financial services to retail clients are also required to have in place:

- a system for the resolution of disputes with those clients — in effect a less formal alternative to redress through the courts — funded by licensees and made available at no cost to the client, and
- arrangements for compensating those clients for loss or damage suffered by reason of a licensee's breach of its statutory obligations.

The regulatory regime is overseen by a consumer protection and market integrity regulator and a prudential regulator.

## **Focus on fallback compensation arrangements**

5.10 Moreover, there are already in place statutory compensation schemes providing consumers with last resort protection in specific areas of the financial services sector.

5.11 These arrangements have been developed in a somewhat piecemeal fashion over the years. They include:

- long-standing arrangements, now represented in NGF and like schemes, which in essence provide investors in markets such as the ASX with recourse to compensation for loss of funds or securities on the insolvency of a broking firm;
- more recent arrangements, through FCS, by which consumers can be compensated in certain circumstances for losses following the failure of an ADI or general insurer.

These arrangements constitute schemes of last resort in particular areas where institutional insolvency could give rise to systemic risk. Their adequacy in providing protection in those areas is not addressed in the review.

5.12 The focus of the review is on the default or fallback arrangements for the protection of consumers of financial services in circumstances where they do not have recourse to those existing last resort compensation arrangements.

### ***Mandate for fallback arrangements***

5.13 There is a legislative acknowledgement — in s912B of the Corporations Act — of a place for compensation arrangements to protect retail clients of financial services licensees. This acknowledgement is noteworthy as an expression of general intent although its substance is somewhat open-ended as indicated below. The legislation goes beyond the imposition of standards of conduct on licensees and the conferral on clients of rights of redress. It includes access to dispute resolution processes as an alternative to legal redress through the courts and addresses the issue whether any compensation awarded will be recoverable.

5.14 Section 912B declares that a licensee who has retail clients ‘must have arrangements for compensating those [clients] for loss or damage suffered because of breaches of the relevant obligations under this Chapter by the licensee or its representative’. It goes on to provide that those arrangements must satisfy any requirements specified in the regulations or else be approved in writing by ASIC. It also provides, interestingly, that in exercising its power to approve alternative arrangements ASIC must have regard to whether those arrangements will continue to cover clients after the licensee ceases carrying on business and for what period. Otherwise the provision gives little guidance on the content of any regulations or on the exercise by ASIC of its power of approval.

5.15 The nature of the compensation arrangements required of licensees is left to be specified in regulations or by ASIC.

### ***Implementation of fallback arrangements***

5.16 The nature of the compensation arrangements required of licensees has been spelled out in regulations which, after a period of consultation and transition, became fully operative in 2008. The regulations call for a licensee to hold professional indemnity insurance which is adequate having regard to specified considerations that relate to its business, clients and exposure to claims.

5.17 While the legislation on its face appears to expect all licensees who deal with retail clients to have compensation arrangements, the regulations exempt from the requirement licensees who are general or life insurance companies or ADIs regulated by APRA. Furthermore, ASIC is authorised to exempt licensees who are related to such a prudentially regulated company where a guarantee is received that ensures payment of awards of compensation to retail clients of the licensee.

5.18 In practice most licensees are required to hold professional indemnity insurance in order to satisfy the need for compensation arrangements. According to ASIC, just under 3,700 of the almost 5,000 financial services licensees can give advice to retail clients. Of that number, all need professional indemnity insurance except for several hundred ADIs and insurers who are regulated by APRA, a handful of others who have been exempted by ASIC on the basis of relationship to an APRA-regulated company, and one other licensee for whom ASIC has approved alternative arrangements.

### ***Eligible claims by retail clients***

5.19 The compensation arrangements called for under the Corporations Act are to protect retail clients who have suffered loss or damage from a licensee's breach of obligations under Chapter 7 of that Act or under any other 'financial services law'.<sup>1</sup> This would include, for example, a claim based on breach of a licensee's duty in providing personal financial advice to inquire into a client's personal circumstances and to have a reasonable basis for the advice provided.

5.20 The legislative concern does not in its terms extend to claims such clients may have based on breach of other statutory or common law standards. A claim based on breach of contract would not be eligible. Nevertheless, EDR schemes have a broader jurisdiction and can take such matters into account in making an award for compensation. Any differences of this kind in liability standards can give rise to questions about the match between the cover provided under professional indemnity insurance and the claims to which licensees may in fact be exposed.

5.21 The definition of eligible claims has a bearing on the potential number and size of claims under any compensation arrangements or second tier scheme should one be introduced and on the costs of those arrangements or that scheme, as well as on the extent of protection afforded to retail clients.

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1 Section 761A.



### ***Compensation for licensee misconduct not investment losses***

5.22 The dichotomy between loss or damage suffered by consumers as a result of licensee misconduct, and claims related to the failure of investment products or other investment losses in the absence of such misconduct is fundamental and needs to be kept in mind. The compensation arrangements referred to in the legislation are designed to provide retail clients with some assurance of recovery where they have a claim against a licensee based on advice in breach of the statutory standard or other misconduct in the provision of services.

5.23 The fallback arrangements stop short of trying to compensate for investment loss in the absence of inappropriate advice or other licensee misconduct. As explained in the Wallis Report, while regulation should strive to minimise risk in certain areas, it is not the role of regulation to eliminate risk in the financial services area. A judgment about risk and reward is inherent in any investment, and the spectrum of risk plays a part in economic efficiency. There is a risk of moral hazard to the extent that investors are cushioned from the financial consequences of their investment decisions.

5.24 It is not surprising however that in practice the line between loss arising from licensee misconduct and loss from investment failure or under-performance may become somewhat blurred. Product providers for example are subject to fallback compensation arrangements in circumstances where they are required to be licensed (where they operate a managed investment scheme for example, but not if they are a company in whose shares clients can invest) and they have direct dealings with retail clients. Where this is the case, a client might have a claim against the provider, following the failure of a financial product, based on misrepresentation of the product in question. The loss or damage attributable to that misrepresentation could equate to the loss in value of the investment. A product provider who does not deal direct with retail clients will not be subject to those compensation arrangements even if it contemplates that its products will be offered to retail clients by other licensees.

5.25 There is potential also for an expectation gap between the compensation sought by an aggrieved consumer and the amount of loss or damage that can be attributed to licensee misconduct. A consumer aggrieved following the failure of an investment product may understandably look to recover the amount lost through the investment and not feel satisfied by recovery of part only of that loss that may be attributable to a licensee upon whom the consumer relied.

5.26 Furthermore, an aggrieved consumer may see an adviser or other intermediary as a more attractive target than a product issuer, especially if the product issuer is insolvent, or a more accessible target than those product issuers, directors, auditors or other participants in the investment chain who are not licensed or subject to an EDR scheme. In circumstances such as these the separation between product and product selection may be tested.

5.27 Again, a client's prospects of recovery may hang upon the line drawn in particular circumstances between advice to follow an investment strategy that turns out to be unsuccessful and advice that fails the legal standard required of a licensed financial services provider. Advisers and other intermediaries play an important part in financial services and should bear an appropriate responsibility. It does not follow that they should be seen as guarantors of the financial products they recommend.

### ***Insurance not a guarantee of compensation***

5.28 As already noted licensees, other than those who are exempt by reason of their presumed financial strength, have to hold professional indemnity insurance in order to meet the licensing requirement for compensation arrangements.

5.29 It is generally acknowledged that such insurance does not constitute a direct mechanism for the compensation of retail clients. Rather it provides a measure of protection for the business of a licensee, providing the licensee with the means to pay compensation that may be awarded to a client. By providing funds which a licensee might not otherwise have available to meet a claim, it works as a proxy for a compensation arrangement. It is not however a guarantee that compensation will be paid.

5.30 Professional indemnity insurance is a commercial product available in the market. It is a product that prudent licensees might utilise regardless of the regulatory requirement in order to manage their business risk. The terms on which cover is offered by insurers, and the pricing of that cover, vary over time in accordance with overall market conditions and insurers' views on relevant risk.

5.31 There has been an apparent tightening in recent years in the availability of professional indemnity insurance for financial advisers in particular.

5.32 ASIC spells out in RG126 various considerations it sees as relevant for a licensee in assessing the adequacy of its professional indemnity insurance cover. It does not follow that terms or features that ASIC would like to see in licensees' insurance cover will be generally available in the market. ASIC pulled back, for example, from calling for licensees to have run-off cover when it became apparent, following industry consultation, that insurers were not prepared to make cover of that kind available to licensees on a general basis.

5.33 Professional indemnity insurance only assists a licensee in meeting a client's claim where the licensee's policy is still effective and responds to the claim in question. ASIC acknowledges that the insurance cover currently available in the market is unlikely to provide a source of funds where a licensee has become insolvent before the claim was brought. It also recognises 'that insurers may exclude some areas of cover in policies for risk management reasons'.<sup>2</sup>

5.34 Upon the introduction of the relevant regulation, the Government described the objective of the compensation arrangements 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.<sup>3</sup>

ASIC says its objective is to 'administer the compensation requirements to maximise their potential to meet this objective'.<sup>4</sup> ASIC adds that 'professional indemnity insurance is not designed to protect consumers directly and is not a guarantee that compensation will be paid'.<sup>5</sup>

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2 ASIC RG 126, para 10.

3 Regulation Impact Statement *Compensation arrangements for financial services licensees*, April 2007, page 7.

4 ASIC RG 126, para 20.

5 ASIC RG 126, para 8.



5.35 While setting out in RG126 what it sees as the minimum requirements for professional indemnity insurance cover, ASIC counsels licensees that ‘it is up to [the licensee] to determine what is adequate professional indemnity insurance for [the licensee] to meet [its] obligations under s912B and obtain such professional indemnity insurance’.<sup>6</sup> ASIC says licensees should take into account ‘all the facts and circumstances’ of their business in determining what cover will be adequate for them, including ‘the nature, scale and complexity’ of their business, but also notes that ‘one of the elements of adequacy is what is practically available at any given time’.<sup>7</sup>

5.36 In other words ASIC largely relies on licensees to maintain insurance cover and on their self-assessment of the adequacy of that cover. Apart from checking at the initial licensing stage that a licensee has insurance cover in place, ASIC does not monitor the terms of that cover or its continuation in force. In this respect ASIC’s approach is relatively light touch.

5.37 There is a risk that a licensee, because of financial pressure or otherwise, may not maintain its insurance cover or may trade off the amount of cover or excess limits for lower premium. There is, of course, a further problem if a provider of financial services carries on a business without being licensed as required. There is no assurance in such a case that the business will hold professional indemnity insurance cover let alone satisfy other standards required of licensees.

### ***Consequences where insurance does not respond***

5.38 Professional indemnity insurance plays a large part in assisting licensees to meet claims brought against them by their clients. In so doing it provides a level of assurance, particularly where a licensee would otherwise be stretched for funds, that claims for compensation by retail clients will be met.

5.39 In some cases however there will no longer be an insurance policy in force, or the claim will fall outside the terms of the cover or will exceed the available limits of the cover. In such cases the licensee, notwithstanding its inability to claim from an insurer, still remains liable for any compensation payable to a client. The client’s prospects of recovery will depend however on the continuation in business of the licensee and its financial resources.

### **Nub of the problem**

5.40 There is an apparent shortfall in the delivery of compensation under current arrangements. In some cases retail clients, while entitled to compensation from licensees with whom they have dealt, are not in practice able to recover that compensation. The risk for a client, where the licensee in question does not have recourse to insurance to cover the claim, is that the licensee may have stopped trading, become insolvent or otherwise have insufficient assets. The client’s prospects of recovering compensation will depend on a recovery in the licensee’s business or the extent of any funds available to meet the claims of unsecured creditors.

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6 ASIC RG, para 50.

7 *ibid* and para 33.

5.41 In other words retail clients who look to providers of financial services to compensate them for loss or damage are exposed ultimately to a licensee's creditworthiness.

5.42 The problem is not just a theoretical one. The review has been informed of cases where clients, while becoming entitled to awards of compensation from licensees with whom they have dealt, have been unable to recover substantial amounts awarded to them.

5.43 It is not easy to quantify the problem. There is a lack of comprehensive data, collected on a consistent basis, about relevant claims against licensees and their outcome let alone about the success of claimants in recovering compensation payments. Relevant claims for this purpose are claims by retail clients for loss or damage attributable to breach by licensees of obligations under Chapter 7.

5.44 Information about claims that are settled without a formal award is not always captured. Whether or not the licensees in question in fact held professional indemnity insurance cover, and cover that met ASIC's standards, is not always clear in cases where clients go wanting.

5.45 The number of cases reported may also understate the problem. Retail clients may not be aware that they have rights to pursue a claim, or have access to dispute resolution mechanisms. Other clients may decide not to make a claim where a licensee is insolvent and the prospects of recovery appear poor. In any event, regardless of the overall size of the problem, the consequences for an individual client may be harsh.

## **Possible remedial measures**

5.46 As has been noted, professional indemnity insurance works by assisting licensees to meet claims by clients and reduces the risk that retail compensation claims will not be met due to a licensee's lack of financial resources. It provides a valuable buffer but, under current arrangements, limited assurance that a licensee will in the end be able to compensate a client. It was not designed to, and does not, provide a comprehensive safety net for consumers.

5.47 Any move to provide further protection for retail clients could include consideration of measures:

- to reduce the incidence of cases where clients suffer loss or damage from licensee misconduct such as through:
  - improvements in professional standards for financial advisers; and
  - efforts to improve the financial literacy of consumers;
- to enhance the utility of professional indemnity insurance as a mechanism to underpin the ability of licensees to meet compensation claims through:
  - more proactive administration of licensing requirements;
  - efforts to facilitate the availability of appropriate insurance cover;

- better disclosure of the insurance cover held by licensees and facilitation of third party rights;
- to focus more attention on the financial resources of licensees in order to reduce the risk of their becoming insolvent; and
- for a scheme of last resort to provide compensation where a licensee is unable to do so.

### ***Protection of consumers at the outset***

5.48 Consideration of the adequacy of compensation arrangements tends to focus on the problems arising after the event when a client suffers loss or damage attributable to licensee misconduct.

5.49 Regard should also be had to the possible relevance of measures to raise standards of licensee conduct, and to enhance the understanding of consumers and their ability to look out for their own interests in their financial dealings.

5.50 Measures of this kind are directed at reduction in the instances where consumers are adversely affected by the misconduct of licensees on whom they rely.

### ***Standards of licensee conduct***

5.51 The *Future of Financial Advice* reforms announced by the Government on 26 April 2010 are aimed at lifting the professional standards and conduct of financial advisers and confidence in and the quality of financial advice. To the extent they achieve their purpose these changes have the potential to reduce the incidence of claims for compensation against financial advisers. The proposals do not generally extend to other financial service licensees.

5.52 One element of the package is the proposed imposition of a statutory best interests duty on licensees who provide personal advice to retail clients. The objective is for advisers to have proper regard to the best interests of their clients and not merely consider their clients' interests when a conflict arises. It is proposed that licensees would meet this duty if they take reasonable steps to act in the best interests of their clients, but they would not be expected to consider every product on the market in giving personal advice on financial products. Other elements are directed to the removal of conflicted remuneration structures.

5.53 A newly established advisory panel on financial advice and professional standards will provide views to the Government aimed at lifting the level of professional standards of financial advisers, including by establishing competency requirements and training for licensees who provide financial product advice. The panel has been involved in ASIC's development of a framework for assessment and professional development of financial advisers designed to improve the quality of advice consistent with industry standards.<sup>8</sup>

5.54 To the extent that the proposed changes contribute to a clearer understanding by licensees of the standards expected of them, and to improved standards of

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<sup>8</sup> ASIC Consultation Paper 153, *Licensing: Training and assessment framework for financial advisers*, April 2011.

conduct, it is to be hoped there will be a decrease over time in the incidence of problems for retail clients.

5.55 Again, if improved standards of conduct result in a reduction over time in claims against insurers, the cost of insurance cover for financial advisers may be mitigated. On the other hand, any uncertainty about the implications of a new statutory best interests duty for the liability of licensees could work the other way, at least until any affect on claims experience can be assessed.

5.56 Any further assessment of the impact of the *Future of Financial Advice* proposals on adviser conduct or on the risk profile of advisers will have to await their final form and implementation.

#### *Financial literacy*

5.57 Programs and other efforts to improve the financial literacy of consumers are also relevant in empowering consumers to make investment and other decisions in their own interests, to better understand the trade-off between risk and potential reward, and in reducing the information asymmetry between them and advisers or other licensees with whom they deal. ASIC provides basic information through its new MoneySmart website to complement face-to-face advice services by helping consumers understand their financial issues and goals before they seek advice. ASIC's recently announced national financial literacy strategy also aims to deliver financial literacy education through schools and higher education institutions, the workplace and in the community, and is another example of efforts to this end.<sup>9</sup>

#### ***Enhancement of insurance cover***

5.58 Given the reliance on professional indemnity insurance as a means of underpinning compensation for retail clients, it is relevant to consider possible ways to make that mechanism more effective.

#### *Assurance that licensees have adequate cover*

5.59 Most licensees are subject to the requirement for professional indemnity insurance. Current arrangements rely heavily on the self-assessment by licensees of the level of insurance adequate for their business and on their maintenance of such cover. The licensees who are exempt from this requirement — on the basis of their apparent financial soundness — do not appear to have had difficulty in meeting any compensation claims.

5.60 Licensees are provided with guidance by ASIC on the features a professional indemnity insurance policy should have and on their assessment of the adequacy of their cover. ASIC generally regards the requirements as self-executing with the onus on a licensee to comply. Apart from a check when a licence is first granted that an applicant holds insurance cover (or is exempt or has approved alternative arrangements), it does not conduct systematic or periodic checks on the insurance held by licensees. Instead, the arrangements appear to work on a self-compliance and self-reporting basis.

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<sup>9</sup> www.moneysmart.gov.au and ASIC *National Financial Literacy Strategy*, Report 229, March 2011.

5.61 An approach of this kind poses a degree of systems risk that licensees are either not insured at the point in time that cover is required, are underinsured or have cover that excludes the grounds on which compensation is awarded.

5.62 By way of comparison, stockbrokers and other market participants are required to advise ASIC within 10 days of the renewal of their insurance cover, as well as letting ASIC know of any notification to their insurer of a claim. Brokers that fail to do so are subject to penalties.<sup>10</sup>

5.63 Similarly, personal investment firms in the United Kingdom are required to notify the regulator that they have obtained professional indemnity insurance within 28 days from the expiry of their previous policy. If notification is not received, FSA contacts the firm and works with it to resolve the issue. While FSA does not consider it is in the interests of firms or consumers 'simply to close down firms on the day their cover runs out', nor does it consider it 'in the interests of consumers ...to allow firms to continue trading without [professional indemnity insurance] indefinitely'.<sup>11</sup> FSA will consider the following possible courses of action:

- the requirement for the firm to have professional indemnity insurance may be waived after taking into account factors such as its financial position, claims records and past business. A firm given such dispensation must comply with additional reporting requirements relating to customer complaints and have adequate financial resources to meet an increased financial resources requirement;
- the provision of individual guidance to the firm where it has professional indemnity insurance that does not comply with the rules; or
- enforcement action where a firm does not have adequate resources overall or is unwilling to consider and implement alternative solutions. This could lead to the cancellation of the firm's authorisation to operate as a personal investment firm.

5.64 FSA also states that it has:

discovered that firms who are unable to obtain [professional indemnity insurance] often have other regulatory problems ..., and some of them do not, or are likely not to, meet our minimum capital requirements. When a [professional indemnity insurance] insurer assesses a personal investment firm it is performing a risk assessment, the results of which influence their decision to provide cover and the price of the policy. If the personal investment firm has unresolved regulatory or financial problems this inevitably causes concerns to the insurer and decreases the availability of cover for that firm.<sup>12</sup>

5.65 It is a matter for consideration whether a more proactive approach by ASIC would provide a worthwhile increase in assurance. One approach, akin to that in the United Kingdom, would be to require licensees to certify to ASIC on an annual basis that they have renewed their policies.

5.66 Licensees might be asked to report through their financial statements whether they hold a current policy of professional indemnity insurance, or have made alternative compensation arrangements, and on the adequacy of their cover for the

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10 ASIC *Market Integrity Rules (ASX Market) 2010*, February 2011, rule 2.2.1.

11 Financial Services Authority, *Professional Indemnity Insurance for personal investment firms: proposed rule changes*, June 2003.

12 *ibid.*

needs of their business. This certification could be made subject to confirmation in the independent audit of those financial statements.

5.67 Another approach would be for ASIC to carry out checks on individual firms that may be financially vulnerable or otherwise to pose a risk.

5.68 Any closer engagement by ASIC with individual licensees on the details and adequacy of their insurance cover would have resource implications for the regulator and industry. A risk-based approach, targeted at licensees who appear more financially vulnerable or otherwise at risk, would have some attraction. There would seem to be scope for such an approach, given that the ultimate concern is with a licensee's creditworthiness and that financially stronger firms may find it easier to negotiate adequate insurance cover than are firms who are more marginally resourced.

5.69 In any move to a more proactive approach by ASIC it may be necessary to review the adequacy of ASIC's existing powers in relation to the granting of licences and sanctions for non-compliance including cancellation of a licence.

#### *Promotion of standard insurance cover*

5.70 There may be useful scope too for the development of standard policies to meet the basic needs of licensees, or particular classes of licensees such as financial advisers. The availability of standard policies would be expected to reduce the transaction costs of licensees in making insurance arrangements that meet regulatory requirements and may facilitate regulatory efforts in monitoring compliance with those requirements.

5.71 Current regulations and guidance require licensees to hold professional indemnity insurance cover that is adequate to their needs and sets out a range of factors to which the licensee should have regard to in assessing those needs, such as the maximum liability that might arise from their membership of an EDR scheme and the financial services they deliver.

5.72 As discussed in Chapter 3 some licensees appear to face difficulties in accessing cover that is adequate to their needs and meets ASIC's requirements.

5.73 In consultations with industry ahead of the commencement of the regulations, ASIC sought to encourage industry and professional bodies to 'consider what standard professional indemnity insurance policies and other measures they can develop to assist their members'.<sup>13</sup> ASIC also expressed an expectation that 'licensees will work actively (alone or collectively) to encourage insurers to meet the demand for professional indemnity insurance products that are consistent with the compensation requirements... [including by] exploring the possibility of developing standardised policies that can cover similarly situated licensees in the same industry, or industry sector'.<sup>14</sup>

5.74 While tripartite negotiations ensued between ASIC, the insurance industry and professional bodies representing licensees, they did not lead to agreement on a standard form of professional indemnity insurance policy.

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<sup>13</sup> Compensation and insurance arrangements for AFS licensees, Consultation Paper 87, ASIC, July 2007, para 17.

<sup>14</sup> *ibid.*, para 18.



5.75 Some professional bodies in the financial services industry have subsequently negotiated master policies under which their members can acquire individual cover on the same terms and conditions as the master policy. Beyond this, efforts to produce standard policies appear to have had little success.

5.76 While the regulatory regime mandates insurance cover for several thousand licensees, insurers for their part are left to offer cover, if they so choose, on their own terms.

5.77 Given more experience with the operation of the regulatory framework, and the expectations of the regulator, it may be timely to explore further the development of a standard policy or policies for licensees generally or a class of licensees. The development of a standard policy would need to be market based and negotiated between professional bodies that represent licensees and the insurance industry. There may be a role for ASIC, or possibly the Government, in the coordination of such an initiative.

5.78 There are examples outside the financial services sector where professional industry associations have established professional indemnity insurance policies that suit the professional requirements of their members. The legal profession in NSW has established LawCover Insurance which issues both professional indemnity insurance policies and run-off policies to legal practitioners.

5.79 Consideration might also be given to the possibility of developing a standard policy on a group basis. That is, a policy might be provided by multiple insurers collectively covering the risk of a pool of insured licensees under a standard set of terms. Insurers might be prepared to provide certain terms in such a policy that they are not willing to offer on an individual risk basis. Consideration would need to be given to whether any industry wide arrangement would require authorisation from the competition regulator.

#### *Coverage of claims after licensees cease to trade*

5.80 A weak point in the current reliance on professional indemnity insurance is the general lack of run-off cover for licensees. This means that clients whose claims come to light after a licensee ceases to trade will have difficulty in receiving compensation where the licensee has wound up its business, has disappeared or is insolvent. The long-tail nature of claims against licensees exacerbates this problem.

5.81 The Corporations Act recognises the risk to which clients may be exposed after a licensee ceases trading. Section 912B(3)(b) requires ASIC, when considering approval of alternative compensation arrangements instead of insurance, to have regard to 'whether the arrangements will continue to cover persons after the licensee ceases carrying on the business of providing financial services, and the length of time for which that cover will continue'.<sup>15</sup>

5.82 ASIC sought in its administrative guidance to require the inclusion of automatic run-off cover in professional indemnity insurance policies. However, following consultation ASIC concluded that insurers were generally not willing to provide automatic run-off cover and did not proceed with its proposal.<sup>16</sup>

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<sup>15</sup> Section 912B(3).

<sup>16</sup> ASIC RG 126, para 40.

5.83 It is understandable that insurers will only be prepared to make run-off cover available to licensees on a basis that is commercially viable. The scope for such cover could be examined further in any move to develop standard forms of insurance cover for licensees. Consideration might be given to the commerciality of a separate group policy that deals specifically with run-off and pools the risk of claims arising from multiple licensees that had ceased to trade. Such a group policy would not necessarily replicate the terms of prior policies held by the former licensees covered by the group policy, but would provide a basis for dealing with claims for compensation after a licensee ceases trading.

5.84 Consideration might also be given to alternative arrangements to deal with compensation claims for a period after a licensee ceases to trade. In the United Kingdom, FSA has been exploring the issue of requiring firms to 'leave resources behind' when they cease to trade, with proposals such as a trust to hold run-off cover, or the transfer of responsibility for future compensation claims to a firm that still operates. FSA has not yet concluded its position on this issue.<sup>17</sup>

#### *Disclosure of insurance arrangements*

5.85 It may be timely as well to look again at the disclosure by licensees of their compensation arrangements. Licensees are currently required to disclose to clients the kind of compensation arrangements they have in place and whether those arrangements satisfy the regulatory requirements. A licensee has to include in its Financial Services Guide a statement that it has in place professional indemnity insurance, alternative arrangements approved by ASIC or is exempt from the requirement. It does not have to go beyond such limited disclosure.

5.86 There is a question whether a minimal disclosure requirement of this kind achieves any useful purpose, and whether additional disclosure would better enable retail clients to protect themselves. It is arguable that a minimal disclosure pursuant to the current requirement could convey a sense of assurance that is not necessarily warranted.

5.87 Any further disclosure of insurance cover should provide consumers with simple yet meaningful information about the protection the licensee has without raising expectations that claims for compensation will necessarily be met in that way.

5.88 ASIC proposed earlier to require more detailed disclosure of insurance arrangements but did not proceed following a process of consultation with industry. Those proposals included disclosure of a number of aspects of a licensee's insurance cover that were intended to make more realistic the expectations of consumers about the level of protection afforded by that cover. It was proposed for example that the licensee include statements such as 'the policy will not necessarily be adequate to meet all possible claims ..' and 'cover might be less effective in the event of insolvency of the licensee...'.<sup>18</sup>

5.89 More meaningful disclosure of available insurance cover, and its limitations, or the basis on which a licensee was exempt from the need to have such cover, would put clients in a better position to assess the credit risk of a licensee.

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<sup>17</sup> FSA, *Review of prudential rules for personal investment firms*, Consultation Paper 08/20, November 2008.

<sup>18</sup> Compensation and insurance arrangements for AFS licensees, Consultation paper 87, ASIC, July 2007, at paras 98-99.

5.90 There may be a question however about the value to consumers, when deciding whether to deal with a particular licensee, of information relevant to their prospects of recovering compensation if they end up suffering loss or damage by reason of the licensee's subsequent misconduct. That question may not be foremost when an adviser is being engaged.

5.91 Any requirement for additional disclosure, if it is to be useful, should be as simple and meaningful as possible. Relevant aspects for disclosure would seem to include the monetary limits of the cover, the level of any excess, any significant exclusions and whether there is any run-off cover. There would need to be a process for keeping any such disclosures up to date.

5.92 Any additional disclosure requirements would need to weigh the benefit to consumers against the cost to licensees of making that information available. Reliance on online delivery, as permitted by the Corporations Act, would facilitate, and reduce the cost of, any additional disclosure.<sup>19</sup>

5.93 Disclosure of the name of the licensee's insurer in itself might be seen as relevant information and important, in particular, in the event that a licensee winds up its business or becomes insolvent and does not respond to a client's claim.

#### *Third party rights*

5.94 A third party such as a retail client already has the right, in limited circumstances, to lodge a claim directly with the insurer of a party from whom it is claiming compensation. Section 51 of the *Insurance Contracts Act 1984* enables a third party to recover directly from the insurer if the insured is liable to pay damages and has died or cannot be found after reasonable inquiry. Access to information about the insurer would assist a consumer in exercising its rights under this section in circumstances where the licensee has closed its business and cannot be found.

5.95 A review of the *Insurance Contracts Act 1984* considered, amongst other things, a broadening of s51 in ways that might have benefited retail clients in other circumstances such as when a licensee has become insolvent. An Exposure Draft issued in 2007 proposed an extension of the right to recover directly from an insurer in circumstances where a third party has obtained a judgment against an insured in respect of a liability and the execution of that judgment is unmet. In the event, following a process of consultation the Insurance Contracts Amendment Bill 2010 proposed limited changes to s51 which would not materially aid a retail client in relation to a failed licensee.<sup>20</sup> The Bill lapsed before enactment and has not yet been reintroduced.

5.96 The ability of consumers to pursue claims where an insured party has become insolvent might be looked at in any further consideration of s51.

#### *More focus on financial adequacy of licensees*

5.97 The root of the problem where retail clients are unable to recover compensation from a licensee lies in the licensee's lack of financial resources. While insurance cover, where held, provides licensees with a buffer in meeting compensation claims, it does not necessarily respond in all cases or to the full extent of a claim. Licensees

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<sup>19</sup> ASIC RG 221, *Facilitating online financial services disclosure*, December 2010.

<sup>20</sup> Key documents in this review are available at [www.icareview.treasury.gov.au](http://www.icareview.treasury.gov.au).

may be financially exposed if they face multiple claims for compensation at any one time, if they have exhausted the capacity of their policy to meet further claims, or face claims that do not fall within their policy. The capacity of licensees to continue trading in such circumstances, and the capacity of consumers to recover compensation, will depend on the financial resources available to the licensee.

5.98 The relevance of financial resources in this context is reflected in the fact that the only licensees who are exempted from the requirement to hold professional indemnity insurance cover are certain licensees who, by reason of being subject to APRA's prudential regulation or like circumstances, can be regarded as relatively sound in financial terms. The exemption of such licensees does not appear to have led to problems with the ability of those licensees to meet compensation claims.

5.99 Under present arrangements however there is very limited scrutiny of the financial resources of licensees. The general obligation of licensees to have available adequate resources to carry on their business is limited in its purpose.<sup>21</sup> ASIC does not see the focus of its guidance on financial adequacy as the protection of clients against credit risk. It appears to regard the separate requirement on licensees to hold professional indemnity insurance as covering this issue.

5.100 In the context of the financial standards for licensees, ASIC's options for compliance do not require licensees operating small businesses to hold any cash or commitment of support for the purposes of compliance.

5.101 This raises the question whether there should be some higher level of comfort that a licensee has adequate resources, when considered in relation to the extent of its insurance cover, to meet compensation claims from clients. For example, licensees might be required to hold an additional form of financial security as a general condition of licence, such as a capital holding or a security bond or guarantee from a financial institution or related entity. The aim would be to give the licensee more capacity to meet awards of compensation that are not covered by professional indemnity insurance.

5.102 It is not suggested that licensees should be subject to anything approaching the capital adequacy standards required of financial institutions that are prudentially regulated by APRA. The question is whether some form of financial security, short of that kind of regulation, would in a practical way reduce the risk of a licensee being unable to meet a claim for compensation. Any such benefit would have to be weighed against the effects of a stricter requirement on barriers to entry and competition in financial services.

5.103 Arrangements of this type apply to investment firms in the United Kingdom who are required to meet capital adequacy requirements in conjunction with their holding of professional indemnity insurance cover. A change in the calculation of the financial requirement will require firms to hold resources worth at least three months of their annual fixed expenditure in realisable assets such as cash (with a minimum holding of £20,000) by December 2013. FSA states that the intended outcome of this change in the financial requirement on investment firms is 'to see a reduction in the level of consumer detriment and the costs to the levy payers contributing to the Financial Services Compensation Scheme (FSCS) from unsuitable advice on

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21 ASIC RG 166, section B – Base level financial requirements.

investment products'.<sup>22</sup> In making this change, the UK regulator recognises that an increase in the formal adequacy requirement will have the effect of raising the barriers to entry to investment business.

5.104 There is a question to whether any additional financial security could be required to be preserved for a specified period after a licensee ceases to trade. Consideration would need to be given to how claims would be made and defended in this period, how the financial security would be held, how payments of awards would be made and how unused capital would be returned to the licensee once the specified period has lapsed. As noted above, consideration is currently being given to this issue in the United Kingdom.

## **A last resort scheme for compensation**

5.105 A statutory compensation scheme, as adverted to in the terms of reference, could be designed to provide retail clients with recourse to payment in circumstances where they are unable to recover compensation to which they are entitled from a provider of financial services. Such a scheme would in effect extend or supplement the recourse already available to clients whose claims fall within the scope of schemes such as NGF or FCS.

5.106 There is a model for such a scheme in the United Kingdom where the Financial Services Compensation Scheme provides a fund of last resort for customers who suffer losses, including from poor investment advice, and are unable to recover compensation because the service provider in question has stopped trading, has become insolvent or has insufficient assets. The scheme offers 'second tier' protection for claims which slip through the 'first tier' protection which is based on a mix of professional indemnity insurance and minimum capital requirements.

### ***Issues in relation to any scheme***

5.107 Consideration of the appropriate scope and elements of such a scheme raises a number of questions including the following:

- **Eligible claims:** whether claims should be limited to circumstances where a licensee has ceased trading, is insolvent or otherwise unable to meet a claim by a retail client.
- **Capping of claims:** whether the amounts recoverable should be limited to a maximum amount, or a proportion of a claim up to such an amount, in order to limit the financial exposure of the scheme, and to mitigate any element of moral hazard, while affording worthwhile protection to consumers.
- **Liability standard for claims:** whether eligible claims should be confined to a breach by a licensee of Chapter 7 obligations, as is the case under current arrangements, and in any case whether there needs to be a closer alignment between those standards and the basis upon which compensation can be awarded under EDR schemes. While there may be an argument for including claims based on the general law of negligence or contract, claims based on

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<sup>22</sup> Review of the prudential rules for Personal Investment Firms (PIFs), Feedback to CP08/20 and CP09/20, Financial Services Authority, 09/19, November 2009, paragraph 1.4.

breach of more general notions of fairness or industry standards may be more problematic.

- **Relationship to current compensation arrangements:** whether mandatory professional indemnity insurance should be retained as a core element of protection. If it is, the statutory scheme would in effect provide a second level of protection behind the primary level pertaining to the licensing requirements for financial service providers. There is a question whether there would need to be any strengthening of the primary level (through financial adequacy standards for example) in order to mitigate the financial exposure of the scheme.
- **Relationship to EDR schemes and legal system:** whether a claim based on an EDR award or the outcome of a court case would be accepted for the purpose of the scheme or be subject to further review on the merits.
- **Relationship to existing statutory schemes:** in an ideal world any new scheme would probably be integrated in some way with schemes such as NGF and FCS which already provide last resort protection in segments of financial services. Issues such as the treatment of funds contributed to NGF by brokers in the past may make integration problematic. Consideration could still be given to possible ways to achieve efficiency through common administration and to measures to assist consumers in identifying and navigating between avenues of recourse that are open to them.
- **Funding of scheme:** it might be expected that a scheme of this kind would be funded by industry. There would be questions about the basis for assessing the contributions of individual licensees and any arrangements for pooling licensees to confine their obligations as far as possible to the funding of claims against licensees in a similar line of business. There is also a question whether contributions other than for regular outgoings should be levied on a pre- or post-event basis.
- **Authority for scheme:** statutory backing, through the licensing arrangements or otherwise, may be necessary in order to achieve mandatory participation and funding by licensees.
- **Governance:** appropriate arrangements for the governance of a scheme, including the extent of involvement by industry, consumer representatives or a regulatory authority would need to be addressed. If statutory backing is required in order to ensure mandatory participation, it is arguable that the governing body should be accountable to government in some way. This may also raise the question whether the governance of EDR schemes should similarly be made accountable to government given any link between EDR scheme awards and claims upon a statutory scheme.
- **Systemic improvements:** in designing a scheme there may be scope for processes to provide feedback to stakeholders on systemic problems with a view to identifying ways in which licensee standards can be raised, the incidence of harm to consumers can be mitigated and claims against the scheme can be contained.



### *PFS/FOS scheme proposal*

5.108 A proposal to establish a compensation scheme has been prepared by Professional Financial Solutions Pty Limited on behalf of the Financial Ombudsman Service. The scheme is described as an industry-based scheme, which would be underpinned by legislative and possible financial support from the Government. The main features of this proposed fund of last resort are:

- the scheme would operate in addition to the current compensation arrangements, would have a statutory mandate and would specify a maximum time period for claims to be lodged;
- the scheme would operate where a retail client has received an award of compensation by an EDR scheme, a court or a liquidator and the licensee is unable or likely to be unable to satisfy at least one claim against it. This may occur where the licensee is insolvent or bankrupt or cannot be contacted after reasonable steps have been taken to do so;
- the scheme would cover loss arising from fraud or misappropriation of funds that involves dishonesty by the licensee;
- the amount of compensation payable to claimants would be subject to caps. For example, a cap of 90 per cent on the first \$120,000 of the claim, a further 70 per cent on the excess up to \$200,000 and a further 50 per cent up to an overall cap of \$280,000, which would equate to a maximum payment of \$204,000 on a claim of \$280,000 or more;
- the scheme would be industry-based with mandatory membership by all licensees who provide financial services to retail clients;
- members would be expected to fund the establishment and operating costs of the scheme and compensation payments to retail clients on prescribed terms and conditions, such as:
  - a pre-funded component to cover anticipated management costs and compensation costs;
  - a post-funded levy if required to compensate retail clients for significant losses;with reference also made to a possible guarantee from government;
- members would be grouped into classes, according to the financial service activities they are licensed to provide, and each class would be subject to a maximum annual levy of one per cent of their revenue. Payments of compensation would be drawn first from the pre-funded component of the class to which the 'defaulting' member belonged, before funds were drawn against other classes or a post-funded levy was called upon;
- the scheme would have a borrowing facility, and would take an assignment of rights from claimants who accept compensation, entitling it to become a creditor in the winding-up of insolvent licensees;
- the scheme would be operated by an independent body governed by a constitution and with a board of directors comprising industry and consumer representatives;

- the scheme would be subject to approval by ASIC but would be independent from ASIC; and
- the interaction between the scheme and other compensation schemes, such as NGF, FCS and under the SIS Act, would need to be determined.

5.109 The proposal is said by its proponents to be a work in progress and is being further developed in consultation with stakeholders particularly in relation to the development of a new funding formula which more closely aligns the costs of the scheme to the class of financial services in which the consumer losses have arisen.

5.110 The proposal is referred to in this paper, given its relevance to the issues under consideration, and its possible assistance to respondents in considering elements of any model for a scheme, but without further comment or any endorsement.<sup>23</sup>

### ***Other considerations***

5.111 The question of a statutory compensation scheme needs to be considered in the context of existing regulatory arrangements for the financial services sector, including the extent and effectiveness of those elements directed to the protection of consumers. These include the existence of statutory last resort compensation schemes covering some critical, but not all, areas of financial services, as well as the default arrangements that rely on the holding by licensees of appropriate professional indemnity insurance cover.

5.112 There is a degree of interconnectedness in the present system and regard should be had in addressing particular problem areas to the effects of any new measures on wider regulatory settings and to market impacts.

5.113 The effects of any new measures, including on barriers to entry in the financial services sector, and on the cost of provision of those services, need to be weighed against the benefits to consumers who may be better protected and the consequential confidence of retail clients in the financial services sector.

5.114 There are shortcomings in the current arrangements. Cases arise where retail clients miss out on compensation to which they are entitled. This results in essence from their exposure to the credit risk of licensees against whom they have claims for compensation.

5.115 Cases of that kind can be very serious for the individuals who miss out on compensation. The size of the problem overall is less easy to gauge.

5.116 Responses to shortcomings in the current arrangements could include a more proactive approach to the administration of licensing arrangements for licensees, renewed efforts to improve the availability to licensees of appropriate insurance cover, and more attention to the adequacy of the financial resources of licensees at the outset, as well as a statutory scheme of last resort that would underpin the payment of compensation by financial advisers and other licensees. There is a precedent for a comprehensive last resort scheme in the United Kingdom,

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<sup>23</sup> *Proposal to Establish a Financial Services Compensation Scheme*, prepared by Professional Financial Solutions Pty Limited for Financial Ombudsman Service, October 2009. Available at [http://fos.org.au/centric/home\\_page/publications/submissions.jsp](http://fos.org.au/centric/home_page/publications/submissions.jsp).

but there does not appear to be a comparable scheme elsewhere in Europe or in North America.

5.117 A key issue in any move to a statutory scheme of last resort will be the funding arrangements. Reliance on industry funding could well necessitate participation and potential contributions by all licensees including those who, under present arrangements, are exempt from the need to hold insurance cover by reason of their presumed relative financial strength. This raises questions of the extent to which more financially secure licensees should be expected to underwrite claims against licensees who are less well capitalised or do not have the backing of a corporate group. A relevant consideration may be the extent to which participants in the financial services industry share an interest in the maintenance of retail confidence in the integrity of relevant markets.

5.118 Another issue is the risk of exacerbating an expectation gap that may already exist for consumers in regard to compensable loss or damage. A move to a last resort scheme, while giving more assurance of some recovery of damages attributable to inappropriate financial advice or other licensee misconduct, will not in itself address losses and damage that flow from the collapse of a product issuer or other investment failures. Any move to widen the range of compensable claims to cover product failures more directly would raise substantial issues relating to moral hazard and comparability of treatment of other forms of investment such as shares.

5.119 In some instances also, such as where a product provider is licensed and deals with retail clients, the line between compensable damage by licensee misconduct, and losses from product failure, which ordinarily are not compensable, can become blurred. This may lead to apparent anomalies between the position of clients who can pursue last resort compensation, and those who cannot, following the failure of an investment product. A blurring of this line may also have implications for the funding of a last resort scheme, increasing its exposure to claims following a product failure as well as for moral risk on the part of consumers.

5.120 A somewhat related issue is the effect of any strengthening of compensation arrangements on the selection by aggrieved consumers of parties against whom to claim compensation. The licensees with whom retail clients have a direct relationship may already attract claims in circumstances where product issuers (who may not be licensed to deal direct with retail clients) or other parties such as directors or auditors share a responsibility. Those other parties will for example not be members of and subject to the jurisdiction of an EDR scheme. Changes to strengthen existing compensation arrangements might have the effect of skewing claims further in the direction of licensees whose liability to retail clients is underwritten by those enhanced compensation arrangements.

5.121 In the end, a balance will have to be made between the effectiveness of any enhanced compensation arrangements in protecting consumers and promoting confidence in the financial services sector, and their impact on the cost and supply of financial services to retail clients and the overall efficiency of the sector.

Information and comment is sought on the issues and possible remedial measures canvassed in this chapter, including on:

5.1 The nature and extent of any shortfall in the delivery of compensation under current arrangements.

5.2 The scope for further measures to lift the standards of licensee conduct or assist consumers in looking after their own interests.

5.3 The scope for a tighter approach to the administration of the current requirement to hold professional indemnity insurance.

5.4 The scope for more standardisation in the kind of professional indemnity insurance cover available for financial service licensees or classes of licensee.

5.5 The usefulness of improved disclosure about a licensee's professional indemnity insurance policy.

5.6 Possible arrangements to deal with claims for compensation after a licensee ceases to trade.

5.7 The case for additional requirements in regard to the financial security of licensees.

5.8 The merits, and key design components, of a last resort scheme to provide compensation for retail clients, including the approach to industry funding.