
Regulation impact statement: Requiring Australian Financial Services Licensees to assure ASIC on the adequacy of their professional indemnity insurance

Background

Requirement for licensees to hold professional indemnity insurance

1. One of the core obligations of Australian Financial Services Licensees (AFSLs or licensees) who provide financial services to retail clients is to have arrangements for compensating those persons 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 2001* (the Act).¹
2. The rationale for the obligation is to ensure that retail consumers are in a better position to access compensation should an award for loss resulting from licensee misconduct be made by a court or ASIC-approved External Dispute Resolution (EDR) scheme. This will help maintain consumer confidence and participation in financial markets.²
3. The requirement for licensees to have compensation arrangements was introduced by the Financial Services Reform Bill 2001. This was followed by an extensive process of consultation about how the obligation should be met which in turn led to the then Government expressing a preference for compensation arrangements based on professional indemnity insurance as the default arrangement to meet the section 912B requirement. This approach, which was expressed in Regulation 7.6.02AAA of the Corporations Regulations 2001 (the Regulations), has been in place since 1 July 2008, following a one year transitional period.

¹ Section 912B of the Act.

² The Treasury, *Compensation for loss in the financial services sector: issues and options*, (September 2002).

4. Subject to some exemptions, Regulation 7.6.02AAA requires licensees to meet the requirement to have compensation arrangements by holding professional indemnity insurance (PII) cover. The regulation requires the cover be adequate having regard to a number of considerations, including:

- the licensee's membership of an EDR scheme, taking into account the maximum liability that has some potential to arise under that scheme; and
- the financial services business carried on by the licensees, including the volume of business, the number and type of clients and the number of representatives of the licensee.

5. This statutory obligation is supplemented by ASIC's *Regulatory Guide 126: Compensation and Insurance Arrangements for AFS Licensees* (RG 126) which provides a guide for licensees on how to assess whether their PII is adequate.

6. When applying for an AFSL, applicants have to provide ASIC with certain key information about their PII cover and confirm that their cover is adequate or that they have a process in place to ensure that they will have such cover by the time they become licensed.

7. Once a licence has been granted, licensees are not required to inform ASIC of the currency or adequacy of the PII on an ongoing basis. However, failure to maintain a PII policy is a serious breach which would require licensees to self-identify the breach and to report this to ASIC in a timely manner.

8. Rather, the onus is on the licensee to ensure they comply with the obligation to hold adequate PII on an ongoing basis, by self-assessing the adequacy of their PII cover taking into account their business needs and the minimum requirements in RG 126. As ASIC explains to licensees in RG 126:

[Y]ou should undertake your own analysis of what is adequate for you... You might find it helpful to engage external consultant, actuaries, brokers or advisers to undertake a risk assessment of your business and provide advice on the amount and type of cover that you should obtain.

9. Around three quarters of all licensees, just under 3,700 licensees, provide financial services to retail clients. The vast majority of those licensees are required to use PII as the default compensation mechanism (whilst around 270 licensees are also prudentially regulated by APRA and are not required to have PII for compensation). The St. John report refers to ASIC's estimate 'that currently some 3,400 licensees are required to hold professional indemnity insurance'.³

Nature of professional indemnity insurance

10. It is important to note that PII is not designed to protect consumers directly. As ASIC explains in RG 126:

[It] 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).

11. Despite this, Mr St. John found that:

[PII] plays an indirect role in facilitating the payment of compensation to a client. Where a retail client is awarded compensation for a loss arising from the licensee's breach of a statutory obligation, the licensee may be able to claim against the insurance policy to help meet the costs of the award.

12. This is acknowledged by ASIC who explain their policy objective in administering the PII requirement as being to reduce the risk that a retail client's losses cannot be compensated by a licensee because of a lack of financial resources.

13. As a member of an External Dispute Resolution (EDR) scheme a licensee is contractually bound to honour an award of compensation made by the scheme. A licensee could draw on either or both its PII and financial resources to pay an award of compensation. It would be expected that the licensee would pay compensation direct where the amount awarded is below the excess payment required under the PII policy, and that higher value awards would be met through claims against PII policies.

Review of compensation arrangements

14. Following the collapse of a number of financial product and service providers in the wake of the global financial crisis, the Parliamentary Joint Committee on Corporations and Financial Services (the PJC) resolved to undertake an inquiry into those collapses, with reference to, among other things, the adequacy of PII arrangements for those who sold the products and services, and the impact on consumers.

15. In its resultant 2009 report, *Financial Products and Services in Australia* (the PJC report), the PJC noted that many of the submissions to its inquiry advocated for the introduction of a last resort statutory compensation scheme but it concluded that more work was needed to determine whether such a scheme would be desirable and cost effective. Recommendation 10 of the PJC report was ‘that the Government investigate the costs and benefits of different models of a statutory last resort compensation fund for investors’.

16. Responding to this recommendation, the Government commissioned Mr Richard St. John to undertake an expert review of the need for and costs and benefits of a statutory compensation scheme for financial services.

17. In his April 2012 report, *Compensation Arrangements for Consumers of Financial Services*, Mr St. John concluded that the introduction of a statutory compensation scheme would be ‘inappropriate and possibly counter productive at this stage’.

St. John report - Recommendation 2.1

18. Rather, the report looks at strengthening the current compensation arrangements and made recommendations for:

- more onus on licensees to verify that they have adequate insurance cover;
- more attention by ASIC to the adequacy of licensees’ financial resources as viewed in conjunction with their insurance cover;
- a more pro-active stance by ASIC in administering compliance by licensees with their obligation to hold adequate PII or other financial resources; and

- strengthening ASIC's ability to police the licensing system.

19. More specifically, recommendation 2.1 (which is directed at the first area listed above), called for licensees be required 'to provide ASIC with additional assurance that their PII cover is current and is adequate to their business needs'.

20. In the body of the report, Mr St. John suggested that the obligation proposed in Recommendation 2.1 might require licensees:

- to submit to ASIC an annual certificate of currency for their policy including such relevant factual information as ASIC requires about the policy;
- to provide an annual declaration, signed by senior management, that in the process of renewing their insurance cover they have satisfied themselves that it meets established standards of adequacy; [and]
- to include in their annual report to ASIC a statement by their auditor that it has reviewed and signed-off on the currency of the insurance policy and its adequacy in covering the risks of the licensee's business.⁴

Problem

21. The problem pertains to the exposure of consumers to the risk that awards of compensation for the loss they suffer as a result of licensee misconduct may not be paid, or fully paid, because a licensee has:

- no or inadequate PII to draw on, or
- inadequate financial resources to pay liabilities that are not met through the PII policy.

22. These risks are referred to in the report through its references to statements made by consumer advocates that:

...All too often, consumers with strong claims against financial service providers, either are unable to recoup their losses due to inadequate insurance being maintained, or do not proceed with litigation due to the uncertainty about whether

⁴ Richard St John, *Compensation Arrangements for Consumers of Financial Services* (April 2012), at paragraph 4.38.

there will be sufficient funds available at the end of the proceeding to satisfy their claim.⁵

23. The specific problem addressed in this Regulation Impact Statement (RIS) is the level of compliance by licensees with their obligation to hold adequate PII cover.

24. The adequacy of licensees' financial resources is being addressed by ASIC and is not dealt with further in this RIS. As part of a set of measures to strengthen current compensation arrangements the St. John report called for more attention to be given to the adequacy of licensees' financial resources to enable better management of risks and unexpected costs such as compensation liabilities (recommendation 2.2). ASIC has been undertaking a sector by sector review of licensee capital adequacy – with changes in one sector commencing from 1 November 2012, progress for other sectors at various stages and for some sectors the review is still to commence.

Non-compliance with compensation requirements

25. As described earlier, under the self-assessment approach each relevant licensee (that is, those who provide financial services to retail clients and use PII as the default compensation arrangement) is required to assess their PII needs according to established adequacy standards (in Regulation 7.6.02AAA and RG 126) and to hold PII that meets those adequacy standards.

26. The St. John report described the current administration of the PII requirement as 'light handed' and concluded that:

there is a risk that some licensees do not maintain insurance cover, are underinsured or have cover that excludes aspects of the services they provide.⁶

27. There is no data on the level of licensee compliance or non-compliance with the requirement to hold PII that is adequate to their needs.

⁵ Paragraph 4.26 with quotes from a submission by Slater and Gordon, page 2.

⁶ Richard St John, Compensation Arrangements for Consumers of Financial Services (April 2012), paragraphs 4.1 and 2.149.

- On the one hand, the report concluded that there is recovery of compensation awards ‘in most cases’ which suggests that the licensees against whom the awards were made had PII and/or that other financial resources to cover the claims brought against them.
- On the other hand, the report finds evidence of compensation shortfall and says:

It is not always clear in such cases whether the licensee had in fact taken out and maintained insurance cover as required, or whether such cover had lapsed following the winding up of the licensee’s business or was still in force but did not respond to the claim.⁷

It refers to cases reported through the review process where licensees who are under financial pressure continued to trade without insurance cover.⁸

28. The report also queries whether ‘licensees might trade off the amount of cover or excess limits for lower premiums, thereby saving money by under-insuring’.⁹

29. The Financial Ombudsman Service Limited (FOS), an ASIC-approved EDR scheme, has advised that awards of compensation made in 20 recent dispute determinations, where the licensee member is insolvent, are expected to remain partially unpaid (on average each claimant’s uncompensated loss will be around \$35,000). This settlement forms part of more than 200 claims against 22 insolvent licensees lodged with FOS since January 2010 and which are still being resolved by FOS or liquidators.¹⁰

30. FOS also refers to another case where the settlement of compensation claims through the PII policy is for amounts considerably less than that claimed by affected consumers (though the amounts claimed in those cases were not tested

⁸ Richard St John, (April 2012), paragraph 4.26, with reference to submissions by Maurice Blackburn and ACTek Superannuation Fund.

⁹ Ibid, paragraph 4.27.

¹⁰ FOS Response to the St. John Report, July 2012 and in further correspondence with the Treasury.

through the awards process). In that case, on average each claimant's uncompensated loss will be around \$280,000.¹¹

31. The implication in these cases for compensation is that the PII policies held by the licensees were not (or are unlikely to be) adequate to meet the total amount of compensation claimed for client loss.

32. However, this does not of itself establish that there is a high level of non-compliance by licensees with their licensing requirement to hold adequate levels of PII to meet their needs.

Consequences of non-compliance

33. Consumers cannot assess for themselves whether they are dealing with a licensee that has the capacity to pay compensation should the need arise. Therefore consumers bear a risk that a licensee fails to hold PII cover at all, or to adequately insure (that risk is shared with other creditors and the licensee itself should inadequate PII result in the licensee's insolvency).

34. Such a risk will only manifest when claims for compensation are made for licensee misconduct. A licensee that has no or inadequate PII is likely to become insolvent because it is unable to meet compensation liabilities. In such circumstances, consumers are unsecured creditors in the insolvency proceedings and may receive only a portion of the compensation claimed. An example has been provided of recovery of compensation of 26 cents in the dollar through insolvency proceedings.¹²

35. On the financial and other impacts on consumers the report says:

... there is no denying the potential seriousness of the consequences for individual consumers who miss out on compensation to which they are entitled. There could be a consequential impact on the confidence of those consumers in financial services.¹³

¹¹ Ibid.

¹² Ibid.

¹³ Richard St John, page 49.

36. Research commissioned by ASIC's Consumer Advisory Panel has explored the social impacts of monetary loss resulting from licensee misconduct.¹⁴ One main finding was that failure to fully compensate investors who lose money because of licensee misconduct can cause the investor severe emotional (including mental health) and financial distress. The report also found impaired consumer trust in the financial system, especially in the Government, banks, financial advisers and ASIC.

37. There are also flow on costs to government and the community, as investors who experience significant losses might turn to the age pension or charities for financial support.

Summary of the problem

38. There is uncertainty about the level of compliance by licensees with their PII licensing requirements. Licensees self-assess their PII requirements and are not required to inform the regulator whether they hold PII on an ongoing basis, or the adequacy of that cover. ASIC's risk-based approach to the surveillance of licensees can uncover licensing breaches, (including breaches of PII requirements) by individual licensees but is not intended to provide blanket certainty to consumers on the likely availability of compensation arrangements should the need arise. The scope of ASIC regulatory action on these issues is discussed under Option A.

39. Consumers have no certainty about whether the licensee they deal with has made arrangements that are adequate to handle possible subsequent claims of compensation and consequently whether they would be able to recover any loss they may suffer through breach of conduct. The consequences of a licensee's failure to meet PII obligations in most cases will only surface when claims are made and then it is too late to correct the breach. The impact on affected consumers can be severe – as described above. Individual consumers can have large uncompensated losses, with examples of average losses of \$35,000 to \$280,000 as noted above.

¹⁴ ASIC Report 240, *Compensation for retail investors: the social impact of monetary loss*, May 2011.

Objectives of Government action

40. As referred to above, the rationale for the obligation on financial services licensees to have adequate compensation arrangements is to protect retail clients who suffer loss from licensee misconduct and to maintain confidence in financial markets.

41. The specific objective of Government action in this area is to have full compliance by those licensees that meet their compensation arrangement obligation through PII (currently around 3,400 licensees).

42. This will reduce, though not eliminate, the risk that consumers are unable to recover compensation for loss from licensee misconduct where they are entitled to do so.

Options that may achieve objectives

Option A: Do nothing

43. This option would see the continuation of the current legislative and administrative processes for ensuring compliance with the obligation to hold adequate PII. That is, the legislative requirements for specified licensees to hold PII, and for that cover to be adequate, would remain. The detailed regulatory guidance on licensees' compensation and insurance obligations would also remain. It is proposed that the key standards for assessing adequacy contained in the regulatory guidance will be translated into regulations and this will provide more certainty for industry and ASIC.

44. ASIC's guidance material, issued in December 2010, was developed through a rigorous process of consultation with industry and research into the PII market. The guidance material has been updated three times since its first release in 2007. In the absence of legislative change, or developments in PII products, there is unlikely to be much scope for the regulator to improve compliance with the PII requirements through further guidance materials.

45. Under the current regime, ASIC has broad information-gathering powers.¹⁵ It can and sometimes does request information about licensees' PII, although this is generally done incidentally as part of a broader surveillance activity.

- For example, ASIC's 2010 review of top 20 financial advisory firms examined their compliance systems including complaints handling and compensation.¹⁶
- ASIC will approach the next 30 largest licensees that provide financial product advice to retail clients with a reduced and more targeted questionnaire which has been informed by the results of the first.¹⁷
- ASIC has also recently undertaken a review of unlisted property schemes which found, amongst other things, evidence of non-compliance with the obligation to hold PII.¹⁸

46. ASIC conducts these surveillance activities using a risk-based approach and would continue to do so under this option. This involves identifying, analysing and evaluating the risks for licensees and focusing activities on those areas assessed as the high risks.

- For example, from its review of the top 20 licensees referred to above, ASIC used the information received from licensees to develop a number of risk indicators, which, along with other inputs (e.g. complaints received by ASIC), have been used to determine the types of risk to licensee businesses on which they need to focus their resources.¹⁹

¹⁵ For example, section 912E of the Act requires AFSLs and their representatives to give such assistance to ASIC as ASIC reasonably requests in relation to whether the licensee and its representatives are complying with the financial services laws, and in relation to the performance of ASIC's other functions. Such assistance may include showing ASIC the licensee's books or giving ASIC other information.

¹⁶ ASIC Report 251 *Review of financial advice industry practice*, September 2011.

¹⁷ *Ibid.*

¹⁸ ASIC Media Release, ASIC review of unlisted property MIS sector (12-168MR, 17 July 2011).

¹⁹ ASIC Media Release 11-202MR, 13 September 2011.

47. ASIC also draws on a range of information sources to inform its risk-based approach to surveillance including:

- complaints received from the general public and other industry participants;
- breach reports from licensees that they were significantly in breach of section 912B of the Corporations Act and RG 126; and
- reports from ASIC-approved EDR schemes (such as the Financial Ombudsman Service Ltd).

48. While ASIC now has information about some licensees' PII as a result of the activities described above, it does not have this information for the broader population of licensees. This means it cannot target licensees which might be at risk of not holding PII because it does not have the information with which to identify those licensees.

49. ASIC could potentially use its information gathering powers to seek PII information from all relevant licensees at a point in time but not to require this information on an annual basis. As a result of this process it could then target licensees which are not holding PII at a point in time. This process would not provide more certainty over time.

Option B: Require licensees to provide ASIC with a certificate of currency and a declaration of adequacy

50. Under this option, licensees would be required to provide ASIC with key information about their PII policy and assurance that it is adequate on an ongoing basis. Specifically licensees would be required to submit annually:

- a certificate of currency of the licensee's PII policy, (which the licensee receives as a matter of course from their insurer) and additional relevant factual information about the policy; and
- a declaration signed by senior management that in the process of renewing their insurance cover they have satisfied themselves that it meets established standards of adequacy.

51. As the requirement to submit these statements would be introduced legislatively, failing to include a certificate of currency or declaration of adequacy with those statements

would attract a penalty. This is consistent with the penalty that applies when failing to comply with the existing obligation in section 989B to lodge annual financial statements. Officers would also be guilty of an offence if they make a declaration of adequacy the content of which is false or misleading.²⁰

52. The certificate of currency would provide ASIC with prima facie evidence that a licensee has PII. ASIC would also be provided with basic information about licensees' PII which it could use as part of its risk-based approach to monitoring and surveillance.

53. One sub-set of licensees – participants of the Australian Securities Exchange – are already subject to requirements to report to ASIC the renewal of their PII, and the amount and nature of their cover.²¹ Those licensees are currently meeting higher standards than those applying to other licensees. The adoption of Option B (or Option D) would not require market participants to report to ASIC more than once a year.

Option C: Require an independent annual audit of PII adequacy

54. Currently licensees have an annual obligation to prepare and lodge with ASIC a profit and loss statement, a balance sheet and an auditor's report with respect to those accounts.²²

55. In addition to giving a statement about whether the accounts represent a true and fair view of the financial performance and financial position of the licensee, an auditor must assess and provide a statement of their opinion on other matters including, the effectiveness of internal controls used by a financial services licensee to comply with financial record keeping and client money-handling obligations.²³

56. Under this option, an auditor would also be required, as part of the annual audit process, to assess and include in their report a statement of opinion on the adequacy of the licensee's PII policy.

²⁰ Section 1308 of the Act.

²¹ ASIC (ASX) Market Integrity Rule 2.2.3.

²² Section 989B of the Act.

²³ Regulation 7.8.13 of the Regulations.

57. Under Option C (or Option D) the auditing profession would be consulted on a practical way to implement this option including:

- how auditors could become familiar with the regulatory standards for adequate PII for licensees (in legislation or ASIC guidance);
- the weight given to the auditor's broader knowledge of the licensed business (including volume of financial services provided), and any licensee history of compensation liabilities (including contingent liabilities for compensation, claims against PII and payments);
- the possibility of making an assessment against benchmarks and how such benchmarks might be established; and
- the form of the opinion to be provided.

Any agreed changes would be made by the Australian Auditing and Assurance Standards Board, for example, by way of updates to *Guidance Statement GS003: Audit and Review Requirements for Australian Financial Services Licensees under the Corporations Act 2001 (GS003)*.

Option D: Require licensees to provide ASIC with a certificate of currency, a declaration of adequacy of their PII and an independent audit of adequacy (implement both Options B and C)

58. Under this option, the Government would implement both Options B and C, that is:

- licensees would be required to provide ASIC annually with a copy of their certificate of currency and a declaration by senior management that in the process of renewing their insurance cover they have satisfied themselves that it meets established standards of adequacy; and
- auditors would be required, as part of the annual audit process, to assess and include in their report a statement of opinion on the adequacy of the licensee's PII policy.

Impact analysis

Option A: Do nothing

59. As outlined above, this option would see a continuation of the existing self-regulatory approach to compliance. In essence, this option would rely on the obligation in law for licensees to have adequate PII and risk-based monitoring and surveillance conducted by ASIC.

60. ASIC would continue to undertake reviews of licensee compliance procedures (such as those described in paragraph 45). It would continue to use its existing information gathering powers to check compliance either randomly, or in conjunction with surveillance processes focusing on licensee obligations generally.

61. However, in relying only on the sources of information summarised at paragraph 47, ASIC does not have a comprehensive range of information to conduct its risk-based monitoring and surveillance. For example, it could not target licensees at risk of holding inadequate PII, for example, by focusing on licensees exhibiting risk-indicators for PII such as high excesses.

62. In these circumstances, there are limitations on the extent to which the Government's objective can be achieved under the status quo.

Table 1: Costs and benefits of Option A

<i>Benefits</i>	<i>Costs</i>
Consumers	
Nil.	There is limited external pressure on licensees to hold adequate insurance under this option. As such, there is a risk that consumers will be unable to recover an award of compensation from AFSLs that have no or inadequate insurance.
Industry (AFSLs)	
This is the least expensive option - AFSLs would not incur any additional administrative or compliance costs.	There is an ongoing risk that licensees who have inadequate PII to meet compensation liabilities becoming insolvent. In the event of widespread incidences of insolvency, the potential loss of confidence in the financial sector may have adverse impacts on the remaining population of licensees who have held adequate PII and/or met their own compensation liabilities. This could include, for example, higher PII premiums or difficulty obtaining finance.
Government	
Nil.	Where consumer losses from licensee misconduct are not fully compensated, the cost of that unmet compensation may be transferred indirectly to the social security system, and borne by taxpayers.
Other	
Nil.	Instances of licensee insolvency resulting from inadequate PII are likely to result in losses for other businesses exposed to the insolvent licensee's creditworthiness. There might be broader and longer term costs to the economy if widespread incidences of licensee insolvency result in a significant loss of consumer confidence in financial markets. Any reduction in retail funds available for investment has the potential to make it more difficult and costly for businesses to raise capital and access finance. Evidence that consumers have unpaid awards of compensation might result in less confidence in the EDR scheme process which is an integral part of the compensation arrangements.

Option B: Require licensees to provide ASIC with information about their PII policy and assurance that it is adequate on an ongoing basis

63. Under this option, licensees would be required to lodge with ASIC annually:

- a certificate of currency of the licensee's PII policy, (which the licensee receives as a matter of course from their insurer) and additional relevant factual information about the policy; and
- a declaration signed by senior management that in the process of renewing their insurance cover they have satisfied themselves that it meets established standards of adequacy.

64. Currently, ASIC expects licensees to reassess the adequacy of their PII cover annually in order to satisfy themselves that they meet the requirements in section 912B and regulation 7.6.02AAA.²⁴

65. However, as licensees are not required to provide ASIC with information or assurance about their PII on an annual basis, there is a risk that a licensee 'sets and forgets' – renewing its PII policy each year for the same cover without reconsidering whether this remains adequate to its operational risks. As such, requiring licensees to provide assurance that their PII is adequate on an annual basis may reduce inadvertent non-compliance, particularly as failure to do so, or the making of a false declaration to ASIC, will carry a penalty.

66. Requiring licensees to provide assurance that their PII policy remains adequate on an annual basis will prompt licensees to ensure their PII policies are adequate to any changing business needs.

67. The annual requirement on licensees to provide to ASIC a copy of a certificate of currency for their PII cover will also provide a disincentive to deliberately run the business with no PII cover. Any licensee that took a calculated risk that they 'could get away' with not having PII would change their assessment of getting caught under

²⁴ ASIC sets out its expectation that PI is reviewed annually at RG126.55.

Option B. Rather, under this annual reporting process ASIC would uncover any licensee required to hold PII that operates without continuous cover.

68. ASIC would also have a more comprehensive set of information on which to base its risk-based approach to monitoring and surveillance. Rather than looking at the adequacy of a licensee's PII as an incidental part of a broader surveillance activity, this information would allow ASIC to identify licensees at risk of not holding PII or holding inadequate PII (for example, licensees who do not submit a certificate of currency) and specifically focus activity on these licensees.

69. The St. John report also notes the need for ASIC to have such information as the basis for implementing a separate recommendation (2.5.3) for ASIC to have a discretion to pass on information to a retail client who is pursuing a claim against a licensee that is no longer available or fails to respond. The Government will give further consideration to that proposal.

70. As licensees should already be assessing the adequacy of their PII on an annual basis, there should be no additional internal costs associated with requiring licensees to provide ASIC with assurance that their PII is adequate. The provision of the required information to ASIC rounds out the current requirements on the licensee to self-assess their PII needs and maintain their cover at adequate levels.

71. Under Option B, the 3,400 or so licensees that are required to use PII as their compensation mechanism will all be required to comply with these new reporting requirements, including those that might regard themselves to be fully complying with the current requirements.

72. Submissions from industry groups that represent various licensed financial services sectors support the need for licensees to provide ASIC with such assurance of the adequacy of their PII cover. The Stockbrokers Association of Australia (SAA) notes that as market participants their members already provide such assurance under ASIC's Market Integrity Rules and ASX operating rules. The consultation process described at paragraph 118 will provide

the opportunity for industry groups to comment on the detail of proposed measures.

73. There will be a small administrative cost for licensees associated with providing ASIC with:

- a certificate of currency of the licensee's PII policy, (which the licensee receives as a matter of course from their insurer) and additional relevant factual information about the policy; and
- a declaration signed by senior management that in the process of renewing their insurance cover they have satisfied themselves that it meets established standards of adequacy.

74. A point of reference, based on analysis undertaken by ASIC on the cost of regulatory change elsewhere in the licensing regime, is that the cost to the licensee would involve:

- a small administrative cost in sending a copy of the certificate of compliance to ASIC;
- far less than one hour cumulatively for directors to sign the declaration (where one hour would cost \$3750).²⁵

75. The additional reporting will, as far as possible, be built into licensees' existing annual financial reporting processes. For example, this additional information could be sought through modified forms required to be lodged with ASIC annually (for example, FS70 – AFSL Profit and Loss Statement and Balance Sheet).

76. There will be costs to ASIC associated with changing its forms and databases to facilitate the collection of this information. ASIC would also need to modify its internal processes to feed this information into its risk-based approach to monitoring and surveillance, although these processes are already subject to ongoing modification and refinement in response to market developments, industry trends and so on.

²⁵ ASIC, Regulation Impact Statement. Retail OTC derivative issuers: financial requirements. July 2012.

Table 2: Costs and benefits of Option B

<i>Benefits</i>	<i>Costs</i>
Consumers	
There would be some additional certainty that licensees hold PII that is adequate to their needs from which consumers can recover compensation for loss from licensee misconduct. This is because licensees would be prompted to reassess and report on the adequacy of their PII through the external pressure of them having to report to ASIC. The possibility of targeted ASIC surveillance resulting from the information it obtains will put greater external pressure of licensees to ensure their PII is adequate.	Under the proposed assurance and reporting process, even if PII is assessed by the licensee to be adequate to their needs, there is no guarantee that it will cover all the claims that might be subsequently made against the licensee in the event their misconduct affects many clients.
Industry (AFSLs)	
For those licensees who acquire or increase the level of PII as a result of the proposed arrangements, there may be some reduction in the risk of individual licensee becoming insolvent as a result of not being able to meet compensation claims through PII. Consequently, some reduction in the likelihood of the broader AFSL population being adversely affected by widespread instances of licensee insolvency as discussed in table 1 above.	As outlined in paragraphs 73 and 74, there would be an additional administrative cost.
Government	
Improved access to compensation might give consumers who suffer loss sufficient financial independence so they do not become reliant on the social security system, the cost of which is borne by taxpayers.	There would be some cost to ASIC associated with changing its forms and databases to facilitate the collection of this information and its internal processes to feed this information into its risk-based approach to monitoring and surveillance.
Other	
Some reduction in the likelihood of: <ul style="list-style-type: none"> • individuals and business experiencing loss as a result of exposure, as creditors, to insolvent licensees; and • the broader and longer term costs to the economy discussed in table 1 	

<i>Benefits</i>	<i>Costs</i>
above.	

Option C: Require an independent annual audit of the adequacy of licensees PII policy

77. Under this option, an auditor would be required, as part of their annual audit of a licensee’s accounts, to assess and include in their report a statement of opinion on the adequacy of the licensee’s PII policy.

78. As noted in paragraph 57, the auditing profession would be a consulted on a practical way to implement this objective. The process for making an assessment of adequacy under this proposal would take into account the practical issues raised by the profession.

79. This option would address the finding in Mr St. John’s report that there is limited external pressure on licensees to hold adequate insurance. If licensees know their PII will be subject to regular independent scrutiny it is expected that their assessment of the adequacy of their PII needs will be up to date and follow required standards.

80. Further, it would prompt licensees to reconsider their cover if an auditor offers a different opinion on the licensee’s needs. It would also bring instances of non-compliance to ASIC’s attention, which ASIC could respond to with remedial measures or enforcement action for individual licensee breaches. It would also provide ASIC a higher level of assurance about other licensees that are complying with the PII requirements, with fewer resources needed for surveillance on PII matters in general.

81. The advantage of Option C compared to Option B is that there would be an independent annual vetting of the licensee’s self-assessment of the adequacy of their PII cover. Under Option B, the certificate of currency (issued by the insurer) would provide evidence that a licensee holds PII; however, ASIC would still largely rely on the licensee’s declaration to ensure the cover is adequate to the licensees needs. Under Option C, ASIC would have an independent view of both the existence of and adequacy of the licensee’s PII cover.

82. This would put greater pressure on licensees to maintain adequate PII than Option B, as the adequacy of their policy would be independently scrutinised on an annual basis.

83. However, the disadvantage of Option C compared to Option B is that ASIC would not have up to date information about licensees' PII (which under Option B would be contained in the certificate of currency).

84. The key cost associated with this option is likely to be an increase in the cost of obtaining an auditor's report that also required to auditor to give their opinion on the adequacy of PII. The likely cost increase will depend on the expectations on auditors which are still to be defined. By way of broad comparison, other regulatory changes to licensees requiring audited statements, which involved the audit of cash flow projections, were estimate to involve additional auditing costs to be \$2000 per licensee.²⁶ Such a comparative cost is likely to be an upper bound for the largest licensees given that:

- current cost estimates for AFSL audits range from \$2,000 to \$10,000 depending on the nature, complexity and size of the business conducted by the AFSL; and
- the additional cost of assessing a licensee's PII adequacy is likely to be proportional to the nature, size and complexity of the licensee's business.

85. The need for auditors to become familiar with the adequacy standards for PII would be a new upfront cost to auditors. To the extent to which the auditor is a member of a professional accounting body, this training could be undertaken as part of their continuing professional development (CPD) obligation. In these circumstances, there would be no additional cost beyond that required to meet the existing CPD requirements.

86. There may also be some cost to the Australian Auditing and Assurance Standards Board who would need to update their *Guidance Statement GS003: Audit and Review Requirements for Australian Financial Services Licensees under the Corporations Act 2001* which sets out matters

²⁶ Ibid.

which auditors should consider when planning, conducting and reporting on the audit of an AFSL.

87. Under Option C, all licensees that have retail clients and meet their obligation to have compensation arrangements through the default mechanism to hold PII, will be required to lodge an auditor's report that includes a statement on the adequacy of the licensee's PII. That is, it would be expected that around 3,400 licensees would need to comply with the requirements. Option C would impose the obligation for an auditor's report on all licensees that hold PII as their default compensation arrangement, including those that might regard themselves to be fully complying with the current requirements.

88. As noted in paragraph 72 submissions from industry groups that represent various licensed financial services sectors support the need for licensees to provide ASIC with such assurance of the adequacy of their PII cover and the consultation process described at paragraph 118 will provide the opportunity for industry groups to comment on the detail of proposed measures.

89. Like Option B, there would be a cost to ASIC in having to change its systems and processes to receive this information.

Table 3: Costs and benefits of Option C

<i>Benefits</i>	<i>Costs</i>
Consumers	
<p>There would be some additional certainty that licensees hold PII that is adequate to their needs from which consumers can recover compensation for loss from licensee misconduct. This is because licensees would be prompted to reassess the adequacy of their PII, and hold cover of that level, through the external pressure of them having to provide an audited report to ASIC. The possibility of targeted ASIC surveillance resulting from the information it obtains will put greater external pressure of licensees to ensure their PII is adequate.</p>	<p>Under the proposed audited report process, even if PII is assessed by the licensee to be adequate to their needs, there is no guarantee that it will cover all the claims that might be subsequently made against the licensee in the event their misconduct affects many clients.</p> <p>The increased cost associated with obtaining an auditor's report is an additional business cost to licensees which may be passed onto consumers through advice and product fees.</p>
Industry (AFSLs)	
<p>For those licensees who acquire or increase the level of PII as a result of the proposed arrangements, there is some reduction in the risk of an individual licensee becoming insolvent as a result of not being able to meet compensation claims through PII.</p> <p>Consequently, there is some reduction in the likelihood of the broader AFSL population being adversely affected by widespread instances of licensee insolvency as discussed in table 1 above.</p>	<p>As noted in paragraph 84, there are additional costs to licensees in obtaining an audit report which assesses adequacy of PII are likely to increase proportionally to the nature, size and complexity of the licensee's business.</p>
Government	
<p>Improved access to compensation might give consumers who suffer loss sufficient financial independence so they do not become reliant on the social security system, the cost of which would be borne by tax payers.</p>	<p>There would be some cost to ASIC associated with changing its forms to accommodate an auditor's statement on the adequacy of a licensee's PII, to facilitate the collection of information and to feed additional information into its risk-based approach to monitoring and surveillance.</p>

<i>Benefits</i>	<i>Costs</i>
	As ASIC would have a higher level of assurance about licensees that are complying with the PII requirements, it could direct its resources to known non compliance by individual licensee and lessen surveillance on PII matters in general.
Other	
Some reduction in the likelihood of: <ul style="list-style-type: none"> • individuals and business experiencing loss as a result of exposure to insolvent licensees; and • the broader and longer term costs to the economy discussed in table 1 above. 	There may also be an impact on auditors as described in paragraphs 85 and 86. While they would be paid for the additional work involved in assessing PII, there would be some additional liability associated with such an extension of their task.

Option D: Require licensees to provide ASIC with a certificate of currency, a declaration of adequacy of their PII and an independent audit of adequacy (implement both Options B and C)

90. This option would involve implementing both Options B and C, that is:

- licensees would be required to provide ASIC annually with a copy of their certificate of currency, additional relevant factual information about the policy and to provide a declaration of adequacy by the senior management; and
- auditors would be required, as part of the annual audit process, to assess and include in their report a statement of the auditor’s opinion on the adequacy of the licensee’s PII policy.

91. This option would provide a more comprehensive set of information on the existence and adequacy of a licensee’s PII cover:

- instances of non-compliance would be brought to ASIC’s attention directly through the auditor’s reports; and

- ASIC would be able feed the alerts provided by auditor's statement of opinion, as well as information from licensees about their PII cover, into its risk-based approach to monitoring and surveillance.

92. Rather, under this annual reporting process ASIC would uncover any licensee required to hold PII that operates without continuous cover and where the auditor considers the PII does not meet the standards of adequacy.

93. This information would allow ASIC to conduct surveillance activity specifically focused on licensees identified to be at risk of holding inadequate or no insurance. For example, it could target licensees who do not submit a certificate of currency or those who receive an unfavourable assessment from an auditor.

94. The costs of option D are a combination of the additional:

- administrative costs to the licensee discussed in paragraphs 73 and 74;
- costs to the licensee of obtaining an audit report which assesses the adequacy of PII discussed in paragraph 84;
- costs to the regulator of changing its forms to accommodate an auditor's statement on the adequacy of a licensee's PII, to facilitate the collection of information and to feed additional information into its risk-based approach to monitoring and surveillance. However, there is an offset because ASIC could direct its resources to known non compliance by individual licensees and lessen surveillance on PII matters in general.

95. The additional cost is spread amongst licensees including those that might regard themselves to be fully complying with the current requirements to hold adequate PII.

96. The benefit of the proposed measures is to provide additional certainty to consumers that the licensee they deal with has made arrangements that are adequate to handle possible subsequent claims of compensation and consequently whether they would be able to recover any loss they may suffer through breach of conduct. However, in cases of systemic licensee misconduct the undertaking of adequate PII

is not necessarily a guarantee that there will be sufficient compensation available for all affected consumers.

97. As the degree of licensee compliance with the PII requirements is not known, the additional cost borne by all relevant licensees might uncover only limited instances of non-compliance and additional certainty than under the current self-assessment process.

Table 4: Costs and benefits of Option D

<i>Benefits</i>	<i>Costs</i>
Consumers	
<p>There would be some additional certainty that licensees hold PII that is adequate to their needs from which consumers can recover compensation for loss from licensee misconduct. This is because licensees would be prompted to reassess the adequacy of their PII, and hold cover of that level, through the external pressure of them having to provide information and an audited report to ASIC. The possibility of targeted ASIC surveillance resulting from the information it obtains will put greater external pressure of licensees to ensure their PII is adequate.</p>	<p>Under the proposed reporting and audited report process, even if PII is assessed by the licensee to be adequate to their needs, there is no guarantee that it will cover all the claims that might be subsequently made against the licensee in the event their misconduct affects many clients.</p> <p>The increased cost associated with obtaining an auditor’s report may be passed onto consumers through advice fees.</p>
Industry (AFSLs)	
<p>For those licensees who acquire or increase the level of PII as a result of the proposed arrangements, there is some reduction in the risk of an individual licensee becoming insolvent as a result of not being able to meet compensation claims through PII.</p> <p>Consequently, there is some reduction in the likelihood of the broader AFSL population being adversely affected by widespread instances of licensee insolvency as discussed in table 1 above.</p>	<p>As noted in paragraph 84, there are some additional costs associating with obtaining an audit report which assesses adequacy of PII are likely to increase proportionally to the nature, size and complexity of the licensee’s business.</p> <p>There would also be a small, perhaps negligible, cost associated with reporting additional information to ASIC.</p>
Government	
<p>Improved access to compensation might give consumers who suffer loss sufficient financial independence so that they do not become reliant on the social security system, the cost of which would be borne by taxpayers.</p>	<p>There would be some cost to ASIC associated with changing its forms to accommodate an auditor’s statement on the adequacy of a licensee’s PII, to facilitate the collection of information and to feed additional information into its risk-based approach to monitoring and surveillance.</p> <p>As ASIC would have a higher level of assurance about licensees that are complying with the PII requirements, it could direct its resources to known non compliance by individual licensees and lessen surveillance on</p>

<i>Benefits</i>	<i>Costs</i>
	PII matters in general.
Other	
Some reduction in the likelihood of: <ul style="list-style-type: none"> • individuals and business experiencing loss as a result of exposure to insolvent licensees; and • the broader and longer term costs to the economy discussed in table 1 above. 	There may also be an impact on auditors as described in paragraphs 85 and 86. While they would be paid for the additional work involved in assessing PII, there would be some additional liability associated with such an extension of their task.

Consultation

April 2011 consultation paper

98. Mr St. John published a consultation paper in April 2011 which invited public comment on his initial research and preliminary observations.²⁷ In that paper, he specifically sought feedback on ‘scope for a tighter approach to the administration of the current requirement to hold professional indemnity insurance’.²⁸ A total of 28 submissions were received in response to the paper.

99. Of the submissions which addressed these issues, both industry groups and consumer advocates broadly supported the proposition that the PII requirements could be better enforced.

100. For example, the Financial Planning Association of Australia (FPA) said:

the Association supports the possible measure to require licensees to report through their annual 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 needs of their business. The FPA also agrees that PI insurance certifications be subject to confirmation in the independent audit of the licensee’s financial statements.

²⁷ Richard St. John, *Review of Compensation Arrangements for consumers of financial services: Consultation Paper* (April 2011).

²⁸ *Ibid*, page 98.

101. The consumer organisations did not see improving the oversight of licensee's PII as a priority but acknowledged that:

There are some weaknesses in the oversight of insurance requirements. These include the reliance on a self-assessment of 'adequacy' and an apparent lack of rigour and regularity in compliance monitoring.

102. Of the submissions which commented on the administration of the requirement to hold PII, only the National Insurance Brokers Association (NIBA) could not see the value:

NIBA has no concerns with the self-policing approach currently in place in relation to insurance brokers.... NIBA does not believe that the submission of forms confirming compliance adds any value to the process and would simply be another costly compliance obligation.

103. Mr St. John also held a series of meetings with key industry bodies, consumer groups and ASIC over the life of his review (as outlined in Chapter 1 of the report).²⁹

Consultation on the final report

104. The Government released Mr St. John's final report for public comment in May 2012 for a two month consultation period and 13 submissions were received. The purpose of this consultation was to inform the Government's response to Mr St. John's findings.

105. Submissions received in response to the final report from a range of stakeholders support the need for a strengthening of the current PII requirements, including the measures in recommendation 2.1. Many stakeholders expressed similar sentiments to those outlined in their responses to the April 2011 consultation paper.

106. The FPA, the Superannuation Professionals Association of Australia (SPAA) and the Joint Accounting Bodies (JAB) all supported the introduction of a requirement that licensees to provide ASIC with additional assurance that their professional indemnity is adequate.

²⁹ Richard St. John 2012, Pages 4-6.

107. The Insurance Council of Australia (ICA) expressed in-principle support for the proposition that licensees should do more to establish they have adequate PII.

108. The consumer body submission recognised the need to improve the operation of existing PII arrangements and supported recommendation 2.1 but advocated more far reaching changes.³⁰

109. In contrast to their April 2011 submission, NIBA did not oppose the recommendation but stated its belief that these requirements should not apply to insurance brokers.

Conclusion and recommended option

110. In varying degrees, Options B, C and D are all likely to improve the assurance that licensees are complying with their obligation to hold adequate PII cover.

111. However, Option D meets the Government's objectives to the highest degree but at the highest cost to licensees.

- Under Option B, the certificate of currency (issued by the insurer) would provide evidence that a licensee holds PII but ASIC would still largely rely on the licensee's declaration to ensure the cover is adequate to the licensee's needs.
- Under Option C, ASIC would have an independent view of both the existence of and adequacy of the licensee's PII cover but would not have up to date information about licensees' PII.

112. By combining Options B and C, Option D provides the most comprehensive set of information and assurance on the existence and adequacy of a licensee's PII cover. As the degree of licensee compliance with the PII requirement is not known, the additional cost borne by all licensees might uncover only limited instances of non compliance under the current self-assessment process.

³⁰ A joint submission was made by the following consumer groups: the Consumer Action Law Centre, the Indigenous Consumer Assistance Network, the Footscray Community Legal Centre, the National Information Centre on Retirement Investments, the Australian Shareholders Association, Financial Counselling Australia, COTA Australia, Choice and the NSW Consumer Credit Legal Centre.

113. This option is at the highest comparable cost to licensees involving administrative costs and an increase in the audit costs as described in paragraph 84. Option D would affect all licensees required to hold PII including those that might regard themselves to be fully complying with the current requirements to hold adequate PII.

114. This option provides the highest level of additional certainty to consumers that the licensee they deal with has made PII arrangements that are adequate to handle possible subsequent claims of compensation, though is not a guarantee that compensation will be paid in a particular case (especially where the misconduct of the licensee is systemic).

115. The additional cost of Option D is likely to be partially passed onto consumers through advice or product fees.

116. The proposal has received support from both industry (the FPA) and consumer groups.

Implementation and review

117. In developing legislative changes to implement Option D, it would be expected that up front consultation with the auditing profession would be required to ensure that the audit requirements are practical whilst providing the additional assurance of the adequacy of a licensee's PII that is being sought.

118. More detailed up front consultation would also be required with ASIC on administrative issues including to ensure that the information is in a form most readily suited to its risk assessment processes. ASIC will also need to update its online forms and database systems to be able to receive and assess this information. The commencement date for the final regulations will have to coincide with the timing of form and database changes.

119. Option D would be implemented through various changes to the *Corporations Regulations 2001* or the *Corporations Act 2001*. It is not yet known which mechanism will be used for affecting these changes but this is not likely to have a bearing on the effectiveness of the requirements themselves.

120. If necessary, these new requirements could be supported by ASIC guidance.

121. Draft regulations or legislation and any accompanying regulatory guidance will be subject to a public consultation process in early 2013. Ongoing monitoring of these reforms will be undertaken by the Treasury and ASIC to ensure that the changes are achieving their objective and whether any further reforms are necessary.