Do you need PI cover?

A new regulation has been recently introduced in relation to AFSL holders’ compensation requirements under section 912B of the Corporations Act while ASIC has released a consultation paper on how it intends to administer the compensation requirements, primarily through professional indemnity insurance.

NEW REGULATION

New compensation requirements were introduced by the Regulation 7.6.02AAA of the Corporations Regulations 2001 on 28 June 2007 (Regulation). These requirements apply to AFSL holders that provide financial services to retail clients.

The new obligations under the regulation will commence on 1 January 2008 for new licensees (ie, those persons granted a licence from 1 January 2008) and 1 July 2008 for existing licensees.

The regulation provides that the primary method of compliance with the obligation is for licensees to obtain professional indemnity insurance and that the level of cover should be “adequate”. However, some licensees may rely on alternative arrangements or guarantees from a related company who is regulated by the Australian Prudential Regulation Authority (APRA).

The Regulation provides that the following matters must be taken into account when determining whether professional indemnity insurance is adequate:

- The licensee's membership of a dispute resolution scheme taking into account the maximum liability that has realistically the potential to arise in connection with:
  - Any particular claim against the licensee; and
  - All claims in respect of which the licensee could be found to have liability; and

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Relevant considerations in relation to the financial services business carried on by the licensee, including the:
- volume of business;
- number and kind of clients;
- kind or kinds of business; and
- number of representatives of the licensee.

However, general insurance companies, life insurance companies and authorised deposit taking institutions regulated by APRA are exempt from the compensation requirements. Licensees who are related to exempt APRA-regulated entities are also exempt where they have a guarantee in place from the APRA-regulated entity that has been approved by ASIC.

The Regulation also provides that security bonds previously lodged with ASIC may be discharged or returned by ASIC where:

(a) the licensee certifies, in the form approved by ASIC, that it holds professional indemnity insurance, or has an alternative compensation arrangement in place that:
   (i) provides compensation protection for clients of the licensee, that is adequate to cover claims to which the security bond could apply; or
   (ii) together with other financial resources available to it, provides compensation protection for clients of the licensee, that is adequate to cover claims to which the security bond could apply;

(b) the licensee is a general insurance company, life insurance company or authorised deposit taking institution regulated by APRA; or

(c) the licensee certifies, in the form approved by ASIC, that it holds a guarantee given by a company or institution mentioned in paragraph (b) that, together with other financial resources available to it, provides compensation protection for clients of the licensee that is adequate to cover claims to which the security bond could apply.

ASIC CONSULTATION PAPER

On 23 July, ASIC released a consultation paper on its proposals for administering the new compensation requirements, including professional indemnity insurance.

ASIC notes that the Commonwealth Government describes the objective of the compensation requirements as to “reduce the risk that compensation claims to retail clients cannot be met by the relevant licensees due to the lack of available financial resources” ie the compensation requirements are not a mechanism for providing compensation directly to consumers. Rather they are a means of reducing the risk that a licensee cannot pay claims because of insufficient financial resources.

To this end ASIC states that its policy objective is to administer the compensation requirements to maximise their potential to reduce the risk that a retail client’s losses (due to breaches by a licensee) cannot be compensated by the licensee due to the lack of financial resources, as far as this is practically possible.

ASIC has developed the following basic policy principles which are intended to guide ASIC’s administration of the compensation requirements:

(a) The primary way for licensees to comply with the compensation requirements will be to have adequate PI insurance.

(b) The PI insurance must substantially deliver the policy objective. The requirement that the PI insurance be “adequate” means that it is fit for achieving the policy objective as far as practically possible.

(c) The standard of “adequate PI insurance cover” will be the benchmark for ASIC approval of any alternative arrangements to PI insurance that licensees put to ASIC.

(d) It is the basic responsibility of each licensee to determine what arrangements are “adequate” in their circumstances.

In general, ASIC proposes that:

(a) a licensee’s PI insurance policy should have a per claim limit at least as high as the maximum monetary limit that applies to their external dispute resolution scheme (EDR) scheme(s);

(b) for insurance brokers, the policy should maintain the aggregate amount of cover which would have been required under the superseded Insurance (Agents and Brokers) Act 1984;

(c) for other licensees:
   (i) the appropriate measure of a licensee’s size is the total gross revenue derived from the licensee’s dealings with retail clients; and
   (ii) the minimum aggregate cover should be assessed on a sliding scale as follows:

   (A) for licensees whose actual or expected revenue from retail services is up to $1 million – minimum $2 million cover;

   (B) for licensees with revenue greater than $1 million – minimum cover should be two times actual or expected revenue from retail services (up to a capped minimum of $20 million cover).

(d) the policy objective and the legislation require the following as key features of an adequate PI insurance policy:

   (i) the policy must cover loss or damage suffered by retail clients because of breaches of obligations under Chapter 7 of the Corporations Act;

   (ii) the policy must cover breaches by both the licensee and its representatives;

   (iii) the policy must be available to cover compensation awards made by the EDR to which the licensee belongs; and

   (iv) as far as possible, the policy must continue to provide cover for a period of time after the licensee ceases business (e.g. run-off cover).

EXCLUSIONS

ASIC has commissioned research which indicates that current polices in respect of professional indemnity insurance products would not be fully adequate for ASIC purposes. These generally include exclusions for fraud, representatives acting outside the
scope of their authority of and products not on an “approved product list”. In addition the research identified deficiencies in excesses and indemnity levels, the lack of availability of run off cover and the limitation of “claims made” policies. ASIC proposes that any shortfall or gap be made up by a licensee using its own financial resources. ASIC proposes a procedure which will help licensee assess whether or not they have adequate financial resources to meet such claims as follows:

**Step 1 – The PI insurance gap**

Estimate the total exposure to claims not covered by the policy (i.e. those potential claims not covered by the policy as discussed in the consultation paper). This could be determined by:

- estimating the maximum exposure to a single client under each gap in cover (e.g. the maximum exposure for loss arising from advice provided in relation to products not on the approved product list); and
- estimating the number of these kinds of claims that will be expected in the policy period.

**Step 2 – Anticipated excess payments**

Estimate the excess payments that you will be required to meet in the policy period.

**Step 3 – Projected cash flows**

Ensure that your 3-month projected cash flows will at all times be sufficient to cover the estimate generated in Step 1 (the PI insurance gap) and the estimate generated in Step 2 (anticipated excess payments) (together, the estimated exposure).

**Step 4 – Audit report**

Ensure that the annual audit report you are required to provide to ASIC addresses your projection of cash flows, taking into account the contingencies discussed at Step 1 and 2.

This means that licensees must include their estimated exposure in their cash flow projections (required by RG 166), and ensure that their cash flow can cover the estimated exposure. This would need to be verified in the usual way under RG 166, including through the audit report. The base level financial requirements in RG 166 are not intended to provide for compensation arrangements, but in practice any estimated exposure needs to be factored into a licensee’s cash flow projections. For example, the need to pay an excess on each claim will have to be factored into the licensee’s cash flow projections.

**ALTERNATIVE ARRANGEMENTS**

ASIC will accept applications for alternative arrangements to be assessed on a case by case basis. However, alternative arrangements will not be approved unless they provide no less protections than adequate PI cover.

ASIC also propose that the following hypothetical examples illustrate what might or might not be alternative arrangements:

- **Self-insurance approach**
  Some very highly capitalised financial services providers might take a self-insurance approach (i.e. to completely replace PI insurance). This might be appropriate for providers that are so substantial that failure to pay claims is very unlikely (akin to the exemption for some APRA-regulated entities). ASIC think this is unlikely to be appropriate other than for a small number of very highly capitalised providers.

- **Industry member fund**
  Alternative arrangements proposed by an industry body may be approved by ASIC. For example, an industry body’s members might wish to set up a compensation fund supported by compulsory levies of members. This could be in addition to PI insurance (i.e. to compensate clients where a member’s insurance is inadequate or they cease trading or become insolvent) or instead of PI insurance. Approval of a fund would depend on the amount of compensation that would be available for clients and the circumstances in which the fund would compensate clients.

ASIC encourages industry bodies to consider whether an alternative arrangement is appropriate for their members and is keen to discuss any such arrangements further with them.

**FEED BACK**

The consultation paper seeks feedback on:

- ASIC’s proposed policy on what is adequate professional indemnity insurance cover;
- some challenges to the regime and some practical options responding to these challenges;
- ASIC’s proposed guidance on how licensees should approach the new requirements; and
- ASIC’s policy for approving alternative arrangements to professional indemnity insurance.

**NEXT STEPS**
