



IMF (Australia) Ltd

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**SUBMISSION REGARDING THE
AUSTRALIAN SECURITIES & INVESTMENTS
COMMISSION'S
CONSULTATION PAPER 87:**

**COMPENSATION AND INSURANCE ARRANGEMENTS FOR
AFS LICENSEES**

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**SUBMISSION TO THE AUSTRALIAN SECURITIES AND INVESTMENTS
COMMISSION IN RELATION TO COMPENSATION AND INSURANCE
ARRANGEMENTS FOR AFS LICENSEES**

1. IMF (Australia) Ltd appreciates the opportunity to comment on the Australian Securities & Investments Commission's recent Consultation Paper 87 titled "*Compensation and insurance arrangements for AFS licensees*" ('the Paper').
2. IMF refers ASIC to its "*Submission to the Department of the Treasury in Relation to Financial Services Compensation Arrangements*" ('IMF's submission to Treasury') of 28 November 2006, which can be found on the IMF website.¹
3. IMF commends ASIC on its approach to the compensation arrangements, especially the proposals for the legislation to contain requirements as to the level and scope of cover. However, we argue that a more proscriptive approach may be necessary in order for the policy objective – that there will be an operative insurance policy able to respond to a licensee's breaches, thereby reducing the risk that retail clients are subjected to losses – to be achieved.
4. Underpinning the arrangements is the principle that it is the responsibility of each licensee to determine what insurance policy is adequate for them. Such an arrangement is likely to lead to the licensee seeking to minimise the cost of their insurance cover by taking out the cheapest possible policy – which is likely to be one that has the lowest level, and narrowest scope, of cover that satisfies the requirements under the legislation.
5. The cost (premiums) of a professional indemnity (PI) insurance policy rises with a higher level and wider scope of cover (or fewer exclusion clauses). But cheaper insurance policies might contain exclusion clauses that make them ultimately worthless to the licensee – and by implication, to any retail clients of that licensee seeking to recover their losses.
6. ASIC has clearly recognised this by proposing that a licensee's PI insurance policy contains an inadequate amount of cover and includes a number of "key features" relating to the scope of cover. This recognition – that in system of self-regulation, licensees must be provided with clear and unequivocal guidance through the legislation as to minimum requirements for their insurance policies – is critical for the policy objectives to be fulfilled.
7. IMF submits, however, that ASIC should go further, especially regarding the scope of cover. While ASIC is no doubt correct that achievement of the policy objectives is subject to "practical limitations" and is "limited by what the insurance market will provide", the proposals can go further to address more of the inadequacies in the current environment without creating unnecessary difficulties for the companies that write such policies.

¹ See www.imf.com.au - 'Publications' tab, then 'Consumer legal issues'.

Amount of cover

8. ASIC states in the Paper that to be adequate overall, a PI insurance policy must have an adequate amount of cover, including both the limit of liability “per claim” and the limit of liability “in the aggregate”.
9. The Paper sets out ASIC’s “tentative proposals” whereby the minimum level of *aggregate* cover will be:
 - (a) a minimum of \$2 million for licensees whose revenue from retail services is up to \$1 million; and
 - (b) two times actual (or expected) revenue from retail services for licensees with revenue greater than \$1 million, up to a \$20 million cap.
10. Meanwhile, the limit *per claim* should be at least as high as the EDR scheme monetary limit per claim.
11. The Paper cites a research study which found that a \$2 million indemnity would cover approximately 90% of all individual claims lodged for an average licensee.

IMF feedback on B3Q3

12. While it is likely that larger licensees (measured by revenue) may have more clients invested in a particular investment as a result of their advice, it is important to note that the potential quantum of losses is not linked to the licensee’s revenue, but to the quality of the licensee’s advice.
13. IMF believes that a minimum a level of cover of \$2 million for a smaller licensee is likely to be inadequate. On an average commission of 2% of the amount invested, \$1 million of revenue would be achieved if a financial adviser places \$50 million of investments. A prescription that there must be \$2 million of aggregate cover would mean, simplistically, that just 4% of the advice might be “negligent” ($\$2M/\$50M = 4\%$) before the cover is exhausted.
14. We submit that:
 - (a) the level of cover for licensees with revenue from retail services up to \$1 million should be increased to a level between **\$5 million** and **\$10 million**; and
 - (b) that licensees with revenue of more than \$1 million should have aggregate cover of *at least* **\$10 million** whatever their level of revenue, increasing to the cap of \$20 million using the revenue formula above.

IMF feedback on B3Q1

15. Regarding the requirement that the *per claim* limit be at least as high as the licensee’s external dispute resolution (EDR) scheme, IMF notes that the limits for a number of EDR schemes – such as the Financial Industry Complaints Service

(FICS) – have been widely criticised as being woefully inadequate and are currently under review.²

16. IMF submits that the legislation should specifically recognise a minimum per claim limit at least as high as the revised limit of \$280,000 being considered by FICS.

Scope of cover

17. IMF commends ASIC for its proposal B4, that the legislation *require* that an adequate PI insurance policy must include:
 - (a) cover for losses or damage suffered by retail clients for breaches of Chapter 7 of the *Corporations Act*;
 - (b) cover for breaches by both licensees and representatives;
 - (c) compensation for awards made by the licensee’s EDR scheme; and
 - (d) cover for a period of time after the licensee ceases business (“run-off cover”) “for as long a period as is commercially available” (proposal E1).

IMF feedback on B4Q1

18. However, IMF believes that ASIC could go further in its list of “key requirements”. As highlighted in IMF’s submission to Treasury, there are a number of serious inadequacies with many “claims made” insurance policies (many of which failed to protect Westpoint investors), including:
 - (a) most “claims made” policies are not automatically renewable, which allows insurance companies to decide *not* to issue new policies after they become aware of information relating to the wrongdoing (either through notification or when information comes into the public domain);
 - (b) claims must be made by clients during the term of the policy in order to trigger it;
 - (c) some policies exclude liability for circumstances that arose prior to the policy that the insured *should* have known about (and by inference, should have notified the insurance company about at the time the policy was written);
 - (d) some policies require claims to be made in writing or stipulate that the notification be made by the licensee;

² For example, the monetary limit on FICS claims is \$100,000. FICS is proposing in its Discussion Paper dated 13 August 2007, titled “*Review of FICS Monetary Limits*”, to increase its monetary limit in two stages, from \$100,000 to \$180,000 as a first step from 1 July 2008, then a further increase to \$280,000 from 1 July 2010.

- (e) some policies exclude cover for conflicts of interest; and
 - (f) claims management expenses (eg legal fees) are typically deducted from the level of cover.
19. IMF expects that the insurance industry will continue to write “claims made” policies as the primary form of PI insurance.
20. It is vital, therefore, that ASIC addresses more of the inadequacies with these policies by *extending* its proposal on scope of cover to ensure the legislation requires that:
- (a) insurance contracts be automatically renewable;
 - (b) other statutory breaches are covered (for example, breaches of the *Trade Practices Act*) and any other deliberate conduct causing loss to the client is covered;
 - (c) cover can not be excluded when an insurance company decides that a licensee *should have known* about a future claim;
 - (d) licensees can make a notification for “known circumstances”, that is, that circumstances have occurred that *may* give rise to a claim in the future, thereby allowing the policy to respond to a future claim;
 - (e) claims can be notified verbally;
 - (f) policies include cover for conflicts of interest; and
 - (g) defence and claims administration costs cannot be deducted from the amount paid out as a result of a successful claim (that is, claims management expenses are paid *in addition* to the level of cover under the policy).

Disclosure

21. IMF understands that the proposed disclosure regulations that formed part of Treasury’s original review of insurance arrangements (Treasury proposed that full disclosure of the terms of the insurance be contained in the licensee’s product disclosure statement) were criticised by the insurance industry. We note that the Paper does not address issues relating to disclosure regarding insurance arrangements.
22. IMF submits that ASIC should continue to engage with the insurance industry and consider how retail clients might be assisted by more substantive disclosure of insurance arrangements.
23. The minimum level of disclosure should include (as set out in IMF’s submission to Treasury):

- (a) the amount of the insurance;
 - (b) the amount of the insurance available on each claim;
 - (c) the identity of the insurer;
 - (d) the beginning and end dates of the insurance;
 - (e) the major exclusion clauses;
 - (f) who is covered by the insurance;
 - (g) a statement as to how and when claims against the insured need to be made;
and
 - (h) a statement as to whether the insured may obtain automatic reinstatement.
24. Such disclosure will be of significant assistance to clients of financial services licensees. It will assist them in assessing the risks of bringing a legal action against a licensee for losses sustained by their breaches by allowing the client to form an opinion *before* the action is brought as to whether the insurance policy will respond to the allegations being made.

IMF (Australia) Ltd
14 September 2007