Compulsory PI insurance for financial advisers: the new compensation arrangements

Following changes to the Corporations Law on 1 July 2007, financial advisers are now required to hold ‘adequate’ professional indemnity insurance (PI insurance). The intended beneficiaries of the changes are the ‘retail clients’ of financial advisers with the aim being that through compulsory PI insurance ‘mum and dad investors’ will be able to regain losses associated with negligent or illegal advice. But the burden of this new regime falls squarely on financial services licensees and insurers.

Changes to the law
Section 912B(1) of the Corporations Act 2001 (Act) provides that a licensee that provides services to retail clients must have arrangements in place for compensating them for loss or damage suffered as a result of a breach of an obligation of the Licensee imposed by Chapter 7 of the Act. This section was dormant prior to 1 July 2007, when it commenced in conjunction with an amendment to the Corporations Regulations 2001 (Regulations) by which reg. 7.6.02AAA was introduced. That regulation sets out in detail what is entailed in the compensation arrangements.

Licensees must now have ‘compensation arrangements’, and this generally means that they must ‘hold professional indemnity insurance cover that is adequate’. For a licensee with a current Australian

TRADITIONALLY, THE FUNCTION of PI insurance was simply to protect the assets of the insured. But the July 2007 changes to the corporations law significantly altered this. They mean that the benefit derived by mum and dad investors is now the primary driver, and no longer merely a positive consequence of PI insurance cover.

In this paper we provide an overview of the changes from a legal perspective and identify the major issues stemming from the new compensation arrangements as they relate to financial services professionals and those in the insurance industry. The paper examines the law as it now stands and the issues that financial services licensees (Licences) licensees should be aware of when renewing a PI insurance policy or considering cover under the new laws. We also provide some predictions on the future of PI insurance and financial advisers in this evolving area of law.
Financial Services Licence (Licence), (that is, a Licence that commenced before 1 January 2008), the initial requirement for adequate PI insurance takes effect on 1 July 2008 (or 31 December 2008 for those licensees who have an existing policy in place due to end between July and December 2008). For licensees who gain a new licence on or after 1 January 2008, the initial requirement takes effect from the date of commencement of the licence. A more onerous enunciation of what constitutes adequate PI insurance will take effect from 1 January 2010.

There are two exclusions to the requirement for PI insurance. First, it is not required where the licensee is an exempt licensee (a general insurance or life insurance company regulated by APRA; or an authorised deposit-taking institution regulated by APRA). Second, it is not required where ASIC has approved in writing an ‘adequate’ alternative compensation arrangement.

The requirement that licensees’ PI insurance cover be ‘adequate’ is the greatest source of difficulty with the changes, and we consider its practical implications in detail in this paper. The regulations direct ASIC to determine whether PI insurance cover is ‘adequate’ with regard to:

1. the maximum liability that realistically has some potential to arise under the licensee’s external dispute resolution (EDR) scheme; and
2. relevant considerations in relation to the financial services business carried on by the licensee, including:
   a. the volume of business;
   b. the number and kind of clients;
   c. the kind, or kinds, of business; and
   d. the number of representatives of the Licensee.

The question of what will constitute ‘adequacy’ under the new laws is also the big issue addressed in ASIC’s Regulatory Guide 126 (which was released in November 2007). The guide sets out the basis on which ASIC will determine what is adequate cover. In the next section we will consider some of the significant aspects of adequacy from the perspective of a licensee comparing PI insurance policies.

**Comparing PI insurance policies**

Under the new regime, the onus is on licensees to assess what is ‘adequate’ PI insurance in their circumstances. ASIC has given extensive guidance on what it considers to be ‘adequate’. The key principles guiding ASIC’s approach to adequacy are:

- that a licensee’s PI insurance is fit for achieving a reduction in ‘the risk that a retail client’s losses (due to breaches by a licensee) cannot be compensated by a licensee due to lack of financial resources’; and
- that the type of PI insurance practically available at any given time is a relevant consideration.

As ASIC has acknowledged, the role of PI insurance is to protect the insured against certain risks, and it does not exist to protect or compensate consumers. It is for this reason that the two principles above seem at odds. ASIC’s policy objective is to protect consumers, while admitting that commercial realities may not (currently) allow for this. Recognising these difficulties, it is perhaps unsurprising that licensees, and not ASIC, have the difficult task of determining the question of ‘adequacy’.

The upshot of this is that licensees and applicants must now think very carefully about their PI insurance, or risk not fulfilling these compensation requirements. Generally, cover will need to be from an APRA-regulated insurer. But the requirement of ‘adequacy’ goes much further than this. Below, we identify the most important and contentious aspects of the compensation arrangements to provide some indication of what licensees should be looking for when obtaining or comparing PI insurance policies or considering alternative arrangements.

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**Initial assessment**

Before plunging into the deep end of insurance that is the PI market, it may be worthwhile for licensees to take stock initially of their needs and responsibilities. The starting point is to consider the two factors that determine whether PI insurance is adequate. First, what is the maximum liability under the EDR scheme? Second, what kind of business does the Licensee conduct? As a general rule, the higher the potential EDR liability, the higher the level of required cover. The broader and more voluminous the business that is conducted, the greater breadth and scope of cover required.

After conducting this initial assessment, licensees should compare the various policies offered by insurers to determine which best suits their specific needs and responsibilities.
Cover
The most important consideration for licensees in comparing PI insurance policies is the cover provided. ASIC has set out minimum requirements for adequacy in the following areas (among others):

- amount of cover;
- scope of cover;
- exclusions;
- excess/deductibles;
- EDR scheme awards; and
- “run-off” cover.

Amount of cover
The most seemingly straightforward of the compensation requirements is that a licensee should hold an amount of cover which is adequate to satisfy possible claims. This involves two factors: the limit of liability under the insurance policy per claim (for each individual claim); and the limit of liability in the aggregate (for all claims). In the licensee’s circumstances, both will be required to be adequate.

ASIC’s minimum adequacy requirement is that licensees with total revenue of $2 million or less have cover to an aggregate claim limit of at least $2 million. For licensees with revenue higher than $2 million, cover should roughly match the licensee’s actual or expected revenue to a limit of $20 million.

Scope of cover
A licensee’s amount of cover may be adequate, but the PI insurance policy may still be inadequate if it does not have sufficient scope.

While all PI insurance policies provide cover for breaches of professional duty, the manner in which this is achieved can vary from policy to policy. The logical conclusion of this is that certain claims will be covered under the terms of one policy, but not under another. This is where it becomes essential that licensees understand the different ways that various aspects of policies provide cover.

The best way for licensees to protect themselves is to always negotiate a policy that goes hand-in-glove with the services that they provide. This is not always a possibility, especially for smaller licensees constrained by financial pressures and lack of bargaining power. But the point here is that in insuring a ‘professional business’, it is important to be mindful of the nature of that business.

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With these considerations in mind, licensees should ensure that their PI insurance policies have sufficient scope to encompass the following minimum requirements (subject to what is available in the market). The policy must cover:

- loss suffered by retail clients due to breaches of the Corporations Act;
- breaches and fraud by both the Licensee and its representatives; and
- EDR scheme awards.

In considering the scope of cover applicants and licensees should also be aware of exclusions.

Exclusions
All PI insurance policies have exclusions, but the exclusions can vary from the narrow and obscure to exclusions that may seriously limit cover. When looking at a potential policy, licensees should carefully consider whether any of the exclusions will limit cover to an unreasonable extent considering the nature of their business.

ASIC requires that policies do not contain exclusions for, among other things:

- EDR scheme awards;
- fraud and dishonesty by agents and representatives; and
- claims for misrepresentation about services.

Currently, many PI Insurance policies contain an exclusion where the insured has acted knowingly fraudulently or dishonestly. That is, if an insured is inadvertently fraudulent, the exclusion will not apply and the claim will be covered. Given that the exclusion for intentional fraud is so widespread, ASIC insistence upon PI Insurance coverage for such acts may prove problematic.
Excess/deductibles
There are three issues that licensees should be wary of when it comes to considering the excess under a potential PI insurance policy under the new provisions. First, considering that excesses can be as high as $250,000, licensees should have regard to whether the excess is at a level that the licensee can confidently sustain as an uninsured loss, taking into account its financial resources. If not, the PI insurance cover will not be adequate.

Second, the licensee should consider the difference between ‘costs inclusive’ and ‘costs exclusive’ excesses. Practically speaking, there is a higher risk of being required to pay a costs inclusive excess. Other factors to be considered are whether the excess can be sustained as well as the licensee’s obligations to cover any shortfall payable from its own resources.

Third, the licensee should closely consider the policy wording in relation to the application of multiple excesses. For example, there is a significant difference between 10 claims arising out of the same investment, but caused by 10 different acts of negligence, and 10 claims caused by one act of negligence. A $250,000 excess may thereby be converted into a $2.5 million excess in the former case.

EDR scheme awards
A less obvious aspect of PI insurance policies than excess is cover for external dispute resolution schemes such as the Financial Industry Complaints Service (FICS), which have traditionally been provided for in policies. PI insurance for licensees must now cover claims made via EDR scheme awards such as FICS to the limit of its jurisdiction to be considered ‘adequate’. Considering that FICS proposes to increase the monetary limit of its jurisdiction, this may prove a difficult requirement for insurers and licensees.

Run-off cover
Another requirement that may have licensees sweating by late 2009 is the obligation to hold ‘run-off’ cover.

PI insurance policies are generally ‘claims made’ policies. This means that cover is granted for claims which are made or notified to the insurer within a period of insurance (without regard to when the cause of action accrued), but not for claims that emerge after a period of insurance. Run-off cover provides a remedy to this situation by covering an insured for claims made after the insurance period. But run-off cover is not widely commercially available, and ASIC has attempted to deal with this difficulty by providing for a relatively manageable minimum of one year.

Looking ahead
It may be worth briefly looking at what the future may hold for financial services professionals and PI insurance in the following areas:

- implementation period;
- inadequate cover;
- alternative arrangements;

A licensee that failed to hold $2 million PI insurance cover in February 2009 would not have adequate compensatory arrangements in place. Inadequate cover is a serious problem. ASIC has suggested that if a licensee cannot obtain adequate cover or approval for an alternative arrangement, it ‘might need to cease operating as a licensee’.

- ongoing assessment/compliance systems;
- disclosure in Financial Services Guide (FSG); and
- new licences.

Implementation period
The new laws took practical effect for new licensees from 1 January 2008, and take effect for existing licensees on 1 July 2008 (or 31 December 2008 for those licensees who hold inadequate PI policy cover, which is due to end between July and December 2008). These dates begin the ‘implementation period’, during which some of the elements of ‘adequacy’ outlined above will not be required. The full range of adequacy elements are required by 1 January 2010.

The policy for assessing adequacy during the implementation period (known as the ‘implementation period policy’) is essentially a bare bones version of the final adequacy policy. For example, during the implementation period, licensees must have the full amount of cover, but will not require run-off cover.

Inadequate cover
A licensee that failed to hold $2 million PI insurance cover in February 2009 would not have adequate compensatory arrangements in place. Inadequate cover is a serious problem. ASIC has suggested that if a Licensee cannot obtain adequate cover or approval for an alternative arrangement, it ‘might need to cease operating as a licensee’. It should be borne in mind that inadequate cover will constitute a breach of section 912B of the Act, which may have serious repercussions. In the Consultation Paper that preceded the release of its Regulatory Guide on the subject, ASIC suggested that where PI insurance cover is inadequate, licensees will have the choice to make up the shortfall with their own financial resources. The initial proposal reeked of self-insurance, and ASIC appears to have backed down from such an approach. Self-insurance will presumably still be an option for licensees, to be
approved under the protocol for 'alternative arrangements' set out below, but it is an unappealing option.

Practically speaking, licensees should take a three-step approach to ensuring that their PI insurance cover is adequate by:

1. negotiating a policy that is appropriate to the nature and extent of their business, having regard to the ASIC minimum requirements and market availability;
2. implementing quality control to ensure that representatives are not acting beyond the Licence or giving negligent or fraudulent advice; and
3. developing and applying for the approval of an alternative arrangement where PI insurance is inadequate or inappropriate, in circumstances in which the resulting cover will be inadequate.

**Alternative arrangements**

While this paper focuses on PI insurance, technically, the law only requires 'arrangements for compensating' clients. This is where 'alternative arrangements' may fill the gap between PI insurance and adequate cover.

ASIC requires that Licensees apply for approval of any alternative arrangement. The test is that an alternative arrangement will only be approved where it provides no less protection than adequate PI insurance cover. Self-insurance, for example, for highly capitalised licensees or an industry member fund, has been floated as a possible alternative arrangement.

Alternative arrangements have their difficulties. Self-insurance is realistically available to few, if any, licensees, while industry member funds require a great deal of organisation and support. Furthermore, industry member funds can become expensive, and are not subject to the conditions of the *Insurance Contracts Act 1984* (Commonwealth). On the other hand, the market for PI insurance can fluctuate, and a market correction in the medium term could see the 'adequacy' of PI insurance policies on offer deteriorate through reduction of the scope of the risk or an increase in premiums or excesses. In such circumstances, licensees may be forced to seek alternative arrangements to cover some or all of their potential liability, and it is thus important that licensees think outside the box of PI insurance.

**Ongoing assessment/Compliance systems**

When thinking inside the box of PI insurance, ASIC expects licensees to review their PI insurance for adequacy at least annually, and may require licensees to provide it with relevant information to conduct its own compliance reviews. Internal review is also expected where major changes are made to a licensee’s business.

In the same vein, ASIC expects that a senior officer or manager of a licensee will oversee the compensation requirements, ensuring regular reviews and maintenance of PI insurance policies.

**Disclosure in FSG**

Another new requirement is that a licensee's compensation arrangements must be disclosed in their FSG, with an explanation as to how the insurance cover or the alternative arrangement will provide cover for the licensee’s and its representatives’ work. ASIC is empowered to take action against a misleading disclosure.

**Conclusion**

PI insurance will soon be difficult to avoid for financial services professionals. It should now be clear that for licensees this is not simply a case of hopping down to the local broker and signing up. The burden of interpreting and applying the nebulous concept of 'adequate' PI insurance is on the Licensees themselves, and it should be taken seriously.

But licensees should not lament this situation. Though the compensation requirements are onerous, having adequate cover for potential breach of duty claims is in the interest of all licensees. To this end, licensees should begin the process of analysing their business, their potential liability and their insurance with a view to finding adequate cover and, in the process, satisfying the new laws.

If the new law results in PI insurance protecting both licensees and investors, it will have proved a success. The trick will be to protect investors without driving insurance premiums prohibitively high.