

# Review of compensation arrangements for consumers of financial services

Submission in response to the Consultation  
Paper by Richard St John

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## 1. Executive Summary

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The Financial Ombudsman Service (“FOS”) has long held concerns based both on its own direct experience of, and general public and market information about, the circumstances in which consumers of financial services suffer losses which they are unable to recover, even when they have a court award or an Ombudsman determination in their favour.

FOS has previously proposed the establishment of an industry based Financial Services Compensation Scheme (“FSCS”) for retail clients. It has conducted extensive research into the need for such a scheme, the arrangements in place both in Australia and internationally and has designed, modelled and proposed a scheme which it believes is appropriate for Australian conditions.

The scheme proposed by FOS is industry based and industry funded, provides adequate but limited compensation to consumers as a last resort. It is intended to be both affordable to licensees and equitable, is post-event funded and designed to mitigate moral hazard and provide incentives for improved risk management. It is not designed to cover investment losses.

If enacted it would provide consistency and efficiency of the delivery of compensation and improve the current patchwork of compensation arrangements. The proposed scheme will provide certainty for consumers and industry alike. This will improve consumer understanding and maintain or improve consumer trust and confidence in the financial services industry and in the efficacy of External Dispute Resolution (“EDR” schemes).

FOS welcomes the release of the April 2011 Richard St John Consultation Paper which was commissioned by Government in response to recommendation 10 of the Ripoll Inquiry and contends that the establishment of an industry based compensation scheme will be an important component of the package of reforms proposed in the review of the Future of Financial Advice (FOFA). FOS fully supports the government’s objective “to provide further protections for consumers of financial advice and to restore trust in the system following the collapse of Storm, Trio, Westpoint and other financial service providers”.<sup>1</sup>

FOS has previously proposed a model scheme in October 2009. Following industry and stakeholder consultation, this has been significantly revised, particularly the proposed funding arrangements. The revised proposal includes capping of benefits and levies, the quarantining of losses into contribution groups and the removal of Government financial support. The key elements of this are set out in this submission. The Richard St. John Consultation Paper has provided examples and

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<sup>1</sup> media release 13/04/2011 The Hon Bill Shorten MP Financial Assistance to Trio’s Superannuation Fund Investors

evidence from both FOS records and ASIC data of examples of consumers who are not compensated even when they have a legal entitlement to recover. As the Consultation Paper says *“It seems clear that cases do arise where retail clients are unable in practice to recover compensation awarded in their favour. However it is not easy to gauge the magnitude of the problem.”* FOS contends that not only does the problem exist, but that establishing the magnitude of the problem while important is not a prerequisite for establishing an FSCS. It is the **potential** for problems to arise that needs to be protected against.

The government is presently considering the expansion of the licensing regime under the Corporations Act 2001 (Cth.) – *Future of Financial Advice Information Pack April 2011*-. This has the potential to bring several thousands of additional licensees under the umbrella of the regulations and, relevantly for this discussion, consumer compensation and EDR scheme requirements. The additional risks associated with this and the new concept of “scaled advice” are not as yet assessed. FOS is strongly of the view that the establishment of an FSCS would add a level of clarity, certainty and security for these new licensees and consumers and that it would be beneficial to introduce an FSCS either in advance of or simultaneously with other changes to the licensing regime

FOS asserts that its designed response is proportional to the intensity of potential market failure as it is post-event funded, does not provide 100% compensation and losses are allocated to the industry sector from which they arose.

The Consultation Paper provides useful information on a number of other arrangements in the Australian and internationally. It is FOS’s view that the proposed scheme provides an opportunity to rationalise this patchwork of compensation arrangements, including addressing its significant gaps, and that this would be consistent with current Government policy reflected in common licensing and dispute resolution legislative requirements.

The Consultation Paper highlights quite extensively the shortcomings in utilising Professional Indemnity Insurance as a vehicle for consumer compensation. FOS agrees with these findings, but also is of the considered view that “improving” the operation of PI insurance in an open and competitive market is an unrealistic expectation and will never be an effective consumer protection mechanism.

The Consultation Paper discusses a range of other measures including improving professional standards, improving financial literacy of consumers, more pro-active administration of licensing requirements by ASIC, disclosure of PI insurance arrangements, and more focus on the financial resources of licensees. It is not clear

if these are proposed as alternatives to a compensation scheme. However, FOS' view is that all or some of these measures may reduce risk and improve the overall operation of the advice market and as such are welcome, but the potential for losses to occur remains and these measures cannot substitute for a properly constructed last resort compensation scheme.

## 2. About this Submission

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The Financial Ombudsman Service (“FOS”), in responding to the Review of Compensation Arrangements for Consumers of Financial Services (“Review”) – Consultation Paper (“Consultation Paper”) released by Treasury in April 2011, relies on the extensive research and analysis it conducted over a lengthy period culminating in FOS’s proposal for a Financial Services Compensation Scheme (“FSCS”) of July 2009 (updated October 2009).

FOS is of the firm view that the only effective and affordable solution to what is a major deficiency in the protection of retail consumers of financial services is the adoption of an industry based scheme as proposed.

FOS acknowledges that it is not in a position to express authoritative opinions on certain aspects of the consultation paper and has therefore reserved its response to those issues which are more particularly aligned with FOS’ expertise and experience.

This submission draws on the experience of FOS and its predecessors in the resolution of disputes relating to financial services and its concerns that over an extended period, FOS has seen firsthand examples of retail consumers who receive court or external dispute resolution (EDR) scheme awards in their favour which have subsequently not been paid because of the disappearance or insolvency of a licensee, fraud and/or the non-indemnification by Professional Indemnity insurance (PII).

FOS welcomes the release of the Consultation Paper and notes that in its research it has confirmed many of the issues which are of concern to FOS. This submission has been prepared by the office of FOS and does not necessarily represent the views of the FOS Board.

## 3. Information about FOS

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### 3.1 Formation of FOS

FOS commenced operations on 1 July 2008. It is estimated that FOS covers up to 80% of banking, insurance and investment disputes in Australia.

It is an independent dispute resolution scheme that was formed through the consolidation of three schemes:

- the Banking and Financial Services Ombudsman (“BFSO”);
- the Financial Industry Complaints Service (“FICS”); and
- the Insurance Ombudsman Service (“IOS”).

On 1 January 2009, two other schemes joined FOS, namely:

- the Credit Union Dispute Resolution Centre (“CUDRC”); and
- Insurance Brokers Disputes Ltd (“IBD”).

FOS has over 20 years’ experience in providing EDR services in the financial services sector.

FOS is an external dispute resolution (“EDR”) scheme approved by ASIC. Membership of FOS is open to any financial services provider carrying on business in Australia including providers not required to join a dispute resolution scheme approved by ASIC. Replacing the schemes previously operated by BFSO, FICS, IOS, CUDRC and IBD, FOS, provides free, fair and accessible dispute resolution for consumers unable to resolve disputes with financial services providers that are members of FOS.

Members of BFSO, FICS, IOS, CUDRC and IBD are now members of FOS. The members of those schemes included:

- BFSO – credit providers, mortgage brokers, payment system operators, Australian banks and their related corporations, Australian subsidiaries of foreign banks and foreign banks with Australian operations;
- FICS – life insurance companies, fund managers, friendly societies, stockbrokers, financial planners, pooled superannuation trusts, timeshare operators and other Australian financial services providers;
- IOS – general insurance companies, re-insurers, underwriting agents and related entities of member companies;

- CUDRC – credit unions and building societies;
- IBD – insurance brokers, underwriting agents and other insurance intermediaries.

### **3.2 Disputes Covered by FOS**

FOS provides services to resolve disputes between member financial services providers and consumers, including certain small businesses, about financial services such as:

- banking;
- credit;
- loans;
- general insurance;
- life insurance;
- financial planning;
- investments;
- stock broking;
- managed funds; and
- pooled superannuation trusts.

As well as its functions in relation to dispute resolution, FOS has responsibilities to identify and resolve systemic issues and obligations to make certain reports to ASIC. FOS has identified the issue of concern to this Review as a key systemic issue facing the financial services industry.

FOS is a not for profit organisation funded by its members, which are financial services providers. It is governed by an independent board with consumer representatives and financial services industry representatives.

## 4. Preamble

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### 4.1 FOS's Proposed FSCS

Over an extended period, FOS has witnessed examples of retail consumers who receive awards in their favour which have subsequently not been paid because of the disappearance or insolvency of a licensee, fraud and/or the non-indemnification of losses through professional indemnity insurance.

Losses have occurred when consumers have been induced to invest in financial instruments which they don't understand and where the advice has been inappropriate for their needs. Notable examples have included Westpoint and Storm but there have been and will continue to be other failures both small and major which will leave consumers uncompensated.

As ASIC research has found (Compensation for retail investors: the social impact of monetary loss – February 2011) there are wider social ramifications of this problem *“The main finding of this study is that failure to fully compensate investors who lost money because of some form of wrong doing by a managed investment scheme or financial planner can cause the investor severe emotional and financial distress. The second key finding is that investors were unable to fully utilise the current compensation system. Thirdly, the loss experience can have a corrosive effect on trust in the financial system.*

For these reasons FOS has and continues to be a strong advocate for the establishment of a FSCS for retail clients in Australia.

FOS has conducted extensive research into the present arrangements for protecting consumers of financial services both in Australia and internationally and has identified serious shortcomings in the current environment. FOS is acutely aware of the drawbacks of relying on mandatory Professional Indemnity insurance as a proxy for a consumer compensation arrangement.

Following on from its research, FOS has prepared and proposed an industry based, last resort, FSCS for retail clients. FOS does not propose or wish to operate the proposed FSCS, which should be independent of the dispute resolution process. FOS would however support the scheme administratively to reduce costs in the initial stages.

The results of this research and the proposed scheme including rules and financial modelling were set out in its Summary of Research dated October 2009 which was submitted to the Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Financial Products and Services in Australia (the “Ripoll Inquiry”).

This submission has been the subject of extensive discussion with industry bodies, consumers, regulators and other parties. As a result of feedback received the funding model for the proposed scheme has been refined. The key changes are that:

- it is proposed to quarantine the funding of claims into the industry sector(s) which have given rise to the need for compensation (for this purpose licensees have been categorised and allocated to “contribution groups”),
- to remove the cross subsidisation from all financial services sectors; and
- the need for government financial support.

## **4.2 Benefits of the Proposed FSCS**

FOS believes that the introduction of FSCS will benefit the financial services industry by:

- addressing uncertainty;
- improving consumer confidence and trust; and
- by giving industry and consumer representatives a role in its development and governance.

The financial services industry has a long and excellent record in self-regulation which would be enhanced by this scheme.

FOS remains convinced that the most effective response to the need to protect consumers is a last resort FSCS as previously proposed, subject to refinements which are more fully set out in this submission. This solution is long overdue and will provide certainty to consumers and industry and support the role of the courts and EDR schemes alike.

## 5. FOS Revised Funding Model

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FOS has proposed a model scheme including draft scheme rules and a funding methodology which were set out in the October 2009 “Proposal to Establish a Financial Services Compensation Scheme” (Proposal Report) prepared for FOS by Professional Financial Solutions Pty Limited.

Since that time there has been extensive consultation with government, industry and consumer representatives. The most common issue raised has been in respect to the funding model. Generally licensees are reluctant to subsidise other parts of the financial system from those parts in which they operate. In addition the likelihood of a government guarantee, especially for an industry based scheme is a matter of debate.

In the creation of the original model, reliance was placed on data received from ASIC which is collected in the licensing process. This data had limitations which have been outlined previously, including double reporting of revenue and aggregation of wholesale and retail business. It did not therefore allow for a precise allocation of licensee revenue into all relevant product or industry sectors.

FOS has subsequently collected more specific information from members, especially in relation to revenue, for the purposes of allocating levies to fund FOS’ EDR operations. This new data collection has the following main features:

- Data is provide directly by licensees
- Data identifies each industry sector
- Data is for retail business only
- Each industry sector has accepted a weighting to give comparable (proxy) revenue values as a basis for apportioning FOS levies between contribution groups.
- The data is reliable.

### Funding model

The revised model proposes a modified approach to funding as follows:

#### 5.1 Sources and Timing of Funding

5.1.1 The establishment and operating costs of the Scheme would be funded by all AFS licensees

5.1.2 Each year the Scheme would set a levy to cover anticipated management costs.

5.1.3 Funding would be a mix of pre-funding for 5.1 and 5.2 above and post-funding to meet projected compensation payment requirements:

5.1.4 Each year the scheme would assess the projected payments during that year to compensate retail clients for losses arising from events reported and impose a levy to cover these costs. This component of the scheme is essentially post- event funded on a projected cash flow basis.

## **5.2 Levy Limit and Distribution**

5.2.1 The levy would be limited to 1% of the revenue of the contribution group(s).

5.2.2 The costs of compensation would first be allocated to the intermediary or advisory contribution group out of which the loss arose.

5.2.3 If the compensation costs are likely to exceed the limit (1%) of that group , then the excess would be allocated to the product manufacturer contribution group to which that advisory group relates ( a “linked” group) up to the limit of 1% of that group’s revenue to the extent that it was unallocated.

5.2.4 No compensation costs would be distributed across other contribution groups.

5.2.5 There would be no government guarantee.

5.2.6 Should funding prove to be inadequate, then the Scheme would have the power to impose a ‘special compensation levy’ to compensate retail clients for significant losses; to scale back the level of compensation available; or to defer payments. This component would be post-funded.

## **5.3. Governance and Related Arrangements**

5.3.1 AFS licensees would agree to fund the Scheme on the terms and conditions set out in a Funding Agreement between AFS licensees and the Scheme;

5.3.1.1 The Scheme would have the power to borrow where necessary and to take assignments of rights from claimants and take steps to recover funds in the winding-up of AFS licensees.

5.3.2 A set of Rules (see Appendix A) would govern the level and nature of compensation and the circumstances in which it may be paid.

5.3.3 In some cases the Scheme would take an assignment of rights from a claimant and pursue a recovery. It is anticipated that it would stand in the shoes of the claimant, becoming a creditor in the winding-up of an insolvent AFS licence where there is a reasonable prospect of dividends. The Scheme would have the same priority in the queue of creditors as the claimant has prior to the assignment. The Scheme would also pursue indemnity and payment of insurance claims under PI policies.

Details on funding are set out in Appendix B of this submission.

## 6. Specific Issues

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**The Consultation Paper raises a number of issues which FOS has not specifically addressed in previous publications. These are briefly addressed as follows:**

### 6.1 Expansion of the Licensing Regime

The government is presently considering the expansion of the licensing regime under the Corporations Act 2001 (Cth.) – *Future of Financial Advice Information Pack April 2011*. This has the potential to bring several thousands of additional licensees under the umbrella of the regulations and, relevantly for this discussion, consumer compensation and EDR scheme requirements. The additional risks associated with this and the new concept of “scaled advice” are not as yet assessed. FOS is of the view that the establishment of an FSCS would add a level of clarity, certainty and security for these new licensees and consumers and that it would be beneficial to introduce an FSCS either in advance of or simultaneously with other changes to the licensing regime.

### 6.2 Magnitude of the Problem

FOS has previously provided evidence of circumstances in which claimants are not compensated and this is referred to in the Consultation Paper. The Consultation Paper also refers to the possibility that consumers will not pursue recovery actions if they become aware of the insolvency of licensees because of the low prospects of recovery and, it is suggested, the additional cost, time and emotional disruption involved.

The paper, inter alia says that “*Regulatory intervention for financial safety should be proportional to the intensity of potential market failure and the promise made.*” And further “*A balance will have to be made between the effectiveness of any enhanced compensation arrangements in protecting consumers and promoting confidence in the financial services sector, and their impact on the cost and supply of financial services to retail clients and the overall efficiency of the sector.*”

FOS believes that it is not only evidence of actual past losses that should be taken into account. According to Austrade ‘finance and insurance is the fourth largest sector in Australia's economy, generating 8.1 per cent or A\$81 billion of real gross value added in 2008-09’.<sup>1</sup>The sheer magnitude of the financial services and the number of participants or providers (4888 licensees and 41556 authorised representatives) merits a consistent and appropriate regulatory intervention for the benefit of consumers and to maintain confidence and trust in the financial services sector itself. It is not only evidence of past losses but the **potential for future losses that should be taken into account.**

FOS asserts that its designed response is proportional to the intensity of potential market failure as it is post-event funded, does not provide 100% compensation and losses are allocated to the industry sector from which they arise.

### **6.3 A Consolidated Approach**

As highlighted in the Consultation Paper, the current avenues for consumer compensation are fragmented, ranging from government guarantees of ADI deposits and insurance claims to a reliance on a private market PI insurance product which has many weaknesses, not the least of which is that it is designed to protect the licensee.

The governance, funding, benefits and design of the current arrangements are diverse as is the legislative support for these arrangements.

#### ***Financial Claims Scheme***

The ability of the consumer to recover costs is also varied and some provide 100% reimbursement. For example the Financial Claims Scheme was recently triggered to meet 18 claims for policyholders of Australian Family Assurance.

#### ***Compensation under SIS***

More recently the government has agreed to pay under the *Superannuation Industry (Supervision) Act 1993* (Cth.) 100% of the losses of 5000 fund members arising from the collapse of Trio Capital Limited. The cost of this will be levied on all other regulated superannuation funds or by extension, their members.

#### ***National Guarantee Fund***

In respect to the National Guarantee Fund (NGF) however, compensation for insolvency is limited to 15% of the “minimum size” of \$80m i.e. \$12m.

Recent years have seen significant progress in rationalisation and merging of EDR schemes in the financial services sector. A compensation system which reflected the EDR environment would improve confidence and trust in EDR.

FOS believes that the proposed FSCS would provide certainty to industry and consumers alike. It is also likely to be more efficient, more equitable and more consistent in its approach to compensation and is more likely to mitigate moral hazard.

### **6.4 Wholesale vs. Retail**

FOS has proposed an FSCS which would apply to retail clients as defined in the Corporations Act 2001, to whom compulsory EDR also arrangements apply.

The Consultation Report suggests that a widening of the approach be considered. This would raise important issues of scale, competency of the clients, moral hazard, costs and the funding methodology.

It is noted that the Government is undertaking a separate review of this subject and the views of FOS have been expressed in its detailed submission to the Options paper released in January 2011.

## **6.5 Investment Losses**

FOS does not propose that an FSCS should cover investment losses. These are specifically excluded in the proposed scheme draft rules at 6.4.2 as follows:

6.4.2 What is excluded from the calculation of compensation?

The Scheme must not pay compensation for any claim to the extent that it relates to or depends on:

- (a) a failure of investment performance to match a guarantee given or representation made;
- (b) a contractual obligation to pay or promise to pay which the Scheme considers to have been undertaken without full consideration passing to the relevant person or in anticipation of possible insolvency; or
- (c) the mere fluctuation in the value of an investment;
- (d) punitive damages.

## **6.6 Is the Proposed FSCS the Only Vehicle for a Compensation Scheme?**

FOS has designed an FSCS which has certain key features including:

- Industry based;
- Industry funded;
- Stakeholder representation;
- Legislative support;
- Last resort;
- Limited but sufficient compensation;
- Cost attributed to responsible industry sector.

By extension to this question FOS advises that it does not itself wish to operate an FSCS, but proposes that a FSCS could leverage off administrative support from FOS e.g. premises, telephony and accounting services to reduce costs, especially in the establishment phase.

If the consumer protection objectives can be achieved and the key features above preserved, FOS would not have concerns about which vehicle was used for this purpose.

## **6.7 Liability Standard for Claims**

The Consultation Paper identifies a possible problem in that the powers of EDR schemes to make awards are not restricted to those specific matters set out in Chapter 7 of the Corporations Law 2001. Similarly courts may find grounds for awards of compensation which may not be restricted to Chapter 7. Should, therefore, a compensation scheme framed under the Corporations Law operate more broadly?

FOS has considered this matter previously. It notes that its terms of reference are broader than the Corporations Law, but its authority arises both by virtue of the requirement that any licensee must be a member of an approved EDR scheme, of which FOS is one, and the membership agreements entered into. Furthermore the professional indemnity insurance which licensees are obliged to arrange must have provision to cover EDR scheme awards.

FOS has looked at the alternative, which is adopted in the UK scheme, which is that the FSCS re-evaluates each individual award of the EDR schemes in accordance with the compensation scheme liability standard. In FOS' view this would add significantly to costs and professional resources required and add major delays to the delivery of compensation. It would also require further explanation to consumers who are already distressed. For these reasons FOS believes that the cost savings from removing any awards made outside the scope of Chapter 7 of the Corporations Law would not warrant the negative consequences outlined above.

## **6.8 Dealing in Unlicensed Products**

Circumstances can and do arise where the person or organisation providing the advice is licensed but the product they are advising on is not covered by the provisions of the legislation. For example, as part of a financial plan a consumer may be advised to invest in real property. From FOS perspective it is not practical to separate determinations of wrongful or inappropriate advice between products and it is the overall behaviour which has to be reviewed.

## 7. Detailed Response to Issues Raised in the Consultation Paper

For completeness FOS lists all the issues canvassed in Sections 2, 3, 4 and 5 of the Consultation Paper. FOS acknowledges that it is not in a position to express authoritative opinions on certain aspects of the consultation paper and has therefore reserved its response to those issues which are more particularly aligned with FOS' expertise and experience.

### 7.1 Chapter 2 Current Compensation Arrangements

FOS is not a participant in the PI Insurance market itself, although it does have a formal process for consultation with the PI Insurers. It also provides advice on claims, by agreement, to certain underwriters including in particular to underwriters of PI Insurance for securities dealers. FOS' main interest is to ensure that as far as possible insurers provide the necessary endorsement or coverage that the policy will respond to FOS' awards up to the relevant limit.

The policies do not however provide coverage for all causes of loss nor do they deal with liabilities for former licensees, whether they have ceased business voluntarily, become insolvent, deceased or disappeared. It should be noted especially that policies are designed to **defend** licensees against claims brought by consumers and specifically provide defence costs. PI insurance is a poor substitute for a properly constructed compensation scheme.

***2.1 The capacity of the insurance market to supply licensees with professional indemnity insurance cover that is adequate to the needs of licensees considering the specific features ASIC requires the licensee to take into account such as minimum levels of cover, excess amounts the licensee can confidently sustain, and coverage of EDR scheme awards.***

This is a matter for licensees to comment on.

***2.2 The circumstances in which the market has been able to supply run-off cover to a financial services licensee.***

As outlined, run off cover is not readily available and particularly not for insolvent licensees.

FOS is not in a position to comment authoritatively on this matter.

***2.5 The longer term outlook for the insurance market in terms of the supply, cost and coverage of professional indemnity insurance for financial service licensees in accordance with the requirements of s912B, associated regulations and guidance from ASIC.***

This is a matter for licensees and insurers. However, FOS is aware that there has been some volatility in terms of market participants and in availability, costs and conditions of insurance policies. This will probably always be the case and reinforces the need for the certainty that a Financial Services Compensation Scheme would provide.

FOS is not in a position to comment authoritatively on this matter.

***2.6 The circumstances in which licensees have found it difficult to acquire professional indemnity insurance cover that meets their needs.***

FOS is not in a position to comment authoritatively on this matter.

***ASIC requirements for professional indemnity insurance***

***2.7 The utility and effectiveness of the guidance provided by ASIC to licensees in enabling them to assess the adequacy of their professional indemnity insurance.***

***2.8 The adequacy of the current administrative approach in providing assurance that licensees meet their requirements to have adequate insurance cover.***

***2.9 The appropriateness of the current exemptions from the need to hold professional indemnity insurance cover.***

***2.10 The scope for a licensee in practice to make alternative compensation arrangements with the approval of ASIC.***

The core problems with the current arrangements are:

- PI policies are designed to protect licensees not consumers. They are not a compensation scheme. They do however provide a source of funds to meet liabilities. Alternative arrangements approved by ASIC similarly are designed to provide financial security.
- Claims can arise a long time after the period of insurance. The same problems of timing of claims may arise where a licensee holds an exemption.
- In neither circumstance is Fraud covered.

The extent to which ASIC's approach to administration, guidance or exemptions is effective, adequate or appropriate is a matter for licensees to comment on.

- FOS suggests that most licensees would, in the absence of regulation, hold PI Insurance as a feature of good risk management practice or to meet the requirements of their corporate clients. In addition some Principals may require their authorised representatives to arrange their own PI insurance.
- The policies are not fail-safe, do not cover all circumstances (e.g. fraud) or liabilities and are not supported by any last resort fund which is typically found to exist with compulsory third party or no-fault insurance requirements e.g. Workers Compensation or Motor Third Party bodily injury.
- Consumers are in no position to judge the questions posed.

#### **Process for Claiming Compensation**

***Information and comment are sought on the experience of respective parties with the process for claiming and recovering compensation for loss or damage arising from a breach of a statutory obligation by a licensee. In particular, the following aspects are of interest:***

***2.11 Awareness by retail clients of the available dispute resolution schemes and compensation arrangements, and the degree of clarity to consumers about using those processes.***

FOS and its predecessor schemes have conducted research in relation to awareness of dispute resolution schemes. The research is designed to assist FOS understand and address issues in relation to consumer awareness. Results from 2009 surveying reveal a 50% general community awareness of FOS and that of those who do contact FOS, 69% approached FOS "on my own" and 31% at someone else's suggestion (13% of those by the FSP they have the dispute with). FOS still has a significant amount of work to do in raising consumer awareness. Pleasingly, the usage of FOS and its predecessor schemes has expanded consistently over the years. In 2009/2010 over 200,000 consumers used FOS' services. This indicates that FOS is making advances in relation to consumer awareness.

It should be remembered that all licensees are required to be members of an (ASIC) approved dispute resolution scheme. This includes a requirement for a proper Internal Dispute Resolution process and for the availability of the IDR and EDR to be brought to the attention of clients including in Product Disclosure Statements.

FOS' concerns relate more to the deficiencies or absence of current compensation arrangements and the alarming reality that licensees may not be in a position to compensate people to whom they are legally liable.

**2.12 Any issues arising from the existence of separate compensation schemes and arrangements in various segments of the financial services sector (for example, NGF and FCS).**

FOS is concerned about the inconsistencies both from the point of view of public policy and the detailed design and approach to the various schemes.

For example the NGF is pre-funded by securities licensees and has accumulated considerable funds but has rarely met a claim. The FCS is funded in the first instance by government and administered by the regulator (APRA). It applies to General Insurance but not Life insurance. Ultimate net costs are levied on the insurance industry.

**2.13 The possible scope for bringing together some of these schemes and arrangements or moving towards some form of common administration.**

FOS would support such initiatives in the interest of consistency and certainty for all parties, improved facilitation of consumer education and communications and the possibility of administrative and cost efficiencies.

**2.14 The experience of respective parties in making and responding to claims for compensation in terms of time, cost and outcomes, including claims pursued through an internal or external dispute resolution scheme or the courts.**

FOS has already supplied data in relation to the experience of consumers when decisions are not paid. The FOS Annual Review contains significant data in relation to disputes and outcomes, detailed information on the number and types of dispute, the level of complexity, time taken to process through the system and it also publishes data, which ranks licensees on many of these measures.

In addition, FOS and its predecessor schemes periodically surveyed consumers in relation to their experience of using the service. For example, data from FICS “one minute surveys” completed during the period January to August 2008 reveal that 37% of consumers valued the fairness of FICS as excellent, 41% good, 8% adequate, 10% poor (3% n/a). Thirty two percent considered the dispute resolution method used by FICS was excellent, 38% good, 14% adequate, 13% poor (3% n/a). Twenty eight percent described the time taken by FICS to deal with their dispute as excellent, 35% good, 20% adequate, 15% poor (3% n/a).

***2.15 Circumstances in which retail clients have been unable to recover compensation awarded to them, or have not pursued claims because of the low probability of being able to recover any award in practice.***

FOS has provided information previously to both the Ripoll Inquiry and to information contained in the consultation paper published by Richard St. John.

***2.16 Circumstances in which retail clients have found it difficult to pursue a claim for loss or damage against a provider of financial services, including where the provider is no longer carrying on business, has become financially stressed or insolvent.***

FOS refers to the information it provided to the Ripoll Inquiry and to this review by Richard St. John which, is contained in the Consultation Paper.

***2.17 Any experience in pursuing compensation from financial services providers who are not in fact licensed as required.***

Unlicensed providers, by definition, cannot be members of FOS. Any claims reported would be treated as outside jurisdiction. FOS is now able to hear claims against former members who have become insolvent. The prospects of a successful recovery of an award by a consumer in these circumstances is however remote.

***2.18 Any practical difficulties arising from differences between the standards of liability for licensees under Chapter 7 of the Corporations Act, the general law and under EDR schemes, and the ambit of liability covered in professional indemnity insurance policies obtainable by licensees.***

We are not aware of difficulties that give rise to concern for FOS in determining claims. Such differences may have an influence on whether a PI policy will respond to a claim. Insofar as the consequences for a compensation scheme are different, please refer to comments in S.6.7.

***2.19 Any issues in practice with compensation claims against licensees by retail clients in regard to the distinction between inappropriate advice or misconduct by a licensee on the one hand and investment losses in the absence of such misconduct on the other.***

FOS terms of reference exclude claims which are only about investment performance except where there has been misrepresentation or non-disclosure... In determining disputes, FOS does not have difficulty in regard to the distinction.

**2.20 Ability of clients to pursue claims through EDR schemes against parties other than licensees with whom they have dealt, who may bear some responsibility for loss or damage (for example directors or auditors).**

FOS does not have the same powers as the courts. It may only make determinations against member licensees and in accordance with its terms of reference.

**2.21 Ability of licensees to seek recourse against other licensees or parties, who may bear some responsibility for the loss or damage suffered by a retail client, in relation to an award of compensation in favour of that client under an EDR scheme.**

FOS does not have the same powers as the courts. It may only make determinations against member licensees and in accordance with its terms of reference. There is nothing in the FOS Terms of Reference which would prevent or impact on a licensee being able to seek its own recourse against a third party.

## **7.2 Chapter 3 Compensation Arrangements in Practice**

### *Issues of interest*

#### **Premium and payout experience**

**Information and comment are sought on trends in premiums for professional indemnity insurance borne by licensees, and on claims experience under those policies, from 2008 when the requirement for professional indemnity insurance was applied broadly to licensees. In particular, the following aspects are of interest:**

**3.1 The trend in premiums for professional indemnity insurance taken out by financial services licensees, and the factors behind that trend**

**3.2 The trend in claims paid under professional indemnity insurance held by those licensees and the value of claims made under those policies which are still outstanding.**

**3.3 As a subset of the above, the proportion of the premiums received from, and claims paid out to, licensees who provide financial advice.**

**3.4 The typical grounds upon which claims under professional indemnity insurance policies are not met.**

There is no current information which is publicly available to respond to these questions. Insurance companies would be best placed to address these matters.

## **Experience with compensation arrangements**

**Comment and perspectives are sought on the effectiveness of current compensation arrangements, including the costs and benefits for consumers and industry of the reliance on professional indemnity insurance as the default arrangement for compensation. In particular, the following aspects are of interest:**

**3.5 The costs and benefits of professional indemnity insurance for licensees and the financial services industry more broadly.**

**3.6 The level of assurance to retail clients that claims for loss or damage will be dealt with and awards for compensation paid.**

**3.7 The contribution of the current compensation arrangements in maintaining confidence by retail clients in dealing with financial services providers, including financial advisers, and in underpinning responsible behaviour by licensees.**

The inadequacies of using PI Insurance as a vehicle for consumer protection and compensation have been articulated extensively over the past several years. It has mainly been for this reason that FOS has commissioned and continues to conduct extensive research into the market and consumer problems that arise and has proposed a Financial Services Compensation Scheme. The limitations of PI Insurance have been recognised and expressed by ASIC, and in this Consultation Paper. In FOS' view there has been little change since it commissioned the Melzan Report Gaps in the Professional Indemnity Market in July 2007.

FOS has not seen any evidence that the existence of PI Insurance maintains or improves consumer confidence. It would be unlikely that retail consumers would understand the products fully if at all.

### **7.3 Chapter 4. Comparison with other arrangements**

**Given the compensation arrangements for financial services in other countries, and in respect to other professions and occupations domestically views and comments are sought on:**

**4.1 The practical operation of those other arrangements including their costs, benefits and scope, and their effectiveness in contributing to consumer protection and the underpinning of consumer confidence in relevant markets.**

**4.2 The possible relevance of those arrangements as models for the compensation of consumers of financial services in Australia.**

FOS has conducted research into overseas and local consumer protection /compensation schemes. The results of this are contained in the Proposal Report dated October 2009 and the Melzan Report on Group Insurance and Compensation Schemes dated June 2007.

FOS notes that there have been subsequent changes to the FCS and overseas schemes, which are set out in the Consultation Paper. These changes do not impact on the substance of FOS' proposals.

FOS has concluded that the model most closely aligned with the needs of Australia is the UK Financial Services Compensation Scheme and it has drawn extensively on it as a model.

## 7.4 Chapter 5 Observations and issues

### *A last resort scheme for compensation*

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

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

FOS has supplied information which is referred to in the Consultation Paper

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

FOS is and would be supportive of any cost effective measures which would improve consumer education and improve licensee performance and competencies and reduce risk.

FOS notes the proposed reforms flowing from the FOFA initiative. These should improve behaviour but may alter liability risks and increase exposure and potential for consumer claims. Of particular note is the possibility of broadening the licensing regime to include "scaled advice", a new and untested concept, together with the potential broadening of the licensing regime to include thousands of accountants.

FOS suggests that initiatives, including projects to improve financial literacy, which are of long standing, are of incremental benefit only. They do not alter the fundamental problem of the non-availability of funds to compensate consumers when problems do arise.

No amount of regulation, legislation, education or financial measures will eliminate risk. Even extensive prudential regulation by APRA still has risk. It is noted that, the Federal Government guaranteed bank deposits during the GFC and introduced the Financial Claims Scheme (FCS), which has already been triggered, albeit for a minor event involving 18 policyholders of Australian Family Assurance.

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

Here again, this may be useful to the extent that there is any evidence of non-compliance but will not address the gaps that exist in the system already or might arise in the future if for example there are changes in the commercial PI insurance market..

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

Insurance Companies are best placed to respond to this suggestion. FOS would be surprised if this were possible in the current free market.

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

The disclosure of policy terms will not assist consumers to evaluate the advice they are receiving, the likelihood of insolvency or disappearance of the licensee or how a policy will respond to a future set of unknown circumstances. Insurance Companies may have other concerns about such a proposal.

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

This relates to the provision of run-off cover which is one of the identified systemic weaknesses in the current approach to compensation. FOS is unaware of any options to deal with this which are universally available.

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

This theoretically has merit. The problems are, however:

- That claims often manifest themselves years after the advice is provided and even then take extensive time to be determined by the courts, insurers and ultimately EDR schemes. For financial security to be effective it would need to be provided for years into the future.

- This is part of the approach taken in respect to builders under some home warranty insurance schemes, where personal guarantees of directors, assignment of assets or provision of bank guarantees may be required. These requirements have many attendant problems. Claims and insolvencies nevertheless still arise.
- The quantum of claims can be and often is multiples of the net worth of the licensee or the business entity, which is what makes insurance a more efficient approach for the licensees. This then brings us back to the core problem.

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

FOS believes that a FSCS as proposed is the best available solution to meeting the very real needs of consumers at a cost which is affordable to industry. It will improve consumer confidence and trust in the financial services market and EDR schemes. It does not seek to replace the important role of PI Insurance and is a last resort scheme only, industry based and post event funded.

FOS believes that a scheme should be introduced as a matter of urgency.

## Appendix A – Scheme Rules – Discussion Version

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### Introduction

These Scheme Rules were prepared in October 2009 by Professional Financial Solutions Pty. Ltd. and have not been updated to reflect any subsequent changes. They are included here for the sake of completeness.

The rules set out in this document relate to a scheme for compensating consumers when Australian Financial Services ('AFS') licensees or their authorised representatives are unable or likely to be unable, to satisfy claims against them because they have become insolvent or, because claimants have sustained fidelity losses.

The compensation scheme has been modelled largely on the compensation scheme that is in place in the United Kingdom (also called the Financial Services Compensation Scheme), which provides compensation to consumers where financial service providers are unable or likely to be unable, to satisfy claims against them.

This compensation scheme forms part of a larger framework intended to compensate retail clients. The Corporations Act 2001 (Cth.) requires AFS licensees to have arrangements for compensating retail clients for losses they suffer as a result of a breach by the licensee or its representatives of their obligations under Chapter 7 of that Act. They may do so by obtaining adequate Professional Indemnity ('PI') insurance.

However, the requirement to hold PI is not a mechanism for providing compensation directly to consumers. Rather, PI is a means of reducing the risk that a licensee cannot pay claims because of insufficient financial resources.

This compensation scheme is a mechanism for providing compensation directly to consumers. The body established to operate and administer the compensation scheme is the Financial Services Compensation Scheme Limited ('Scheme'). The rules enable the Scheme to pay compensation only to retail clients, as defined in the Corporations Act 2001 (Cth.). The rules specify who is eligible to receive compensation and in what circumstances, how much compensation can be paid to a claimant; and how the Scheme will be funded.

The Scheme provides information to claimants and potential claimants about the way the Scheme works and the procedures that claimants need to follow when making a claim.

## **Outline of the Rules**

These rules are divided into seven parts covering all aspects of the Scheme.

### **Part 1: Definitions**

This part sets out the definition of terms used in the Rules.

### **Part 2: The Scheme**

This part sets out the broad obligations of the Scheme, including the obligation to publish an Annual Report and to develop procedures for dealing with complaints.

### **Part 3: The qualifying conditions for paying compensation**

This part sets out the qualifying conditions that must be satisfied before the Scheme can pay compensation to claimants. These are that a claimant is eligible to claim; the activity that gave rise to the loss is covered by the Scheme; the person against which the claim is being made is covered by the Scheme; and that the claimant has assigned their rights to the Scheme. This part specifies who is eligible to receive compensation by the Scheme and the activities that are covered by the Scheme.

### **Part 4: Assignment of rights**

This part enables the Scheme to make an offer of compensation conditional on the claimant assigning to it their rights to claim. If the Scheme recovers from the insolvent AFS licensee a greater sum than it has paid to the claimant, it must pay the balance to the claimant.

### **Part 5: Rejection of application and withdrawal of offer of compensation**

This part allows the Scheme to reject an application for compensation or withdraw an offer of compensation in specified circumstances.

### **Part 6: Payment of compensation**

This part requires the Scheme to pay a claim for compensation within a specified time unless certain conditions apply and specifies the maximum amount of compensation the Scheme can pay to a claimant, on the basis that there should be some part of the claim which is not compensable and for which the claimant must bear the loss.

### **Part 7: Transitional issues**

This part specifies the manner in which transitional issues are to be dealt with by the Scheme.

# 1 Definitions

In these Rules the following expressions have the following meanings:

<i>ASIC</i>		means the Australian Securities and Investments Commission.
<i>authorised representative</i>		has the meaning given to that term under Chapter 7 of the <i>Corporations Act 2001</i> (Cth.).
<i>Board</i>		means the Board of Directors of the <i>Scheme</i> .
<i>Claim</i>		means a valid claim made in respect of a civil liability owed by a relevant person to the claimant.
<i>Constitution</i>		means the constitution of the <i>Scheme</i> .
<i>compensation scheme</i>		means the scheme established for the purpose of compensating retail clients in cases where <i>participants</i> and the <i>authorised representatives</i> of <i>participants</i> are unable, or likely to be unable, to satisfy claims against them because they have become insolvent, or in circumstances where retail clients have suffered a pecuniary loss due to the dishonesty of a <i>participant</i> or the <i>authorised representative</i> of a <i>participant</i> .
<i>covered claim</i>		means a claim which is covered by the compensation scheme, as defined in Rule 3.4.
<i>dishonesty</i>		includes fraud.
<i>External Resolution</i> ('EDR')	<i>Dispute Scheme</i>	means any external resolution scheme approved by ASIC under Chapter 7 of the <i>Corporations Act 2001</i> (Cth.).
<i>funding agreement</i>		the agreement reached between the <i>participants</i> and the <i>Scheme</i> including but not limited to, <i>participants'</i> agreement to comply with these <i>Rules</i> and fund the <i>Scheme</i> .
<i>industry association</i>		means the relevant industry body representing one or more types of <i>participants</i> .
<i>participant</i>		means any AFS licensee providing financial services to retail clients who enters into the <i>funding agreement</i> , and thereby agrees to be bound by these Rules.
<i>relevant person</i>		means a person for claims against whom the <i>Scheme</i> provides cover, as defined in Rule 3.5.

*retail client* is any person who at any material time was a retail client, as defined in Chapter 7 of the *Corporations Act 2001* (Cth.).

*Scheme* means the Financial Services Compensation Scheme Limited

## 2 The Scheme

### 2.1 Purpose of the Scheme

The *Scheme* must administer the *compensation scheme* in accordance with these Rules. The *Scheme* may pay compensation to *retail clients* in accordance with these Rules.

### 2.2 Amendment of the Rules

The *board* may amend these rules in accordance with the *constitution* after consultation, as the *board* considers appropriate, with *participants*, the *industry association* or *industry associations* representing *participants*, ASIC, External Dispute Resolution Schemes and relevant consumer groups.

### 2.3 Governance of the Scheme

#### 2.3.1 Composition of the Board

The *board* consists of an independent chair, and an equal number of directors representing the interests of *participants*, and the interests of consumers, appointed in accordance with the *constitution*.

#### 2.3.2 Responsibilities of the Board

The *board's* responsibilities include the following:

- (a) overseeing and monitoring the activity of the *Scheme*;
- (b) ensuring that these Rules are adhered to;
- (c) analysing statistical information in relation to the *Scheme*; and
- (d) effecting appropriate changes to these Rules after consultation in accordance with Rule 2.2.

### 2.4 Annual Report

The *Scheme* must make and publish an Annual Report. The Annual Report must include information on:

- (a) the number of claims received;
- (b) the nature of the claims received;
- (c) the distribution of claims across product and market segment;
- (d) the outcome of the claim;
- (e) the length of time between when each claim was made and resolved;
- (f) the number and nature of defaults that the *Scheme* declares; and
- (g) the manner in which the *Scheme* is funded.

## **2.5 Independent Review of the Scheme**

### *2.5.1 Matters for Review*

The *board* must commission an independent review of the *Scheme* three years after the commencement of the *Scheme* and at least once every five years thereafter or as otherwise agreed with *ASIC*. The review shall cover the following areas:

- (a) whether the scope of the *Scheme* is appropriate;
- (b) satisfaction with the *Scheme* of *participants* and complainants;
- (c) whether the *Scheme* has complied with these Rules;
- (d) public awareness of the *Scheme* and its operations;
- (e) effectiveness of these Rules.

### *2.5.2 Results of Review*

The *Scheme* will make the results of the independent review available to *participants*, *ASIC* and to the public.

## **2.6 Audit**

The *board* must cause the accounts of the *Scheme* to be audited annually.

## **2.7 Complaints against the Scheme**

The *Scheme* must put in place and publish procedures for the handling of complaints relating to any aspect of the operation of the *compensation scheme*.

## 3 When will the Scheme pay compensation?

### 3.1 What is the Procedure for Making a Claim for Compensation?

The *Scheme* must produce and publish information for claimants and potential claimants on the operation of the *compensation scheme*, including the *Scheme's* procedures for receiving and handling claims.

### 3.2 What are the Qualifying Conditions for Paying Compensation?

The *Scheme* may pay compensation to claimant if it is satisfied that:

- (a) the claimant is a *retail client* (or legal personal representative of a *retail client*) who has made an application for compensation;
- (b) the claim is in respect of a *covered claim*;
- (c) the claim is against a *participant* or an *authorised representative* of a *participant* whom the *Scheme* has declared to be in default after commencement of the *Scheme* on [date]; and
- (d) where the *Scheme* requires, the claimant has assigned the whole or any part of that claimant's rights against a *participant* or an *authorised representative* of a *participant* or against any third party to the *Scheme* on the terms required by the *Scheme*.

### 3.3 Who May Make a Claim?

To be eligible to receive compensation, the claimant must be a *retail client*. The *Scheme* may also pay compensation to a person who makes a *claim* on behalf of another person if the *Scheme* is satisfied that the person on whose behalf the claim is made:

- (a) is or would have been *retail client*; and
- (b) would have been paid compensation by the *Scheme* had they been able to make the *claim* themselves.

### 3.4 Which Claims are Covered?

A *covered claim* is a claim:

- (a) brought in relation to any act or omission by a participant or any act or omission for which a participant may be responsible;
- (b) in relation to the provision of a financial service on or after [date – 6 years prior to commencement date], including the provision of all forms of financial services, financial advice or financial products such as derivatives, foreign and payment products; foreign exchange contracts, general Insurance, securities, managed investment schemes, life insurance products, superannuation, and other financial investment products; and

- (c) in respect of which there has been a determination in favour of the claimant by:
  - (i) an External Dispute Resolution Scheme;
  - (ii) a court or tribunal of competent jurisdiction; or
  - (iii) a trustee in bankruptcy, liquidator or any other recognised insolvency practitioner,

provided that the claim is not covered by the Financial Claims Scheme pursuant to the *Financial System Legislation Amendment (Financial Claims Scheme and Other Measures) Act 2008* ('FCS Act'). Examples of financial products include: derivatives, foreign and payment products; foreign exchange contracts, general Insurance, securities, managed investment schemes, life insurance products, superannuation, and other financial investment products.

A *covered claim* includes a claim where there has been:

- (i) a failure of the *relevant person* to pay or deliver money or property that was received by the *relevant person* in the course of providing financial services, where the failure arises from or is constituted by an act or omission that involves *dishonesty*, or
- (ii) a fraudulent dealing with property that was received by the *relevant person* in the course of providing financial services, where the fraudulent dealing arises from or is constituted by an act or omission that involves *dishonesty*.

### **3.5 Who is a Relevant Person?**

A *relevant person* is a person who was, at the time the act or omission giving rise to the *claim* against it took place:

- (a) a *participant*; or
- (b) an *authorised representative* of a *participant*.

### **3.6 When May the Scheme Determine a Relevant Person is in Default?**

A *relevant person* is in default if the *Scheme* has determined it to be in default under this Rule. The *Scheme* may determine a *relevant person* to be in default after the commencement of the *Scheme* on [date] when, in the opinion of the *Scheme* it is unable or likely to be unable to satisfy at least one *covered claim* against it as the *relevant person*:

- (i) is a body corporate and becomes insolvent at a particular time if, and only if, at that time:
  - A an administrator of the body corporate is appointed under section 436A, 436B or 436C of the *Corporations Act 2001* (Cth.);
  - B the body corporate commences to be wound up or ceases to carry on business;
  - C a receiver, or a receiver and manager, of property of the body corporate is appointed;
  - D the body corporate is appointed, whether by a court or otherwise; or
  - E the body corporate enters into a compromise or arrangement with its creditors or a class of them,
- (ii) a natural person and becomes insolvent at a particular time if, and only if, at that time:
  - A a creditor's petition or a debtor's petition is presented under Division 2 or 3 of Part IV of the *Bankruptcy Act 1966* against the person; or a partnership in which the person is a partner; or 2 or more joint debtors who include the person;
  - B the person's property becomes subject to control under Division 2 of Part X of the *Bankruptcy Act 1966*;
  - C the person executes a deed of assignment or deed of arrangement under Part X of the *Bankruptcy Act 1966*; or
  - D the person's creditors accept a composition under Part X of the *Bankruptcy Act 1966*,
- (iii) cannot be contacted at its last place of business and that reasonable steps have been taken to establish a forwarding or current address, but without success;

### 3.7 Publicising Declarations of Default

If the *Scheme* makes a determination of default pursuant to Rule 3.6, the *Scheme* must take appropriate steps to ensure that the default is published and that potential claimants are informed of how they can make a claim for compensation as soon as possible after a determination has been made that a *relevant person* is in *default*. The default may be published on the website of the *Scheme*, and made available on request by telephone or in writing.

### **3.8 Assistance to Claimants**

The *Scheme* may agree to pay the reasonable costs of the *retail client* bringing or continuing insolvency proceedings against a *relevant person* (whether those proceedings began before or after a determination of default), if the *Scheme* is satisfied that those proceedings would help it discharge its functions under these Rules.

## 4 Assignment of Rights

### 4.1 Compensation Payments Made Conditional on an Assignment

The *Scheme* may make payment of compensation to a claimant in respect of a *covered claim* conditional on the claimant assigning the whole or any part of their rights against the *relevant person*, or against any third party or both, to the *Scheme* on the terms required by the *Scheme*.

### 4.2 Payments to the Scheme

If a claimant assigns the whole or any part of that claimant's rights against any person to the *Scheme* as a condition of payment, the effect of this will be that any sum payable in relation to the assigned rights will be payable to the *Scheme* and not the claimant.

### 4.3 Recoveries

If the *Scheme* takes assignment of rights from the claimant under Rule 4.1, it may pursue such recoveries as it sees fit. If the *Scheme* makes recoveries through rights assigned under 4.1, it may deduct from any recoveries paid over to the claimant under Rule 4.1 part or all of its reasonable costs of recovery and distribution (if any).

### 4.4 Off-set of Recoveries

Where compensation was paid under Rule 6.1.3, if a claimant agrees to assign their rights to the *Scheme* and the *Scheme* subsequently makes recoveries through those rights, those recoveries must be paid to the claimant to the extent that the amount recovered exceeds the amount of compensation.

## 5 Rejection of application and withdrawal of offer of compensation

### 5.1 Inaccurate and Incomplete Applications

If an application for compensation contains any material inaccuracy or omission, the *Scheme* may reject the application.

### 5.2 Rejection of Applications

The *Scheme* may reject an application if the *Scheme* considers that a claim in respect of the liability would have been defeated by a defence of limitation at the earlier of:

- (a) the date on which the *relevant person* is determined to be in default; and
- (b) the date on which the claimant first indicates in writing that they may have a claim against the *relevant person*.

### 5.3 Discretion to Reject Applications

Where a claimant fails to respond to correspondence or a request for information from the *Scheme* within the time allowed for such a response, the *Scheme* may write to the complainant requiring a response to that correspondence within one calendar month, failing which the *Scheme* may reject an application for compensation. If the claimant fails to respond within one calendar month after a letter is sent under this Rule, the *Scheme* may reject the claim. If the *Scheme* rejects an application under this Rule, it may, at its discretion decide to reinstate that application.

### 5.4 Withdrawal of Offer

The *Scheme* may withdraw any offer of compensation made to a claimant if the offer is not accepted or if it is not disputed within 90 days of the date on which the offer is made. The *Scheme* may repeat any offer withdrawn under this clause. The *Scheme* must withdraw any offer of compensation if it appears to the *Scheme* that no such offer should have been made.

### 5.5 Interim Payments

Where the amount of compensation offered is disputed by the claimant, the *Scheme* may withdraw the offer and may consider making a reduced or interim payment before doing so. The *Scheme* may repeat any offer withdrawn under this clause.

### 5.6 Withdrawal of Misplaced Offer

The *Scheme* must seek to recover any compensation paid to a claimant if it appears to the *Scheme* that no such payment should have been made, unless the *Scheme* believes on reasonable grounds that it would be unreasonable to do so, or that the costs of doing so would exceed any amount that could be recovered.

## 6 Payment of compensation

### 6.1 Timing of Payment

#### 6.1.1 When must compensation be paid?

The *Scheme* must pay a claim as soon as reasonably possible after:

- (a) it is satisfied that the conditions in Rule 3.2 have been met; and
- (b) it has calculated the amount of compensation due to the claimant,

and in any event within three months of that date, in which case payment must be made no later than six months from that date.

#### 6.1.2 When may payment be delayed?

The *Scheme* may postpone paying compensation if the *Scheme* considers that the claimant should first exhaust their rights against another *relevant person* or a third party, or make and pursue an application for compensation to any other person.

### 6.2 Table of Compensation Limits

The limits on the maximum compensation sums payable by the *Scheme* are set out in the below table:

Scheme compensation limits
90% of the first \$120,000
Plus 70% of the next \$80,000
Plus 50% of the next \$80,000
<b><u>Maximum possible compensation \$204,000</u></b>

Should the aggregate funding payments in any one year exceed the maximum limit of 1% of the contribution group(s) revenue as defined, then the scheme may adjust payments by reducing the total amounts payable or by deferring payments into subsequent funding years.

## 6.3 Method of Payment of Compensation

### 6.3.1 To whom must payment be made?

If the *Scheme* determines that compensation is payable, it must pay it to the claimant, or as directed by the claimant.

### 6.3.2 Reduced or interim payments

If the *Scheme* is satisfied that in principle compensation is payable, but considers that immediate payment in full would not be prudent because of uncertainty as to the amount of compensation payable to a claimant, it may decide to pay an appropriate lesser sum in final settlement, or to make payment on account.

### 6.3.3 Reasonable prospects of recovery from third parties

The *Scheme* may also decide to make a payment on account or to pay a lesser sum in final settlement if the claimant has any reasonable prospect for recovery in respect of the claim from any third party or by applying for compensation to any other person.

## 6.4 How is Compensation to be Quantified?

### 6.4.1 Compensation payable

Provided the qualifying conditions for payment of compensation under Rule 3.2 have been met, the amount of compensation payable to the claimant is:

- (a) the sum of *covered claims* relating to the same type of default determined under Rule 3.6 that the claimant has against a *relevant person* in default;
- (b) less the amount of any liability which the *relevant person* may set off against any of those claims;
- (c) subject to Rule 6.2 that sets limits on the amount of compensation payable for various types of default.

In calculating the compensation payable, the *Scheme* may rely, to the extent that it is relevant, on any determination by:

- (i) an External Dispute Resolution Scheme;
- (ii) a court of competent jurisdiction;
- (iii) a trustee in bankruptcy, liquidator or any other recognised insolvency practitioner.

#### 6.4.2 What is excluded from the calculation of compensation?

The *Scheme* must not pay compensation for any claim to the extent that it relates to or depends on:

- (a) a failure of investment performance to match a guarantee given or representation made;
- (b) a contractual obligation to pay or promise to pay which the *Scheme* considers to have been undertaken without full consideration passing to the *relevant person* or in anticipation of possible insolvency; or
- (c) the mere fluctuation in the value of an investment.
- (d) punitive damages

#### 6.4.3 Set off

In calculating the compensation payable, the *Scheme* must take into account any payments to the claimant (including amounts recovered by the *Scheme* on behalf of the claimant) made by the *relevant person* or the *Scheme* or any other person, if that payment is connected with the *relevant person's* liability to the claimant.

#### 6.4.4 Contributory negligence

The *Scheme* may decide to reduce the compensation that would otherwise be payable for a claim, if it is satisfied that there is evidence of contributory negligence by the claimant and it would be inequitable for the *Scheme* not to take account of the evidence of contributory negligence.

### 6.5 Personal Representatives, Agents and Joint Claims

#### 6.5.1 Personal representatives

Where a person makes a claim as the personal representative of another, the *Scheme* must treat the personal representative in respect of that claim as if he were standing in the shoes of that other person.

#### 6.5.2 Agents

If a claimant has a claim as an agent for one or more principals, the *Scheme* must treat the principal or principals as having the claim, not the claimant.

#### 6.5.3 Joint claims

If two or more persons have a joint claim, each of those persons is taken to have a claim for their share, and in the absence of satisfactory evidence as to their respective shares, the *Scheme* must regard each person as entitled to an equal share. A joint claim is subject to the compensation limits set out in Rule 6.1.3 as if the claim were made by one person.

## 7 Transitional provisions

These Rules will apply to complaints received on or after [date]. The *Scheme* may only make a determination of default after that date.

The act or omission which is the subject of a *covered claim* must have occurred on or after the [date – 6 years prior to commencement of Scheme].

## Appendix B - Heads of Funding Agreement –Discussion Version

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### 1. Parties

Financial Services Compensation Scheme Limited (the *Scheme*)

Each person that agrees to participate in the *Scheme* (the *participants*, as defined under the *Rules* of the *Scheme* (the *Scheme Rules*) to ‘any AFS licensee providing financial services to retail clients who enters into the *funding agreement*, and thereby agrees to be bound by these Rules’).

### 2. Objective

The *Scheme participants* intend to agree to:

- (a) comply with the *Scheme Rules*;
- (b) fund the costs of establishing and managing the *Scheme*; and
- (c) fund the costs of providing compensation to those claimants that the *Scheme* agrees to pay compensation upon the declaration of a default under Rule 3.6, either through a standard compensation levy or through a special compensation levy, if the latter is required to meet the significant costs of compensating claimants in the event of one or more defaults.

### 3. Funding Assumptions

It is assumed that:

- (a) the Constitution of the *Scheme* will establish that the *Scheme* has the power to borrow where necessary to meet compensation costs in excess of the maximum levy. (as set out in Part 5); and
- (b) the Constitution of the *Scheme* will establish that the *Scheme* has the power to take assignments of rights from claimants (as contemplated in Rule 3.2(d)) and to take the necessary steps to make a recovery in the liquidation of a participant or former participant that the *Scheme* declared in default under Rule 3.6.

### 4. Documentation

The terms and conditions of the funding of the *Scheme* by its *participants* will be set out in an agreement (the *Funding Agreement*) to be entered into by the *Scheme* and each of its *participants*.

Other than defined terms, all *italicised* terms in this Heads of Agreement document have the meaning given to them under the *Rules*.

## 5. Terms and Conditions of the Funding Agreement

The terms and conditions of the *Funding Agreement* will need to provide:

<p><b>5.1 Adherence to the Scheme Rules</b></p>	<p>The <i>participant</i> will comply with the <i>Scheme Rules</i>.</p>
<p><b>5.2 Power of the <i>Scheme</i> to impose levies</b></p>	<p>The <i>Scheme</i> has the power impose a levy for management expenses, fidelity costs or compensation costs, provided that the <i>Scheme</i> has reasonable grounds for believing that the funds available to meet relevant expenses are, or will be insufficient to meet the level of the <i>Scheme's</i> anticipated expenditure:</p> <ul style="list-style-type: none"> <li>(a) in the financial year to meet management expenses, including any costs of developing and establishing the <i>Scheme</i> and interest on borrowings (<i>management expenses levy</i>);</li> <li>(b) in the financial year to compensate those claimants that the <i>Scheme</i> agrees to pay compensation upon the declaration of a default under Rule 3.6 (<i>standard compensation levy</i>);</li> <li>(c) in any period determined by the <i>Scheme</i> to cover the special costs of compensating those claimants that the <i>Scheme</i> agrees to pay compensation upon the declaration of a large default under Rule 3.6 (<i>special compensation levy</i>).</li> </ul>
<p><b>5.3 Statement of business</b></p>	<p>(a) The participant will provide the <i>Scheme</i>, by the end of [month], with a statement of:</p> <ul style="list-style-type: none"> <li>(i) contribution group or groups to</li> </ul>

	<p>which it belongs;</p> <p>(ii) the total amount of business which it conducted in the previous financial year in relation to each of those contribution groups, being revenue.</p> <p>(b) If the <i>participant</i> does not submit a complete statement of business by the required time, then it will pay an administrative fee of [\$250].</p> <p>(c) The <i>Scheme</i> will provide guidance to <i>participants</i> on the data required, to which agreed weightings will be applied to determine a proxy revenue for the purposes of calculating levies on a comparable basis between contribution groups.</p>
<p><b>5.4 Establishment Levy</b></p>	<p>(a) The <i>participant</i> will pay to the scheme a share of the <i>establishment levy</i> for the development costs and initial set up costs of the scheme</p> <p>(b) Each <i>participant's</i> share of the <i>establishment levy</i> will be at least [scheduled dollar amount] for each financial year.</p> <p>(c) The <i>Scheme</i> will calculate the amount of a <i>participant's</i> share of the <i>establishment levy</i> as a proportion of their total revenue as disclosed in their statement of business.</p>
<p><b>5.5 Management expenses levy</b></p>	<p>(a) The <i>participant</i> will pay to the <i>Scheme</i> a share of each <i>management expenses levy</i>.</p> <p>(b) The <i>management expenses levy</i> may not exceed [scheduled percentage/dollar amount] for each financial year.</p>

	<p>(c) Each participant's share of the <i>management expenses levy</i> will be at least [scheduled dollar amount] for each financial year.</p> <p>(d) The <i>Scheme</i> will calculate the amount of a <i>participant's</i> share of the <i>management expenses levy</i> as a proportion of their total proxy revenue..</p>
<p><b>5.6 Standard compensation levy</b></p>	<p>(a) The purpose of the <i>standard compensation levy</i> is to provide the <i>Scheme</i> with sufficient funds to pay compensation with respect to defaults determined under Rule 3.6 of the <i>Scheme Rules</i>.</p> <p>(b) This levy will be set by the <i>Scheme</i> based on its assessment of the needs of the <i>Scheme</i> to meet projected annual compensation costs.</p> <p>(c) The <i>participant</i> will pay to the <i>Scheme</i> a share of each <i>standard compensation levy</i>.</p> <p>(d) The <i>standard compensation levy</i> will not exceed (1%) of proxy revenue for each financial year.</p> <p>(e) Each participant's share of the <i>standard compensation levy</i> will be at least [scheduled dollar amount] for each financial year.</p> <p>(f) The <i>Scheme</i> will calculate the amount of the <i>participant's</i> share of the <i>standard compensation levy</i> as a proportion of their proxy revenue as disclosed in their statement of business.</p> <p>(g) The levy in any year under (f) may be inadequate to fund compensation payments in relation</p>

	<p>to a particular Contribution Group. If the relevant Contribution Group is linked to another Contribution Group, that Group may be levied for any shortfall using the process covered by this rule.</p>
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<p><b>5.7 Special compensation levy</b></p>	<p>(a) The purpose of the <i>special compensation levy</i> is to enable the <i>Scheme</i> to meet the costs of compensating claimants in the event of significant losses arising from one or more defaults. For example, a <i>special compensation levy</i> might be required if the <i>Scheme</i> faced the prospect of compensating clients who had been advised by participants or their <i>authorised representatives</i> to invest in Westpoint, which had since been determined in ‘default’.</p> <p>(b) The <i>Scheme</i> will allocate any <i>special compensation levy</i> to the contribution group in proportion to the amount of compensation costs arising from that contribution group up to the levy limit of that contribution group.</p> <p>(c) Any excess above the levy limit of the contribution group must be allocated to a linked contribution group and whose levy limit has not been reached up to the limit of the linked contribution group.</p> <p>(d) If the <i>relevant person</i> (as defined under the <i>Scheme Rules</i>) declared in default under Rule 3.6 is an <i>authorised representative</i> of a <i>participant</i> and the <i>participant</i> does not take responsibility for the loss arising from their actions, then the <i>Scheme</i> will allocate the compensation costs arising from that activity to the contribution group to which the activity relates.</p>
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<p><b>5.8 Contribution Groups</b></p>	<p>(a) The <i>participant</i> may belong to more than one contribution group.</p> <p>(b) The <i>Scheme</i> has an absolute discretion to determine which contribution group or groups will be levied for any particular default;</p> <p>(c) The contribution groups which <i>participants</i> may be included are :</p> <p>General Insurance</p> <p>Insurance Brokers</p> <p>Financial Advisers</p> <p>Fund Managers</p> <p>Loan Portfolios</p> <p>ADI deposits</p> <p>Life Insurers</p> <p>Other...</p> <p>(d) The <i>Scheme</i> may amend these contribution groups from time to time as it sees fit.</p>
<p><b>5.9 Levy limits for each class of participant</b></p>	<p>(a) The levy limits for each contribution group of <i>participants</i> are to be (1%) of proxy revenue.</p> <p>(b) The <i>Scheme</i> may, in its discretion, determine the levy limits for each contribution group of <i>participant</i> for the purpose of a <i>special compensation levy</i> on any basis it sees fit. Possible bases may include:</p> <p>(i) the claims experience of that contribution group;</p> <p>(ii) the proxy revenue of that contribution group, as a proportion of the total revenue of all contribution groups; and</p> <p>(iii) the contribution group which the <i>Scheme</i> is responsible for anticipated significant compensation costs.</p>

<p><b>5.10 Calculation of the special compensation levy</b></p>	<p>(a) The <i>Scheme</i> will calculate the <i>participant's</i> share of the <i>special compensation levy</i> by:</p> <ul style="list-style-type: none"> <li>(i) identifying the contribution group or each of the contribution groups to which the <i>participant</i> belongs;</li> <li>(ii) identifying the compensation costs to each of the contribution groups of <i>participants</i>;</li> <li>(iii) calculating, in relation to each contribution groups, the <i>participant's</i> proxy revenue as a proportion of the total proxy revenue of all <i>participants</i> in the same contribution group.; and</li> <li>(iv) applying the proportion calculated in (iii) to the figure in (ii).</li> </ul> <p>(b) If the <i>participant</i> belongs to more than one contribution group, the <i>Scheme</i> will add the proxy revenue for each contribution group at step (iii)</p>
<p><b>5.11 New and former participants</b></p>	<p>(a) If the <i>participant</i> becomes a <i>participant</i> part way through a financial year the <i>participant</i> will be liable to pay the <i>management expenses levy</i>, <i>fidelity fund levy</i> and <i>standard compensation levy</i> from the quarter that it enters the <i>Scheme</i>.</p> <p>(b) If the <i>participant</i> becomes a <i>participant</i> part way through a financial year they will not be liable to pay a share of a <i>special compensation levy</i> made in that year.</p>
<p><b>5.12 Method and timing of payment</b></p>	<p>(a) The <i>participant</i> must pay its share of any levy made by the <i>Scheme</i>:</p> <ul style="list-style-type: none"> <li>(i) in one payment; or</li> <li>(ii) where the <i>Scheme</i> agrees, by quarterly instalments.</li> </ul> <p>(b) The <i>participant's</i> share of any levy made by the <i>Scheme</i> is due and payable 30 days from when the invoice is issued.</p>

<b>5.13 Cessation of participation</b>	If a person ceases to be a <i>participant</i> part way through a financial year it will remain liable for any unpaid levies which the <i>Scheme</i> has already made on that person.
<b>5.14 Surplus funds</b>	<p>If the <i>Scheme</i> has more funds than the <i>Scheme</i> believes will be required to meet levies for the next 12 months, it may <i>either</i>:</p> <ul style="list-style-type: none"> <li>(a) refund the surplus to all participants or to a contribution group of participants as it deems fit; or</li> <li>(b) reduce the levy that is imposed on all participants or a contribution group of participants in the following 12 months as it deems fit.</li> </ul> <p>A surplus may arise through a miscalculation or levies or because the <i>Scheme</i> has successfully pursued a recovery in the liquidation of a participant or former participant that it declared to be in default Rule 3.6.</p>
<b>5.15 Termination of Funding Agreement</b>	<ul style="list-style-type: none"> <li>(a) By agreement of the parties on [six months] written notice</li> <li>(b) Prescribed events eg, breach of laws, default or other serious breach of <i>Funding Agreement</i>, other.</li> </ul>
<b>5.16 Audit</b>	The <i>Scheme</i> will appoint an auditor in accordance with the <i>Scheme Rules</i> .
<b>5.17 Dispute resolution</b>	An agreed process for resolution of disputes
<b>5.18 Notices</b>	<ul style="list-style-type: none"> <li>(a) Notices to the <i>Scheme</i> must be directed to the Chief Executive Officer of the <i>Scheme</i></li> <li>(b) Notices to the participant must be directed to the Responsible Officer of the <i>participant</i>.</li> </ul>

## Appendix C – Explanation of Economic Model and Data

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### Data Collection – Total Industry Data

The report prepared by Professional Financial Solutions “Proposal to Establish a Financial Services Compensation Scheme” in October 2009 Report used a set of data which ASIC had made available which included certain financial information which allowed some funding and levy calculations to be carried out. The report also identified certain weaknesses in the use of that data. A much more robust and useful set of data has now become available and has been implemented as described below. Please refer to the October 2009 Report for any details of the previous modelling work.

Since the above Report was produced FOS has introduced a new way of funding its activities using a funding model that spans all the different financial services sectors. This involves collecting data for each FOS member, such as Premium Income, Funds Under Administration, ADI deposits. Importantly the data collected is in respect of the retail business conducted by AFS licence holders.

For each data item collected a ‘weight’ has been accepted by the different industry sectors. When the weight is applied to a sector’s reported revenue the resulting value is referred to as the ‘proxy revenue’. The ‘proxy revenue’ for each sector may then be viewed as broadly comparable. This ‘proxy revenue’ is used as a basis for apportioning FOS’ costs.

The table below sets out the current data item and its weight.

Industry Sector	\$Reported Revenue	Weight
General Insurance	Premium income	20%
Insurance Brokers	GI Brokerage	100%
Financial Advisers	FUA	0.3%
Fund Managers	FUM	0.7%
Various issuers	Loan portfolio	1.0%

Industry Sector	\$Reported Revenue	Weight
ADIs	Deposits for ADIs	1.5%
Various issuers	LUM	0.5%
Life Insurers	Life Insurance Premiums	20%
<i>New business area</i>	<i>TBA</i>	<i>Y%</i>

$$\text{\$ Reported Revenue} \times \text{\% weight} = \text{Proxy Revenue}$$

The resulting proxy revenue gives a value in each industry sector that each AFS licence holder participates in. These values may then be used to calculate the level of compensation payments able to be afforded by each sector in isolation from any other sector.

The basis on which a compensation levy may be determined, as described earlier, uses:

- \$ minimum p.a. amount;
- \$ maximum p.a. amount; and
- A % of proxy revenue, capped at 1%, but within the \$minimum and \$ maximum.

The total dollar amount of compensation able to be funded by a particular industry sector can then be determined. If there was no maximum dollar levy, the total amount able to be raised by the levy would be 1% of the proxy revenue. Introducing a maximum dollar cap will reduce the amount that can be funded - the lower the \$ maximum, the lower the amount of compensation that can be funded.

The modelling work has been carried out by, Professional Financial Solutions Pty Limited, actuarial consultants. The table below sets out how much compensation each sector can fund and how that amount reduces as a progressively lower cap is put in place. For example, in the following table the insurance brokers could fund compensation payments of \$20 million per annum using a 1% levy with no other constraint, reducing to \$12 million p.a. where no individual licence holder paid more than \$250,000 per annum.

## Funding Limits

Maximum levy collections per annum, in \$millions, if there is a cap on each AFS licence holder:

Sector	Cap on \$ Maximum for an AFSL holder			
	Unlimited	\$1.0m	\$0.5m	\$0.25m
General Insurers	\$44m	\$24m	\$17m	\$12m
Brokers	\$20m	\$14m	\$13m	\$12m
ADI's deposits	\$178m	\$24m	\$16m	\$11m
Loan Portfolio	\$173m	\$29m	\$20m	\$14m
Funds Under Management	\$102m	\$64m	\$48m	\$34
Life Insurers	\$37m	\$13m	\$8m	\$5m
Advice	\$19m	\$12m	\$10m	\$8m

Some of the above values may be expected to be conservative and do not take into account any estimates for licensees who are not members of FOS.

The proposed Scheme has the added feature, described earlier in Section 4 of this report, where compensation funding in a year may be drawn from two sector groups. This proposal recognises that certain types of advice are closely aligned with a particular product suite. The most obvious of these are the Brokers, who are closely aligned with the General Insurers, and the Advice sector which is predominantly aligned with a range of investment products i.e. the Funds Under Management sector.

The added feature referred to above is described using the following example. Assume events occurred requiring compensation from the Advice group where payments to be made in a year are to be, say, \$25 million i.e. greater than this sector could fund irrespective any \$ maximum cap. As this sector has an associated product sector, the excess of at least \$6 million would then be funded from the FUM sector.

In any one year there is, ultimately, a limit on the funds available for compensation being the limit of the sector, or the combined funding from two sectors in the circumstances described above. Part of the design of the Scheme also recognises that it is possible that a funding limit may be exceeded in any one year. If this occurs, compensation payments, unable to be met from the current year's funding, may need to be deferred. In effect this will add to the required levy in future years to fund those compensation payments.

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<sup>i</sup> <http://www.austrade.gov.au/Invest/Why-Australia/Strong-and-Sophisticated-Financial-Services-Sector/Strong-and-Sophisticated-Financial-Services-Sector/default.aspx>