



# T-RUN

## TAILORED REGULATORY UPDATE NEWSLETTER

### STOP PRESS: ASIC Re-Issues RG 126 – Compensation Arrangements

Just as we were about to push the send button on this edition of T-RUN alerting you to numerous difficulties with meeting the requirements of RG 126, ASIC has re-issued the regulatory guide, clarifying most of the issues we raised.

In particular, the re-released guide on P.I. insurance and compensation arrangements (let's call it RG 126 Version 2) clarifies:

- the scope of coverage required for fraudulent and dishonest acts;
- that adequate PI insurance policies do not need to explicitly refer to liability for breaches of 'Chapter 7 of the Corporations Act'. However, they must have the effect of providing cover for breaches of Chapter 7;
- ASIC's expectations about reinstatements; and
- language used in RG 126 where feedback indicated that ASIC's requirements did not fully reflect current insurance terminology or could be made clearer.

Let's briefly look at each of these in turn.

#### Fraudulent and dishonest acts

The PI policy must cover fraud/ dishonesty/ infidelity by directors, employees and other representatives of the licensee, and exclusions in the policy must not exclude these things.

#### Chapter 7

ASIC clarified that it does not require PI policies to expressly state that they cover 'breaches of Chapter 7'. Rather, the policy needs to cover losses caused by negligent, fraudulent or dishonest conduct by directors, employees or other representatives that amount to a breach of Chapter 7 and give rise to liability to retail clients. ASIC noted several relevant sections under which liability to retail clients may arise. These include ss953B, 953C, 991A, 1022B, 1022C and 1041I. These sections cover provision and content of disclosure documents and other offer documents, unconscionable conduct, false or misleading statements, inducing persons to

deal, dishonest conduct and misleading or deceptive conduct.

The PI policy also needs to cover liability under EDR Schemes. However, as long as the effect of the policy is to cover this, it is not necessary for the policy to expressly state this.

The PI policy only needs to indemnify the *licensee* for civil liability. It does not need to (and indeed should not) indemnify any person for any criminal penalty.

#### Re-instatements

ASIC expects that PI policies will have at least one re-instatement, unless the limit of the policy is twice the minimum limit referred to in RG 126 (i.e. \$2m to \$20m).

ASIC also clarified that when assessing adequacy of the cover, licensees need to take into account whether the policy covers the overall provisions of the policy. For example, if the policy covers claims made by wholesale clients or claims outside the scope of s912B (i.e. the compensation arrangements provision), licensees may need to increase the overall amount of cover so that there is adequate cover available for claims that fall within s912B. (NB: you need to keep records of how you determined what amount was adequate).

In announcing RG 126 Version 2, ASIC has also reminded licensees who will be seeking to rely on 'alternative arrangements' under RG 126 to allow enough time for their application to be considered by ASIC, and to obtain PI insurance if their alternative arrangements are not approved.

While ASIC provided no guidance on how long it would take to assess an application for alternative arrangements, it is clear that, with the new requirements coming into effect on 1 July 2008, licensees need to act soon.

It seems ASIC has received a lot of calls from industry, alerting them to the difficulties they have addressed in RG 126 Version 2. The changes (or 'clarifications') in RG 126 Version 2 certainly reflect many of the problems our clients had experienced in sourcing adequate cover.

Another problem we have encountered with PI is the huge discrepancy in knowledge between insurance brokers on the new requirements. It is vital that you ensure that your brokers are familiar with the requirements (we heard about one broker telling a client of ours about requirements that were in the draft RG 126, but nowhere else – that broker was saying that licensees required far more cover than the RG currently requires).

The FPA has also recently announced that they are calling for tenders for the provision of a group PI policy which will be designed to meet the FPA membership requirements for PI insurance and cater for the FICS monetary limits.

**Tip:** For those of you who are FPA members, keep a regular eye on developments with the touted 'group PI Policy'. Clearly, we cannot vouch for the FPA policy. However it is likely to be worthwhile making an assessment of the offer if/when it becomes available. Despite this, you should still line up some sort of "backup" if the FPA policy isn't available until very close to the required July deadline.

**Tip:** If you haven't done so already, start a formal PI insurance review project and resource it properly so that you can properly assess your obligations and compliance with them. Remember, under RG 126, the requirements that need to be met by 1 July 2008, get even more difficult for the second tranche of requirements that need to be met by 1 January 2010.

**Tip:** go to our blog and see what others have said about this developing area. Be brave and put in a comment or two yourself about your thoughts and experiences to date. The blog is available at: <http://www.holleynethercote.com.au/HN/AFSLBlog.aspx>

## AUSTRAC Issues Draft Guidance Note on 'No Action' Letters

Some of you will be familiar with 'no action' letters that ASIC can issue when the regulator has determined that, despite some potentially unlawful conduct by the licensee, it will take 'no action' in relation to that particular conduct.

Now AUSTRAC has followed in these footsteps by issuing draft guidance on how it intends dealing with applications from reporting entities for it to take no action in relation to particular conduct.

But there is one major difference. Under the Corporations Act, licensees are required to report significant breaches of the financial services laws to ASIC. However, reporting entities under the AML/CTF Act have no mandatory requirement to report breaches, significant or not, to AUSTRAC. AUSTRAC's guidance needs to be viewed in that light.

Requests for no-action letters must be in writing and contain 'all information that may be pertinent to the issue of a no action letter'.

You should be aware that, according to the draft guidance:

- AUSTRAC may at any time withdraw or revise a no-action letter;
- AUSTRAC reserves the right to take any action it considers appropriate, particularly if there has been incomplete disclosure;
- no-action letters should not be relied on as a precedent;
- while any information provided in relation to an application for no-action is treated confidentially, it may be passed to the ATO and/or a relevant designated agency (eg ASIO, ACCC, AFP, APRA, and ASIC), pursuant to the AML/CTF Act; and
- information cannot be provided on a 'without prejudice' basis.

We suggest you should assess each instance on a case-by-case basis and seek advice prior to applying to AUSTRAC for a no-action letter.

Also, keep in mind that the guidance is only in draft form at this stage. We will notify you of developments.

You can find the draft guidance at [http://www.austrac.gov.au/files/gn\\_noactionletter.pdf](http://www.austrac.gov.au/files/gn_noactionletter.pdf)

## AUSTRAC Compliance Reports: Do We or Don't We?

Many of you will have received one or more letters from AUSTRAC stating that you may need to complete a periodic compliance report for them (the first of which is due 31 March 2008). Some of you have asked whether this applies to you.

Section 47 of the AML/CTF Act requires 'reporting entities' to submit compliance reports for the time period and in the form determined by AUSTRAC. However, s47(5) contains an exemption from this requirement for a "reporting entity if all of the designated services provided by the reporting entity are covered by item 54 of table one in section 6."

To refresh your memory, item 54 of table one in section 6 covers a holder of an Australian financial services licence who just *arranges* for a person to receive a designated service.

This covers the vast majority of financial planners, who only deal in or arrange financial products that are deemed to be 'designated services' for AML/CTF purposes.

Therefore, reporting entities who only provide designated services under item 54 of table one in section 6 do not need to submit the periodic compliance reports under section 47 of the AML/CTF Act.

If you are required to submit a report, (say, because you are actively issuing financial products, and not just "arranging"), AUSTRAC has reminded reporting entities that you face possible civil penalties if you have not submitted the report by this date. Information about the compliance report is available on AUSTRAC's website at [www.austrac.gov.au](http://www.austrac.gov.au).

## Beware Instalment Warrants

We have heard several instances of financial planners wanting to take advantage of the new rules that effectively allow gearing in SMSFs, by recommending instalment warrants as an investment tool for trustees to use.

However, licensees and representatives need to be careful about what type of financial product the instalment warrant is, if it is in fact a financial product at all.

We have heard of instalment warrants being defined variously as mortgage products (not a financial product), derivatives, securities and miscellaneous financial products.

It is vital to know what type of product a particular instalment warrant is, for two primary reasons:

1. to ensure you can take advantage of the SMSF gearing rules; and
2. to ensure that you are authorised to advise in relation to the particular type of product.

We therefore recommend that you seek a legal opinion on the type of instalment warrant you are wanting to offer, prior to recommending it to clients.

## Margin Lending to be a Financial Product?

The Productivity Commission recently released a draft report on Australia's consumer policy framework, recommending that the regulation of consumer credit be transferred to ASIC.

In response, ASIC lodged a submission with the Productivity Commission suggesting that certain credit-related activities (margin lending in particular) could be covered by Chapter 7 of the Corporations Act.

Currently, credit is not a "financial product" for the purposes of licensing. The Productivity Commission is looking to release its final report in April 2008. We will monitor developments.

## New Standards on the Horizon for Planners

The Financial Planning Association (FPA) has released a set of draft Practice Standards. The FPA is seeking feedback on the proposed new standards from members.

The practice standards are stated to be enforceable by the FPA in the same way the Code of Ethics and Rules of Professional

Conduct are enforceable. We therefore encourage all members to carefully review the proposed standards and make any relevant submissions to the FPA.

The draft states that “the practice standards are not intended to indicate or imply any additional legal duty upon members. They are intended to state the expectations of practice at the level of the reasonably diligent financial planning professional acting competently.”

The draft also states that the standards are “not limited to the provision of financial advice as defined by the Corporations Act 2001 ... but extends to the provision of any professional service by the financial planning professional in his or her professional capacity.”

Four main standards are covered:

1. Quality Client Engagement;
2. Quality Client Information;
3. Providing Quality Recommendations;
4. Providing Quality Advice.

Each of the standards is supported by an Objective, Principles, Explanatory Notes and examples of what documents or conduct will evidence adherence to the relevant Principle.

We encourage members to contribute feedback to the FPA. The Draft Practice Standards can be found at:

<http://www.fpa.asn.au/files/ProfPracStandardsMemberConsultation.pdf>

Members can email comments to:  
[professional.standards@fpa.asn.au](mailto:professional.standards@fpa.asn.au)

## Rudd Reform Agenda Kicks Off

In our last issue of T-RUN we let you know that a new Financial Services Working Group has been established. Since then, the Minister for Superannuation and Corporate Law, Senator Nick Sherry, has opened the first session of the working group.

Ostensibly set up to ‘simplify’ financial services, especially regarding disclosure obligations, the

working group has said its initial focus will be to develop a short-form disclosure document for the First Home Saver Account.

We expect a raft of recommendations that will affect the broader financial services industry to follow.

Also, the Assistant Treasurer, Minister for Competition Policy & Consumer Affairs, Chris Bowen, addressed IFSA recently and gave hope that relaxed withholding rates are on the way for managed funds.

As part of a push to make Australia’s financial services industry a ‘hub’ of the Asia Pacific, the Minister spoke of allowing the financial services industry to ‘compete on a level playing field’ internationally, with a view to making investment in Australia more appealing and helping to make the export of our financial services more attractive.

To this end, the Government has asked the Board of Taxation to review the taxation of managed funds.

## ASIC Action

Well, ASIC certainly hasn’t been sitting on its hands over the Easter period. Here’s some of the regulatory action taken over the last few weeks.

- After initially freezing funds in November 2006 in an illegal foreign currency scheme, ASIC has now obtained orders to close the illegal managed investment scheme. Operated by an unregistered NZ company, investors paid at least \$14.5m into the scheme with promised returns of 4.23% per month.
- In a long-running matter, ASIC has been granted orders against a Melbourne financial planner, restraining the planner and other parties from dealing with the assets of a number of alleged unregistered managed investment schemes.
- Three financial operators have been nabbed by ASIC. One, who worked as an authorised representative, allegedly used clients’ funds to satisfy personal debts,

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and has been permanently banned from providing financial services. Two others pleaded guilty to operating an unregistered managed investment scheme.

- A North Queensland man is facing charges for operating an unlicensed investment scheme and embezzling more than half a million dollars from clients.
- An unregistered managed investment scheme with more than \$10m is being liquidated.

In other action, ASIC has announced that it will be targeting heavily traded securities in the wake of market volatility. ASIC's inquiries relate particularly to conduct that could involve the spreading of false or misleading rumours or predatory trading, which could amount to market manipulation or insider trading.

## New Report Counts the Cost of Compliance

ASIC has released Report 123, titled "A Report on Costs of Financial Services." The report was prepared by a market research firm who interviewed 64 financial services organisations. It identifies the major costs of compliance and an expectation that costs could increase 15-20% per year.

Major cost components of compliance were identified as staff costs, training, documentation, IT, outsourcing, procedures, monitoring and recording, and opportunity costs.

Interestingly, while most respondents recognised the costs of compliance as high, there was almost no knowledge of total compliance costs. Consequently, very few respondents reported to their Board on compliance costs.

While the report indicated a general maturity and acceptance of the need for regulation in the financial services industry, several disadvantages of the current regime were identified, including:

FSR overly prescriptive, excessive documentation, increased costs, ineffective consumer protection, staffing issues (some

respondents stated that it is now difficult to attract high quality staff as potential staff are deterred by high levels of paperwork and perceived low productivity), legislation too complex, and duplication across regulators.

The report makes for interesting reading. It is available at:

[http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/REP\\_123\\_A\\_Report\\_on\\_Costs\\_of\\_Financial\\_Services\\_2007.pdf/\\$file/REP\\_123\\_A\\_Report\\_on\\_Costs\\_of\\_Financial\\_Services\\_2007.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/REP_123_A_Report_on_Costs_of_Financial_Services_2007.pdf/$file/REP_123_A_Report_on_Costs_of_Financial_Services_2007.pdf)

## Well, I'll be blogged

Have your voice heard, and hear what your colleagues in the financial services sector are saying about the latest hot topics.

Our new Financial Services Blog is designed to help industry engage with each other and share views, experiences and approaches to tackling common problems.

Check it out at

<http://www.holleynethercote.com.au/HN/AFSLBlog.aspx> and have your say on the things that are important to you. The success of this initiative will depend on clients and other participants not being shy and letting their views and experiences be known.

Current topics include P.I. Insurance and SOAA versus SOAs – Incorporated by Reference. Topics close to many people's hearts at the moment. If you want another topic added, just ask.

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This newsletter is current as at **March 2008**.

For a list of useful FSR articles, go to [www.holleynethercote.com.au](http://www.holleynethercote.com.au), an associated law firm website.

This newsletter briefly summarises a complex area of law and one that is very dependent upon the precise facts that would apply. It is not a substitute for legal advice.