

# Proposal to Establish a Financial Services Compensation Scheme

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## Executive Summary

This Report provides a summary of research conducted by and on behalf of the Financial Ombudsman Service on the proposed Financial Services Compensation Scheme.

Initially completed in January 2009, it has been extensively revised to reflect FOS's consultation with the relevant Ministers, Treasury and the Australian Securities and Investments Commission.

The introduction of a Scheme would assist retail clients who have suffered a loss due to the insolvency or disappearance of an Australian Financial Services licensee. The Scheme would bring Australia's financial services compensation arrangements into line with other international financial services hubs such as the United Kingdom, and into line with other sectors of the Australian economy that already have schemes to compensate consumers.

Currently, even if a retail client of an AFS licensee is awarded a sum in compensation by an External Dispute Resolution scheme or a court, they are unlikely to receive that sum if the AFS licensee becomes insolvent or disappears.

Over 2008-2009, the Federal Government took steps to reduce the risk that retail clients will not receive the compensation they are due. The Government legislated to protect consumers by requiring AFS licensees to hold Professional Indemnity insurance and introduced a Financial Claims Scheme for claims made against banks and general insurers. However, high profile collapses involving AFS licensees such as those of Westpoint and Storm Financial have highlighted some of the inadequacies the existing compensation arrangements.

The Scheme has been designed so that all stakeholders play an important role. It would be:

- An industry-based scheme operated by an entity governed by the key stakeholders: industry and consumers;
- Funded by AFS licensees through regular levies;
- Subject to approval by the Australian Securities and Investments Commission; and
- Supported by the Federal Government, through a requirement on AFS licensees to become members of the Scheme and a last resort guarantee.

The Scheme would benefit consumers by providing a fundamental element of protection. It would:

- Provide an equitable and affordable avenue by which to obtain compensation;
- Cover existing gaps left by the reliance of the current protection regime on PI insurance; and
- Partially compensate retail clients in the event that an AFS licensee becomes insolvent or disappears up to a level that reflects the design of EDR schemes; and
- Create an incentive for retail clients to exercise proper prudence when selecting an AFS licensee, by paying part, but not all, of their full claim for compensation against the AFS licensee.

The Scheme also promises significant benefits for the financial services sector. For example it would:

- Provide an incentive for risk management for both retail clients and AFS licensees;
- Enhance the reputation of relevant markets and consumer confidence in EDR schemes and in the regulatory system and financial services sector more broadly, particularly in the current financial climate; and
- Potentially replace the need for multiple compensation arrangements that are currently in place.

Initial budget and compensation claims costs estimates have been prepared. These indicate that the average compensation costs would be in the order of \$12 million. It is proposed that these costs would be pre-funded by AFS licensees through a levy.

Initial estimates of establishment and operating costs for Year 1 are in the order of \$2.3 million. It is proposed that these initial costs, together with usual operating costs, would be met through a levy on AFS licensees..

The introduction of the Compensation Scheme would be facilitated by Federal Government support in the following areas through:

- Requiring all AFS licensees to become members of the compensation scheme as part of the obligation to have arrangements to compensate retail clients under the *Corporations Act 2001* (Cth); and
- A guarantee of extremely large compensation costs that exceed a percentage (notionally 1%) of AFS licensee revenue in any one year, akin to the arrangements that underpin the Australian Reinsurance Pool Corporation.

The process of consulting the Federal Government on the proposed Scheme continues. This consultation will contribute to the finalisation of the Scheme design, as will feedback received from industry and consumer stakeholders.

It is also envisaged that, if established, this would be a 'living Scheme' that would evolve with experience over time, and be guided by the experiences of key stakeholders in industry, consumers and regulators.

**Acronyms**

ACH	Australian Clearing House Pty Ltd
ADI	Authorised Deposit Taking Institution
AFS	Australian Financial Services Licensee
APRA	Australian Prudential Regulation Authority
ARPC	Australian Reinsurance Pool Corporation
ASIC	Australian Securities and Investments Commission
ASXSCF	Australian Stock Exchange Supplemental Compensation Fund
EDR	External Dispute Resolution
FCS	Financial Claims Scheme administered by APRA
FCS Act	<i>Financial Claims Scheme and Other Measures Act 2008 (Cth)</i>
FOS	Financial Ombudsman Service
FSA	Financial Services Authority of the United Kingdom
FSCS	(proposed) Financial Services Compensation Scheme
NGF	National Guarantee Fund
PFS	Professional Financial Solutions
PI	Professional Indemnity insurance
Rules	Discussion Version of the Rules that would govern the Scheme appended to this Report
SIS Compensation	Compensation available under the <i>Superannuation Industry (Supervision) Act</i>
UK FOS	Financial Ombudsman Service of the United Kingdom
UK scheme	Financial Services Compensation Scheme of the United Kingdom

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Neither this Report nor any of the documents appended to it constitute legal advice and accordingly should not be relied upon as legal advice. The Report provides an overview of the key issues relevant to the development of a compensation scheme. It will be necessary for legal advisors to be engaged to advise on any rules under which the Scheme may operate, prepare any agreements, assist in the preparation of the Scheme's constitution and related matter.

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# 1 Introduction

## 1.1 Why does Australia need a Financial Services Compensation Scheme?

The recent collapse of several financial entities has highlighted a significant risk to Australian consumers. The collapse of Westpoint and Storm Financial has particularly left retail clients facing substantial personal losses with the prospects of recovery being at best highly uncertain.

As retail clients have sought compensation from the Australian Financial Services licensees they dealt with, some have been confronted with an alarming reality. Many AFS licensees simply do not have the insurance or the assets required to properly compensate people to whom they are legally liable. This leaves their former clients to join a long queue of creditors, potentially waiting years in the hope that they will be repaid in winding up proceedings.

This has become particularly evident to the Financial Ombudsman Service. FOS, as detailed in Appendix A to this Report, is the External Dispute Resolution body which handles most complaints against AFS licensees.

The collapse of Westpoint provides a useful example of the problem faced by retail. Over the period 1 January 2006 to 30 June 2008, FOS received over 400 complaints relating to Westpoint. Of this number, there were 37 retail clients who successfully made complaints to FOS, but did not receive any compensation because the respondent AFS licensees became insolvent. A further large number of claims were also made to FOS but were outside its jurisdiction because they had already become insolvent.

### 1.1.1 Recent steps to protect consumers

Over 2007-2008, the Federal Government took two important steps towards protecting retail clients.

The first involved making it mandatory for AFS licensees to hold Professional Indemnity insurance unless they are prudentially regulated by the Australian Prudential Regulatory Authority. The second involved the introduction of a Financial Claims Scheme administered by APRA for the benefit of the retail clients of certain insolvent prudentially-regulated licensees.

However, the steps taken by the Federal Government to date *were not intended to be a comprehensive consumer safety net*. The consumer protection measures that are currently in place rely on the market, and *only partially reduce* the risk that consumers will not be compensated.

A detailed analysis of this problem is contained in the Melzan Pty Ltd Report on Compensation Funds that forms Appendix B to this Report and is available on request.

### 1.1.2 Inadequacies of Professional Indemnity insurance

At present, AFS licensees are required to have arrangements for compensating retail clients under the *Corporations Act 2001 (Cth)*. The Corporations Regulations provide that this may be achieved either by holding adequate PI insurance or making another arrangement approved by ASIC.

Research conducted for ASIC as long ago as December 2006<sup>1</sup> indicated that most PI policies leave a gap in consumer protection because they do not cover losses sustained by retail clients where the principal of a licensee has been fraudulent or dishonest, or has misappropriated the funds of a client. They may also have very high excesses, which may cause an AFS licensee to quickly become insolvent if even a small number of claims are made under that PI policy.

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<sup>1</sup> Report 107 - <http://www.asic.gov.au/asic/ASIC.NSF/byHeadline/Reports>

By providing the guidance contained in RG126<sup>2</sup> on what comprises 'adequate' PI insurance, ASIC went some way towards addressing some of the inadequacies of PI insurance as a consumer protection mechanism in mid 2008. ASIC is presently discussing even higher standards of PI with the insurance industry at present, with a view to such standards commencing in 2010.<sup>3</sup> *However as recently as August 2009, ASIC has recognised that PI remains a market-based solution which has a number of inherent limitations.* As indicated to the Joint Parliamentary Committee on Corporations and Financial Services in August 2009, ASIC believes that as a consumer protection mechanism, PI is limited by:

- (a) what the market is willing to underwrite, expressed in the terms of the insurance contract, for example:
  - (i) insurance policies do not generally cover fraud by the principal, as such coverage is considered to create a mechanism for the insured to profit through their fraudulent actions;
  - (ii) PI insurance may be unavailable if the licensee has breached the PI insurance contract e.g. by failing to notify claims;
  - (iii) PI insurance may be unavailable to the retail investor if the breach by the licensee (upon which the retail client's claim is based) is an identified exclusion under the policy; and
  - (iv) PI insurance is generally a claims-made insurance contract and generally only covers claims made during the term of the contract.
- (b) what the financial services industry can afford in relation to insurance premiums.<sup>4</sup>

### **1.1.3 Gaps in existing compensation schemes**

There are a number of existing compensation schemes such as the:

- The National Guarantee Fund is a compensation fund available to meet certain claims which arise from dealings with participants of the Australian Stock Exchange and, in limited circumstances, participants of the Australian Clearing House Pty Ltd. The NGF may pay compensation for the matters listed under the Corporations Regulations (see Part 7.5) including compensation for loss that results if a dealer transfers securities without authority.
- The Australian Stock Exchange Supplemental Compensation Fund is designed to deal with claims that arise from a client suffering a loss as a result of giving money or other property to a stockbroker and that money or property being misappropriated. Also covered is the situation where a client gives a stockbroker authority over property and there is subsequent fraudulent misuse of the authority by the stockbroker.
- The Financial Claims Scheme, introduced by passage of the *Financial System Legislation Amendment (Financial Claims Scheme and Other Measures) Act 2008 (Cth)* is intended to introduce a crisis management framework to assist deposit holders and policyholders in the event of the insolvency of a general insurer or deposit-holder. Compensation schemes such

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<sup>2</sup> [http://www.fido.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg126.pdf/\\$file/rg126.pdf](http://www.fido.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg126.pdf/$file/rg126.pdf)

<sup>3</sup> ASIC submission to the Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Financial Products and Services in Australia at 84:  
[http://www.aph.gov.au/senate/committee/corporations\\_ctte/fps/submissions/sub378.pdf](http://www.aph.gov.au/senate/committee/corporations_ctte/fps/submissions/sub378.pdf)

<sup>4</sup> ASIC submission to the Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Financial Products and Services in Australia at 83:  
[http://www.aph.gov.au/senate/committee/corporations\\_ctte/fps/submissions/sub378.pdf](http://www.aph.gov.au/senate/committee/corporations_ctte/fps/submissions/sub378.pdf)

as these leave a number of gaps, primarily because they only provide recourse to the clients of *some AFS licensees*.

**1.1.4 Summary of inadequacies in existing arrangements**

The following table summarises the existing compensation arrangements and any relevant inadequacies.

Compensation arrangement	Who does it protect?	Inadequacies
<b>Requirement that AFS licensees hold professional indemnity insurance in accordance with ASIC Regulatory Guidance.</b>	AFS licensees.  Retail clients do not have direct access to PI cover, except in very limited circumstances.  For further information, see Appendix E.	Even with strict guidance from ASIC, it is up to the PI market to determine whether it will offer run-off, how it will impose limits to aggregate claims, excess levels, what types of fidelity it will cover.  PI is a product provided on a commercial basis.
<b>Financial Claims Scheme</b>	Retail clients who hold a deposit or policy with a prudentially regulated entity that becomes insolvent and may not meet its obligations to retail clients.  For further information, see Appendix F.	The FCS only provides compensation for retail clients that have purchased <i>certain products</i> .  It does not provide protection for retail clients that have purchased other products, or have purchased a service such as personal financial advice.
<b>Existing compensation arrangements (e.g. NGF, SIS Compensation)</b>	Cover situations where clients have lost money or property through fraud or dishonesty.  For further information, see Appendix G.	They do not cover <i>all financial services</i> : relate primarily to stockbrokers and superannuation funds.  They do not cover insolvency, except in very limited circumstances.

**1.2 Are there other schemes that compensate consumers?**

Compensation schemes are already used extensively – both in Australia and overseas – to protect consumers from the risk that their claim will not be paid due to the insolvency of the firm they have claimed against.

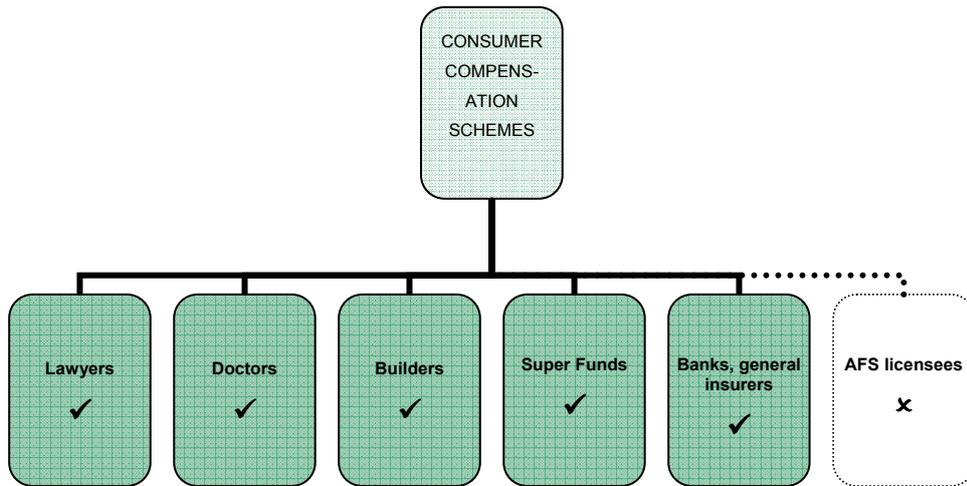
**1.2.1 Compensation schemes in other sectors of the Australian economy**

As indicated in Figure 1 below and the copy of the previous research contained in Appendix B, there are schemes in place to protect:

- the clients of lawyers in all States (for example, LawCover and Fidelity Fund in NSW);
- doctors (Health Care Liability schemes in NSW and Federal levels);
- builders (Home Warranty Insurance);
- stockbrokers (NGF);
- the members of superannuation funds under the SIS Act.

However there is no scheme in place to protect the retail clients of AFS licensees.

Figure 1



### **1.2.2 Financial services compensation schemes in United Kingdom and other countries**

There are a number of compensation schemes in place to protect consumers who deal with financial planners, insurance brokers and other financial advisors overseas, including in the United Kingdom, Canada and the United States (as indicated in Appendix B).

Research on the various international models of financial services compensation arrangements indicate that the United Kingdom scheme, *provides a relevant model for a compensation scheme in Australia to reduce the gaps in consumer protection.*

The UK scheme is:

- a centralised fund established by legislation and backed by a legislative requirement on authorised firms (similar to 'AFS licensees' in Australia) to hold PI;
- administered by the regulator, the Financial Services Authority;
- funded on an ongoing basis through levies on authorised firms; and
- available to individuals where an authorised firm is unable, or likely to be unable, to pay claims against it (insolvency).

The proposal for an Australian Financial Services Compensation Scheme contained in this Report is based to some degree on the UK scheme, although, as set out in Appendix H, there are also some important differences between the proposed Australian scheme and the scheme that exists in the UK.

## 2 What are the features and benefits of the Scheme?

### 2.1 Core features

#### Compensation

- The Scheme would cover key gaps left by the current protection regime, including the failure to pay in the event that an AFS licensee becomes insolvent. It would protect consumers in the event of fraud and misappropriated funds, in addition to negligence and other causes of action.
- Retail clients could receive compensation up to a portion of the EDR scheme limits. The proposed Scheme shares some important features with the UK scheme, but is also designed to meet the particular gaps in consumer protection and the specific regulatory environment in Australia. Appendix H contains the important points of difference between the Scheme and the UK scheme.
- Details on compensation are set out in Part 3 of this Report.

#### Funding

- All the establishment and operating costs, and compensation costs of the Scheme would be funded by all AFS licensees;
- Funding would be a mix of pre-funding and post-funding:
  - Each year the Scheme would set a levy to cover anticipated management costs and compensation costs. This component would be pre-funded.
  - Should additional funding be required, then the Scheme would have the power to impose a 'special compensation levy' to compensate retail clients for significant losses. This component would be post-funded.
- 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;
- 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.
- In addition, the Scheme would be assisted by way of a guarantee of very large compensation costs that exceed a percentage (notionally 1%) of AFS licensee revenue in any one year.
- A set of Rules (see Appendix C) would govern the level and nature of compensation and the circumstances in which it may be paid.
- 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.
- Details on funding are set out in Parts 5 and 6 of this Report.

#### Governance

- The Scheme would be industry-based. It would be operated by an independent body, governed according to its Constitution and by a Board of directors representing both consumers and industry.

**Regulatory framework**

- By an amendment to the regulatory framework, each AFS licensee that provides financial services to retail clients would be required to become a member of the Scheme, as part of the ‘compensation arrangements’ they are required to have to hold an AFS license.
- The Scheme would, by proposed amendment to legislation or regulations, be subject to approval by ASIC, in a similar manner to the existing requirement that EDR schemes are approved by ASIC.

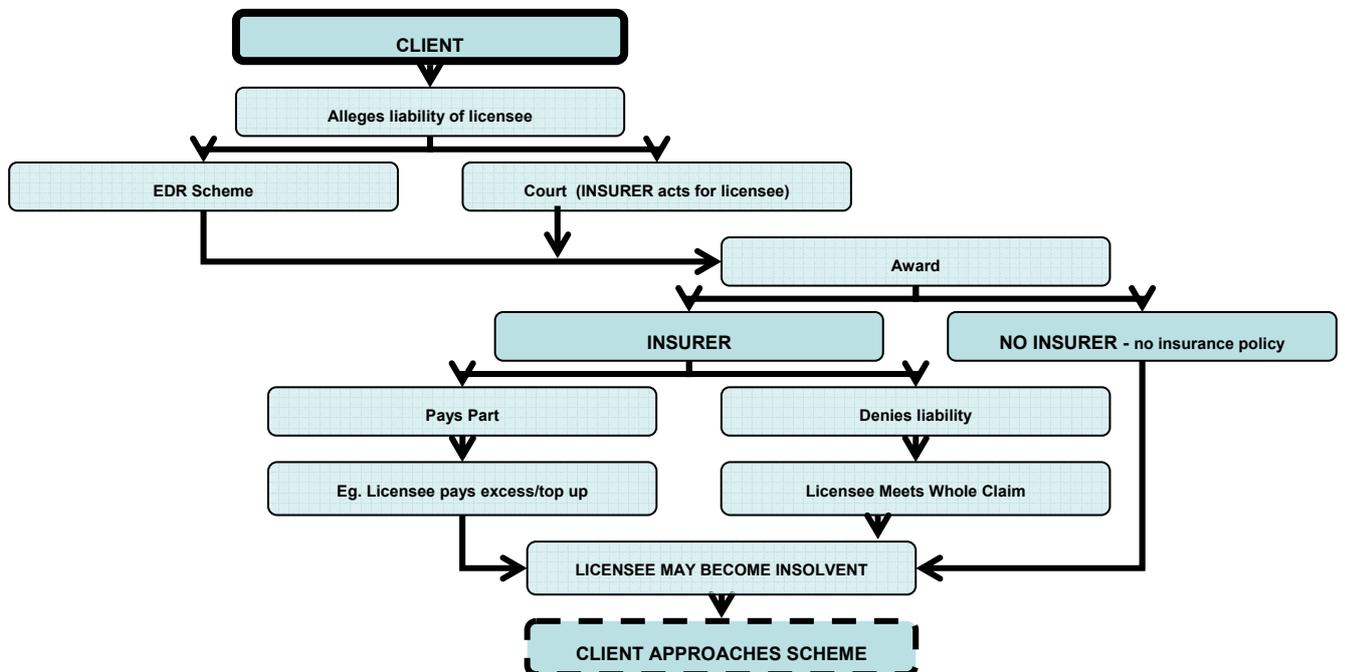
**Interaction between the Scheme and existing compensation mechanisms**

- The Scheme would provide compensation to some retail clients who may currently have access to compensation under the NGF and SIS Compensation. Careful consideration and consultation will be required to determine the extent to which the Scheme will potentially replace the need for those funds.
- The Scheme would develop an appropriate arrangement, such as a Memorandum of Understanding with the APRA-administered Financial Claims Scheme. For example, the Scheme may wish to make a claim to FCS funds if it has imposed a levy on an insolvent prudentially-regulated AFS licensee. In addition, the Scheme may require access to information held by the FCS in order to make a default determination about an AFS licensee.

**Interaction between the Scheme and EDR Schemes**

- The Scheme would not replace the need for EDR schemes. Rather, because it would ensure that most awards made by an EDR scheme were actually paid, it would underline the need for EDR Schemes and bolster consumer confidence in EDR schemes. The interaction between the Scheme, EDR schemes and PI insurance is set out in Figure 2.

**Figure 2**



## 2.2 Benefits of the Scheme

The Scheme would meet the objective of minimising the gaps in consumer protection by providing an affordable compensation mechanism for retail clients.

Benefit	Reasons
<b>Addresses key gaps in consumer protection</b>	<ul style="list-style-type: none"> <li>• Covers fraud and misappropriation of funds</li> <li>• Covers insolvent or missing AFS licensees</li> </ul>
<b>Accessible to retail clients</b>	<ul style="list-style-type: none"> <li>• Directly accessible by retail clients</li> <li>• Clear eligibility criteria</li> <li>• Measures in place to ensure those with low levels of financial literacy are aware it exists and can access it</li> </ul>
<b>Appropriate level of compensation</b>	<ul style="list-style-type: none"> <li>• Compensation aligned to EDR scheme jurisdiction, therefore meets retail clients' reasonable expectations of what level of compensation they might receive, even in cases of insolvency</li> </ul>
<b>Affordable for licensees and does not put upward pressure on prices</b>	<ul style="list-style-type: none"> <li>• Segment of industry that causes loss to retail clients pays the compensation within reasonable limits</li> <li>• Compensation costs above a certain level met by Federal Government guarantee</li> </ul>
<b>Provides incentive for risk management</b>	<ul style="list-style-type: none"> <li>• PI market encourages licensees to manage risks in order to obtain PI at an affordable premium</li> <li>• Benefit limits encourage retail clients to choose AFS licensee carefully – whilst the Scheme is aligned to the EDR award limits, the claimant may only receive part of their award</li> <li>• Does not create a moral hazard for regulators</li> </ul>
<b>Compatible with other compensation arrangements</b>	<ul style="list-style-type: none"> <li>• Supports, and does not attempt to replace EDR Schemes</li> <li>• Supplements the requirement that non-prudentially regulated AFS licensees hold PI insurance</li> <li>• Can operate in parallel with the Financial Claims Scheme</li> <li>• Could remove the need for multiple fidelity schemes – eg. NGF.</li> </ul>
<b>Developed by consumers and industry through their representation on the FOS Board</b>	<ul style="list-style-type: none"> <li>• Stakeholder ownership. Initiation of External Dispute Resolution schemes in 1990s demonstrated that industry engagement can improve culture of risk management inside AFS licensees.</li> </ul>
<b>Industry-based: governed by independent corporate entity, the Board of which comprises representatives of industry and consumers.</b>	<ul style="list-style-type: none"> <li>• Independent from regulators yet standards and/or oversight provided by ASIC.</li> <li>• Independent from industry, while funded by industry and industry represented on Board.</li> <li>• Independent from consumer groups, while consumers are the beneficiaries of the Scheme and consumer groups are represented on the Board.</li> </ul>

Benefit	Reasons
Allows for regulatory oversight by ASIC within an industry-based structure	<ul style="list-style-type: none"> <li>• Approved by ASIC or meets criteria to be set by ASIC.</li> <li>• The success of EDR schemes demonstrates the strength of this model of an industry-based scheme, which meets the high standards set by the financial services regulator.</li> <li>• As with EDR schemes ASIC could provide guidance on the independence of the scheme.</li> </ul>

### 2.3 Risk minimisation measures

The Scheme has been designed to minimise the risks that are associated with compensation schemes.

Potential risk	How the Scheme minimises risks
That AFS licensees could exercise less caution or even become willing to engage in fraud in the knowledge that retail clients will be compensated by the Scheme.	<ul style="list-style-type: none"> <li>• The existence of a Scheme would not change the legal liability of the AFS licensee. The retail client will approach the relevant EDR scheme or court to obtain a determination in their favour.</li> <li>• The Scheme is designed to address this potential ‘moral hazard’ so that the retail client will <i>only be partially compensated</i> by the scheme.</li> <li>• The Scheme would sit within, and add a final yet fundamental element to the existing consumer protection measures that are imposed upon AFS licensees.</li> </ul>
That if retail clients know they have recourse to a compensation fund, they will not be as careful as they would otherwise be when selecting an AFS licensee.	<ul style="list-style-type: none"> <li>• The Scheme would reduce this potential risk because it caps the maximum benefit that a retail client may claim. The retail client will <i>only be partially compensated</i> by the scheme.</li> <li>• The Scheme encourages retail clients to exercise proper caution when obtaining financial services as the Scheme would not be available for all types of financial losses. For example, it does not cover any claim to the extent that it relates to the mere fluctuation in the value of an investment or the failure of investment performance to match a guarantee made by an AFS licensee.</li> </ul>
That some AFS licensees might take steps, such as corporate restructuring, to avoid paying levies.	<ul style="list-style-type: none"> <li>• The Scheme would be funded by levies.</li> <li>• Both <i>minimum</i> and <i>maximum</i> levies apply.</li> <li>• The minimum levy could be set very low, at say \$250 to ensure that the Scheme is affordable for small AFS licensees.</li> <li>• The maximum levy would be set by the Scheme in its discretion at a point that would reduce the incentive for large AFS licensees to restructure their corporate or licensing arrangements to avoid a large levy.</li> </ul>

## 3 How would the Scheme work for consumers?

The Scheme would operate in accordance with the Scheme Rules (a discussion version of which is contained in Appendix C) and would govern:

- When and how the Scheme would compensate retail clients;
- The level of compensation available from the Scheme;
- Governance of and reporting by the Scheme;
- Rejection of application and withdrawal of offer of compensation;
- Timing and method of payment of compensation; and
- Transitional matters.

### 3.1 *When may the Scheme pay compensation?*

It is intended that there be five key elements to a successful claim to the Scheme:

- (a) The claimant must be a retail client;
- (b) The claim must be against an AFS licensee (or an authorised representative of an AFS licensee) that has agreed to pay levies to the Scheme;
- (c) The claimant must have received a determination in their favour by:
  - (i) an EDR scheme;
  - (ii) a court or tribunal of competent jurisdiction; or
  - (iii) a trustee in bankruptcy, liquidator or any other recognised insolvency practitioner;
- (d) The determination must relate to the provision of a financial service no more than six years prior to the commencement date; and
- (e) The Scheme has declared that the AFS licensee or an authorised representative of an AFS licensee is in default, meaning that they are unable or likely to be unable to satisfy at least one claim against it. The Scheme may form this view if:
  - (i) the body corporate is insolvent;
  - (ii) the individual is bankrupt; or
  - (iii) the AFS licensee or authorised representative cannot be contacted at its last place of business and reasonable steps have been taken to establish a forwarding or current address, but without success.

### 3.2 *How much would the Scheme pay?*

There are suggested limits on the level of compensation that the Scheme pays contained in Rule 6.2 of the Rules in Appendix C. Proposed limits are set by reference to FOS limits of financial jurisdiction.

These suggested limits will require further consideration and consultation with stakeholders to ensure workability and equity. Careful consideration will need to be given to the limits applicable to income stream products.

An example of the operation of the Scheme compensation limits is set out below.

Scheme Rule 6.2 (discussion version of the Scheme Rules – see Appendix C)	Example Claim 1 \$100,000	Example Claim 2 \$180,000	Example Claim 3 \$300,000
On up to the first \$120,000 a payment of 90% will be paid	90% of \$100,000 = \$90,000	90% of \$120,000 = \$108,000	90% of \$120,000 = \$108,000
On the excess over \$120,000 and up to a total claim made amount of \$200,000 – a further 70% of this amount	Plus nil in this case	Plus 70% of \$60,000 = \$42,000	Plus 70% of \$80,000 = \$56,000
On the excess over \$200,000 and up to a total claim made amount of \$280,000 – a further 50% of this amount.  Nil on any amount over \$280,000	Plus nil in this case	Plus nil in this case	Plus 50% of \$80,000 = \$40,000  Nil on the last \$20,000
<b>Total Claim Amount Payable</b>	<b>\$90,000</b>	<b>\$150,000</b>	<b>\$204,000 (the maximum possible claim payment)</b>

### 3.3 Does the Scheme cover Fraud?

The Scheme would cover fraud. It is important that the Scheme cover fraud because there are two key gaps in existing consumer protection measures:

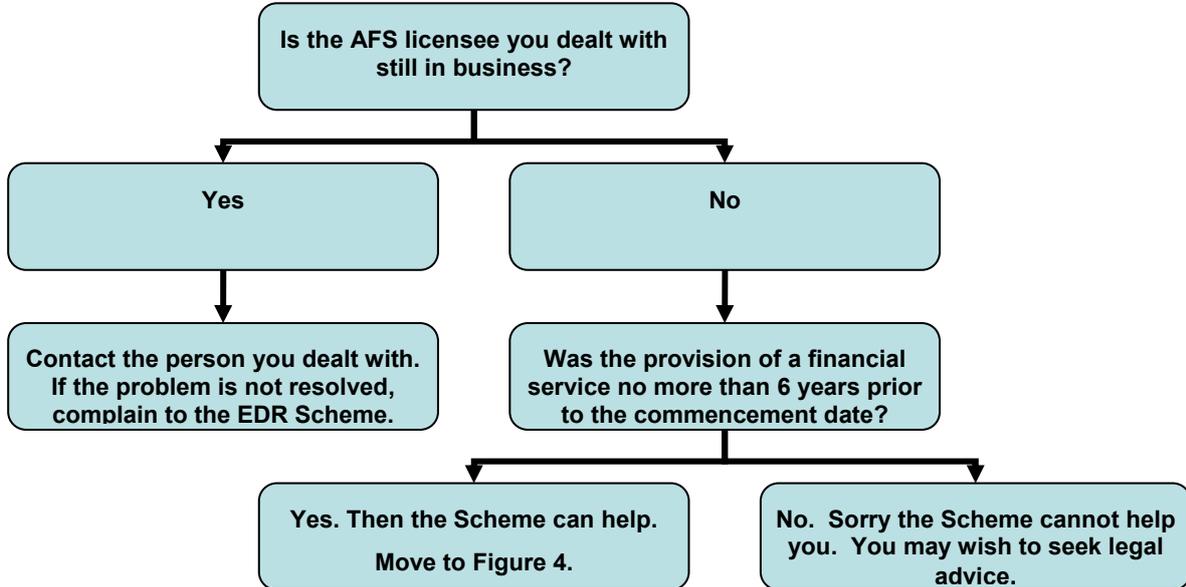
- (a) Although AFS licensees are required to hold PI insurance, PI insurance does not, and is very unlikely to ever, extend to fraud by the principal of an AFS licensee. Fraud by the principal is a risk that cannot be shifted to the insurance market.
- (b) Although there are several compensation schemes that operate as fidelity funds in the financial services sector, they have a narrow application, applying primarily to stockbrokers and futures dealers. Critically, they do not provide any measure of protection to the vulnerable retail clients of other financial service providers, such as financial planners.

It is not intended that the Scheme would make determinations on fraud. Rather, a claimant would require a court or EDR scheme award with respect to the fraud.

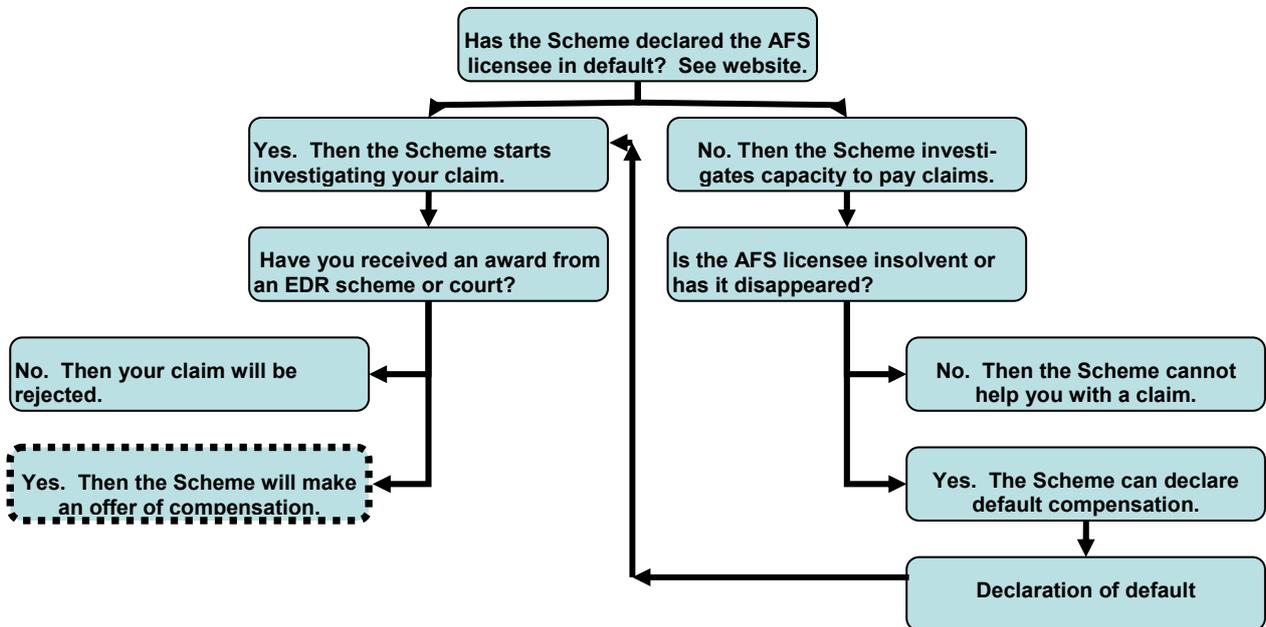
**3.4 How would a consumer make a claim?**

Figures 3 and 4 are flow-charts indicate the various matters which a retail client would need to consider prior to making a claim.

**Figure 3**



**Figure 4**



## 4 How much would the Scheme cost?

### 4.1 *Estimates of the costs of the Scheme*

As part of the ongoing consultation with the Federal Government on the Scheme, preliminary estimates have been prepared of:

- Compensation costs for an 'average' year;
- Potential Year 1 costs likely to be incurred in establishing and operating the Scheme.

Importantly, these estimates are based on claims data and other advice from FOS, covering the period from 1 January 2006 to 30 June 2008.

#### 4.1.1 *Issues with the UK as a source of cost data*

As part of preparing these estimates, consideration was given to using the United Kingdom costs experience as a basis for estimating what the Australian Scheme might cost. Considerable research was undertaken into the UK scheme. This included obtaining a significant body of data about the compensation and operating costs of the UK scheme, as well as a meeting with the UK scheme to assess the comparability of the two compensation schemes.

The UK scheme and proposed Australian Scheme are not comparable schemes for the purposes of cost estimates because:

- Claims costs differ because the UK scheme covers a wider scope of claims (both prudentially and non-prudentially regulated) than proposed for the Australian Scheme;
- The organisational structure of the UK scheme is more expensive as the UK scheme does not accept determinations about the quantum of compensation claimed by UK's EDR scheme (the UK FOS), whereas the Australian Scheme would;
- It is more expensive to do business in UK than Australia;
- Australia's industry based scheme will be less expensive than a statutory scheme; and
- It is more useful to use an approach based on Australian information.

Further differences between the two schemes are set out in Appendix H.

### 4.2 *Compensation Costs for an average year*

It is estimated that in an average year, the Scheme would receive:

- Claims of \$12 million per annum; and
- Claim numbers of 180 per annum.

Based on data on awards to retail clients made in respect of member of FOS, AFS licensees, whose memberships were terminated in the period 1 January 2006 to 30 June 2008 and were identified as having entered insolvency, the data shows:

- 78 awards of an average amount of \$65,000;
- Anecdotal evidence from FOS senior management of a further 70 claims for which no specific data was recorded.

- FOS estimates that it receives about one third of all claims.<sup>5</sup>

While the above may represent the 'average' outcome, additional modelling work has been done to test the affordability of significantly higher levels of potential payments. Appendix I uses the FOS data and its knowledge of Westpoint claims. The total assumed payments in this example is almost 3 times higher than the 'average' figure above.<sup>6</sup>

### **4.3 Year 1 Establishment and Operating Costs**

It is estimated that establishment and operating costs in Year 1 would total some \$2.3 million comprising:

- One-off set up costs of \$1.1 million; and
- Operational costs of \$1.2 million.

These estimates cover establishment and operating costs such as:

- Expert input to establish the Scheme infrastructure covering legal, accounting, IT and actuarial;
- Board oversight;
- Chief Executive Officer plus a core staff of 6 people; and
- Other operational costs such as travel, accommodation, staff recruitment and training.

These estimates assume that the Scheme would be operational for six months in Year 1. While work can commence on establishing the legal documents and IT systems quickly, it would be some six months before the operational environment would be in place, and there would be 6 months of actual operational costs incurred during Year 1.

These estimates have been developed using information provided by FOS. Whilst the UK scheme has been given consideration in the preparation of these cost estimates, it is not a comparable scheme for the reasons set out in Part 4.1 above.

The estimates assume leverage offered by FOS, for a fee, covering provision of space in existing FOS premises, accounting, telephony and some IT support.

The following part describes how the funding model would operate including the levy required to meet the above initial and ongoing costs and claim payment amounts.

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<sup>5</sup> For example, FOS has advised that its analysis of Westpoint claims shows FOS received some 33% of the total Westpoint claims.

<sup>6</sup> PFS also undertook what could be viewed as stress testing, using a scenario requested by Treasury earlier this year. The total potential payments under this scenario are again much higher than in the Westpoint example. The detailed results of this are contained in a PFS letter to Treasury of 6 March 2009.

## 5 How would industry pay for the Scheme?

### 5.1 Outline of funding arrangements

The funding requirements, as described in the previous part, arise from a need to meet either payments in respect of accepted claims or to cover the costs to establish and operate the scheme.

The proposed Scheme is to operate as an industry-based scheme. It is proposed that industry, that is all AFS licensees, will be responsible for funding payments in respect of approved claims. Similarly, once up and running, industry will also meet the operating costs. It is also proposed that the Federal Government provide some support for the Scheme.

Source of Funding Support	Cost	Timing of funding
<b>AFS licensees</b>	Establishment costs in Year 1	Borrowing. Principal and interest met through Year 1 levy.
<b>AFS licensees</b> Levied as a percentage of each AFS licensee's revenue	Ongoing operating costs including interest on any borrowings	Pre-funded. Levied at the beginning of a financial year for projected management costs for that year.
<b>AFS licensees</b> Levied as a percentage of each AFS licensee's revenue	Standard costs of compensating claimants	Pre-funded. Levied at the beginning of a financial year for projected standard compensation costs for that year.
<b>AFS licensees</b> Levy limited to a certain percentage of AFS licensees' revenue	Significant costs of compensating claimants where the Scheme has declared a default	Post-funded. Levied as required, for as many years as necessary.
<b>Federal Government</b>	Compensation costs in excess of limits on 'special compensation levy'	Required only if compensation is so high that AFS licensees' liability exceeds cap (notionally 1% of annual revenue).

Funding by AFS licensees is discussed in this Part 5 and proposed Government funding is discussed in Part 6.

### 5.2 How would a levy on AFS licensees be set?

The costs of compensating retail clients would be wholly funded by AFS licensees in 'layers' of funding.

The Scheme would be funded by AFS licensees pursuant to an agreement that they enter into with the Scheme (see Discussion Version Heads of Agreement in Appendix D to this Report).

An economic model of the compensation scheme was developed in order to test its affordability for the industry, or parts of the industry, that may meet the cost of compensating retail clients. The economic model is based on the core features of the Scheme set out in Part 2 of this Report.

The levy is dependant on the size of the amount to be funded, however, it is also dependent on the revenue base over which it is spread.

Any levy structure needs to balance the competing concerns to keep the levy 'affordable' (requiring a wide levy-paying group) and to target the group to which the 'responsible' AFS licensee belonged (which may reduce how wide the levy-paying group may be).

A detailed explanation of the economic model and the basis of allocating costs between the various AFS licensees are contained in Appendix I. *This appendix covers the limitations in the use of the data and the resulting levy rates on which it is based.*<sup>7</sup>

Each AFS licensee:

- Is licensed to conduct business in one or more financial products e.g. general insurance etc;
- Provides limited financial data to ASIC each year including its aggregate revenue for the previous year pursuant to a Funding Agreement with the Scheme (see Appendix D). Revenue is not identified for each financial product or product group i.e. only a single aggregate revenue figure is available.

### **5.2.1 Framework within which the levy would be set**

Where an event occurs which gives rise to claim payments, a levy, as a percentage of revenue, can be determined using one or more of the following parameters:

- Identify those AFS licensees which may advise on the financial products that have given rise to a claim. This sub group may be used to meet a proportion of the claim payment costs;
- All AFS licensees may be levied a proportion of the claim payment costs;
- A dollar minimum levy amount;
- A dollar maximum levy amount;
- The levy may be calculated based on funding the required amount for one or more years; and
- More than one levy may operate at a time, if required.

The above provides significant flexibility in managing different claim payment scenarios.

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<sup>7</sup> See also PFS letter to the Department of Treasury dated 6 March 2009.

### 5.5.2 Implications of the maximum levy

Under the proposed rules one of the variables the Scheme may set is a maximum levy as a percentage of the revenue of AFS licensees. In addition it may also cap the levy from any licensee at a maximum dollar amount.

A consequence of capping levies using a maximum dollar amount is that it would redistribute part of the cost of funding any levies away from large AFS licensees towards medium and small AFS licensees. The dollar cost and the percentage of revenue paid by small AFS licensees are both larger if the dollar levy cap for large AFS licensees is reduced.

For example, if the levy is 1% of revenue with no maximum for individual AFS licensees, then funding from one of the biggest institutions of up to 1% of \$20 billion in revenue, or \$200 million from this licensee could be available if a compensable event of very large magnitude occurred. However if a maximum of say \$10 million is applied to the levy any one licensee can be expected to pay, the amount that could be raised by a levy on this licensee will be no more than \$10 million, and in effect the smaller AFS licensees would bear additional levy costs because of the dollar cap.

The levy in Section 5.3 below uses a relatively low dollar maximum cap of \$150,000 per annum. This is in the context of funding \$14.3 million in an 'average' year. In addition to estimating the claims for compensation that the compensation scheme would receive in an 'average' year we have also 'stress tested' various other scenarios to establish how affordable a larger levy would be for AFS licensees.

For example, our economic modelling indicates that if the compensation scheme received notice of \$200m in claims in Year A required to be funded over three years, and a further \$100m in the following year which was also required to be funded over three years, then this would give rise to a maximum levy of just over 1% of AFS licensee revenue during the three funding years.<sup>8</sup>

However, modelling the same scenario but using a \$ maximum annual cap of \$500,000 p.a. reduces the maximum levy from just over 1% p.a. to 0.335% p.a.

### 5.3 How would the levy on AFS licensees work in Year 1?

Using the estimates set out in Part 4 of the Report, the costs to be borne by AFS licensees in Year 1 can be summarised as follows:

- \$12 million in claim payments;
- \$1.1million in one-off set-up costs
- a further \$1.2 in operational costs of the Scheme, that is, \$14.3 million in total; and

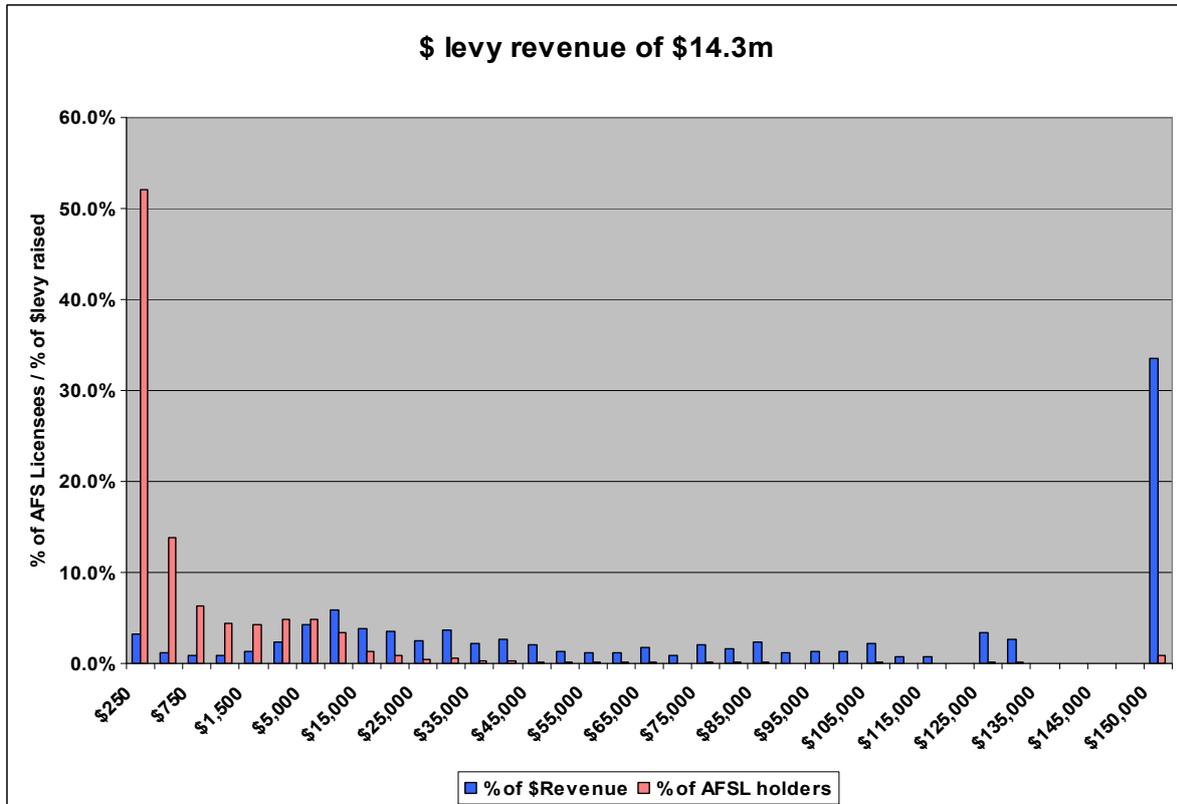
The parameter values used to calculate a levy of \$14.3 million are:

- The levy applies to the whole industry;
- \$250 minimum levy per annum;
- a \$150,000 maximum; and
- A single levy applies for one year.

<sup>8</sup> This assumes that the levy applies to the whole industry, that the minimum levy would be \$250 per annum, the maximum levy would be \$150,000 per annum and that a single levy applies in one year. This figure is also based on AFS licensee revenue as reported to ASIC. Data appears to have been 'double reported' to ASIC, and therefore the levy percentage expressed here are understated.

The calculated levy, as a percentage of the 2007 revenue of AFS licensees is 0.023% of revenue.

The incidence or spread of the levy among AFS licensees is illustrated in the following graph.



The graph illustrates that a significant proportion of all AFS licensees (52% or 1,830 licensees) are small business which are expected to pay the minimum annual levy. The total raised is under \$0.5 million..

Correspondingly, a very small proportion of AFS licensees (just under 1% or 32 licensees) are large business which are expected to pay over \$4.8 million or over 33% of the total levy amount to be raised.

As mentioned in Part 4, modelling has been done to examine how the levy may vary with different levels of claim payments. Appendix J contains additional examples of potential levy rates to fund different levels of claim payment.

## 6 How could Government support the industry-based Scheme?

The proposed Scheme would be an industry-based scheme, which would be underpinned by legislative and financial support from the Government.

### 6.1 Amendment to regulatory framework

It is proposed that:

- all AFS licensees that provide financial services to retail clients would be required to become a member of the Scheme, in order to meet the obligation to have 'compensation arrangements'; and
- the Scheme be subject to approval by ASIC, in a similar manner to the existing requirement that EDR schemes are approved by ASIC.

Just as an AFS licensee is required to become member of an approved EDR scheme, so too would AFS licensees be required to become a member of the Scheme, subject to its approval by ASIC.

One way to achieve this addition to the existing regulatory framework may be to amend Corporations Regulation 7.6.02AAA.

Such an amendment could provide that:

- the requirement contained in the *Corporations Act 2001* (Cth) to have compensation arrangements is subject to the requirement that, in addition to holding adequate PI insurance, AFS licensees participate in a compensation scheme;
- the compensation scheme must comply with standards set by ASIC or be approved by ASIC.

### 6.2 Supplementary support through a Government guarantee

Each AFS licensee may only be levied up to a levy limit (notionally 1% of revenue), which the Scheme would set at its discretion.

When a segment of the industry reaches that percentage of revenue, then the balance of the industry will be levied.

When all AFS licensees have been levied up to the levy limit, then further compensation costs will need to be met in another financial year and/or met with assistance from the Federal Government as discussed in Part 6.

A levy that would exceed 1% of AFS licensee revenue would trigger the need for the Federal Government to contribute to funds in excess of 1% of AFS licensees' revenue.

For example, if the annual revenue for all AFS licensees were \$70 billion and the Government chose to guarantee compensation costs above 1% of uncapped AFS licensee revenue, then this guarantee would be called upon only if compensation costs exceeded \$700 million. However, the Scheme has been designed to minimise the possibility of a call on any Government guarantee.

There are a number of variables within the discretion of the Scheme which would provide the Scheme with the means to distribute the levy so as to reduce or eliminate the need to call on Federal Government assistance in this scenario. Importantly, this includes the ability to extend

the funding period past one year, so that it becomes less likely that the compensation costs for any one year reach 1% of uncapped AFS licensee revenue.

There are a number of precedents for the Federal Government providing assistance to an industry to meet catastrophic claims events. For example, the *Medical Indemnity Legislation Amendment Act 2005* (Cth) established a regime whereby there could be an appropriation of Consolidated Revenue for the purpose of meeting Exceptional Claims Scheme (that exceed their insurance of \$20 million).

The Australian Reinsurance Pool Corporation provides a useful comparison. Insurance companies which write eligible insurance contracts may reinsure through ARPC the risk of claims for eligible terrorism losses. Premium income continues to build ARPC's first layer of funds available to cover claims from declared terrorist incidents. The pool is supplemented by a bank line of credit of \$1 billion, underwritten by the Commonwealth (funded by the premium pool), as well as a Commonwealth guarantee of \$9 billion.

## 7 Conclusion

This Report proposes a compensation scheme for the retail clients of AFS licensees in Australia. It has been updated and revised to reflect consultation with the Federal Government to between January and September 2009.

The Scheme is intended to meet a key risk to consumers: that they will not receive payment of awards made by EDR schemes or courts if an AFS licensee becomes insolvent or disappears.

While industry-based, the Scheme, and the consumers it is intended to protect, would benefit from support from the Federal Government, both in the form of AFS licensee requirements and a last resort guarantee.

The Scheme would provide the final, yet fundamental, element of consumer protection measures to protect retail clients in financial services.

## Appendix A – Financial Ombudsman Service

Independent dispute resolution services for the vast majority of Australian banking, insurance and investment disputes are now available under one roof. On 1 July 2008, the Banking & Financial Services Ombudsman (BFSO), Financial Industry Complaints Service (FICS) and Insurance Ombudsman Service (IOS) merged to form the national Financial Ombudsman Service. The Credit Union Dispute Resolution Centre (CUDRC) and Insurance Brokers Disputes Limited (IBD) became, respectively, the Mutuals and Insurance Broking divisions of the Financial Ombudsman Service on 1 January 2009. FOS dispute resolution services are free to consumers.

This independent umpire provides free, fair and accessible dispute resolution for consumers and some small businesses unable to resolve a dispute directly with their financial services provider. External dispute resolution processes can help to resolve disputes through negotiation or conciliation as an alternative to court proceedings and can make decisions which are binding on participating financial services providers.

The FOS helps to increase public awareness and access to external dispute resolution processes for consumers by providing a single national service for banking, insurance and investment disputes in Australia. Membership of the Financial Ombudsman Service is open to any financial services provider carrying on business in Australia.

FOS independent dispute resolution processes cover complaints about financial services including:

- Banking;
- Credit;
- Loans;
- General insurance;
- Life insurance;
- Financial planning;
- Investments;
- Stock broking;
- Managed funds; and
- Pooled superannuation trusts.

The merging of separate schemes to establish the Financial Ombudsman Service follows calls for greater accessibility and public awareness. Merging of these schemes enables efficient use of resources, cross-fertilisation of expertise and more accessible dispute resolution processes

## **Appendix B – Melzan Report on Compensation Funds**

This Appendix comprises the preliminary research undertaken by Melzan Insurance Consulting on international compensation funds and design options for an Australian compensation scheme.

Please request a copy of this report from FOS, should you require one.

# Appendix C – Scheme Rules – Discussion Version

## Introduction

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 of 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 of a 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 Dispute Resolution Scheme</i> ('EDR')	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.
<i>retail client</i>	is any person who at any material time was a retail client, as defined in Chapter 7 of the <i>Corporations Act 2001</i> (Cth).
<i>Scheme</i>	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 the 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; or

### **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 proceeding 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>

### 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.

#### 6.3.1 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.

### 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 D - Heads of Funding Agreement – Discussion Version

### 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*)).

### 2. Objective

The *Scheme participants* intend to agree to:

- (a) comply with the *Scheme Rules*;
- (b) fund the costs of 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 Federal Government will provide the funding required to establish the *Scheme*;
- (b) 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 for the general funding pool (as set out in Part 5); and
- (c) 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 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>Consideration will need to be given to how the establishment costs of the <i>Scheme</i> will be met.</p>
<p><b>5.3 Statement of business</b></p>	<ul style="list-style-type: none"> <li>(a) The <i>participant</i> will provide the <i>Scheme</i>, by the end of [month], with a statement of: <ul style="list-style-type: none"> <li>(i) classes to which it belongs;</li> <li>(ii) the total amount of business which it conducted in the previous financial year in relation to each of those classes, being revenue.</li> </ul> </li> <li>(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].</li> <li>(c) The <i>Scheme</i> will provide guidance to <i>participants</i> on the data required, so as to avoid double-counting of revenue, such as that paid in commissions to authorised</li> </ul>

	representatives.
<b>5.4 Management expenses levy</b>	<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 revenue as disclosed in their statement of business.</p>
<b>5.5 Standard compensation levy</b>	<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 business-as-usual 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 [scheduled percentage/dollar amount] 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 total revenue as disclosed in their statement of business.</p>
<b>5.6 Special compensation levy</b>	<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</p>

	<p>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 class in proportion to the amount of compensation costs arising from, that class up to the levy limit of that class.</p> <p>(c) Any excess above the levy limit of the class must be allocated to each other class whose levy limit has not been reached ('<i>general funding pool</i>'), in proportion to the relative sizes of the levy limits of those remaining classes in the <i>general funding pool</i>.</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 class to which the activity relates.</p>
<p><b>5.7 Classes of participant</b></p>	<p>(a) The <i>participant</i> may belong to more than one class.</p> <p>(b) The <i>Scheme</i> has an absolute discretion to determine which class or classes will be levied for any particular default;</p> <p>(c) The classes of <i>participants</i> are:</p> <ul style="list-style-type: none"> <li>Class 1 – Derivatives</li> <li>Class 2 – Deposit and Payment Products</li> <li>Class 3 – Foreign Exchange Contracts</li> <li>Class 4 – General Insurance</li> <li>Class 5 – Securities</li> <li>Class 6 – Managed Investment Schemes</li> <li>Class 7 – Life Insurance Products</li> <li>Class 8 – Managed Investment Schemes – timeshare only</li> <li>Class 9 – Superannuation</li> <li>Class 10 – Miscellaneous Financial Investment Products</li> </ul> <p>(d) The <i>Scheme</i> may amend these classes from time to</p>

	time as it sees fit.
<b>5.8 Levy limits for each class of participant</b>	<p>(a) The levy limits for each class of <i>participants</i> are to be 1% of revenue.</p> <p>(b) The <i>Scheme</i> may, in its discretion, determine the levy limits for each class 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> <ul style="list-style-type: none"> <li>(i) the claims experience of that class;</li> <li>(ii) the revenue of that class, as a proportion of the total revenue of all classes; and</li> <li>(iii) the class which the <i>Scheme</i> is responsible for anticipated significant compensation costs.</li> </ul>
<b>5.9 Levy limit for the general funding pool</b>	The levy limit for the <i>general funding pool</i> is 1% of revenue. This is the maximum percentage that <i>participants</i> can be asked to contribute to the <i>Scheme</i> in any one financial year.
<b>5.10 Calculation of the special compensation levy</b>	<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 class or each of the classes to which the <i>participant</i> belongs;</li> <li>(ii) identifying the compensation costs to each of the classes of <i>participants</i>;</li> <li>(iii) calculating, in relation to each class, the <i>participant's revenue</i> as a proportion of the total <i>revenue</i> of all <i>participants</i> in the same class, using the statement of business; 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 class, the <i>Scheme</i> will add the <i>revenue</i> for each class at step (iii)</p>
<b>5.11 New and former participants</b>	<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>

<b>5.12 Method and timing of payment</b>	<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 the 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>	<p>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.</p>
<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 class of participants as it deems fit; or</li> <li>(b) reduce the levy that is imposed on all participants or a class 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>	<p>The <i>Scheme</i> will appoint an auditor in accordance with the <i>Scheme Rules</i>.</p>
<b>5.17 Dispute resolution</b>	<p>An agreed process for resolution of disputes</p>
<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 E - PI insurance provisions

Section 912B of the *Corporations Act 2001*(Cth) ('Act') provides that:

'(1) If a financial services licensee provides a financial service to persons as retail clients, the licensee must have arrangements for compensating those persons for loss or damage suffered because of breaches of the relevant obligations under this Chapter by the licensee or its representatives. The arrangements must meet the requirements of subsection (2).

(2) The arrangements must:

(a) if the regulations specify requirements that are applicable to all arrangements, or to arrangements of that kind - satisfy those requirements; or

(b) be approved in writing by ASIC.'

The regulations made under the above sections are contained in the Corporations Regulations 2001 ('Regulations') from reg 7.6.02AAA.

These regulations provide:

- (a) that the requirement to have compensation arrangements is subject to the requirement that AFS licensees hold adequate PI insurance; and
- (b) that prudentially regulated deposit-taking institutions, general insurers and life insurers are exempt from the requirement that AFS licensees hold adequate PI insurance.

ASIC has provided guidance for AFS licensees on 'Compensation and Insurance Arrangements' under Regulatory Guide 126. This outlines ASIC's policy for administering the above arrangements and commenced in July 2008.

ASIC provided guidance on what amounts to 'adequate' PI with respect to the following matters:

- Insurer
- Amount of cover
- Scope of cover
- Terms and exclusions
- Excess/Deductibles
- Runoff

In the alternative, an AFS licensee may apply to ASIC to have its 'alternative arrangements' to PI insurance approved by ASIC.

ASIC plans to impose more stringent standards for what amounts to 'adequate' PI commencing January 2010. ASIC continues to consult with the PI industry on this matter.

## Appendix F - Financial Claims Scheme

### Financial Claims Scheme

In mid October 2008, the Federal Government introduced and passed the *Financial System Legislation Amendment (Financial Claims Scheme and Other Measures) Act 2008*.

The FCS Act is intended to introduce a crisis management framework to assist deposit holders and policyholders in the event of the insolvency of a general insurer or deposit-holder.

#### General insurance policyholders

The FCS Act provides a compensation scheme for eligible policyholders if a general insurer fails. The FCS Act features a Policyholder Compensation Facility which will be administered by the APRA.

The following classes of policyholders will be eligible to claim compensation:

- individuals who have insured against risks in Australia with an APRA-regulated general insurer;
- small businesses (those with an annual turnover of less than \$2 million);
- certain family trusts; and
- Australian-based non-profit organisations.

APRA will determine claims. Claims will be assessed solely by reference to the policy's terms and conditions.

Where APRA pays compensation, the claimants rights will be transferred to APRA and APRA may recover in the liquidation process.

A levy is to be imposed on general insurers where the assets of an insolvent general insurer do not cover the costs of the Policyholder Compensation Facility and its administration. The details will be prescribed in regulations.

The levy amount will not exceed 5% of the gross premiums received by a general insurer.

#### Deposit holders

The FCS Act enables APRA to pay holders of accounts and other selected financial products with insolvent ADIs the net credit balance of those accounts and products.

These benefits are not automatic: they will only apply if the Treasurer declares that the FCS applies to a particular ADI.

If the FCS applies to an ADI then the holder of an account is entitled to receive the net credit balance of their protected account plus accrued interest. Regulations may prescribe limits on the amount payable but the Government's recent announcements indicate that there is no intention to impose a limit until 2011.

Unlike the general insurance arrangements, *both* corporations *and* individuals may apply. Claimants need not be Australian residents.

There is a limit of \$20 billion per ADI.

A levy is to be imposed on ADIs to help fund the FCS. The details will be prescribed in regulations.

The levy paid by an ADI cannot exceed 0.5% of the ADIs liabilities to its depositors.

## Appendix G – Existing Australian compensation schemes

	<b>National Guarantee Fund</b>	<b>ASX Supplemental Compensation Fund</b>	<b>SIS Compensation</b>
<b>Purpose</b>	Provides compensation in various situations including to clients of failed ASX stockbrokers who have entrusted property to the broker and in cases of unauthorised transfer of securities (Division 4 of Part 7.5);	Compensation for retail clients who entrusted property to a stockbroker who have trading permission to deal in futures, claims where client suffers loss due to misappropriation or fraudulent misuse of property	Losses suffered from fraudulent conduct or theft  Covers regulated super funds and approved deposit funds
<b>Legislation</b>	<i>Corporations Act 2001</i> <i>National Guarantee Fund Act 1987</i>	<i>Corporations Act 2001</i>	<i>Superannuation Industry (Supervision) Act 1993</i>
<b>Exclusions</b>	Loss arising from: <ul style="list-style-type: none"> <li>investment decisions</li> <li>a Dealer failing to act to buy or to sell</li> <li>Money lent to a dealer</li> <li>Conduct by an entity other than the specified entity which is the Dealer</li> <li>Alleged unauthorised withdrawal or misappropriation by the Dealer</li> <li>Individual derivatives contracts or futures</li> </ul>	'Excluded persons' are not able to make a claim. These include the Dealer, a spouse, relative etc  Loans to the Dealer are not covered	Self-managed funds and exempt public sector funds
<b>Administration</b>	Securities Exchanges Guarantee Corporation Limited, statutory trustee, subsidiary of ASX	Claims Review Panel of the Australian Stock Exchange Limited	Trustee applies to the Minister for a grant of financial assistance
<b>Funding</b>	Minimum fund of \$80M set  Original funding from merge of state fidelity funds  Investment income  Potential to apply levy or borrow funds  Net assets currently under management of \$96.8 million	Minimum fund of \$2M  Potential to apply levies	Consolidated Revenue  Levy funded as a percentage of fund assets, post funded

**Financial Services Compensation Scheme**

	<b>National Guarantee Fund</b>	<b>ASX Supplemental Compensation Fund</b>	<b>SIS Compensation</b>
<b>Compensation Limits</b>	Unlimited	<p>\$1,000,000 for fraudulent misuse or defalcation of money or property by a single market participant.</p> <p>\$1,000,000 from any series of claims arising out of the same set of circumstances.</p> <p>\$100,000 for any one claimant arising out of a single set of circumstances.</p>	Minister's determination.
<b>Time Limits</b>	<p>Claim to be made within 6 months unless otherwise set by SEGC.</p> <p>3 months to appeal disallowed claims.</p>	Claim to be made within 6 months unless otherwise set.	Nil.

In addition, there is an obligation on the operators of other financial markets on which the trades of retail clients are executed to have compensation arrangements (Division 3 of Part 7.5). These arrangements are required to cover fraud and defalcation by brokers on these markets

## Appendix H – UK and proposed Australian Scheme comparison

Feature	United Kingdom – Financial Services Compensation Scheme (UK scheme)	Australia – proposed Financial Services Compensation Scheme ('compensation scheme')
<b>Scope of cover</b>	Covers claims in relation to all financial services, including claims relating to products offered by firms that are prudentially regulated (such as deposit-taking institutions, general insurers, life insurers).	Unlike the UK scheme, the Australian compensation scheme does not need to cover claims with respect to deposits and general insurance products because they are covered by the Financial Claims Scheme ('FCS').
<b>Caps on compensation</b>	Up to £50,000 depending on the nature of the financial service.	Suggested payment limit of up to \$204,000 depending on financial service and subject to consultation with stakeholders. This payment would be a percentage of the total claim – a retail client who receives EDR or court award of \$280,000 or above could receive only \$204,000 from the Scheme.
	By comparison Financial Ombudsman Service of the UK limit is £100,000.	By comparison, Australian Financial Ombudsman Service limit is generally \$280,000.
<b>Funding</b>	Levies applied to firms authorised by the Financial Services Authority ('FSA').	Unlike the UK scheme, levies imposed by the Scheme not the regulator.
	Levies are imposed on that part of the industry responsible for a default. Where default is large, compensation costs will be borne by all authorised firms.	Levies applied to AFS Licensees that participate in the Scheme.  Like the UK scheme, at first instance, higher levies applied to that part of the industry responsible for a default. Where default is large, compensation costs will be borne by all AFS licensees.
	Claims are pursued with solvency practitioners where there is a likely payout.	Like the UK scheme, the compensation scheme will have the power to seek to take assignments and pursue recovery of funds in the winding up of an AFS licensee.
<b>Default declarations</b>	UK scheme declares firm in 'default' where they are unable or likely to be unable to satisfy at least one claim against it.	Like UK scheme, Australian compensation scheme would declare AFS licensee in 'default' where they are unable or likely to be unable to satisfy at least one claim against it.

Feature	United Kingdom – Financial Services Compensation Scheme (UK scheme)	Australia – proposed Financial Services Compensation Scheme ('compensation scheme')
<b>Governance</b>	UK scheme is governed by a body which forms part of the UK financial services regulator (FSA).	Unlike the UK scheme, the Australian compensation scheme would be a non-profit industry-based scheme governed by an independent Board comprising representatives from industry and consumers.
<b>Relationship to EDR</b>	The UK scheme is separate from the UK Financial Ombudsman Service (UK FOS).	The Australian compensation scheme would be independent from EDR schemes, yet a close relationship with FOS promises financial leverage benefits.
	Authorised firms required to contribute to both EDR and FSA through levies imposed by the regulator.	As in the UK, in Australia the financial services industry would effectively fund the EDR and compensation schemes (although levies collected by industry from an industry-based scheme rather than the regulator).
	Does not recognise quantum of awards made by UK FOS (although it does recognise decisions on liability) – reconsiders facts and UK scheme makes its own decision.	Unlike the UK scheme, the Australian compensation scheme would require a claimant to obtain an award from an EDR scheme or a court prior to seeking compensation through the compensation scheme.
<b>Relationship to regulator</b>	UK scheme was set up under the <i>Financial Services and Markets Act 2000</i> (FSMA), and is funded by levies imposed by the regulator (FSA).	Unlike the UK scheme, the compensation scheme is independent from the regulator (ASIC) although it will be approved by or will meet standards set by ASIC.
<b>Recoveries</b>	UK scheme has power to step into shoes of claimant and seek recovery of compensation paid to claimant in winding-up proceedings.	Like the UK scheme, the Australian compensation scheme would have the power, with consent, to step into shoes of claimant and seek recovery of compensation paid to claimant in winding-up proceedings.

# Appendix I – Explanation of Economic Model and Data

## Data Collection – Total Industry Data

FOS has taken steps to source data from various industry associations and government regulatory bodies to identify potential sources of useable data.

Industry wide information was made available by ASIC. This data covered the three financial years ending on 30 June 2005, 2006 and 2007. The information, for each AFS licensee in Australia, covered certain basic data. The data was de-identified by ASIC using a unique identifier for each AFS licensee was provided, and not the actual AFS licensee number. The information remains confidential and the property of ASIC. Only aggregate results are contained in this model.

Some analysis of the ASIC data was carried out to verify the quality of the data set. Some data integrity issues were identified, with the major issues addressed through discussion with ASIC. While a useable data set was then available, there are limitations on the modelling work able to be undertaken due to the nature of the limited data collected by ASIC.

Some of the observations on the data are relevant to understanding and interpreting the modelling results. Examples of key data available and certain limitations in how the data may be used include:

- (a) Revenue for each financial year. Revenue is a single figure representing the aggregate amount across all products and areas of advice i.e. there is no segmentation of data available. Also the aggregate revenue for all AFS licensees when combined was broadly twice the size expected. Based on our investigation and further discussions with ASIC, it was agreed that AFS licensees, who are insurers, also included premiums as part of their reported revenue. The levy rates calculated by the model are, therefore, lower than would otherwise be the case if there was no such 'double counting'.
- (b) Products that each AFS licensee is licensed to provide. This information is in the form of a variable list. The comment above on revenue taken together with this product list is one of the major constraints on the modelling work. It is not possible to identify a specific \$ revenue amount and associate it with a particular product or type of advice. However, this issue has been partly addressed. See below for further information.
- (c) Type of advice each AFS licensee may provide e.g. retail, wholesale. Each AFS licensee was also categorised by whether it was licensed to provide retail, wholesale or retail and wholesale advice, or if they were not licensed to provide advice at all.

## Initial Data Analysis

Results based on the three years of data 2005 -2007	
Type of Advice	Market Share
General Financial advice	18.3%
Financial Advice	75.2%
Wholesale Advice	4.5%
No advice	2.0%

**Results based on the three years of data 2005 -2007**

Type of Client AFS licensee licensed to provide advice to	Market Share
Retail (Only)	1.9%
Wholesale (only)	10.1%
Retail and Wholesale	88.0%
No advice	n.a.

**Modelling Industry Wide Data having regard to data constraints**

One of the modelling outcomes is the calculation of a levy based on a percentage of revenue where the percentage may be specific to an industry segment and/or to the whole financial services industry.

Revenue is not available as a product specific dollar amount. However, in the event of a claim, the specific product or products that gave rise to a claim may be identified. For example, if a claim arose relating to a general insurance matter, the model can be easily configured to identify all AFS licensees who are licensed to provide advice in any of the general insurance product sets. The actual revenue used is the total revenue for each of these identified AFS licensees. This provides a basis on which a levy may be calculated.

While the revenue identified above is not product specific, it is specific to all AFS licensees who are licensed to conduct business in the affected product space.

If implemented, the Scheme may wish to consider putting in place a data collection arrangement that addresses the inadequacies of the current data, in order to improve the operation of the Scheme.

**Data Collection – Industry wide claims**

It is important to note that the proposed compensation scheme has no predecessor, and so there is no actual claims experience to be analysed. However, the last several years of claims data from FOS has been provided. This gives relevant information on a range of claims made, claims paid and claims outstanding or dismissed.

Importantly, the FOS data also identifies certain “systemic” claims issues, for example, Westpoint which is examined later in the report. A further data item for each claim is the “principal product”. This may be used to help identify the corresponding products provided under an AFS license. The AFS licensees who may operate using this product set would become the target revenue on which the levy is based as described above.

The combination of a set of claims, and an identified AFS license product set allows a levy to be calculated, as both a claim amount and the revenue base that may be used to set the levy.

## Appendix J – Examples of Economic Model

This Appendix sets out the outputs from the economic model based on two examples of use of the economic model. Limitations on the levy calculations as a result of the revenue data are discussed in Part 4.<sup>9</sup>

### 1 Levy calculations for an average year

The first example uses the costs set out in Part 5.3. The parameter values used to calculate a levy to support raising \$14.3 million are:

- The levy applies to the whole industry;
- \$ 250 minimum levy p.a.
- \$150,000 maximum levy p.a.
- A single levy applies for one year.

The calculated levy, as a percentage of the 2007 revenue of AFS licensees is 0.023% of revenue.

The actual model output is on the following page.

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<sup>9</sup> See PFS letter to Treasury of 6 March 2009

## Financial Services Compensation Scheme

Amount to be funded	
Fund <i>Either</i> Retail or Aggregate amount	<b>Retail</b>
Retail Claim	\$382,900,000
Retail recovery (after rules)	\$300,860,000
Aggregate amount =	\$41,000,000
Claim Event triggers funding requirement =	\$14,300,000
less any recoveries from	
* AFSL directly	\$0
* AFSL via PI insurance	\$0
* FCS process	
Payment to be funded from AFSL holders	\$14,300,000
	\$ Min      \$ Max
Tier 1: Minimum \$ levy pa	\$0      \$250,000
Tier 2: Maximum \$ levy pa	\$250      \$150,000

Funding Rules	
Pre Funding \$amount	
Target level of pre-funding	0.0%
Amount to be funded	\$0
Fund over no. of years =	3
Tier 1. % raised directly from "claim groups" i.e.	0.0% \$0
Tier 2. Balance raised from all AFSL Holders	\$0
Check \$ minimums work...	
Tier 1 \$ Min - OK	Use Tier 2 \$ Min of -\$000,001

Funding Rules	
Post Funding \$amount	
Target level of post-funding %	100.0%
Amount to be funded =	\$14,300,000
Fund over no. of years =	1
Tier 1. % raised directly from "claim groups" i.e.	0.0% \$0
Tier 2. Balance raised from all AFSL Holders	\$14,300,000

Calculate levy & review Analysis below

Analysis of levy revenue		Pre funding levy tier 1 ( \$000,000 )				Pre funding levy tier 2 ( \$000,000 )				Levy as a % of Revenue pa		
		Levy Revenue	% of \$Revenue	No of AFSL holders	% of AFSL holders	Levy Revenue	% of \$Revenue	No of AFSL holders	% of AFSL holders	Tier 1	Pre Funding	Post Funding
From	To <=											
\$0	\$0	\$0	0.0%	0.0	0.0%	\$0	0.0%	0.0	0.0%	Tier 1	0.000%	0.000%
\$0	\$250	\$0	0.0%	0.0	0.0%	\$0	0.0%	0.0	0.0%	Tier 2	0.000%	0.023%
\$250	\$10,000	\$0	0.0%	0.0	0.0%	\$0	0.0%	0.0	0.0%			
\$10,000	\$50,000	\$0	0.0%	0.0	0.0%	\$0	0.0%	0.0	0.0%			
\$50,000	\$100,000	\$0	0.0%	0.0	0.0%	\$0	0.0%	0.0	0.0%			
\$100,000	\$149,999	\$0	0.0%	0.0	0.0%	\$0	0.0%	0.0	0.0%			
\$150,000	\$150,000	\$0	0.0%	0.0	0.0%	\$0	0.0%	0.0	0.0%			
\$150,000	\$250,000	\$0	0.0%	0.0	0.0%	\$0	0.0%	0.0	0.0%			
Total Raised =		\$0	0.0%	0.0	0.0%	\$0	0.0%	0.0	0.0%			
Analysis of levy revenue		Post funding levy tier 1 ( \$000,000 )				Post funding levy tier 2 ( \$14,300,000 )						
From	To <=	Levy Revenue	% of \$Revenue	No of AFSL holders	% of AFSL holders	Levy Revenue	% of \$Revenue	No of AFSL holders	% of AFSL holders			
\$0	\$0	\$0	0.0%	0.0	0.0%	\$0	0.0%	0.0	0.0%			
\$0	\$250	\$0	0.0%	0.0	0.0%	\$457,500	3.2%	1830.0	52.1%			
\$250	\$10,000	\$0	0.0%	0.0	0.0%	\$2,395,167	16.7%	1469.0	41.8%			
\$10,000	\$50,000	\$0	0.0%	0.0	0.0%	\$3,115,207	21.8%	139.0	4.0%			
\$50,000	\$100,000	\$0	0.0%	0.0	0.0%	\$2,129,804	14.9%	29.0	0.8%			
\$100,000	\$149,999	\$0	0.0%	0.0	0.0%	\$1,402,322	9.8%	12.0	0.3%			
\$150,000	\$150,000	\$0	0.0%	0.0	0.0%	\$4,800,000	33.6%	32.0	0.9%			
\$150,000	\$250,000	\$0	0.0%	0.0	0.0%	\$0	0.0%	0.0	0.0%			
Total Raised =		\$0	0.0%	0.0	0.0%	\$14,300,000	100.0%	3511.0	100.0%			

## 2 Levy Calculations for Westpoint

Using several years of data from the FOS claims database, the following examples set out how the Scheme would have met compensation costs for Westpoint through industry levies.

### Example A – Using the Scheme to compensate unpaid Westpoint claimants

This example relates to the FOS members (being AFS licensees) against whom FOS made Westpoint awards but were not paid. It assumes that AFS licensees who were licensed to provide advice on investment products would be selected as the group to fund those claims. This group includes product sets such as all Managed Investment Schemes (excluding the MIS for horse racing syndicates) and Investment Life Insurance Products. The minimum dollar amount to be levied against each AFS licensee is \$250. The maximum levy has been set at \$150,000 to keep it consistent with other example levy calculations.

Total Claims	No. of Claims	Total Value of Claims after applying Claims Payment Rules
\$2.4m	37	\$2.2m
<b>RESULT</b>	<b>A levy of 0.003% of annual revenue of those AFS licensees who were licensed to provide advice on investment products.</b>	

### Example B – Using the Scheme to compensate all Westpoint claimants

If the Scheme were required to pay all of the Westpoint claims referred to FOS, not just those which were not paid, then that example would create the following profile:

Total Claims	No. of Claims	Total Value of Claims after applying Claims Payment Rules
\$41.0 million	425	\$32.5 million
<b>RESULT</b>	<b>A levy of 0.24% of annual revenue of those AFS licensees who were licensed to provide advice on investment products.</b>	

This model enables FOS to test scenarios based on a snapshot of data from ASIC from 2005, 2006 and 2007 financial years. If established, the Scheme will need to develop an operating system which would have to be supported with data collected from AFS licensees and from ASIC.

If the above \$32.5 million was to be levied across the whole financial services industry, the resulting levy is 0.09% of revenue.

### Detailed explanation supporting the above Westpoint Examples

The data captured by FOS identified those Westpoint claims which, having been assessed, either have not been or appear unlikely to be paid by the relevant FOS member i.e. by the AFS licensee. There are 37 such claims. The worked examples below are based on the Westpoint claims data and the revenue for all AFS licensee who offered advice in the product areas which gave rise to the Westpoint claims. The levy process is also described below.

**FOS Summary of Westpoint Claims**

The data analysed covered the period 1 January 2006 to 30 June 2008. During this period the number and value of claims were:

Claim Size		No. of claims	Total Value of Claims
From	To		
\$0	\$20,000	18	\$177,249
\$20,000	\$30,000	14	\$347,725
\$30,000	\$50,000	129	\$5,792,018
\$50,000	\$70,000	64	\$3,725,355
\$70,000	\$120,000	107	\$10,347,650
\$120,000	\$150,000	35	\$5,002,703
\$150,000	\$200,000	28	\$5,058,980
\$200,000	\$250,000	4	\$939,230
\$250,000	\$350,000	13	\$3,713,675
\$350,000	\$500,000	11	\$4,634,528
\$500,000	\$1,000,000	2	\$1,224,006
<b>Totals</b>		<b>425</b>	<b>\$40,963,120</b>

Of the above claims, the 37 previously referred to above had the following characteristics:

Claim Size		No. of claims	Total Value of Claims
From	To		
\$0	\$20,000	0	\$0
\$20,000	\$30,000	1	\$23,260
\$30,000	\$50,000	19	\$860,130
\$50,000	\$70,000	3	\$173,298
\$70,000	\$120,000	13	\$1,192,900
\$120,000	\$150,000	1	\$145,000
\$150,000	\$200,000	0	\$0
\$200,000	\$250,000	0	\$0
\$250,000	\$350,000	0	\$0
\$350,000	\$500,000	0	\$0
\$500,000	\$1,000,000	0	\$0
<b>Totals</b>		<b>37</b>	<b>\$2,394,588</b>