Practical PI considerations for financial advisers

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Anthony Anastasio ● Director ● Everest Risk Group

"[Advisers] should enquire as to whether the prospective new professional indemnity insurer offers retrospective cover."

Anthony Mangafas ● Senior associate ● William Roberts Lawyers

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Overview

Professional indemnity (PI) insurance covers the cost of potential claims and disputes arising from a third party alleging a breach of professional duty. PI cover is mandatory for virtually all holders of an Australian financial services licence that deal with retail clients under the *Corporations Act 2001*.

ASIC in its Regulatory Guide 126 *Compensation and insurance arrangements for AFS Licensees* stipulates the minimum requirements for PI insurance including: the amount of cover, scope of cover, exclusions and persons covered.

Learning objectives

After reading this article, you should be able to:

› explain the purpose of PI insurance

› outline the factors affecting PI premiums

› discuss the common areas of misunderstanding in relation to PI insurance

› raise key questions to ask insurance brokers in relation to PI insurance.

Overview of PI Insurance

Professional indemnity (PI) insurance is designed to protect the insured against legal costs and damages brought by third parties alleging a breach of professional duty. The ramifications of a claim against a business can be significant and long lasting, regardless of the extent of the actual breach, or even if there was no proven definite breach at all.

Possible impacts on the business include loss of reputation, disruption to business operations, legal costs and liquidation.

PI insurance covers “pure economic loss” only and should not be confused with commercial general liability (CGL) insurance, which covers damage to property and personal injury as well as economic loss. Whether a PI policy or CGL policy responds to the claim will depend upon the particular circumstances. PI insurance generally covers individuals working in a “professional” capacity. However, in some cases it may cover non-professionals who are deemed to have provided advice that is professional in nature.

William Roberts Lawyers’ senior associate, Anthony Mangafas, explained that PI cover is typically limited to the activities provided for in the Australian financial services (AFS) licence.

“It’s certainly not uncommon for an authorised representative to take out a professional indemnity insurance policy even when the licensee has taken out a professional indemnity insurance policy under which the authorised representative is covered,” he said.

“In the event of a claim, the question will be whether the alleged act, error or omission falls under the professional indemnity policy held by the licensee or the policy held by the authorised representative”.

Within the realm of financial advice, arrangements for compensationis a compulsory requirement under section 912B (“Compensation arrangements if financial services provided to persons as retail clients”) of the *Corporations Act 2001* (Corporations Act). Applicants for an AFS licence that have retail clients must confirm that they have adequate PI insurance cover in place at the time of making the application.

PI insurance for financial advisers is regulated under ASIC’s Regulatory Guide 126 *Compensation and insurance arrangements for AFS licensees* (RG126), republished in August 2017. RG 126 provides guidance on how ASIC administers the compensation requirements under section 912B of the Corporations Act.

The objective of this insurance is to ensure that all losses suffered by clients as a result of misconduct or inappropriate advice made by AFS licensees or their representatives, can be paid.

Everest Risk Group’s director, Anthony Anastasio, explained the purpose of PI Insurance as a compensation and consumer protection mechanism.

“Ironically PI Insurance is there to protect the interests of the licensee and its representatives rather than the consumer,” he said.

Anastasio added that the insurer has the right to take control of the legal aspects of defending a claim which is of considerable benefit to the licensee.

“So if the client decides that the advice they received wasn’t correct or in their best interests and they bring a claim, the insurer will step into the shoes of the licensee and defend the claim,” he said.

Importantly, not only will it provide cover to the end consumer if [the adviser is] found to be responsible for negligent advice, it will also provide defence cost cover which is a really important aspect of the cover. Defence costs can range even for a very run of the mill claim from $20-30,000, all the way up to millions of dollars if the claim gets into a very large protracted dispute.”

Minimum cover requirements

RG 126 provides guidance on the minimum requirements for PI insurance cover, and states at 126.54:

We consider that, to be adequate, a PI insurance policy must have a limit of at least $2 million for any one claim and in the aggregate for licensees with total revenue from financial services provided to retail clients of $2 million or less. For licensees with total revenue from financial services provided to retail clients greater than $2 million, minimum cover should be approximately equal to actual or expected revenue from financial services provided to retail clients (up to a maximum limit of $20 million).

Further, an allowance for defence costs must be provided over and above this, so that at least the minimum amount remains available to compensate clients and is not consumed by legal costs.

Quicklink

To download RG 126, visit www.asic.gov.au:

› Select “regulatory resources”

› Under “Find a document”, select “Regulatory guides”

› Select “View full list” and scroll to “RG 126 Compensation and insurance arrangements for AFS licensees.

Claims-made insurance

PI insurance is written on a “claims-made” basis, meaning that the insured must have a policy in force on the date the insured first becomes aware that a claim is being made, not on the date of the event as is the case with insurance written on a “claims-occurring” basis. PI claims can become quite complex if significant time has elapsed between the event and the claim associated with it.

Run-off cover

Run-off cover provides advisers with continuing PI cover for a period of time after their circumstances change, for instance, if they leave the industry, change licensees or apply for their own AFS licence. While run-off cover is not mandatory under current legislation it is crucial for maintaining continuity of coverage.

When changing licensees, it is prudent for an adviser to obtain confirmation from their old licensee that they will be covered for the work they undertook while authorised under their licence.

Factors affecting PI premiums

Every insurer has a range of questions it asks of PI policy applicants to suit its own purposes and underwriting appetites. Factors guiding PI insurance premiums include, but are not limited to:

- licensee revenue
- competency and experience of management and advisers
- level of excess and required limit of indemnity
- complaints and claims history
- what is on the approved product list (APL)
- investment allocation
- amount of funds under advice
- types of advice offered
- an organisation's culture.

Licensee revenue

According to Anastasio, licensee revenue is a key driver of the overall premium charged.

"Obviously, the larger the licensee, the larger the commensurate premium to cover that exposure," he said.

Competency and experience of management and advisers

Anastasio noted that insurers will seek to gauge the expertise of a firm's management and advisory teams as well as compliance systems in place.

"They will want to see there's a demonstrated expertise in the management staff and the advisers. Obviously, they don't like [it if a firm has] a whole bunch of advisers who have just started out in the industry. As a general rule, they'll want to see that they've got the adequate mentors and other senior people in the organisation that could lead them through that advice piece and provide that best interests test for their clients," he said.

Level of excess and required limit of indemnity

As with all insurance policies, the level of excess and required indemnity nominated by the insured will affect the premium.

"Regulatory Guide 126 will delineate what the limit should be and the types of cover that the licensee needs to purchase to make it a compliant policy," Anastasio said.

Complaints and claims history

According to Anastasio, a business's complaints and the claims history is always a considerable driver of premiums.

"The insurers will expect the odd complaint, but it's more about understanding that if there's a complaint in a certain area [from a third party] that the business will address it in their everyday workings. The complaints register is a really key document. It really has to be maintained by the practice and constantly managed and updated," he said.

APL content

The nature of the APL, what it contains and the authorisations on the business's AFS license will provide a risk profile scenario from which insurers can underwrite.

Investment allocation

Anastasio explained that underwriters look for diversification with no significant exposure to any one investment product.

"The investment allocation — the underwriters want to see a good spread of investment. They don't necessarily want to see the advisers putting every single client in the same investment category because you'll want a diversified strategy," he said.

"A more diversified strategy is a more defensible strategy for the insurance company should, for example, another GFC hit and a certain allocation of investment does tank."

Amount of funds under advice

A larger amount of funds under advice necessarily means that a business has a commensurate risk exposure and will, therefore, attract higher PI premiums from insurers.

Types of advice offered

The types of advice offered by a financial advice business, and disclosed to the insurer, will affect the PI premiums it pays. For instance, margin lending typically increases the amount of premium charged as, by its nature, it increases risk exposure.

An organisation's culture

Anastasio highlighted the importance of company culture to underwriters when setting premiums.

"[It's about] ensuring that the culture of an organisation dictates an advice-driven model and that the best interests tests are always at the front of mind when the advisers are giving that advice to their clients," he said.

Consider

Historically, PI rates have been more attractive to larger dealer groups than smaller advice businesses. However, Anastasio observed that there has been a trend among insurers to view standalone licensees as more desirable due to a perception of tighter compliance processes and the ability of the insured to exercise greater direct control over business operations.

"The larger the dealer group gets, the more difficult it is to push that supervision and control and audit process through a large number of ARs, all sitting geographically in different spots of Australia," he said.

"So, as a result, they're becoming a bit less desirable than the standalone licensee that may have under 10 advisers. The smaller practices, between half a million to a million dollars [in revenue] can achieve perhaps a better premium rate than some of the larger dealer groups that have had a less desirable claims history as a result of that lack of control.

"In the PI space, there are actually fewer insurers that will provide cover to a dealer group than a standalone licensee. You're really left with a handful of players in Australia and some overseas [groups underwritten at] Lloyds to provide cover. So, as a result, that dealer group space is quite finite."

Common types of PI claims

The types of claim covered by PI insurance policies range from those arising from bad investment advice including advising consumers to invest in risky and complex instruments through to failing to properly effect financial transactions, improperly managing funds and more recent scenarios such as social engineering.

These claims can include allegations of negligence, breach of statutory duty, breach of contract, breach of fiduciary duty, and misleading and deceptive conduct.

Switching clients between products

Anastasio highlighted that when an adviser recommends that a client switch from one life insurance product to another, it is crucial to explain the full details and features of the product, such as terms around pre-existing conditions. It should also be noted that ASIC has specifically stated that switching must necessarily be covered under PI policies.

“When changing a client from product A to product B, it’s really vital that the client understands the features of product B over product A and that the client isn’t inadvertently accepting pre-existing conditions cover under the second product,” he said.

“[For instance], if the client had a back injury 10 years ago that the current cover is covering but the new cover doesn’t, it’s really important it is documented that the client has accepted that that risk is no longer covered and that the advantages of the new product in other facets outweigh the fact that the back injury is no longer covered. We find that when product changes are made, large claims can occur because of those incidences.”

Misleading and deceptive conduct

Misleading and deceptive conduct is a common type of claim, particularly when an investment fails to perform in the manner that the client expected. Anastasio explained that it is crucial for the adviser to take the time to properly prepare statements of advice (SOAs).

“It’s really important that in the statement of advice, the planner really delineates why they’ve taken the client on a certain journey, that all the advice is documented in the SOA and the client actually understands where they’re going with this investment,” he said.

“[This includes] file notes about the conversations you’ve had, not just burying it somewhere in a statement of advice. So really trying to educate the client on the strategy you’ve put in place for them so they understand it. The more they understand it the more they’ll be prepared to accept fluctuations in the market.”

Case study 1

Claim against financial adviser for misleading and deceptive conduct and failure to advise

The insured financial adviser provided financial advice to their client in relation to an investment through the use of a margin loan. Six months later, the client issued a letter of demand advising that they had suffered a loss following the recommendations made by the insured. The client alleged misleading and deceptive conduct on the part of the insured and failure to advise.

The client issued a complaint with the Financial Ombudsman Service (FOS) seeking restitution of the amount of the shares. The shares were quantified to total approximately $60,000.

The claimant was adamant about pursuing a claim in the Supreme Court in the event that FOS did not make a determination in its favour. The costs of defending the claim would soon outweigh the true value of the claim.

Accordingly, a commercial approach was adopted and the claim was eventually settled, with the insured agreeing to pay the claimant the amount of $35,000 plus costs.

Source: Everest Risk Group

Case study 2

Claim against financial adviser for failure to advise

The insured received a letter of demand from their client seeking compensation for the amount of $105,000 plus costs flowing from the financial advice provided by the insured financial adviser regarding their client's investment in certain products recommended by the insured. The client alleged that the insured failed to provide a detailed explanation of the products including any risks associated with the products in its SOA.

The insured denied the allegations and solicitors were appointed by the insurer to assist with the defence of the claim. The insured conceded that it may not have diligently provided the correct information to its client, but maintained a defence that the client was a seasoned investor and would have been aware of the risks of investing.

The insured maintained this defence, and the claim was settled at mediation for 50% of the original claim plus costs.

Source: Everest Risk Group

Fraud and dishonesty

Anastasio noted that fraud and dishonesty continues to be a problem in the industry, particularly for dealer groups.

"It's really vital that licensees monitor their staff and have adequate checks and balances [in place] when they're bringing new advisers into the firm to ensure that they come from reputable backgrounds," he said.

Online scams

According to Anastasio, one of the most prominent forms of new claim is around online scams by hackers.

“Advisers are receiving what they believe are email instructions from their clients to make an investment exit or to transfer funds into certain accounts. But … it’s hackers, typically from overseas criminal syndicates, putting through spoofed emails which appear to come from the client but are essentially from a hacker directing them to transfer funds into the hacker’s account,” he said.

“We’ve seen those claims range from as little as $50,000 all the way up to a quarter of a million dollars in our portfolio of clients. It’s really important that financial advisers are made aware of these kinds of claims and that they verify instructions to transfer funds with a telephone call to their client, rather than just acting on the email alone.”

Conversations with brokers around PI cover

Financial advisers should always interview any potential insurance broker to ensure they are in a position to make a well-informed decision as to what cover is most appropriate for them.

Key considerations for advisers when discussing PI cover with brokers include:

› whether they have prior experience working with advisers,

› policy exclusions

› how the excess is levied

› external dispute resolution (EDR) scheme awards

› other forms of insurance that may be relevant.

Experience working with financial advisers

Anastasio highlighted the advantages of engaging an insurance broker who is experienced in working with PI cover for financial advisers.

“Financial advisers’ PI isn’t like other PI policies. It is very bespoke. There’s only a finite number of insurers that do it, so you’re really better off sticking with specialists that understand your industry and understand how you do business,” he said.

“They can adequately convey that to the insurance market and obtain the relevant information that can make your practice stand out versus the run of the mill practices that may not have the same level of checks and balances that yours does. So by employing the right insurance broker you should get a better result.”

Policy exclusions

It is prudent for advisers to be fully aware of points in their risk profile that may interact with the insurance policy and trigger exclusions in order that they can be managed.

How the excess is levied

Anastasio noted that some inferior policies levy the excess per claimant rather than per claim, which greatly increases costs when a claim is made.

"[For instance], if you have 100 claimants all affected by the same piece of investment allocation and they all come to you at once making a claim, paying 100 excesses could essentially bankrupt a small financial practice," he said.

"Therefore, it's really important that … if a claim stems from the same event, that the claim is only paid once rather than several times per customer."

EDR scheme awards

RG 126.54 stipulates that under the minimum requirements for PI policies, EDR scheme awards must be adequately covered. However, Anastasio noted that this is not necessarily the case for all policies.

"We're seeing some policies which may sublimit the EDR to say half a million dollars per policy period which goes against what the legislation says where you must have an adequate sublimit for the policy period. If there's more than one customer affected by only having one sublimit, it cannot be right for the customer," he said

Other forms of relevant insurance

Mangafas suggested that when discussing PI cover with brokers, financial advisers should also enquire about other forms of insurance that may be of benefit to them.

"Other forms of insurance may really be relevant to the financial adviser's business. Insurance such as property damage and business interruption insurance, public liability insurance, cyber insurance, employer's liability insurance, and directors and officers liability insurance," he said.

Common areas of misunderstanding

PI insurance is a particularly complex area of the financial advice administrative process. Common areas of misunderstanding in relation to PI cover include potential gaps in cover when providing investment advice, what "claims made" actually means, compliance issues, ensuring defence costs are covered and changing insurers.

Potential gaps in cover when providing investment advice

According to Mangafas, Financial advisers engaging in investment management activity, such as MDAs [managed discretionary accounts], can potentially find themselves with a gap in PI cover.

"The key consideration there for an independent financial adviser is to ensure that they're aware of the differences between investment advisory services and investment management services because those two types of services are different," he said.

“Fundamentally, an independent financial adviser really needs to ensure that their professional indemnity insurance policy covers them for all of their financial activities.”

Consider

Given that PI insurance cover is claims-made in nature, it must cover not only current business activity, but also those in which the business has previously engaged. For instance, a financial advice business may not have advised on MDAs for a number of years but a claim could still be potentially lodged against such a legacy business.

What does “claims made” actually mean?

Anastasio observed that financial advisers often misunderstand what the claims-made nature of a PI insurance policy actually means.

“Professional indemnity is very different to, for instance, public liability insurance. A public liability insurance program will set the loss at the time the injury occurs. So if an injury occurred five years ago, it would be the policy that was in force five years ago that responds to the claim,” he said.

“PI policies are different in that it’s the policy in force at the time the claim is made that responds. So, as a result of that, it’s vital that advisers tease out at the time of renewal any kind of potential circumstance, complaint or otherwise that they believe could perhaps manifest into a claim in future periods of insurance. Without doing that, you can find yourself in a grey spot of cover.”

Types of claims

Mangafas explained that financial advisers are often confused by what their PI insurance covers them for and the types of claims their clients are able to make.

“There are a variety of different types of claims brought against financial advisers which are covered under professional indemnity insurance policies. They include claims for compensation arising out of, for example, bad investment advice, including risky and complex instruments, like derivatives and managed investment schemes; claims for failing to properly effect financial transactions as instructed; and claims for failing to properly manage funds,” he said.

“A lot of these claims generally include allegations of negligence, breach of statutory duty, breach of contract, breach of fiduciary duty and misleading and deceptive conduct.”

Ensuring defence costs are covered

Anastasio noted that many licensees appear to misconstrue ASIC’s guidance in RG 126 in relation to the covering of consumers’ defence costs.

“The professional indemnity insurance market typically sets the defence cost limit inclusive of the overall limit available to the customer [however, costs may be separated from indemnity payments]. What the regulatory guide is trying to do is ensure that the limit is actually reserved for the customer and not eroded by the defence costs,” he said.

“It is important that where, for instance, the minimum limit may be two million [dollars] that an additional half a million or a million dollars is purchased to allow the defence costs to still be there in addition. So a key consideration is making sure the defence cost limit is compliant with [RG 126].”

Changing insurers

According to Mangafas, there are key considerations for financial advisers when changing insurers in relation to retrospective cover, disclosure of information, run-off cover, timing and ASIC requirements.

“[Advisers] should enquire as to whether the prospective new professional indemnity insurer offers retrospective cover and, if so, is the cover from a retroactive date [usually the date that the AFS licence was issued] that’s suitable to the financial adviser,” he said.

“The financial adviser also needs to make sure that they tell their current insurer of all incidents and errors that could result in a claim being made as soon as they happen to ensure that the financial adviser doesn’t prejudice their cover under the current policy of insurance.

“Another consideration is whether the prospective new professional indemnity insurer offers run-off cover. Further considerations include ensuring that the cover with the prospective new professional indemnity insurer begins no later than immediately upon cover with the current insurer ending.

“The financial adviser also needs to ensure that any cover provided by a prospective new professional indemnity insurer satisfies the ASIC requirements and whether there’s continuous cover under the policy that the prospective new insurer is offering is another issue that is certainly worth taking into consideration.”

Conclusion

PI insurance is a complex but necessary instrument for the operation of a successful financial advice business, besides being a compulsory requirement for AFS licensees under the Corporations Act. Key considerations for advisers in relation to PI cover include policy exclusions, how the excess is levied, EDR scheme awards, potential gaps in cover, common types of claim, ensuring defence costs are covered and implications when changing insurers.

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