

Financial services reform proposals

The Commonwealth Treasury released the Corporate and Financial Services Regulation Review Proposals Paper for public comment on 16 November 2006. The closing date for submissions to Treasury is 22 December 2006. The proposals aim to simplify and enhance corporate and financial services regulation in Australia. It is expected that the proposals will be introduced into Parliament in 2007.

The proposals cover financial services regulation, company reporting obligations, auditor independence, corporate governance, fund raising, takeovers and compliance. In this article we review the key proposals on financial services regulation.

Sales recommendations

Changes to the current definition of "financial product advice" under chapter 7 of the *Corporations Act 2001* (Cth) propose to distinguish between the provision of financial product advice and a pure product sale recommendation.

Financial product advice is presently divided into personal and general advice. If a financial services provider considers the customer's objectives, financial situation or needs when recommending or selling a product, they are providing personal advice. However, an issue arises when the primary intention of the financial services provider is not to provide advice but merely to sell particular products and the customer's personal information is used to recommend a suitable product from that list of products. Similarly, a financial services provider who is authorised only to provide general financial advice may be unable to recommend one out of a list of products even though they may be well placed to make that recommendation, because to do so would amount to personal advice.

It is proposed that in certain situations financial product providers and their representatives would be able to recommend a particular financial product or products and that this recommendation, called a sales recommendation, would not be captured by the personal and general advice definitions even though it may contain elements of personal or general advice. The sale recommendation proposals do not apply in relation to a superannuation product or retirement savings accounts.

The sales recommendation proposals are limited to representatives who only sell on behalf of product issuers.

A corporate licensee would be able to be licensed to provide both financial product advice and sales recommendations, but each individual representative of that corporate licensee, whether an authorised representative or an employee or director, would only be able to provide either financial product advice or to make a sales recommendation but not both.

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introduction



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Welcome to the first quarterly issue of our *Financial Services Law Bulletin*.

It has been a busy time on the regulatory front. Our leading article reviews the key proposals to simplify and enhance financial services regulation. Other articles consider CAMAC's report on "Personal liability for corporate fault", the draft regulation on compensation arrangements for financial services licensees and the appropriately named Do Not Call Register Act.

Another article examines how a delay by a superannuation trustee when considering a TPD claim, and inadequate communication with a member, can potentially leave the trustee exposed.

We hope that you find this issue informative and useful. We welcome your feedback - please let us know what you think.

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In addition, persons making sales recommendations will be required to provide a Sales Recommendation Warning to the customer. The Sales Recommendation Warning would cover matters such as the identity of the product issuers they act for, the classes of products they can sell, the fact that they are recommending and selling the product and not providing financial product advice, the need for customers to assess the suitability of the product and information regarding product costs and the representative's related remuneration.

Sales recommendations will also be subject to the licensing obligations under chapter 7 of the Corporations Act and the false and misleading and unconscionable conduct provisions of the *ASIC Act 2001* (Cth).

Obligation to provide Statement of Advice

Concerns have been expressed as to the need for a Statement of Advice ("SoA") to be provided by a financial adviser when providing a free initial consultation to a customer. In these initial meetings, the focus is usually on providing general investing advice as opposed to making a recommendation about a particular product to the customer. However, the consideration of the customer's circumstances and goals when providing the financial advice would bring the advice within the definition of personal advice and therefore impose an obligation on the financial adviser to furnish the customer with an SoA. In addition, the requirement to provide an SoA can be costly to advisers servicing small investor clients and may in turn discourage advisers from providing services to small investors.

It is proposed that an exemption to providing an SoA be made where:

- personal advice is provided but
 - no recommendation is given regarding a specific financial product or the products of a specific product issuer; or
 - the only advice is to continue holding an existing product;

- no remuneration or any other benefit is derived by the financial adviser in relation to the advice;
- the adviser keeps a record of the advice provided in a Record of Advice ("RoA"); and
- the customer can acquire a copy of the RoA on request.

Further, it is proposed to introduce a threshold limit of \$10,000 for the requirement to provide an SoA. An SoA would not be required where the amount to which the advice relates is less than \$10,000 although the adviser would be required to keep a Record of Advice. The threshold exemption would not apply to advice in relation to the following products and services:

- life and general insurance products;
- superannuation and retirement savings accounts products; and
- multiple or a series of transactions where total investments are greater than \$10,000.

Cross-endorsement of authorised representatives

At present, cross-endorsement arrangements allow an insurance agent to be the authorised representative of several insurance companies, provided the insurers consent to the agent being the authorised representative for each other.

However, an insurer is exposed to joint and several liability for the conduct of all authorised representatives, even where the representative is not authorised by the insurer in relation to the class of financial service to which the liability relates.

Consequently, amendments have been proposed to limit joint and several liability to those cases where the authorised representative provides financial services in relation to the same class of financial service or the same sub-class of insurance product.

Pooled Superannuation Trusts ("PST") and product disclosure

The product disclosure and retail client protection requirements currently apply to all investors in PSTs irrespective of size.

However, those requirements do not apply to other services such as services (other than the issue of a superannuation product) provided by a PST to a trustee of a superannuation fund, approved deposit fund or PST with at least \$10 million in assets. Those services are treated as services to wholesale clients.

It is proposed that the retail/wholesale client distinction be expanded to investors in PSTs and thereby remove product disclosure requirements in relation to wholesale client investors.

Registered managed investment schemes investing in unregistered managed investment schemes

In a bid to address concerns raised by registered managed investment schemes wishing to invest in foreign markets and Australian based unregistered managed investment schemes (which is currently prohibited by chapter 5C of the Act), it is proposed to lift the prohibition on investments in offshore unregistered schemes which are not operated by the responsible entity of the Australian managed investment scheme. ASIC Class Orders will continue to authorise certain kinds of investments in Australian unregistered managed investment schemes.

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Personal liability for corporate fault

In September 2006 the Corporations and Markets Advisory Committee (“CAMAC”) released its report on “Personal liability for corporate fault”. In this report, CAMAC makes recommendations for a “principled and consistent approach to the imposition of personal liability on individuals by reason of corporate misconduct”, and attempts to achieve a balance between imposing appropriate levels of responsibilities on those involved in the governance of companies while avoiding placing undue burdens on them.

Background

CAMAC reviewed the circumstances in which directors or other individuals involved in managing a company can incur personal criminal liability in consequence of misconduct by the company. CAMAC reviewed relevant provisions in environmental protection, occupational health and safety, hazardous goods and fair trading laws. In its review, CAMAC identified two principal areas of concern.

The first area of concern is the tendency in legislation across Australia to include provisions that impose personal criminal sanctions on individuals for corporate breach by reason of their office or role within the company (rather than their actual acts or omissions) unless they can establish an available defence.

Secondly, CAMAC noted considerable disparities in the terms of personal liability provisions in the legislation

reviewed, which results in undue complexity and less clarity about requirements for compliance.

CAMAC referred to various arguments for going beyond corporate penalties and imposing liability on individuals in consequence of corporate fault. These arguments include the limitations of monetary penalties given the ability of companies to pass the cost of such penalties on to others, the recognition that in cases where there is personal fault the corporate structure should not shield the persons who should be personally liable, the desire to express public disapproval as well as to provide incentives to promote compliance.

Individual liability in a corporate context

The report draws a clear distinction between an individual’s criminal liability for his or her own misconduct in a corporate context, and an individual’s criminal liability in consequence of misconduct by a company. The report focuses on the latter, and is concerned with situations where legislation in effect deems an individual criminally responsible for a breach by a company of a statutory requirement, and where the imposition of criminal liability on individuals for corporate fault is in addition to, rather than instead of, the imposition of criminal sanctions on the company in question. In such cases the individual is held criminally liable unless they can prove one or more of the defences in the legislation.

CAMAC notes that the pattern in the legislation reviewed is to impose liability on a company by reference to the acts and state of mind of any of its officers or other persons acting within the scope of their actual or apparent corporate authority. The effect of this is that a company may commit a criminal offence in consequence of the behaviour of one or more persons from within a large group of employees and other individuals. This

may occur without any prior knowledge, active involvement or even acquiescence of those individuals who may be held by the statute to be personally liable in consequence of the corporate fault.

Accessory liability

CAMAC received numerous submissions, including that the public interest in accountability must be balanced against the rights of individuals not to be exposed to criminal penalties where they could not reasonably have influenced or prevented the relevant conduct.

CAMAC noted that the overall view in submissions it received is that personal liability for corporate fault should generally be confined to accessory liability, and that there should be a direct relationship between the actions or omissions of individuals and their consequential liability. Accordingly, an individual should only be exposed to a penalty for a corporate offence to the extent that he or she is directly involved in that offence.

Submissions were also made suggesting it is not reasonable to impose personal liability on persons merely because of their position in a corporation, where the breach was caused by conduct outside their control and they made reasonable efforts to ensure that there were appropriate compliance systems and processes. Many corporate misdemeanours come down to processes or culture within the organisation, not the conduct of a particular director or manager over something within their control.

CAMAC Conclusions

CAMAC concluded that as a general principle individuals should not be penalised for misconduct by a company except where it can be shown that they were accessories to the conduct, i.e. personally assisted or were privy to the conduct. CAMAC was concerned about the trend in various pieces of legislation to treat corporate officers as

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Do not call

The frankly named *Do Not Call Register Act 2006 (Cth)* together with the *Do Not Call Register (Consequential Amendments) Act 2006 (Cth)*, both assented to on 30 June 2006, provide the framework for a national Do Not Call Register and telemarketing contact standards.

The legislation will operate alongside existing legislation, including the *Spam Act 2003 (Cth)* and the anti-hawking provisions under the *Corporations Act 2001 (Cth)* that govern financial services providers.

The Australian Communications and Media Authority (ACMA) will be responsible for enforcing the legislation and penalties for breaching the legislation will range from formal warnings to infringement notices to court proceedings. The Courts will have power to impose fines of up to \$1.1 million. These penalties are significantly greater than those under

the anti-hawking provisions. The Courts will also have power to make orders for the recovery of a financial benefit and compensation.

Individuals with an Australian telephone number will be able to put their names on the Do Not Call Register (anticipated to be operational in May 2007) at no cost if they do not wish to receive certain unsolicited telemarketing calls. Certain exempt bodies (such as charities, religious organisations, and government bodies) are not obliged to comply with the prohibitions on telemarketers under the new legislation. The commencement of the provisions

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criminally liable for misconduct by their company unless they can make out a relevant defence. Provisions of this kind are objectionable in principle and unfairly discriminate against corporate personnel compared with the way in which other people are treated under the criminal law, including the reversal of the onus of proof which is contrary to the general presumption of innocence in criminal law. Furthermore, the broad liability provisions may hold corporate personnel liable and subject to penalties for corporate conduct that they could not reasonably have influenced or prevented.

CAMAC also noted that the encouragement of corporate compliance with applicable laws, which the committee supports, does not justify a general abrogation of the rights of individuals.

CAMAC considered that liability for breach of a legal requirement by a company should fall in the first place on the company itself, noting that it should not be assumed that penalties such as monetary penalties will not have an impact on shareholders and others who have a stake in the success of the company or will not influence the behaviour of individuals who control and manage the company. CAMAC recommends that only

an individual who is personally implicated in such a breach should be exposed to personal liability as an accessory in accordance with ordinary criminal law principles.

Designated officer liability

CAMAC acknowledges that in some circumstances it may be desired to impose a specific statutory duty on a "designated officer" to ensure that a company complies with particular legislative requirements, in effect imposing a form of strict liability.

CAMAC suggested that this approach only be considered where an individual is required to perform one or more specific "on the spot" operational tasks or specific administrative obligations on behalf of the company, there is an important public purpose underpinning the specific tasks or obligations required of that officer, and, at most, only a limited element of personal discretion or exercise of judgment is required.

Extended accessorial liability

CAMAC also accepted that there may be circumstances in which it is considered appropriate to impose a more positive duty of care on particular individuals than may be derived from ordinary

principles of accessorial liability. The three criteria suggested for assessing the elements of any extended personal liability provision are practicality and fairness, whereby it should not be assumed that directors or other managers of larger enterprises are, or can be, aware of every aspect of the day to day functioning of their corporations, the suitability of any defences provided in the provision, and the enforceability of such provisions.

Greater harmonisation

CAMAC noted the current proliferation of differing approaches detracts from good corporate governance and complicates compliance. CAMAC recommends a more consistent approach and that the Australian Government publish a policy concerning principles for imposing criminal liabilities on individuals for corporate fault in Commonwealth legislation, together with model provisions, and that steps be taken at inter-governmental levels, such as through an appropriate ministerial body, to adopt similar principles and model provisions.

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Disclosure in the face of suspected fraud by an insured

When faced with a potentially fraudulent claim, insurers can find themselves in a quandary where they have an obligation to disclose documents to the insured but to do so would alert the insured and could help further the fraud.

The Australian Capital Territory and Queensland (in the case of motor vehicle insurance) have recognised this quandary. As a result, both jurisdictions now permit insurers, in the face of suspected fraud, to withhold documents that help establish the insured's fraudulent behaviour from the insured, under either section 73 of the *Civil Law (Wrongs) Act 2002 (ACT)* or section 48 of the *Motor Accident Insurance Act 1994 (QLD)*.

In September 2006, Justice Connolly of the ACT Supreme Court ruled on an application made by NRMA under section 73 of the *Civil Law (Wrongs) Act*. In this matter, NRMA suspected that an insured had filed a fraudulent claim. NRMA did not wish to disclose certain documents to the insured that helped to establish NRMA's fraud defences. The Court determined that NRMA was entitled to withhold the documents from the insured.

The *Civil Law (Wrongs) Act* provides that parties to court proceedings must make full and frank disclosure to the other party for the purpose of conducting the litigation in a fair and efficient manner. Section 73 of the Act provides an exception and states:

- if a respondent has reasonable grounds to suspect a claimant of fraud, the respondent may apply to the Court for approval to withhold from disclosure under this chapter

documents or information that would alert the claimant to the suspicion; or could help further the fraud.

- the application may be made without notice to the claimant; and
- if the court gives approval on application under subsection (1), the respondent may withhold from disclosure documents or information in accordance with the approval.

The Court confirmed that an application made by an insurer under section 73 may be made *ex parte* without notice to the insured. Furthermore, the order, and the fact an order exists, may be withheld from the insured. The Court recognised that any notification to an insured of the application, where the insurance company suspects fraud, may in itself cause the insurance company difficulty in proving fraud against the insured. Fraud has been defined as an intentional dishonest act or omission done with the purpose of deceiving. The Court in *NRMA* determined that the suspicion by the insurer of a dishonest claim by the insured was the first step in determining whether or not a fraud, or the investigation of a fraud, should occur.

Whether an insurer can invoke the rights contained within section 73 is dependent on whether the insurer has a suspicion that fraud has been perpetrated and whether reasonable grounds exist for that belief. Specifically, it requires the existence of facts that are sufficient to induce the state of mind in a reasonable person that fraud may have occurred.

Whilst the application of these principles under statutes are limited to the ACT and possibly Queensland, they may be useful in other jurisdictions that do not have similar legislation but where the courts have a discretion to make similar orders. There is case law in NSW, for example, confirming that in some circumstances it

may not be in the interest of justice to require a defendant to serve evidence prior to a trial which would "if the plaintiffs are not genuine, put the plaintiffs on notice of some allegedly suspicious circumstances and enable them to tailor or endeavour to tailor their evidence to meet the circumstances": *Markus v Provincial Insurance Co Limited* (unreported, NSW Supreme Court, Clarke J, 11 May 1983). The concept that there may be a legitimate forensic advantage in withholding the disclosure of potential evidence in such circumstances was followed in *Broadwater Taxation and Investment Services v Hendriks* (unreported, NSW Supreme Court, Santow J, 9 September 1993) and *Marsden v Amalgamated Television Services Pty Ltd* (unreported, NSW Supreme Court, Levine J, 7 May 1999).

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Draft regulation on compensation arrangements for financial services licensees

The Commonwealth Government has released a draft regulation in relation to the obligation on financial services licensees to have adequate compensation arrangements in place.

Under section 912B of the *Corporations Act 2001* (Cth), financial services licensees providing financial services to retail clients must have arrangements in place to compensate customers who incur losses due to their breach of relevant obligations under chapter 7 of the Act. The compensation arrangements must be prescribed by regulation or approved by ASIC to be a valid arrangement under the section.

Insurance required

The draft regulation stipulates “adequate” professional indemnity insurance as the required compensation arrangement for all financial services licensees (although alternative arrangements can still be

approved by ASIC). Rather than specifying details of acceptable insurance cover, the regulation requires financial services licensees to determine for themselves what insurance cover is adequate for their business. However, certain factors must be considered in assessing adequacy of insurance coverage:

- the highest possible liability of the licensee under any relevant external dispute resolution schemes;
- nature and volume of the licensee’s business;
- number and kind of clients;
- number of licences held; and
- number of authorised representatives.

When considering an alternative compensation arrangement for a licensee, ASIC must also have regard to the above factors.

Summary in FSG

Licensees and their authorised representatives will be obliged to include a summary of their professional indemnity insurance in their Financial Services Guide. The draft regulation does not

specify what information must be included in the summary.

Exemption

Prudentially supervised licensees such as general and life insurance companies, authorised deposit-taking entities and related entities whose obligations will be guaranteed by such entities, will be exempt from these requirements.

Where to from now?

It is proposed that the regulation will commence on 1 January 2007. The Government has requested feedback on whether a transitional period (of say three months) will be needed to allow licensees to assess their current insurance coverage and implement any changes. Even so, licensees should be taking steps now to ensure they have adequate professional indemnity insurance or to apply to ASIC for approval of alternative arrangements.

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regarding the prohibitions and a requirement that agreements comply with the legislation are yet to be proclaimed, but can be expected to commence by 1 July 2007.

These prohibitions are, in summary, that a person must not make, or cause to be made, a telemarketing call to an Australian number if the number is registered on the Do Not Call Register, unless:

- the relevant telephone account-holder (or its nominee) consented to the call being made. Consent (which is defined in detail in schedule 2 of the legislation) can be express or inferred; or
- the person (access seeker) has

submitted the number as part of a list of telephone numbers to ACMA, and during the 30 days up to the day on which the call was made, the access seeker received a response from ACMA that the number was not registered on the Do Not Call Register (or was silent on the subject); or

- the person made the call (or caused the call to be made) by mistake; or
- the person took reasonable precautions, and exercised due diligence, to avoid the contravention.

The Do Not Call Register (Consequential Amendments) Act 2006 enables the development of relevant industry codes and standards relating to telemarketing calls (such as the time at which

telemarketing calls may be made, the information which must be provided and the termination of calls).

While there are clearly benefits of a national Do Not Call Register for consumers and telemarketers, it is yet to be seen how the additional compliance burden will impact on industry. Among other things, internal procedures and processes may need to be reviewed to ensure compliance, and outsourcing contracts with call centres may need to be revisited.

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The clock is ticking

A time limitation in the *Superannuation (Resolution of Complaints) Act 1993* (Cth) (“Complaints Act”) in relation to complaints in respect of total and permanent disability (“TPD”) claims, has the potential to prejudice a member’s right to a Superannuation Complaints Tribunal (“SCT”) review (and potentially expose a superannuation trustee to complaints and, conceivably, a claim for compensation by the member for having to pursue a remedy through the courts).

This article examines how a delay by a superannuation trustee when considering a TPD claim, and inadequate communication with a member about his or her rights to complain to the SCT, can potentially leave the trustee exposed. We also set out some simple steps that a trustee can take in an effort to protect both its own and members’ interests.

The Complaints Act

The SCT cannot deal with a complaint about a decision of a trustee relating to the payment of a TPD benefit unless the complaint is made within a period of two years after the making of the decision to which the complaint relates (see section 14(6A) of the Complaints Act).

In this context, “decision” means the original decision of the trustee in relation to the claim (see section 14(6C) of the Complaints Act).

Even if, as a result of a complaint, the original decision is confirmed or varied (or another decision is substituted for the original decision), the later determination is taken to have been made at the time

when the original decision was made (see section 14(6D) of the Complaints Act).

Decision making process

A member must first try to resolve a complaint arising from a decision of a trustee before lodging a complaint with the SCT (section 19 of the Complaints Act) and the trustee must properly consider and deal with the complaint within 90 days after the complaint is made (section 101 of the *Superannuation Industry (Supervision) Act 1993* (Cth)). It may be that, as a result of the complaint, the trustee decides to review its original decision in relation to the claim and consider new evidence. It is not uncommon for trustees to review an original decision in relation to a TPD claim. This review may be because the member provides new evidence, or because a complaint is made about the original decision (whether trustee or insurer).

Such a review can be a lengthy process. With medical examinations, vocational assessments, corresponding with the insurer and giving the member an opportunity to respond to evidence obtained by the insurer, 18 months can easily pass before the review is completed. However, the two year time limitation in relation to TPD claims means that, if an original decision is reviewed and the review process takes a lengthy period of time, a member could lose his or her right to complain to the SCT. Furthermore, a member could lose this right by not appreciating when the time limitation expires. For example, even if the member was aware of the two year time limitation, he or she may not be aware that it commences when the original decision is made.

If the trustee has not clearly communicated when the time limitation commences, the member may have a right of recourse against the trustee (for example, a claim for compensation by the member for having to pursue a remedy through the courts in circumstances where a free alternative was available).

Steps that can be taken

Two key points should be noted:

- it is crucial that trustees expeditiously consider TPD claims, especially when it involves reviewing an original decision. Care should also be taken to ensure that the original decision is only made once all relevant evidence is considered and the member has had the opportunity to review it and make any further submissions; and
- clear communications with the member are crucial. Prudently, a trustee should flag, in general terms, that limitations and time limits relating to complaints to the SCT apply in its product disclosure statement (the Corporations Act requires the PDS to contain information about the trustee’s dispute resolution system and how that system may be accessed) (see section 1013D(1)(g) of the *Corporations Act 2001* (Cth)).

In addition, a trustee should review the notice it currently provides for the purpose of complying with Corporations Regulation 7.9.48 (a prescribed notice that must be sent following a decision in relation to a complaint). While this regulation prescribes that the notice must include, among other things, the date of the decision in relation to the complaint, it should also include the date of the “original decision” and that the two year time limitation to complain to the SCT applies from the date of the original decision.

These simple steps may ensure that a member does not lose its right to complain to the SCT and may prevent a member having a right of recourse against the trustee for failing to expeditiously consider a complaint or properly communicating time limitations applying in relation to complaints to the SCT.

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Terrorism insurance scheme to continue

On 15 September 2006, Treasury released its report on its review of the need for the continued operation of the *Terrorism Insurance Act 2003* and made recommendations to refine the current terrorism insurance scheme. The Federal Government has agreed to all the recommendations and further consultation is to occur.

Terrorism Insurance Act

Following consultations with key stakeholders, and consideration of experiences in the international arena, the review concluded that there is still a need for the Act to continue in operation. The primary factors included:

- the sustained unavailability of terrorism insurance for commercial property and business interruption, a view shared by industry groups such as the Insurance Council of Australia, the Property Council of Australia and the Australian Bankers' Association; and
- the continued operation of similar schemes in other countries such as the United Kingdom and France.

Refining the scope of the scheme

The scope of the terrorism insurance scheme was considered in light of issues raised by stakeholders, resulting in the following recommendations being made:

- the scheme will be extended to cover commercial insurance provided in relation to all public authorities; and
- premiums will continue to be collected at current rates, subject to the next review within three years.

The Australian Reinsurance Pool Corporation (ARPC) will retain discretion to determine how

premiums will be used once the pool reaches \$300 million. This may be to build the pool further, purchase reinsurance or a combination of the two. It has been estimated that over the next three years, the ARPC will receive approximately \$100 million per year in premium income. On this basis, if the ARPC was to continue adding all premiums to the pool, by 2009 the pool would reach approximately \$550 to \$585 million;

- an increase in insurer retentions in three stages up until 2009, to reach a maximum industry retention per incident of \$100 million. This is on the basis that existing retention levels are low compared to industry standards. It is believed that this will make scheme retention levels more comparable to commercial reinsurance and encourage increased involvement in the scheme; and
- reinsurance premiums for bundled insurance policies will only be charged on the sections of the policy where terrorism risks are excluded.

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