



ASIC

Australian Securities & Investments Commission

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Insurance broker remuneration arrangements

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Executive summary

Background

Australian law imposes specific requirements on Australian financial services (AFS) licensees, including insurance brokers, to tell retail clients about remuneration in connection with their provision of financial services. It also requires AFS licensees to adequately manage conflicts between their interests and the interests of their clients (both wholesale and retail).

Late last year ASIC began a review of the remuneration practices of general insurance brokers (brokers) to assess their compliance with legal obligations, particularly in relation to managing conflicts of interest and disclosing remuneration. ASIC also aimed to identify the types of remuneration arrangements that exist between brokers and general insurers (insurers) in Australia.

Earlier in 2004, the New York State Attorney General investigated allegations that some insurance brokers in the United States were:

- encouraging their staff to place business with preferred insurers that paid them higher commissions ('steering'); and
- soliciting fictitious quotes to make the preferred insurer's bid looked more competitive ('bid rigging').

As part of its review, ASIC wanted to determine whether there was any evidence of these practices in the Australian industry.

Methodology

ASIC selected 15 brokers—a mix of small, medium and large firms. In addition, nine insurers were asked to provide information regarding their relationships with brokers.

ASIC used its compulsory powers to obtain statements and documents, mainly for the 18-month period ending December 2004. The review considered brokers' operations for both wholesale and retail clients. The law imposes core obligations that apply to all clients—wholesale and retail—and additional disclosure obligations to retail clients.

Given the limited scope of the review, ASIC did not examine in depth all aspects of the insurance broking industry and the review covered only a sample of brokers and insurers. ASIC's findings should therefore be read in that context. Nevertheless, ASIC expects brokers and insurers to carefully consider the findings of this report.

Key findings

Contingent remuneration

More than half of the brokers ASIC reviewed had contingent remuneration arrangements in place. Most of those brokers placed a significant proportion of their business with insurers who pay contingent remuneration. ASIC also found that the amounts of contingent remuneration received by the brokers reviewed had generally increased substantially over their last three financial years. Contingent remuneration is legal only if inherent conflicts are appropriately managed and the remuneration is properly disclosed. Since the review, several large international brokers have terminated or suspended indefinitely some contingent remuneration arrangements.

Conflicts of interest

While all of the selected brokers had some conflict management procedures in place, ASIC found that the brokers generally considered that most, if not all, conflicts of interest arising from contingent and other preferential remuneration arrangements could be adequately managed by disclosure. However, where contingent remuneration arrangements that give rise to a conflict of interest become very significant to broker revenue or profit, or are too complex to adequately disclose, ASIC considers there is an increased risk that disclosure will not be a sufficient way to deal with the conflict. In such cases, merely disclosing the conflict and imposing internal controls may be inadequate—the only way to adequately manage the conflict may be to avoid it. Each case needs to be assessed on its merits.

Disclosure to retail clients

ASIC found that disclosure to retail clients in Financial Services Guides and Statements of Advice was not always sufficient in relation to contingent remuneration, non-monetary benefits (such as entertainment, gifts, sponsorship, access to IT and other resources) and indirect benefits received from insurers via cluster groups.

Bid-rigging and steering

ASIC found no evidence of systemic abuses of the kind uncovered in the United States. For example, ASIC discovered no instances of bid-rigging, and only limited evidence that suggested steering may exist at some level in the Australian insurance broking industry.

Future action

As a result of the review, ASIC has identified certain brokers where further regulatory work is required. In relation to some of these firms, ASIC intends merely to clarify its understanding of the procedures and arrangements in place. In other cases, ASIC anticipates that changes to broker procedures and compliance arrangements might be necessary. Subject to satisfactory resolution of ASIC's concerns, ASIC does not anticipate the need for enforcement action.

Management of conflicts of interest and disclosure of remuneration by insurance brokers will continue to be the subject of regulatory scrutiny by ASIC. In particular, where contingent remuneration arrangements exist, ASIC will expect to see robust arrangements for managing conflicts. Where brokers seek to rely on disclosure to deal with a conflict, it is critical that the disclosure about the conflict is timely, specific, prominent and meaningful.

ASIC acknowledges the activities of the relevant industry bodies in promoting industry standards. ASIC continues to work closely with industry bodies to ensure that brokers and insurers act in the best interests of their clients. ASIC will maintain liaison with the Australian Prudential Regulation Authority to ensure consistency of approach in the regulation of the insurance industry.

In administering the law, ASIC will take into account the proposals put forward in the Federal Government's proposals paper *Refinements to Financial Services Regulation*, issued in May 2005.

Section 1: Background

The Australian insurance broking industry

Australian law imposes specific requirements on Australian financial services (AFS) licensees, including insurance brokers, to tell retail clients about remuneration in connection with their provision of financial services. It also requires AFS licensees to adequately manage conflicts between their interests and the interests of their clients (both wholesale and retail).

There are more than 700 licensed general insurance brokers in Australia. Most are small to medium sized. The number of large brokers is relatively small, and some of these are part of international groups.

Insurance brokers are often seen by their clients as professional consultants. The principal function of a broker is to act as agent for the prospective or intending insureds to find and arrange appropriate insurance on their behalf. This is so even though a major source of brokers' remuneration is commissions paid by insurers.

A broker may also act as agent of an insurer. Examples include 'binder'¹ arrangements and performing administrative functions for an insurer.

As a broker can act in dual capacities, it is important for the broker to clearly disclose on whose behalf it is acting when recommending insurance products to clients.

ASIC review of broker remuneration practices

In November 2004 ASIC commenced a review of the remuneration practices of general insurance brokers to assess brokers' compliance with their legal obligations, particularly in relation to managing conflicts of interest and disclosing remuneration. ASIC also aimed to identify the types of remuneration arrangements that exist between general insurance brokers and general insurers in Australia.

Earlier in 2004, the New York State Attorney General investigated allegations that some insurance brokers in the United States actively

¹ The term 'binder' is defined in s761A of the *Corporations Act 2001* to mean an authorisation given to a person by an AFS licensee who is an insurer to do either or both of the following for risk insurance products (other than interim cover):

- (a) enter into contracts on behalf of the insurer as insurer; and/or
- (b) deal with and settle claims on behalf of the insurer.

encouraged their staff to place business with preferred insurers that paid higher commissions by providing directions and staff incentives to do so (a practice known as ‘steering’). There were also allegations that some US insurance brokers were engaged in ‘bid-rigging’, i.e. soliciting fictitious or non-arms length quotes from insurers to make the preferred insurer’s bid look more competitive.

As part of its review, ASIC wanted to determine whether there was any evidence of steering or bid-rigging in the Australian general insurance broking industry.

ASIC is one of a number of regulators internationally that are examining the remuneration practices of insurance brokers.

Methodology

To gather information for the review, ASIC served notices² under s912C of the *Corporations Act 2001* (Corporations Act) and s31 of the *ASIC Act 2001* (ASIC Act) on 15 general insurance brokers and nine general insurers (referred to in this report as ‘brokers’ and ‘insurers’ respectively).

The sample consisted of a mix of small, medium and large brokers and some of the largest insurers.

The s912C notice required the broker to give to ASIC a written statement answering a number of questions relating to:

- financial benefit arrangements (including contingent remuneration) between the broker and the insurers they placed business with;
- disclosure of remuneration;
- systems and procedures to monitor and manage conflicts of interest; and
- procurement of non-arms length insurance quotes (i.e. bid-rigging).

The s31 notice required the broker to produce to ASIC:

- sample copies of financial benefit arrangements and documents relating to the operation of those arrangements;
- sample documents relating to disclosure of remuneration to retail and wholesale clients; and
- documents setting out systems and procedures to monitor and manage conflicts of interest.

² Notices were issued under the compulsory powers of ASIC. A failure to comply with the notices or a response containing false or misleading information can result in civil and/or criminal proceedings against the respondent under the Corporations Act and the ASIC Act.

ASIC also served notices on nine insurers along similar lines but tailored to the circumstances of insurers. The statements and documents obtained from the insurers were reviewed to obtain a better understanding of the relationships between brokers and insurers.

The 'relevant period' specified in the notices, unless otherwise stated, was 1 July 2003 to 9 December 2004.

It is important to note that, given the limited scope of the review and the sample size, ASIC's inquiry did not examine in depth all aspects of the insurance broking industry. ASIC's findings should therefore be read in that context. Nevertheless, they warrant careful consideration by brokers and insurers.

Section 2: Legal requirements

The transitioning of brokers under the *Financial Services Reform Act 2001* (FSR Act)³ during the relevant period of the review meant that the review considered two sets of laws—the Corporations Act financial services provisions (introduced by the FSR Act) and the now repealed *Insurance (Agents & Brokers) Act 1984* (IABA). However, as most selected brokers and insurers obtained an AFS licence in late 2003 or early 2004, the main focus of ASIC’s review was on compliance with the Corporations Act.

Current requirements

A number of sources of law govern the activities of insurance brokers. These include the Corporations Act, the Corporations Regulations 2001 (Corporations Regulations), the ASIC Act, various secret commissions legislation, and common law fiduciary obligations.

Unless otherwise stated, all section references in this report are to the Corporations Act and all references to specific regulations are references to the Corporations Regulations.

General obligations

As AFS licensees, brokers have a number of general obligations under the Corporations Act and Corporations Regulations. These include:

- ensuring that their financial services are provided *efficiently, honestly and fairly* (s912A(1)(a));
- avoiding misleading or deceptive conduct (s1041H) (similar obligations are also imposed under Part 2 Division 2 of the ASIC Act.);
- complying with financial services laws and taking reasonable steps to ensure that their representatives do the same (s912A(1)(c) and (ca));
- having adequate risk management systems (s912A(1)(h));
- having adequate compliance arrangements (reg 7.6.03(g)); and
- not describing themselves or their services as ‘independent’, ‘impartial’ or ‘unbiased’ if they receive:
 - (i) commissions (but do not rebate them in full to clients);

³ The two-year FSR transition period ended on 10 March 2004.

- (ii) remuneration calculated on the basis of volume of business referred to insurers; or
- (iii) gifts or benefits from insurers that may reasonably be expected to influence the brokers (s923A).

These obligations apply to financial services provided to both retail⁴ and wholesale⁵ clients.

Quality of advice

When providing financial product advice to their clients, brokers have a range of legal obligations. For retail clients, personal advice⁶ must be appropriate having regard to the client's circumstances: s945A. For all clients, provision of advice must also be consistent with the general obligations outlined above.

These obligations co-exist with brokers' common law obligation to exercise reasonable care and skill and to act in the best interests of their clients. In addition, brokers must not receive 'secret commissions' in connection with their advice (e.g. s179 *Crimes Act 1958* (Vic); s249D *Crimes Act 1900* (NSW)).⁷

⁴ A retail client for general insurance products is defined under s761G to mean an individual, or a small business (employing less than 100 people for manufacturing business or 20 people for other business) purchasing certain specified insurance products including motor vehicle, home building, home contents, sickness and accident, consumer credit, travel, personal and domestic property insurance.

⁵ A wholesale client is defined in s761G to mean a person other than a retail client.

⁶ Personal advice is defined in s766B to mean financial product advice that is given or directed to a person in circumstances where:

- (a) the provider of the advice has considered one or more of the person's objectives, financial situation and needs; or
- (b) a reasonable person might expect the provider to have considered one or more of those matters.

⁷ While ASIC does not directly administer this legislation, a contravention of such obligations by a broker may amount to a failure to provide financial services efficiently, honestly and fairly, i.e. a breach of s912A(1)(a) of the Corporations Act. Additionally, a breach of 'any law of the Commonwealth, or of a State or Territory ... [that] involves fraud or dishonesty and relates ... to financial products' may be investigated by ASIC under s13(1) of the ASIC Act.

Managing conflicts of interest

As AFS licensees, brokers already have an obligation to properly manage conflicts of interest under s912A(1)(a) (acting ‘efficiently, honestly and fairly’) and under their common law duties.

The requirement under s912A(1)(aa) to have in place ‘adequate arrangements’ for the management of conflicts of interest became an express AFS licensee obligation from 1 January 2005. This applies to financial services provided to both wholesale and retail clients.

ASIC’s policy for administering this obligation is set out in Policy Statement 181 *Licensing: Managing conflicts of interest* [PS 181]. Under [PS 181], brokers are generally required to identify conflicts and manage them by avoidance or a combination of internal controls and disclosure.

For conflicts management arrangements to be adequate, they will need to be documented and will generally include having a written conflicts management policy: [PS 181.44].

Where disclosure of a matter is an appropriate method for managing a conflict of interest, the disclosure should be ‘timely, prominent, specific and meaningful’: [PS 181.52].

In some cases, however, disclosure will not be sufficient to adequately manage a conflict of interest. For example, remuneration practices that place the interests of the broker or its representatives in direct and significant conflict with the interests of the client should be avoided and not merely disclosed: [PS 181.39].

Disclosure of remuneration, associations and other interests

Where financial services are provided to *retail clients*, the Corporations Act also requires a broker to disclose to clients more detailed information about remuneration, associations and other interests in a Financial Services Guide (FSG)⁸ and, where personal advice is provided, a Statement of Advice (SOA).⁹

Where brokers provide financial services to *wholesale clients*, the FSG and SOA provisions of the Act do not apply. However, brokers will generally be

⁸ The main content requirements of an FSG are set out in s942B(2) and Policy Statement 175 *Licensing: Financial product advisers—Conduct and disclosure* [PS 175].

⁹ The main content requirements for SOAs are set out in s947B(2) and [PS 175].

required to disclose at least some information about remuneration, associations and other interests under:

- common law obligations to avoid conflicts and act properly because of their agency relationship with the clients;
- secret commissions legislation; and/or
- the obligations under the Corporations Act to manage conflicts of interests and to provide financial services efficiently, honestly and fairly.

Federal Government's proposals paper: Refinements to Financial Services Regulation

In May 2005, the Federal Government issued a proposals paper entitled *Refinements to Financial Services Regulation* (the Refinements paper).¹⁰

The Government issued the Refinements paper following consideration of the views of a cross-section of the community on the effectiveness of the FSR Act. While the response from the community is that the reforms to financial services regulation have achieved the objectives that were set out for them, it has become clear that parts of the regime need refinement.

In embarking on the refinement process, the Government aims to:

- ensure that consumers receive information that is relevant to their needs;
- reduce the compliance burden on industry; and
- clarify the intent of the legislative and regulatory framework that applies to the financial services industry.¹¹

The Refinements paper, which is subject to public consultation, put forward various amendments to the Corporations Regulations to address these aims. ASIC has announced that it will undertake eight projects in response to the release of the Refinements paper.¹²

¹⁰ A copy of the Refinements paper is available on the Treasury website at www.treasury.gov.au/contentitem.asp?NavId=002&ContentID=973

¹¹ Foreword to the Refinements paper by the Hon. Chris Pearce MP, Parliamentary Secretary to the Treasurer.

¹² ASIC Media Release [MR 05-110] *ASIC welcomes financial services refinements proposal paper*, available on ASIC's website at www.asic.gov.au.

A number of the proposals in the paper affect the activities of insurers and insurance brokers.¹³

ASIC will take into account the Refinements paper proposals in determining whether AFS licensees are complying with the financial services provisions of the Corporations Act.

ASIC will generally not take action for breaches of the financial services provisions that are the subject of the refinement proposals, where that conduct is more likely than not to be lawful if the refinement proposal became law.

This general position is subject to circumstances where the conduct is, or is likely to:

- materially harm or disadvantage consumers; and/or
- undermine the confident and informed participation of consumers in the financial market.

The current obligation on AFS licensees to report significant breaches of the financial services laws to ASIC still applies to the those financial services provisions that are the subject of the Refinements paper.

ASIC expects AFS licensees to continue to identify breaches, or likely breaches of these provisions, give proper consideration to whether the breach is significant and, where required, provide timely notifications to ASIC.

Pre-FSR requirements

The key features of IABA relevant to the review are summarised below. The section references in this list are references to IABA:

- There was no distinction made under IABA between retail and wholesale clients.
- In relation to *advice*, brokers were generally prohibited from making false or deceptive statements in relation to amounts payable by the client in connection with a contract of insurance or the effect of terms and conditions in the contract of insurance: s13.
- In relation to *remuneration*, brokers were required to disclose to clients the fee to be charged for the broker's services and, upon request from the client, the amount of commission payable by the insurer to the broker:

¹³ For example, Proposal 1.3 under which an FSG 'need only contain brief, generic information about remuneration and conflicts of interest concerning the provision of personal advice'.

s32. Brokers were prohibited from receiving any ‘gift, gratuity, benefit or other reward (however described)’ from insurers unless such payments were received in connection with effecting or arranging contracts of insurance or settling claims: s35(1).

- In relation to *contingent remuneration*, brokers were prohibited from receiving payments from insurers that were based on or contingent upon the number of contracts arranged, the total amount of premium payable under such contracts or the total amount of sums insured under such contracts: s35(2). This prohibition did not apply to brokers acting under a binder: s35(3).
- Brokers were required to disclose the existence and nature of any association with an insurer who was to issue the contract of insurance that the insurance broker proposes to arrange or effect: s38.

Brokers had other obligations under common law to avoid conflicts of interest and to act properly because of their agency relationship with their clients. The secret commissions legislation (such as the *Crimes Act 1900* (NSW) and the *Crimes Act 1958* (Vic)) also applied to advice given by brokers.

Section 3: Project findings

Broker remuneration arrangements

Types of remuneration

The main types of remuneration paid by insurers to brokers consisted of:

- commissions—including flat rate commission based on premium, contingent remuneration, override commission (extra commission payable on top of the normal rate paid by participating insurers)¹⁴ and extra commission for conducting business electronically etc.;
- ‘fee for service’—often referred to as administration fees, including fees for performing functions such as claims handling, marketing or risk management services; and
- non-monetary remuneration—including entertainment, gifts, sponsorship, access to IT and other resources.

Brokers may charge their clients a separate fee in addition to receiving commissions. Alternatively, a broker may be remunerated solely by a fee paid by the client. In that situation, the broker will usually rebate the commission in full to the client or arrange for premium to be quoted net of commission.

A further source of brokers’ remuneration is commission from ‘premium funders’ that provide credit to clients of brokers wishing to borrow the premium amount.¹⁵

Contingent remuneration

Eight of the 15 selected brokers (53%) had contingent remuneration arrangements during the relevant period specified in the notices (1 July 2003 to 9 December 2004). Of the eight brokers:

- five were large brokers (four of which are part of international groups); and
- three were small to medium sized brokers.

¹⁴ According to the respondents, reasons for payment of a higher rate included response to higher rates offered by competitors and/or the insurer being chosen by the broker as a ‘preferred’ insurer for specified lines of business or a portfolio of business.

¹⁵ Premium funding, as a credit facility, is excluded from the definition of ‘financial product’ under s765A(1)(h)(i) of the Corporations Act. However, a credit facility is a financial product under s12BAA(7)(k) of the ASIC Act.

RECENT TERMINATIONS/SUSPENSIONS

Three of the four large international brokers targeted have indicated that they had recently terminated or suspended indefinitely their contingent remuneration arrangements (where they acted as agent of the insured) pending their own review.¹⁶ There was no indication that other brokers were considering such reviews.

CONTINGENT REMUNERATION BENCHMARKS AND PAYMENTS

The contingent remuneration arrangements were mainly based on the volume of business referred and/or a share of the insurer's profit. The formulae used to determine the amount of contingent remuneration were often complex and may depend on such factors as premium written, sum insured, rate of insurance renewals, the level of claims, loss ratio etc. While some contingent remuneration arrangements applied to selected business lines, others applied to the whole portfolio. Contingent remuneration is usually paid to the broker after expiry of an agreed period as a lump sum. In some cases it is also paid as non-monetary benefits.

DUAL CAPACITIES

Brokers received contingent remuneration in two capacities:

- (a) as agent of the intending insured; and/or
- (b) as agent of the insurer (e.g. in a binder arrangement).

Based on a review of agreements provided, of the eight brokers that had contingent remuneration arrangements:

- four had type (a) arrangements.
- one had mostly type (b) arrangements, and
- three had exclusively type (b) arrangements.

Some brokers argued that a conflict of interest was less likely to arise with type (b) arrangements.

¹⁶ An insurance agent related to one of these three international brokers did not terminate or suspend its contingent remuneration arrangements, presumably on the basis that it did not consider a conflict of interest would arise in its capacity as agent of the insurer.

ECONOMIC DEPENDENCE

In terms of economic dependence, the contingent remuneration amounts received by selected brokers¹⁷ in their latest financial years¹⁸ were immaterial, in the accounting sense, in relation to their:

- annual gross revenue;¹⁹ and
- annual net profit before tax (except in one case).²⁰

However, the brokers generally placed a significant proportion of their business with insurers that paid contingent remuneration to them.²¹

The amount of contingent remuneration paid to Australian brokers in ASIC's sample as a proportion of their annual gross revenue (0.05% to 2.6% in their latest financial years) was considerably less than that for brokers in the US (average 7% but up to 12%).²²

TREND OF INCREASING CONTINGENT REMUNERATION

For selected brokers that received and insurers that paid contingent remuneration in their last three financial years, there was generally a substantial increase in the dollar amounts for contingent remuneration during that period.

Some of the factors that may have accounted for the increase include:

¹⁷ Only six of the brokers were able to provide contingent remuneration figures as two of them only entered into the contingent remuneration arrangements after their last financial year.

¹⁸ The latest financial year ends of the brokers were mainly 30 June 2004 or 31 December 2003.

¹⁹ For the six brokers, contingent remuneration as a percentage of gross revenue ranged from 0.05% to 2.6%.

²⁰ Of the six brokers, contingent remuneration as a percentage of net profit before tax ranged from 0.25% to 5% for five of them. For the other broker, the percentage was about 40% in 2004 and 10% in 2003.

²¹ Premiums written for insurers with contingent remuneration arrangements as a percentage of total premiums written by the selected brokers ranged from 17% to 75% in the latest financial years of those brokers.

²² It has been reported that contingent commissions among the 100 biggest insurance brokers in the United States currently comprise as much as 12% of their annual gross revenue, according to *Business Insurance* magazine, and average about 7% of their top line. See Roger Wade, 'A brief history of contingent commission agreements', *KPMG Insiders*, 5 January 2005.

- the former prohibition under IABA against some forms of contingent remuneration arrangements being no longer applicable to brokers when they transitioned to the FSR regime in 2003 or early 2004;
- contingent remuneration relating to arrangements entered into in earlier years being paid in later years after expiry of the agreed periods; and
- general growth in premiums and profitability of general insurers between 2003 and 2004.²³

Cluster group arrangements

Many brokers, usually of small to medium size, are members of so-called 'cluster groups'. A cluster group is headed by a company that may or may not hold an AFS licence but generally does not carry on the business of a broker. It appears that the main benefits of such an arrangement for member brokers are:

- more efficient and effective negotiation of terms and conditions with insurers by the head company on a centralised basis;
- access to membership services, which may include compliance advice, IT support, training programs etc; and
- in some cases, rebates or distributions made to members by the head company if it makes a surplus. Under some arrangements, the broker member would only be eligible for the rebate if it had placed a certain minimum amount of business (premium) with the preferred insurers. In that situation, the rebate would exhibit some characteristics of contingent remuneration.

Sources of funding for the head company include:

- extra commissions paid by participating insurers to the head company when members place specified lines of business with those insurers ('override commissions');
- commissions from premium funders; and
- membership fees.

In some cases, override commissions could be a major source of revenue for the head company. To the extent that membership services and distributions

²³ According to KPMG in its *General Insurance Industry Survey 2004 Australia* (p. 2), gross written premiums increased by 12% and underwriting profitability before tax improved by 428% between 2003 and 2004 for all insurers surveyed (being those earning premiums greater than \$200m in 2004).

by the head company are partially funded by insurers, ASIC believes that they should be regarded as part of the remuneration that the broker receives from the participating insurers. Membership services are in the nature of non-monetary remuneration from those insurers.

The rebates were found to be immaterial, in the accounting sense, to the annual gross revenue and, except in one case,²⁴ to the annual net profits before tax of the selected brokers.

Some cluster group members also entered into contingent and other preferential remuneration (such as override commission) arrangements with insurers directly.

Brokers have an obligation to disclose in their FSG rebates/distributions and non-monetary benefits (such as membership services) received from cluster group head companies to the extent that they are indirectly provided by insurers. Where such remuneration and benefit cannot be ascertained at the time the FSG is given to the client, a description of the means by which they are to be calculated or provided should be made in the FSG: reg 7.7.04(2).

Additionally, a broker should disclose the fact that it is a member of a cluster group in an SOA, if this is likely to constitute an ‘interest’ that is reasonably capable of influencing the advice of the broker: s947B(2)(e)(i).

Broker facilities

‘Broker facility’ is a term used to describe an industry arrangement that:

- is based on the broker agreeing with a single insurer or a panel of insurers that any risk that falls into certain categories or within a pre-agreed set of parameters may be placed into the broker facility. The parameters for eligibility include such criteria as occupation or business of the insured, asset size, claims experience and sum insured;
- has mainly been aimed at small and medium size clients;
- often involves the broker receiving additional remuneration for undertaking the underwriting and claims administration functions on behalf of the insurer(s); and
- involves pre-agreed policy wordings that need to be referred to the insurer(s) for approval if any variation is required.

Some brokers have argued that broker facilities are a legitimate and efficient means for small and medium sized clients to obtain appropriate and

²⁴ Not the same broker as that in footnote 20, which had material (40%) contingent remuneration as a percentage of net profit before tax.

affordable covers. This is especially so where the insured is a common interest group (such as a club or other association seeking public liability, professional indemnity or some other industry-specific insurance), as a broker facility affords a certain level of commercial convenience for such group cover.

In ASIC's notices, brokers were required to provide some information about broker facilities. Findings based on the responses were as follows:

- eight of the 15 selected brokers had entered into such facilities;
- financial benefits derived from broker facilities as a percentage of gross revenue ranged from 0.7% to 63% in the latest financial years of the eight brokers; and
- the fact of placement into a broker facility was not usually disclosed to clients.

There is no express statutory requirement that a broker must disclose the fact that a broker facility is being used.²⁵ However, brokers may need to disclose other matters in relation to the facility that could represent a conflict of interest or could influence their advice. Possible examples include:

- contingent or other preferential remuneration arrangements; and
- where a broker acts for an insurer under a facility but acts for the insured in respect of claims.

Where the giving of advice to a client to place their business into the facility is carried out without due regard to the needs of the client, mere disclosure of the placement through the facility would not of itself be sufficient. If the placement constituted a failure of the broker to act in the best interests of the client, this would represent a breach of its common law fiduciary duty and Corporations Act duties such as the duty to act efficiently, honestly and fairly and to ensure that the advice is appropriate. However, based on a review of the responses, there was nothing to suggest that there were breaches of this nature.

Unsigned agreements

It is noted that a number of copies of agreements provided by some brokers and insurers in relation to contingent remuneration arrangements, broker facilities and other arrangements operating during the relevant period were

²⁵ There is, however, a specific requirement to disclose a binder arrangement (if it is part of the facility) in the FSG: s942B(2)(i), s942C(2)(j) and [PS 175.69].

not signed and/or dated by the parties. Some seem to have been in existence for a long time.

It appears that an industry practice may have existed amongst some brokers and insurers to rely upon draft written agreements that were implemented but were not formally executed by the parties. This raises concerns about the certainty and enforceability of the terms of such agreements, and the capacity of the broker to provide financial services to clients efficiently, honestly and fairly, as required by s912A(1)(a).

However, it is acknowledged that the unsigned agreements provided to ASIC may not be conclusive evidence of the prevalence of brokers and insurers operating under unexecuted agreements in general.

Managing conflicts of interest

ASIC reviewed the disclosure of conflicts of interest by selected brokers during the relevant period and their documented procedures for managing conflicts of interest in relation to the commencement of s912A(1)(aa) from 1 January 2005.

Wholesale clients

Where contingent remuneration appeared to have given rise to a conflict of interest,²⁶ some brokers had not disclosed to wholesale clients:

- the existence of the arrangements;
- the basis for calculating the contingent remuneration; and/or
- (where applicable) that the contingent remuneration applied to the particular transaction.

ASIC believes that the information outlined above is necessary for the disclosure to be ‘specific and meaningful’: [PS 181.52].

In relation to disclosure of contingent remuneration to wholesale clients, one broker indicated it would disclose in its invoices to clients that remuneration arrangements could be found on the broker’s website. Whether or not disclosure of a conflict of interest via the invoice and the broker’s website would be ‘timely, prominent, specific and meaningful’ (as required by [PS 181.52]) would need to be determined based on the facts of each case.

²⁶ Generally, it appears that contingent remuneration or other preferential remuneration arrangements (e.g. override commission) with insurers that relate to the broker acting in its capacity as agent of the insured would give rise to a conflict of interest that must be managed.

Override commissions

Override commission arrangements could also constitute a conflict of interest but may not have been adequately disclosed in some cases to both wholesale and retail clients.

Acting in dual capacities

Although some brokers argued that any contingent remuneration associated with their capacity as agent of an insurer did not represent a conflict of interest, this issue would need to be assessed on a case-by-case basis. It is noted that the National Insurance Brokers Association considers, and ASIC agrees, that a conflict of interest could arise in the following situation:

Where a broker acts as agent of an insured in some situations and as agent of the insurer and not the insured in others e.g. the insurer may arrange one policy for an insured on the open market and another under a binder. If the insured is not made aware of this situation [by] the insurance broker a conflict of interest may arise.²⁷

Corporate groups

Conflicts of interest within a corporate group require careful management. The following observations are made:

- In some cases, a broker acted for the insured while a related company (usually an insurance agent)²⁸ acted for the insurers. Where contingent remuneration applied only to financial services provided by the related insurance agent but not to those provided by the broker, some brokers argued that no conflict of interest existed in relation to the contingent remuneration. Nevertheless, it is important that there is adequate disclosure to ensure that clients know for whom the broker and the insurance agent act when insurance products are recommended to them.
- In the above situation, if the broker had referred business to its related insurance agent, the association would probably have constituted a conflict of interest that would need to be managed.
- Clear disclosure in both the FSG and the SOA is even more critical when clients are dealing with a third person acting as an authorised representative of both the broker and a related insurance agent. That

²⁷ NIBA, 'Hints for Insurance Brokers Dealing with Conflicts of Interest', issued December 2004, available at: www.niba.com.au/niba/html/hints_for_insurance_brokers_dealing_with_conflicts_of_interest.cfm

²⁸ While an insurance agent arranges insurance for the public, it acts as agent of the insurer only and not of the insured.

authorised representative would be wearing ‘two hats’ in making product recommendations to the same client.

Documented procedures

The obligation under s912A(1)(aa) to have adequate arrangements in place for managing conflicts of interest started on 1 January 2005, after the relevant period of the review. However, the selected brokers were asked to provide their conflict management procedures if they were in place at the date of the notices. All were able to provide those procedures. A review of these documents indicated that:

- documentation varied from short statements to detailed manuals;
- some of the manuals may be inadequate in setting out detection and monitoring procedures to ensure that any non-compliance with the licensee’s conflict management arrangements is identified on a timely basis and appropriately acted upon;²⁹ and
- robust information barriers or ‘Chinese walls’ were mentioned as an internal control necessary to manage conflicts where a broker is appointed to a new client who is in direct competition with an existing client and where there is sharing of premises between a broker and an insurance agent.³⁰

In their procedures, brokers generally considered that most, if not all, conflicts of interest arising from contingent and other preferential remuneration arrangements could be adequately managed by disclosure. While each case has to be assessed on its merits, ASIC’s policy is that remuneration practices that place the interests of the broker or its representatives in direct and significant conflict with those of its clients should be avoided and not merely disclosed: [PS 181.39]. There is an increased risk that mere disclosure may be insufficient where, for example, contingent remuneration constituting a conflict of interest is very significant to a broker’s revenue and/or profit.

²⁹ For example, in one case, the management of conflicts procedures state that there will be ‘regular audits’ without explaining details such as who will conduct the audits, how often audits will be carried out or to whom such audits will be reported.

³⁰ This is consistent with internal controls suggested in [PS 181.35]–[PS 181.37].

Steering

In response to a question in the s912C notices, all selected brokers stated to ASIC that they did not provide any financial benefits to encourage staff to place business with particular insurers.

In the s31 notices to brokers, ASIC also asked for a copy of all documents provided to staff and representatives in relation to the operation of financial benefit arrangements with insurers. There was nothing in the produced documents that evidenced any directive or encouragement from management to steer business to preferred insurers.

However, ASIC did receive material from one member of a cluster group containing statements made by the group's head company encouraging its members to utilise the services of preferred 'suppliers', i.e. insurers and premium funders. In particular, those statements indicated that the preferred suppliers paid extra commissions to the head company, the benefits of which could be passed on to members in the form of a rebate.

While it cannot be inferred from this that a broker member will necessarily be influenced by such statements, it does suggest that steering may exist at some level of the Australian insurance broking industry.

It should be noted that steering is not necessarily prohibited under the Corporations Act. However, in some circumstances, steering could lead to a breach of the Corporations Act and other laws if, for example, it resulted in inappropriate advice, misleading or deceptive conduct or other detriment to the interests of clients. Furthermore, where it is the practice of a broker to steer, there may be a conflict of interest that must be adequately managed by avoidance, or a combination of appropriate internal controls and disclosure.

Disclosure of remuneration***Retail clients*****GENERAL REMUNERATION**

In their FSGs, the selected brokers generally disclosed the receipt of:

- commissions from insurers as a percentage range;
- if applicable, contingent remuneration payable by insurers and broker fees payable by the client; and
- fee for service type remuneration from insurers.

In some cases, disclosure of a commission percentage range (as required by reg 7.7.04(3)) without further disclosure of the means by which the

commission was to be calculated or provided may not be sufficient to comply with reg 7.7.04(2)(b).

Disclosure of the composition of the commissions may be necessary for managing potential conflicts of interest if the commission rate included an override component or other incentives for the broker to refer business to particular insurers.

However, it should be noted that disclosure of remuneration (and other information) in the FSG is covered by the Refinements paper currently released for consultation. The outcomes of the Refinements paper proposals will require further policy development by ASIC in collaboration with the Treasury in ensuring that regulatory guidance is consistent with policy objectives.

ASIC could not ascertain from the information obtained whether 'fee for service' type remuneration received by some brokers reflected the economic value of the service to the insurer. If the remuneration significantly exceeded the economic value of the service, clients could be misled about the true nature of the remuneration. There could also be a risk of the broker receiving hidden or secret commissions and a failure to adequately manage a conflict of interest.

The actual dollar amounts for commissions and broker fees charged to the client were disclosed in the sample SOAs provided to ASIC.

CONTINGENT REMUNERATION

The level of disclosure regarding contingent remuneration varied in the brokers' FSGs. Some disclosures were very brief, and stated, for example, that 'the broker may receive profit share commission from insurers where it has an agreement in relation to performance'. Others provided a more detailed description of the basis of the profit share and/or volume bonus and if applicable, the nature of non-monetary benefits provided to the brokers if the benchmarks were met.

Two of the brokers did not disclose their contingent remuneration arrangements in their FSGs until after ASIC issued notices to them on 9 December 2004, nearly six months after the arrangements were entered into.

Contingent remuneration was not disclosed in the sample SOAs of some of the brokers that had contingent remuneration arrangements. It was not clear whether contingent remuneration applied to those particular transactions. If it did, disclosure would have been required under s947B(2)(d).

Brokers should consider the level of disclosure about contingent remuneration on a case-by-case basis, having regard to what a retail client would reasonably require for the purpose of making a decision whether to acquire the financial services (s942B(3)) and the need to manage any conflict of interest.

OTHER REMUNERATION

Rebates received by some cluster group members, to the extent that those rebates were indirectly funded by participating insurers, were not disclosed by some brokers to clients on the basis of immateriality.

There did not appear to be a recognition by some brokers that membership services provided by the cluster group head company (if to some extent funded indirectly by insurers) represented non-monetary remuneration and should have been disclosed as such.

Other types of non-monetary remuneration were also not disclosed by some brokers in their FSGs or SOAs on the basis of immateriality and/or difficulty in quantifying the actual amount of the benefit.

As discussed in Section 2, 'Legal requirements', brokers must disclose in their FSG all remuneration and other benefits, including non-monetary benefits. There is no materiality element in the disclosure obligations under the legislation. Therefore, any remuneration should be disclosed in the FSG to the extent that it is received in connection with the broker's financial services, although the level of detail required to be disclosed should take into account what a retail client would reasonably require. If the small value of the remuneration cannot reasonably be considered capable of influencing the advice, disclosure may not be required in the SOA.

Where remuneration from an insurer relates to a fee for service arrangement, one broker argued that no disclosure was required in the FSG or SOA as the remuneration did not relate to the provision of financial services.³¹ However, if the 'fee for service' is capable of influencing the broker in providing financial product advice, disclosure in the SOA would be required: [PS 175.129]–[PS 175.130].

³¹ Disclosure obligations under s942B(2) or s947B(2) are not triggered if the remuneration does not relate to the provision of a financial service.

Wholesale clients

Based on the responses, while brokers' fees were disclosed in the advice/invoice to wholesale clients, commissions were usually only disclosed to them upon request.

The Corporations Act does not expressly prescribe any obligation to disclose to wholesale clients the remuneration paid to brokers by insurers. However, where remuneration received from an insurer constitutes a conflict of interest, that conflict would need to be managed by the broker through, for example, disclosure to the client, irrespective of whether the client is retail or wholesale.

Appropriateness of advice

None of the responses indicated that contingent or other preferential remuneration had influenced advice or resulted in inappropriate advice.

Some brokers argued that as contingent or other preferential remuneration arrangements were mainly with reputable and large insurers, these insurers generally offered the most suitable products or service for their clients anyway. The brokers believed that they could manage any potential conflict of interest by disclosing their remuneration to clients.

A proper assessment of whether advice given by brokers is appropriate can only be achieved through an extensive inspection of client files, and detailed analysis of the advice based on client needs. These types of assessments were beyond the scope of ASIC's review and have not been carried out. Future reviews by ASIC will seek to test this issue.

'Bid-rigging'

One of the questions in ASIC's s912C notices to brokers and insurers asked whether there had been any instances where the broker, its employees, related entities or representatives procured or provided insurance quotes that were not on arms length terms (i.e. engaged in 'bid-rigging'). All respondents indicated that they did not engage in, or were not aware of, such practices.

ASIC's s31 notices to brokers also required production of all documents that set out the systems and procedures in place to monitor and manage the risk of unfair or dishonest conduct, including procurement of quotes that are not at arms length.

In response to a question in ASIC's s912C notice on whether it had provided quotes not based on arms length terms, one insurer answered that it had

indicated to a broker (unnamed) that premiums would be reduced for one of the broker's clients on renewal. However, the broker advised the insurer that the reduction was not necessary and that expiring terms would suffice. The conduct occurred in circumstances where the broker acted as the agent of the client. It is not clear whether there were legitimate commercial reasons for the broker not to accept a lower quote from the insurer.

An insurer also indicated to ASIC that it was aware of instances of brokers advising insurers, after they had given a quote for certain business, that they may increase their quote to a certain level and still retain the business. The stated possible reasons for this practice include:

- brokers are normally paid commission as a percentage of gross written premium (GWP). An increase in GWP on the policy concerned therefore increases the commission payable to the broker; and
- a broker may be embarrassed before its client by a low quote, if premiums in previous years were higher and there is no good explanation for the lower premium in this case. An increase in the quote would remove that embarrassment.

The two types of practices outlined above raise a question of whether the broker was preferring its own interest over that of its client in order to obtain a higher commission based on the higher premium. If so, this would constitute a breach of a range of legal obligations, including:

- the broker's common law fiduciary duty to its client;
- the duty to act efficiently, honestly and fairly;
- the obligation to provide suitable advice to its client;
- the obligation to adequately manage conflicts of interest; and
- the consumer protection provisions of Subdivision D of Division 2 of the ASIC Act and Part 7.10 of the Corporations Act.

Other than the two practices outlined above, which may not fit the criteria for bid-rigging, there was nothing in the responses to suggest that bid-rigging has occurred in the Australian insurance broking industry.

Miscellaneous potential breaches

Apart from the potential breaches relating to disclosure of remuneration or management of conflicts of interest discussed earlier in this section, ASIC's review also identified some miscellaneous potential breaches. These are set out in the following table.

Table 1: Miscellaneous potential breaches identified during ASIC's review

Conduct	Potential breach of Corporations Act
Failure to give an SOA or Statement of Additional Advice in relation to renewal of insurance cover. ³² (The broker concerned included a general advice warning when it was personal advice)	s946A or under Class Order [CO 04/576], s948AA
Failure to disclose in the FSG that the broker may sometimes act under a binder	s942B(2)(i)
Failure to disclose in the FSG association with insurers whose products may be recommended (although the association is disclosed in the SOA)	s942B(2)(f)
Combining an FSG and a SOA in one document	s947E

³² Under the Refinements paper proposals (proposal 2.1), advice providers may be exempted from providing an SOA or Statement of Additional Advice where there is an ongoing relationship between a retail client and a provider, and there are no significant changes in the client's personal circumstances or basis of the advice since the last SOA was given. The provider would instead be required to keep a record of the subsequent advice for seven years and provide it to the client, if requested.

Section 4: Conclusion and future action

Conclusion

In conducting its review, ASIC did not find evidence of systemic misconduct of the kind or scale uncovered in the United States. However, ASIC did identify deficiencies in relation to Australian brokers' management of conflicts of interest and disclosure of remuneration.

Future action

ASIC will be in contact with individual entities to seek to resolve and remedy any potential breaches identified, and discuss areas for improvements in their compliance procedures. Having regard to the nature of the apparent breaches that have been identified in this review and subject to satisfactory resolution of the breaches, it is unlikely that ASIC will need to take enforcement action in relation to them.

ASIC intends to consult with relevant industry bodies and consumer groups regarding the implications of these findings before determining whether any guidelines or regulatory changes are required for insurance brokers. Where appropriate, ASIC will make further inquiries into some of the issues identified. ASIC will maintain liaison with the Australian Prudential Regulation Authority to ensure that there is a consistent approach in the regulation of the insurance industry.

Management of conflicts of interest and disclosure of remuneration by insurance brokers will continue to be the subject of regulatory scrutiny by ASIC. In looking at this issue in subsequent reviews, ASIC will expect to see robust conflict management arrangements and, where disclosure is appropriate to managing conflicts of interest, disclosure that is timely, specific, prominent and meaningful. ASIC will also review the extent of any growth in contingent remuneration and expects that brokers will carefully review such arrangements, to satisfy themselves that they are meeting all of their obligations.

In considering the adequacy of disclosure, ASIC will take the Federal Government's Refinements paper proposals into account.