ASIC

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REPORT 29

Preferential remuneration project

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Executive summary

Background

Preferential remuneration is the higher commission paid to financial advisers when they recommend financial products issued by their institution rather than by third party fund managers.

Preferential remuneration is of growing importance because large financial institutions are acquiring an increasingly significant segment of the financial advising market. They own 60% of the top 50 adviser groups, and part own a further 12%. There are very few large adviser groups remaining that are not owned by banks, insurance companies or fund managers.

Payment of preferential remuneration is permitted if advisers comply with Corporations Act requirements for disclosing commissions, giving advice, and recording the advice and commission.

From 11 March 2004, tougher Corporations Act requirements — introduced by the *Financial Services Reform Act 2001* (FSR Act) — apply to all financial services businesses. The law now applies to more products, and to remuneration paid to a more extensive range of related parties. There are new provisions to ensure that advice and commissions are recorded and disclosed in a clear, concise and effective manner, and that a reasonable level of detail is provided to consumers.

Project purpose

ASIC conducted this surveillance project to ascertain whether consumers were receiving the advice and disclosure required by law, and to put financial institutions on notice that preferential remuneration would be subject to ongoing regulatory scrutiny.

Because the surveillance visits for this project were conducted principally during the 2002–2003 financial year, before the changes introduced by the FSR Act took effect, the project findings are based on the 'old' advice and disclosure requirements under the law. They do not take into account any new procedures that financial institutions may subsequently have put in place, in response to the new FSR Act requirements.

Project background and methodology

Section 1 of this report provides a detailed background to the project, including a summary of the old and new advice and disclosure requirements, and an explanation of the significance of commission payments in the financial services industry. The section also outlines why ASIC is concerned

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about the quality of advice being provided, not least because of the risk that advice is influenced by preferential remuneration incentives. It concludes with a synopsis of other related ASIC projects and initiatives.

The surveillance project methodology involved an initial review of the advisory arms of a number of financial institutions. Three institutions were short-listed for detailed review and 70 advisers were selected from the short-listed institutions, leading to the examination of 405 of their client files. Section 2 describes the project methodology in more detail.

Project findings

There are three key findings:

- **Appropriateness of master trusts** — Consumers were routinely advised to invest through master trust vehicles without clear documentation as to why those vehicles were appropriate. Master trusts were recommended as the principal investment to almost three-quarters of the 405 consumers covered in this project. Many files examined contained generic explanations as to why the investment was appropriate. But fewer than 10% documented specific explanations of why a master trust was recommended to the client. Clearer, customised documentation of the reasons supporting the recommendation of these investments is essential, because in some circumstances a master trust is a costly option (particularly when there is only a small balance in the account) and is not always appropriate for particular consumers.
- **Commission and fee disclosure** — Preferential remuneration was disclosed in a majority of cases, but documentation of the disclosure, and the detail and clarity of the disclosure, would need to improve to meet the standard now imposed by the FSR Act. The client file reviews suggest that many consumers are not yet aware that financial institutions pay advisers more when the advisers recommend in-house products. In a number of instances advisers failed to make it clear to consumers exactly how much they were being paid in commissions and specifically that they were paid higher commissions to recommend in-house products.

  There was also confusing disclosure of non-commission-based fees and charges.
- **Quality of advice** — Findings on the quality of advice were, as anticipated, broadly consistent with the ASIC/ACA survey that had been conducted at much the same time, although ASIC is aware that many financial institutions have since taken steps to tighten up on advisers' procedures.

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Inadequate documentation evidencing compliance with the ‘know your client’ and ‘know your product’ rules often made it difficult to be satisfied that advisers’ recommendations of in-house products were not motivated by higher remuneration.

Specific examples of advice deficiencies are listed in Section 3, and chiefly relate to inadequate explanation and/or documentation.

Future action

ASIC anticipates that in the process of preparing for their new Australian financial services (AFS) licences, financial institutions will have taken steps to improve commission disclosure, compliance, and management of conflicts. Now that the FSR transition period has ended, and the FSR Act provisions apply, ASIC will conduct further research and compliance visits to ascertain whether the requirements of the new law are being met. ASIC will also work with industry to develop improved guidelines. Further details are provided in Section 4.

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Section 1: Background

Legal requirements — disclosure of commissions and advice

During the FSR transition period, which ended on 10 March 2004, there were two regimes that required advisers to disclose commissions. Section 849 of the old law[1] applied to securities advisers who had not yet transitioned to the uniform financial services regime introduced by the FSR Act. Section 849 provided that the disclosure of commissions, fees and other interests was required where an adviser made a securities recommendation to a person who might have reasonably been expected to rely on it.

Advisers operating under a new AFS licence are subject to the disclosure requirements of Part 7.7 (in particular, s947B and 947C) of the Corporations Act. Part 7.7 was inserted by the FSR Act and commenced operation on 11 March 2002 subject to a two-year transition period.

These two sets of requirements are similar in many respects, although Part 7.7 covers a wider range of financial products. Also, Part 7.7 requires disclosure of remuneration and benefits payable to a wider group of related parties. For example s849 of the old law covered payments to the adviser and associates of the adviser that might be likely to influence recommendations. Section 947B of the new law covers payments to the adviser, a related body corporate of the adviser, a director or employee of the adviser or a related body corporate or an associate of any of them, that might be likely to influence recommendations. Further, Part 7.7 contains a 'level of detail' requirement, which mandates disclosure at a level of detail that a consumer would reasonably require for the purpose of deciding whether to act on the advice. Further, this information must be presented in a clear, concise and effective manner.

Both old and new laws also require an adviser to give suitable advice. Section 851 of the old law prohibited an adviser from making a securities recommendation to a person who might reasonably have been expected to rely on it unless the adviser had a reasonable basis for making the recommendation. Similar requirements now exist under s945A(1) of the new

[1] 'Old law' refers to the *Corporations Act 2001* as in force immediately before the commencement of the *Financial Services Reform Act 2001* (FSR Act). 'New law' refers to the *Corporations Act 2001* (as amended by the FSR Act, the *Financial Services Reform (Consequential Provisions) Act 2001*, the *Financial Services Reform (Consequential Provisions) Act 2002* and the *Financial Services Reform Amendment Act 2003*).

law but, again, they extend to a wider range of financial products. Further, under the new law, a failure to provide suitable advice is now an offence carrying a penalty of 200 penalty units, 5 years imprisonment or both. There are now explicit requirements under s946A to give clients a Statement of Advice (SOA) documenting the advice provided.

Additional information is provided in Appendix A regarding the old law requirements, and in Appendix B regarding the new law requirements. Appendix C compares the old and new regimes.

The significance of commission payments

Financial advisers have a system of remuneration that differs from other professional advice groups in that financial advisers are usually not paid by their clients but generally derive their income from the commissions paid to them by fund managers. Most advisers depend on fund managers for their revenue and do not charge consumers on a ‘fee-for-service’ basis.

Fund managers aim to build distribution of their products and pay commission to encourage product sales. The commissions accrue to the adviser when consumers invest in fund managers’ products. This system of remuneration can give rise to conflicts of interest because the adviser has a duty to give suitable advice to each client, but is paid for that advice by the fund manager. This system of remuneration has the potential to place a focus on selling products, rather than on giving impartial advice.

Commission-based remuneration means that advisers and fund managers are co-dependent. Fund managers need advisers to promote their products and advisers need fund managers for their livelihood. The law recognises this conflict. It imposes the ‘appropriate advice rule’ and requires disclosure of anything that could influence the advice given.

ASIC is concerned that:

- consumers may not appreciate the distinction between paying direct fees for adviser services, and paying indirectly through product entry fees on which commission is paid to the adviser — they may erroneously perceive that commission-based advice is ‘free’; and
- consumers may not appreciate exactly how much they pay in total when they pay indirectly by commissions.

There are many different types of commissions but the main ones are commissions that are paid when the consumer makes an investment in a fund (ie upfront commissions) and trail commissions that are paid as long as a consumer remains with a fund. Although upfront commissions are often

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rebated to consumers, the trail commissions usually remain intact. Trail commissions of 0.35% to 0.7% annually make up a crucial part of an adviser's income and provide a basis for valuing an adviser's business.

Other commissions fund managers may pay advisers include soft dollar commissions like conference sponsorship, study tours, holidays and airline tickets. Fund managers can also reward advisers with shares for meeting specific sales volumes. For example, one financial institution reviewed during this project rewards advisers with options over shares.

Advisers are required to disclose commissions and benefits paid directly or indirectly to them.

Complaints about quality of advice

The incentive of preferential remuneration can affect the quality of advice provided.

ASIC has observed a trend of increased complaints about the quality of advice. This is consistent with Financial Planning Association (FPA) experience, which notes that 46% of complaints from investors are about unsuitable advice. This may reflect the different expectations of advisers and consumers.

A survey of managed fund consumers in July 2001 by Sweeny Research commissioned by the Investment and Financial Services Association (IFSA) showed that while the level of fees was important to investors, disclosure and transparency was also a key concern. For example, only 57% of consumers surveyed were confident that their adviser had disclosed all fees and charges, 32% did not understand the fees that they were paying and 54% would prefer fees stated in dollar terms.

Most complaints about poor advice, lack of disclosure of fees and charges and misrepresentation are dealt with by the Financial Industry Complaints Service Limited (FICS). FICS decisions in 2002 show increasing levels of inappropriate advice, usually resulting from a failure to take into account consumer objectives. FICS received 83 financial planning complaints in 2000, 186 in 2001 and 257 in 2002.

Historically, ASIC has reviewed different aspects of compliance with the disclosure and advice obligations in the financial services industry and some of these reviews have led to enforcement outcomes and bannings. ASIC has also released a number of reports and statements relating to the quality of advice and disclosure, including the following publications:

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ASIC publications

Ramsay report

In 2002, ASIC released the report *Disclosure of fees and charges in managed investments, review of current Australian requirements and options for reform*, which was prepared by Professor Ian Ramsay. This report, known as the 'Ramsay report', made a number of important points about disclosure of product issuer fees, but also contained some recommendations about disclosure of adviser fees by product issuers. The report stated that the fees section of a Product Disclosure Statement (PDS) should contain disclosure of fees paid to advisers — both upon an initial investment and on an ongoing basis. Where other payments may apply, such as bonuses for having clients invest specified amounts in certain financial products, Professor Ramsay recommended that the PDS draw attention to the fact that these arrangements exist. Professor Ramsay also saw merit in having more standardised disclosure of the extent to which investors may negotiate rebates with advisers.

Report on primary production schemes

In February 2003, ASIC reported on the quality of advice and disclosure of commissions for tax-driven mass-marketed schemes. ASIC's report examined the correlation between the receipt of high commissions by financial advisers and the provision of inappropriate or misleading advice to encourage investors to invest in tax schemes.

Joint ASIC/ACA survey on quality of advice

In February 2003, ASIC and the Australian Consumers Association (ACA) released the results of a joint survey on the quality of advice provided by a sample of financial advisers including the planning arms of some financial institutions. In the third survey of its kind, consumers obtained 124 plans from advisers around the country. Panels of industry experts assessed whether the plans met the legal requirements under the old law and 'best practice' standards of the industry. The survey identified a number of weaknesses and concerns about the advice process and the quality of advice.

Policy Statement 175

ASIC published Policy Statement 175 *Licensing: Financial product advisers — Conduct and disclosure* [PS 175] on 26 June 2003. The policy statement gives guidance on remuneration disclosure and best practice for SOAs under the FSR Act amendments, as well as related matters like the obligation to keep good records.

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ASIC fee model

In August 2003, ASIC released a good practice model for fee disclosure in PDSs under the FSR Act amendments. Consistent with Professor Ramsay's recommendations, this model requires product issuers to indicate which fees include commissions payable to an adviser, together with details of these commissions. It also requires product issuers to provide more detailed information about whether and how the consumer can receive a rebate of those commissions or otherwise negotiate the level of those commissions.

ASIC ancillary benefits research report

ASIC is currently preparing a research report on ancillary benefits — also known as soft dollar commissions — which are benefits given to licensees or their advisers in addition to standard commissions. Examples include volume bonuses, overseas conferences, free software and shares in the product provider. The structures for ancillary benefits sometimes give preference to in-house products. The report examines the kinds of benefits received and how they are disclosed.

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Section 2: Project methodology

Review of remuneration practices

The project commenced with a review of nine financial institutions and their advisory arms.

Based on that review, ASIC obtained information from seven financial institutions that sold in-house products to consumers in the last financial year. ASIC notices were served on those institutions requiring production of information regarding:

- organisational structure;
- distribution channels for group products (advisers and any other staff who promote the products);
- product lists;
- remuneration arrangements;
- specific training on disclosure of commissions; and
- marketing plans.

Detailed review of three financial institutions

Three financial institutions were short-listed for detailed review. All offered a full range of products, including external and internal products, and had preferential remuneration arrangements where advisers recommended in-house products.

Notices under s788, requiring a licence holder to prepare information for ASIC, were served on the three financial institutions. In the first notice ASIC sought a list of all advisers and the total income generated by adviser, including details of:

- placement commissions;
- upfront brokerage;
- ongoing brokerage;
- service fees (if any);
- bonuses; and
- any other fees or benefits.

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Selection of advisers

On the basis of that information, a sample of 70 advisers was selected. The sample included advisers from each institution and with a mix of high, medium and low sellers of in-house products. A second s788 notice was served on the financial institutions requiring the following information for each selected adviser:

- every product sold by each of the selected advisers;
- details of commission received for each product sold;
- full name of each consumer to whom the product was sold;
- address and contact details of the consumer;
- amount invested by the consumer;
- date of investment; and
- amount of commission received by the adviser for the investment.

This information was used to select a sample of client files from each adviser.

Audit of files

ASIC selected 405 files, showing a mix of consumers by adviser, location across Australia, and portfolio size. Notices under s30 of the *Australian Securities and Investments Commission Act 2001* were served to obtain the client files from each financial institution.

When reviewing the files ASIC considered the following issues:

- whether the adviser recommended internal or external products and what the main types of recommended products were;
- the type of remuneration and the disclosure;
- whether the adviser recommended master trusts;
- the types of fees and the disclosure;
- the basis for the recommendation; and
- the standard of record-keeping.

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Section 3: Project findings

Master trusts — appropriateness must be documented

Many advisers recommended that consumers channel all their assets into a master trust or a wrap account linked to the adviser.

Master trusts may not be appropriate for all consumers. Master trusts can be expensive and it can take time to switch from one adviser to another if the consumer's investments are made through a master trust linked to the first adviser.

Master trusts advertise their ability to trade on a wholesale level but consumers may not always obtain discounts or benefits from the economies of scale and increased negotiation power available to these trusts. Further, consumers may pay higher ongoing fees or trails overall than if they had invested directly in the retail version of the underlying fund because the master trust adds its own fee layer.

Master trusts have three levels of fees:

- underlying fund manager's wholesale fee of between 0.5 and 1%;
- master trust fee of between 0.5 and 2%; and
- adviser's fee of between 0.5 and 1%.

This results in a fee structure of up to 4%. The higher level of fees is often explained as being for the service and flexibility offered by a master trust. However, as an alternative, a consumer could invest directly into a retail product with a fee of 1.5% to the fund manager and an adviser's fee of 0.5%, representing a much lower fee structure. A small difference in fee levels can make a large difference to long-term savings.

The benefits of a discretionary master trust are generally more applicable for larger investments and then only if the consumer needs a lot of flexibility. The benefits of master trusts may offset the higher overall fee levels for high net worth individuals. The FPA acknowledged in 2001 that the master trust benefits of full service delivery and diversification are not useful to consumers who have small balances. Yet small investors may find it difficult to find an adviser who is not linked to a master trust because investing money through a master trust is simpler and may lower administration costs for advisers.

ASIC understands, however, that industry has recently developed some 'lower service' master trusts at reduced fee rates.

Almost three-quarters of the 405 consumers covered in this project had been advised to invest principally through master trusts. Although many of the files examined during the project contained generic explanations for why using trusts was appropriate, fewer than 10% documented specific explanations. The FSR Act provisions will make it easier for ASIC to enforce more comprehensive documentation of explanations.

Commission payments — disclosure shortcomings

In 52% of cases where preferential remuneration was paid, disclosure of that remuneration was made to the consumer (usually in a financial plan).

A further 25% of files (where preferential remuneration was paid) may have had preferential remuneration disclosures made to the consumer, but the documentation on the files did not conclusively demonstrate that this had occurred.

The styles of disclosure used by many financial advisers did not aid comprehension, particularly of the financial impact of fees. Many files had inadequate s849 disclosure and little useful information about fees and charges. Each of the advisory arms had a pro forma disclosure template that advisers generally used.

One entity disclosed commission in the financial plans under a heading ‘Upfront fee disclosure’ followed by a table. This page was followed by another page headed ‘Ongoing fee disclosure’. There was no mention of preferential remuneration or any reference to s849 disclosure.

Another had an alternative style that referred to s849 and briefly explained the types of commission payments in a client letter.

The third used a slightly different arrangement that referred to s849 and presented a financial table in the ‘Analysis of needs, goals and financial position’.

There were many different types of fees that could be charged, but often disclosure was patchy and inconsistent.

In some cases there was insufficient information to reconcile the file with commission payments received by the adviser.

There are a number of high-risk scenarios for consumers where ASIC observed from its review of files that more specific and detailed disclosure is required. These include, for example, where a consumer is ‘twisted’ or ‘churned’ from an external product into an in-house product.

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The above disclosure shortcomings, while more difficult to challenge under the law prevailing at the time, would probably now not comply with the 'clear, concise and effective' requirement of the FSR Act.

Advice not always fully explained

It was sometimes unclear whether advisers had complied with their obligations to give suitable advice under s851 because the file contained no explanation as to why recommendations were made or no provision of supporting calculations.

In many cases advisers purported to give 'limited advice' but the basis for this approach was not clear.

Specific findings from file reviews include the following examples:

- Several advisers recommended that consumers convert a pension or other product into internal products held through a master trust without explaining why.
- Several advisers failed to alert consumers to Centrelink issues.
- In some cases there was inadequate explanation of margin lending.
- There was inadequate documentation of advice for some small balances.
- In many cases, the stated reason for the recommendation was to 'ensure capital growth and maximise wealth' — no client-specific reason was given.
- In some cases, large volumes of generic fund manager material on the files made it difficult to understand what advice had been given to the consumer.
- Some files appeared to be transaction-based and there was little ongoing advice.

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Section 4: Future action

Commission disclosure

There has been some public and industry concern about inherent conflicts in the current commission system of payments. As described earlier, this conflict is exacerbated when financial institutions pay preferential remuneration for in-house products. The results of this project suggest that consumers may not always be aware that financial institutions pay preferential remuneration for in-house products and how much is being paid.

It appears that overseas regulators are seeking to deal with the issues raised by preferential remuneration by requiring advisers to make additional disclosure. In the United States advisers must disclose whether they receive any extra financial incentives to sell a particular fund or class of shares. In the United Kingdom, the Financial Services Authority has proposed disclosure obligations to ensure that consumers understand the scope of the advice service that different advisers may offer.

In releasing Policy Statement 175 [PS 175] on conduct and disclosure for financial advisers, ASIC has also started the process of improving disclosure of commissions in the context of the FSR Act reforms. [PS 175] notes, among other matters, that the requirement for clear, concise and effective disclosure means that all the information about remuneration, commissions and other benefits should be presented in one place in the SOA and in a way that is easy for the consumer to understand: see [PS 175.143].

[PS 175.157] currently gives guidance on comparative disclosure in cases where there is switching between products.

ASIC considers that:

- the obligation to ensure that financial services are provided efficiently honestly and fairly under s912A(1)(a) of the Corporations Act; and
- the requirement to disclose information with such level of detail as a person would reasonably require for the purpose of deciding whether to act on advice under s947B(3) and 947C(3) of the Corporations Act,

support the improved disclosure of preferential remuneration for in-house products.

Financial institutions must ensure that their advisers disclose preferential remuneration in line with legal requirements and best practice. ASIC will work with industry to formulate improved guidelines for the disclosure of commissions, in particular to ensure that SOAs set out comprehensively and

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clearly exactly how much consumers will pay in commissions and identify approximately how much extra remuneration advisers receive when they recommend in-house products rather than external products in that class.[2]

Compliance with obligations

Poor record-keeping by both advisers and licensees makes it difficult for licensees to monitor their advisers and deal with complaints from consumers and for compliance auditors to carry out their responsibilities. ASIC currently imposes licence conditions that require licensees to maintain records of Financial Services Guides (FSGs) and SOAs. ASIC will continue to monitor record-keeping practices and the supervision of advisers by licensees and, in particular, to review compliance audits. Policy Statement 164 *Licensing: Organisational capacities* [PS 164] gives guidance on licensees assessing their advisers at [PS 164.50].

A licensee's compliance plan or alternative risk management measures should set out in a clear and comprehensive manner how the licensee will:

- ensure that records are kept and maintained; and
- monitor advisers' compliance with their obligations to disclose interests and provide suitable advice.

ASIC will scrutinise the adequacy of record-keeping by licensees and advisers through targeted surveillance.

Management of conflicts

ASIC has released a policy proposal paper on the management of conflicts and is consulting with industry on the application of proposed s912(1)(aa) of the Corporations Act. This provision will require the holders of an AFS licence to have adequate arrangements in place to manage conflicts of interest. ASIC will discuss with industry whether specific guidance is needed on the management of conflicts that arise when advisers are paid preferential remuneration for recommending in-house products.

[2] Although this report has focused on the specific disclosure requirements for personal advice, FSGs may also need to include disclosure about preferential remuneration arrangements: see s942B(2)(e), 942B(3), 942C(2)(f) and 942C(3) of the Corporations Act.

Further research and surveillance

In view of the industry issues identified by ASIC's findings, ASIC proposes to conduct further research and surveillance into the quality of advice available to consumers. This research will take into account recent industry initiatives.

For example, ASIC understands that some financial institutions no longer have preferential remuneration arrangements for in-house products. ASIC is also aware that the FPA has embarked on a 'professional partnership' program in response to the results of the joint ASIC/ACA survey. ASIC also notes that the FPA and IFSA have recently released a discussion paper on alternative remuneration (soft dollar commissions). ASIC's further work will include the extent to which industry initiatives address the findings in this report.

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Appendix A: Old law

This section describes the legal and policy requirements applying during the period covered by this project.

Section 849(2) of the Corporations Act required securities advisers giving advice in certain circumstances to disclose:

(a) any commission or fee, or any other benefit or advantage, whether pecuniary or not and whether direct or indirect, that they (or their associates) have received or may or will receive in connection with making a securities recommendation; and

(b) any other pecuniary or other interest, whether direct or indirect, of the adviser (or an associate) that may reasonably be expected to be capable of influencing them in making the recommendation.

That meant that:

- commission, fees or other interests of associates of an adviser had to be disclosed;
- commission, fees or other interests that had to be disclosed could be direct or indirect;
- commission, fees or other interests that had to be disclosed could be pecuniary or non-pecuniary; and
- these disclosure requirements only applied where a recommendation was made in relation to securities. Under the old law, securities were defined to include shares, debentures, interests in managed investment schemes (which, for this purpose, includes superannuation) and options. They did not include insurance, derivatives other than options, futures or foreign exchange contracts.

Section 849(2) did not apply to any commission or fee that the adviser received directly from the client, however.

In what circumstances was disclosure to be made?

Subsection 849(1) provided that a disclosure of interests had to be made where a securities recommendation was made to a person who might reasonably have been expected to rely on it. ASIC interprets this requirement as meaning that a disclosure of interests had to be made only where an adviser was making a personal securities recommendation. A personal securities recommendation is a recommendation made expressly or impliedly

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to the effect that some action in relation to certain securities is appropriate for a consumer based on the consumer's particular needs.

How was the disclosure to be made?

If the recommendation was made orally, then the disclosure had to be made orally at the time of making the recommendation. If the recommendation was made in writing, the disclosure had to be set out in that written document in such a way as to be no less legible than other material in that document. Even if the disclosure had been made previously, it had to be repeated in each document containing a written securities recommendation.

What had to be disclosed?

The old law required that particulars of the fees, commissions and other interests had to be disclosed. This meant that it was not sufficient to state merely that commission may be payable or that certain securities may be held or that a benefit may be obtained by the adviser in connection with a dealing by the consumer. ASIC Policy Statement 122 *Investment advisory services: the conduct of business rules (s849 and s851)* [PS 122] at [PS 122.78] notes that the disclosure had to be made in a manner that was clear and easy for the client to understand, taking into account the consumer's level of sophistication.

The FPA in its Practice Guideline *Disclosure of financial adviser benefits and other charges incurred by clients* outlines how it considers Rule 106 of the FPA's Rules of Professional Conduct should be applied. Although this rule is not a legal requirement, the document is useful as an indication of standards of disclosure that the industry has imposed on itself. It states that disclosure of particulars of adviser benefits should be expressed in percentage terms as a minimum and in dollar terms where practicable. It further states that ongoing commission and fees should be expressed on an annualised basis and that the estimated dollars payable in respect of these matters for the first year should be shown, assuming no change to the initial investment.

Types of interests that needed to be disclosed

The following interests had to be disclosed under the old law:

- upfront commissions — paid by product issuers;
- trail commissions — ongoing periodic payments payable by a product issuer to the adviser who initially sold the product to a consumer for the period for which the product is held by the consumer;

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- soft dollar payments — these are non-cash benefits such as subsidised office space, access to research databases, provision of office equipment, advertising rebates and training seminars and may be provided by product issuers to advisers or their firms in connection with dealings in products issued by them following recommendations made by those advisers;
- reward schemes — for example, an adviser may be given a 'free' trip if a certain number of dealings in securities are generated through recommendations made by them;
- commission splits — the commission payable by a product issuer may be split between a licensee and its advisers. Section 849 required that the details of amounts of commission payable and the percentage split be disclosed as forming part of the 'particulars' of commission received by the adviser in connection with making the securities recommendation;
- own holdings — if the recommendation was likely to generate dealing in the product to the extent that it might have had an influence on the price of the product. For example, this might have occurred where the recommendation related to a large volume of thinly traded securities. The adviser might have benefited due to the alteration of the price of their own holdings and accordingly, the adviser's holdings should have been disclosed;
- affiliations with issuers and underwriters — advisers or their associates might have been affiliated with an entity that had an interest in dealings arising from a recommendation, such as the issuer themselves or an underwriter or adviser to the issuer. These affiliations had to be disclosed where they were reasonably likely to influence the recommendation made by the securities adviser.

Materiality

All fees, commissions, benefits and advantages resulting from the recommendation or a dealing arising from the recommendation had technically to be disclosed, regardless of their materiality. ASIC has, however, stated that immaterial fees, commissions, benefits or advantages need not be disclosed under limb (a) of the s849 requirements above.

Materiality was a factor in determining whether an 'other interest' (see limb (b) of the s849 requirements above) was likely to influence the recommendation. An immaterial interest may not have needed to be disclosed for that reason. For example, if a reward was payable to advisers for selling a large volume of a specified security and an adviser had no

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prospect of reaching that limit, they would not have been required to disclose that reward.

Who were the associates of a securities adviser?

Associates of a securities adviser included:

- the licensee from whom the adviser held a proper authority;
- if the adviser was a body corporate carrying on a securities business — the directors and secretaries of the body corporate, its related bodies corporate and their directors and secretaries;
- the adviser's partners in a partnership carrying on business as a securities dealer; or
- the trustee of a trust in relation to which the adviser benefited or was capable of benefiting.

Common law obligations

Although s849 did not apply where general securities advice, as opposed to personal securities advice, was being provided, the common law obligations in connection with the giving of advice by a fiduciary applied.

These are:

- to fully disclose any conflict of interest that may affect the general securities advice; and
- to adopt due care, diligence and competence in giving that advice to ensure that it is suitable for the purpose for which the persons to whom it is provided are reasonably likely to use it.

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Appendix B: New law

Since implementation of the FSR Act, ASIC regulates the advice industry in two main ways:

- Licensing — the requirement to hold an AFS licence and comply with provisions that apply to licensees giving advice; and
- Disclosure — licensees giving advice to retail clients must provide an FSG and, if the advice is personal advice, an SOA. A PDS must be given if a recommendation is made to acquire a financial product.

Under s911A(1), all persons carrying on a financial services business are required to hold an AFS licence. Under s912A(1)(a), licensees are required to ensure that the financial services covered by the licence are provided efficiently, honestly and fairly.

Under s941A, a licensee must provide an FSG to consumers. The contents are prescribed and require the disclosure of remuneration and associations: s942B(2)(e) and 942B(2)(f). This must be disclosed in a clear, concise and effective manner (s942B(6A)) and at a level of detail that a consumer would reasonably require for the purpose of making a decision whether to acquire financial services from the providing entity: s942B(3).

Under s945A an adviser is required to give appropriate advice — that is, advice where the adviser has determined the consumer's relevant personal circumstances, made reasonable inquiries into these circumstances and having regard to those circumstances and an investigation into the subject matter of the advice, given appropriate advice. Failure to give appropriate advice is an offence. Subsection 945B(1) requires an adviser to give a warning if the advice is based on incomplete or inaccurate information.

Section 946A sets out the regime for SOAs and requires advisers to provide consumers with an SOA that sets out the basis on which the advice is given, details of remuneration capable of influencing the advice and information about relationships capable of influencing the advice. Failure to provide an SOA is an offence. The SOA must be clear, concise and effective (s947B(6) and 947C(6)) and, in cases where consumers are advised to dispose of products, advisers must provide extra information on the charges and any of the benefits lost: s947D.

Under s1012A(3) an adviser must give a consumer a PDS when making a recommendation to acquire a financial product.

Further, an exposure draft of the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill proposes that s912A(1) be

amended to include a requirement that a licensee must have in place arrangements for the management of conflicts of interest that may arise wholly, or partially, in relation to activities undertaken by the licensee or a representative of the licensee: proposed s912(1)(aa).

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Appendix C: Comparison of old and new law

Part 7.7 of the new law provides that, when a licensee ('the providing entity') provides personal advice to a retail client, the providing entity must disclose information about:

- any remuneration (including commission) or other benefits that the providing entity (or a related body corporate, a director or employee of the providing entity or a related body corporate or an associate of any of the foregoing) is to receive;
- any other interests, whether pecuniary or not and whether direct or indirect, of the providing entity (or any associate); and
- any associations or relationships between the providing entity (or any associate) and the issuers of any financial products,

that might reasonably be expected to be capable of influencing the providing entity in providing the advice. This requires the disclosure of payments to a broader group of related parties than under the old s849 requirements.

Financial services covered

Under Part 7.7, disclosure of remuneration, associations and other interests is required for personal advice in relation to any type of financial product.

These requirements have a wider coverage than under the old s849 requirements, which were confined to advice about securities (as then defined in s92 — for example, shares, debentures, interests in managed investment schemes, options).

Personal advice

Disclosure of remuneration, associations and other interests is only required when the providing entity provides personal advice. Personal advice is financial product advice that takes into account the client's personal objectives, financial situation and particular needs: see [PS 175.11]–[PS 175.17] for the circumstances ASIC will take into account when considering whether advice is personal advice or not.

Retail clients

Disclosure of remuneration, associations and other interests is only required when the providing entity provides personal advice to retail clients. The underlying assumption of the FSR Act is that financial products or services

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are provided to a person as a retail client except where the Act clearly states otherwise.

Whether a consumer is a retail client depends on the type of financial product to which the services relate. There are separate definitions for:

- general insurance products;
- superannuation interests; and
- other kinds of financial products.

The distinction between wholesale and retail clients did not exist under the old s849 requirements. Section 849 technically applied to any personal securities recommendation provided by a securities adviser regardless of the circumstances of the client.

When must disclosure be made?

As a general rule, the providing entity must disclose remuneration, associations and other interests either:

- in the SOA, if the SOA is given to the consumer when the advice is provided; or
- orally when providing the advice, if the SOA is not given to the consumer when the advice is provided.

In substance, this is the same as under the old s849 requirements, which provided that:

- if the recommendation was made orally, then the disclosure needed to be made orally at the time of making the recommendation; and
- if the recommendation was made in writing, the disclosure needed to be set out in that written document in such a way as to be no less legible than other material in the document.

What must be disclosed?

The providing entity is required to disclose information about any remuneration, associations and other interests, which may include:

- all upfront commissions;
- trail commissions — ongoing periodic payments by product issuers to the adviser who initially sold the product to a client during period that the client holds the product;
- ‘soft’ dollar commissions or benefits — non-cash benefits provided by product issuers such as subsidised office space, access to research

databases, provision of office equipment, advertising rebates and training seminars;

- ‘back office’ payments — a payment for services provided to a product issuer, such as claims handling services and other administrative services that would otherwise be performed by the issuer itself, unless they are not reasonably capable of influencing the providing entity in providing the advice;
- reward schemes — for example, where the providing entity is given a ‘free’ trip if the number of financial products issued as a result of advice they provide exceeds a certain target;
- the providing entity’s own holdings — if the advice is likely to generate dealing in the product to the extent that it may have an influence on the price of the product. For example, this may occur where the advice relates to a large volume of a thinly-traded security. The providing entity may benefit due to the alteration of the price of their own holdings and accordingly, their holdings should be disclosed;
- affiliations or associations with product issuers and underwriters — the providing entity may be affiliated with an entity that has an interest in whether or not the client acts on the advice, such as the issuer or an underwriter or adviser to the issuer. These affiliations should be disclosed where they might reasonably be expected to be capable of influencing the advice.

The types of remuneration, associations and other interests that must be disclosed are substantially the same as under the old s849 requirements.

Is there a materiality requirement?

Generally, in administering the law, ASIC will take the view that disclosure is not required for information about remuneration, commission and other benefit where:

- the payment of, or the amount of, the remuneration, commission or other benefit does not depend in any way on whether the consumer acts on the advice;
- the remuneration, commission or other benefit is rebated in full to the consumer; or
- the providing entity was not, and could not reasonably be expected to have been, aware of the remuneration, commission or other benefit: [PS 175.128].

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However, even where the providing entity (or a related body corporate, a director or employee, or an associate) receives the same level of commission for all the financial products it recommends, the commission received should normally be disclosed in the SOA. This is because the receipt of the commission might reasonably be expected to be or have been capable of influencing the providing entity in deciding whether to recommend that the client purchase any financial product: [PS 175.139].

Similarly, under the old s849 requirements, ASIC has stated that immaterial fees, commissions, benefits, advantages or other interests need not be disclosed.

What level of detail must be disclosed?

Under both Part 7.7 and the old s849 requirements it is insufficient for the person providing the advice to merely state that a benefit will or may be received and that further details are available on request.

The FSR Act is supplemented by regulations, which mandate that an SOA must include detailed statements in relation to the remuneration (including commissions) and other benefits that an adviser is to receive, including:

- the total amount of remuneration commissions and benefits payable stated as an amount (or if the total amount cannot be identified when the SOA is provided, setting out a description of the method of calculation); and
- written detail of when and how the remuneration, commission and other benefits are payable.

In administering Part 7.7, ASIC takes the view that an SOA should normally set out, in easy to understand language, in one place:

- the circumstances in which the remuneration, commission and benefits required to be disclosed are expected to be received, the person(s) who would pay them, the adviser(s) expected to receive them and their source(s);
- in the case of monetary benefits required to be disclosed — a clear statement of the method of calculating each benefit, together with:
  - (i) the actual dollar amount of each benefit (where this can be ascertained at the time the SOA is provided);
  - (ii) worked dollar example(s) or percentages (where the actual dollar amount of the benefit cannot be identified at the time the SOA is provided); and

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(iii) the total of all monetary benefits expressed as a single dollar amount (where this can be identified when the SOA is provided); and

- in the case of non-monetary benefits required to be disclosed — a clear description of the benefits: [PS 175.131].

Ranges, rates, comparisons, simple tables and formulae should normally be included in the SOA to ensure that the information is presented in a clear, concise and effective manner. It is insufficient to merely state in the SOA that a benefit will or may be received and that consumers can ask for further details to be provided: [PS 175.132].

The old s849 requirements did not prescribe that commissions and other benefits need to be disclosed in the same level of detail. The regulations are also more prescriptive than the FPA's Practice Guideline and Rules of Professional Conduct (which are an industry standard rather than a legal requirement) because s947B, 947C and 947D require disclosure in dollar terms unless regulations provide otherwise, whereas the industry standard only requires disclosure in dollar terms where practicable.

Who are associates of the providing entity?

The associates of the providing entity include:

- if the providing entity is a body corporate — the directors and secretaries of the body corporate, its related bodies corporate and their directors and secretaries;
- the providing entity's partners in a partnership carrying on a financial services business; and
- the trustee of a trust in relation to which the providing entity benefits or is capable of benefiting.

Also, in the case of an authorised representative, s947C(2)(c)(iii) and (iv) specifically require disclosure of remuneration that the authorising licensee or an employee or director of the authorising licensee may receive.

This is substantially the same as under the old s849 requirements.

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