Australian Securities & Investments Commission

REPORT 17

Compliance with advice and disclosure obligations: Report on primary production schemes

February 2003

Important note:

The applicable law in relation to the entities and offer documents that were surveyed in the course of this campaign is that applying immediately before the *Corporations Act 2001* as amended by the *Financial Services Reform Act 2001* (FSR Act). Appendix 2 highlights some of the changes introduced by the FSR Act, as well as existing requirements that have been maintained under the FSR regime. The legal requirements outlined in the body of this report still apply to existing product issuers in relation to their existing classes of financial products for as long as they are not governed by the FSR regime.

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Executive summary

The Australian Securities and Investments Commission (ASIC) is concerned about the quality of advice and disclosure in relation to the promotion of tax-effective mass-marketed schemes in the primary production managed investments sector. In particular, ASIC is aware of:

- the questionable commerciality of some of the schemes;
- at times, the poor quality and absence of adequate disclosure;
- occasional inappropriate or misleading advice; and
- payment of high commissions in excess of market norms for other retail investment schemes.

As a result of ASIC's research and analysis in this sector, ASIC conducted a nationwide review of primary production managed investment schemes. This involved a survey of offer documents and surveillance field visits to promoters and advisers of such schemes throughout 2001 and early 2002.

At the same time, the Commonwealth Senate Economic References Committee on Mass Marketed Tax Effective Schemes and Investor Protection heard evidence from consumers, industry representatives, analysts and other interested parties as to how such schemes might be regulated by ASIC and the Australian Taxation Office (ATO).

ASIC's surveillance examined whether there is a correlation between the receipt of high commissions by financial advisers and the provision of inappropriate or misleading advice to investors to invest in such schemes. This report contains the findings of that surveillance, as well as the results of an independent survey of investors in such schemes, commissioned by ASIC.

Although the focus of this project was to examine levels of compliance with advice and disclosure obligations in one part of the managed funds industry, ASIC did encounter some limited instances requiring formal investigations into misconduct. As at the date of this report, those enquiries are continuing.

The findings of the campaign also give rise to avenues for potential law reform opportunities or further guidance which ASIC will explore with the Commonwealth Treasury.[1] Furthermore, ASIC is committed to working with relevant industry associations with a view to enhancing the quality and professionalism of advice provided to retail investors.

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[1] The applicable law in relation to the entities and offer documents that were surveyed in the course of this campaign is that applying immediately before the *Corporations Act 2001* as amended by the *Financial Services Reform Act 2001* (FSR Act). Appendix 2 highlights some of the changes introduced by the FSR Act, as well as existing requirements that have been maintained under the FSR regime. The legal requirements outlined in the body of this report still apply to existing product issuers in relation to their existing classes of financial products for as long as they are not governed by the FSR regime.

1 Tax-effective primary production schemes

Introduction

Typical tax-effective schemes have a number of distinctive features relating to the establishment of the scheme, investor benefits (including tax effectiveness) and the sales practices of promoters.

Many tax-effective schemes can be high risk in an unproven industry, often have long lead times and may have little direct involvement by investors, who usually acquire no assets other than rights.

ASIC has concerns about the promotion of these schemes. In particular, ASIC detected, both before and during the surveillance:

- a low level of compliance with all legal requirements regarding recordkeeping;
- difficulties in assessing whether sufficient capital was being maintained and contributed to core activities. In particular, new investor funds were seemingly being diverted to non-core expenditure items such as management fees and marketing expenses;
- responsible entities frequently outsourced important functions and often engaged inexperienced managers; and
- financial arrangements frequently involved the appointment of related parties to perform extensive services for responsible entities and upfront payment for these services.

Senate Economic References Committee

From 29 June 2000 the Commonwealth Senate Economic References Committee conducted an inquiry into mass-marketed tax-effective schemes and investor protection. The committee's attention was drawn to:

- the questionable commerciality of the schemes;
- criticism of the schemes by industry analysts;
- the poor quality of disclosure;
- the poor quality of advice; and
- the regulatory framework and consumer protection safeguards in this sector.

A number of organisations from government and private industry made submissions on, among other matters:

- the failures of mass-marketed tax-effective schemes;
- the ATO action to disallow deductions claimed by investors in a number of mass-marketed tax-effective schemes and the subsequent complaints by investors; and

- ASIC regulation of such schemes, particularly in relation to the quality of market information and disclosure by promoters and the advice given to investors.

ASIC regulation of tax-effective schemes

Section 1(2) of the *Australian Securities and Investments Commission Act 2001* (ASIC Act), requires ASIC to maintain, facilitate and improve the performance of the financial system and the entities within the system in the interests of commercial certainty and reducing business costs.

Specifically, the structure of managed investment schemes, including tax-effective schemes, is regulated by Chapter 5C of the *Corporations Act 2001* (Corporations Act). The disclosure obligations for managed investment schemes are set out in Chapter 6D.[2]

To operate a managed investment scheme, an entity must hold a securities dealers licence from ASIC authorising it to act as a responsible entity. ASIC has published policy[3] outlining the criteria it will use in assessing a responsible entity's ability to carry out its duties efficiently, honestly and fairly. The criteria include:

- the capacity to carry on business;
- education and experience;
- good fame and character;
- the engagement of agents;
- compliance systems;
- accountability; and
- meeting minimum capital requirements.

When an entity becomes a licensed responsible entity it can apply for the registration of a managed investment scheme. The scheme must be registered with ASIC but can only be registered if it has a constitution and compliance plan that complies with the Corporations Act.

The responsible entity must establish a compliance committee if less than half the directors are external. The compliance committee must have at least three members, and the majority of these must be external members.

In operating a managed investment scheme a responsible entity has broad-ranging statutory duties, including the obligation to report breaches of the law or its licence to ASIC, act in the best interest of scheme members, regularly value scheme property and audit the compliance plan annually.

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[2] This report is based on the law and ASIC policies prior to 11 March 2002. See Appendix 2 for a brief summary of some of the changes introduced by the *Financial Services Reform Act 2001* (FSR Act).

[3] Policy Statement 130 *Managed investments: Licensing* [PS 130] and Policy Statement 131 *Managed investments: Financial requirements* [PS 131].

ASIC's regulatory role in this sector is focused on the adequacy of disclosure to investors and enforcing compliance by responsible entities and their officers with their statutory duties. ASIC can conduct surveillance visits, revoke securities dealers licences, appoint a temporary responsible entity or apply to the court to wind up a managed investment scheme. ASIC approaches such matters on a risk-rated basis and applies its normal surveillance and enforcement criteria when determining which matters to pursue. Historically, ASIC has deployed a disproportionate percentage of its resources to the regulation of this sector, which represents only a minority of funds under management.

Where the law permits and, in particular, where members' interests are jeopardised, members of a scheme may also apply to wind up the scheme or remove the responsible entity.

ASIC must grant a securities dealers licence authorising an entity to operate managed investment schemes if it satisfies the statutory and policy criteria for a licence. ASIC has limited powers of refusal and cannot refuse to license an entity where it meets the licensing criteria.

ASIC must also register a managed investment scheme if it satisfies the registration requirements of the law. ASIC cannot refuse to register a scheme simply based on its merits. ASIC does not assess the commercial viability of any managed investment scheme.

Where responsible entities, their officers or their representatives are suspected of breaching the law, ASIC can investigate and pursue enforcement action, including civil, administrative and criminal remedies. ASIC's enforcement response will depend upon the nature and seriousness of any breach and the extent to which there is harm or loss to investors.

Managed investment schemes can and do fail for many reasons. They could be incompetently established (not enough capital, poor research of the market), or alternatively are well established but suffer crop failure or a reduction in demand for the product. This may be of particular risk for agricultural schemes given the inherent risks of the underlying assets, in particular those that are subject to climatic conditions.

In addition to its regulatory role in authorising responsible entities to operate a managed investment scheme and the registration of schemes, ASIC also enforces disclosure obligations with respect to these schemes. ASIC focuses on the disclosure of risks, returns and other relevant information which an investor should have before deciding to invest. For example, the use of historical returns and long-range projections is common in primary production scheme offer documents. ASIC has published guidelines[4] with respect to the use of forecasts and projections. ASIC has also exercised its corrective disclosure powers to stop disclosure documents that did not satisfy the legal disclosure requirements.

[4] These guidelines are now incorporated into Policy Statement 170, *Prospective financial information* [PS 170], which supersedes earlier policy guidance.

Since early 1997, ASIC has issued a number of media releases and consumer alerts[5] warning investors of the risks associated with investing in tax-driven schemes, including primary production schemes.

Legal requirements on advice and disclosure

The Corporations Act and the ASIC Act set out a number of legal requirements on advice and disclosure[6] which apply when promoters or advisers seek out investors to subscribe for interests in schemes.

Offer documents

In most cases, the investor must subscribe for interests in a scheme through an application form contained within an offer document (ie prospectus). The responsible entity is liable for the contents of the offer document. The offer document for interests in a scheme must contain all the information that investors and their professional advisers would reasonably need to make an informed decision about whether to invest in the scheme, including the risks involved. When considering the adequacy of disclosure in offer documents, ASIC seeks to ensure effective disclosure of matters that may indicate risk or may dissuade investment.

ASIC has issued two media releases in relation to tax-driven schemes which explain ASIC's interpretation of the legal position on disclosure of risks. In [MR 99/111][7] ASIC identifies a number of issues a promoter should consider when determining the level of disclosure in an offer document, while in [MR 00/209][8] ASIC warns of the importance of checking the authenticity of an ATO product ruling advertised in a scheme's offer document.

Advice

The requirements on disclosure of advisers' fees and commissions are set out in s849 of the Corporations Act and reg 7.3.02B of the Corporations Regulations.

Advisers must provide investors with an Advisory Services Guide (ASG) that details:

- the services they offer;
- how they are licensed;
- how they are paid, including any commissions earned; and
- how they handle customer complaints.

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5 For example, [MR 97/21], 'ASC warning on overly optimistic advertising for ostrich schemes', 30 January 1997, and consumer alerts on ASIC's FIDO website under the topic 'tax-driven investments including agricultural and film schemes'.

6 This report is based on the law and ASIC policies prior to 11 March 2002. See Appendix 2 for a brief summary of some of the changes introduced by the *Financial Services Reform Act 2001* (FSR Act).

7 'Tax scheme promoters must disclose tax risks', 20 April 1999.

8 'Tax-driven schemes and product rulings', 10 May 2000.

The ASG must contain all the information that investors would reasonably need to make an informed decision about whether they want the services.

If an adviser makes a personal securities recommendation (ie one that takes into account the investment objectives, financial situation and particular needs of the prospective investor) rather than providing general securities advice, they must also:

- disclose any commissions, fees or other benefits they may receive in connection with the recommendation;[9] and
- comply with the 'know your client, know your product'[10] rule to ensure that they have a reasonable basis for making a recommendation to the client.

[9] Corporations Act, s849.

[10] Corporations Act, s851.

2 Surveillance methodology

In this project, ASIC sought to test the extent to which high commissions might provide an inducement to advisers and representatives to place their own interests above those of the investor in the provision of good advice. Information held by ASIC indicates that the primary production industry generally pays consistently higher commissions than other schemes. As a consequence, responsible entities in this sector were chosen for surveillance.

The campaign was conducted in three phases.

Phase 1: Review of offer documents

Using ASIC's public database systems, a list was prepared of the 103 responsible entities holding a licence to operate primary production managed investment schemes. These 103 responsible entities operated 131 registered schemes, in relation to which there were 92 offer documents. ASIC reviewed the disclosure of commissions in each of those offer documents.

Phase 2: Information gathering

After excluding those schemes without current offer documents, ASIC confined the scope of the surveillance to 29 responsible entities in relation to 41 schemes which paid commissions of over 10%.

In relation to each offer document for these schemes, ASIC requested information from the responsible entities about:

- the investors who had subscribed for interests in those schemes in 2001;
- how much each investor had subscribed; and
- the identity of the advisers who had received commissions in respect of those investors.

A total of 1423 individuals were identified (33 in the ACT, 204 in NSW, 822 in Queensland, 72 in SA, 5 in Tasmania, 94 in Victoria and 193 in WA).

Phase 3: Audit of investor files

The following criteria were used to determine which of the 1423 investors were most at risk:

- payment of commissions of 15% or greater;
- investment of $50,000 or more and the adviser was paid commission of 10–14.99%; or
- the receipt of advice from an adviser whom ASIC rated as 'high risk' based on its own risk-rating data.

This resulted in 301 client files being selected for desk audit by ASIC.

Of the advisers whose client files ASIC reviewed:

- 78% described themselves as full-time financial planners;
- 14% were accountants;
- 4% were accountants who provided offer documents only; and
- 4% were representatives without any formal qualifications who provided information only.

The desk audits were conducted based on the issues identified as satisfying the minimum legal requirements that advisers should meet to discharge their obligations.

Some 194 files were identified as unsatisfactory, and both the representatives who had recommended the product and the principals of those representatives were visited. They were questioned on the particular recommendations and their practice generally.

Interviews were also conducted with the more than 100 clients who were prepared to speak to ASIC.

Consumer survey

While the surveillance campaign was in progress, ASIC commissioned an independent survey of 100 investors who had invested in some of the primary production schemes targeted in the project. The purpose of this consumer survey was to gauge the level of investor understanding of commissions and risks. The findings of this survey are set out in Appendix 1.

3 Surveillance findings

Phase 1: Review of offer documents

Of the 92 offer documents reviewed during Phase 1 of the campaign, 28 had unsatisfactory disclosure of commissions. Of these 28, 15 did not disclose the percentage of commissions or marketing fees and trailing commissions, while 13 did not disclose marketing fees and trailing commissions.

ASIC's analysis revealed commission levels for primary production managed investment schemes ranging from 2.73% to over 20%, with more than one-third of the schemes paying 10% or more. These levels are generally higher than those paid in other parts of the industry, which average between 1.75% and 4%.

At this stage of the surveillance, ASIC formed the view that disclosure of commissions in offer documents was not always consistent, nor did it comply with the law where commission affected returns. ASIC was particularly concerned where the commission disclosure was not in dollar terms because investors would have to calculate the actual commission to be paid to their adviser.

Phase 2: Information gathering

Unsatisfactory compliance with ASIC notices

ASIC was concerned that compliance with its information-gathering notices was sometimes unsatisfactory. In particular:

- some responsible entities had provided misleading or incorrect answers to ASIC;
- a number of the principals who had been identified as offering interests in a scheme were not licensed by ASIC; and
- certain responsible entities and other principals did not ensure that their representatives complied with legal obligations, such as identifying the licensee in advertising and signage.

Poor control over representatives

ASIC also discovered that some principals appeared to have poor control over their representatives.

Twelve of the companies identified in responses to ASIC's notices did not hold licences to act as securities dealers. In those cases, ASIC discovered that a director of that company was an authorised representative of the responsible entity that had responded to ASIC's notice.

This outcome posed a risk to investors because they may invest in a scheme relying on advice from a representative of the responsible entity, while remaining unaware of the relationship between the representative and the responsible entity.

In one instance, 25 investors subscribed for interests in a scheme via an intermediary which held no files on those investments. In that case, the intermediary explained its recordkeeping deficiencies as being justifiable because it had an informal 'arrangement' with another licensee. Another intermediary told ASIC it had introduced 19 investors into a scheme, but had no client files because it maintained that it had not given any advice.

Trends

Responsible entities and their related parties

Of 28 principals reviewed by ASIC, four were the responsible entity that also promoted the scheme, while two were companies that were closely related to a responsible entity. Of those six:

- two of the responsible entities paid commission rates of 15% or more to their representatives;
- two of the responsible entities paid commission rates of 10% to their representatives; and
- the two related companies paid commission rates of 10% and 15% respectively to their representatives.

A number of the representatives of the responsible entities promoting these schemes also held proper authorities from other licensees. One such licensee subsequently advised ASIC that it would no longer accept cross-endorsed proper authorities. That licensee told ASIC it was concerned that cross-endorsed authorities might lessen its ability to adequately supervise its representatives and the products it is selling.

Some of the related companies also had a lending arm which provided finance to clients to invest in the schemes. In one example, five of the eight clients who invested through a company which was related to a responsible entity took out loans from that financier. The average level of gearing in this instance exceeded 70%.

Location[11] of principals

The geographic spread of clients surveyed by ASIC was as follows:

- 3% purchased their investment from a principal located in the ACT;
- 13.2% purchased their investment from a principal located in NSW;
- 55.6% purchased their investment from a principal located in Queensland;
- 3.1% purchased their investment from a principal located in SA;
- 0.4% purchased their investment from a principal located in Tasmania;
- 7.6% purchased their investment from a principal located in Victoria; and
- 17.1% purchased their investment from a principal located in WA.

The results changed once the sample size was reduced following the application of the three targeting criteria (ie commission of 15% or greater; investments greater than $50,000 and commission received of 10–14.99%; and investors with high-risk advisers). For example, the results for Queensland showed a high

[11] Location is classified as the State where the principal's registered office is situated.

percentage (55.6%) relative to other States of principals who received commission of 10–14.99%; however, they also show far fewer commission payments above 15% or investments that were larger than $50,000 (13.6%).

Phase 3: Audit of investor files

Following its desk audit of files and interviews with investors, ASIC found that:

- compliance with s849 of the Corporations Act (disclosure of commissions) was at times unsatisfactory;
- generally, principals and representatives were confused about whether they were providing no advice, general securities advice or making a personal securities recommendation;
- the supervision of representatives by their principals was at times unsatisfactory;
- investors were not always given advice in accordance with s851 of the Corporations Act ('know your client, know your product'); and
- recordkeeping, particularly in advisers' client files, was poor.

Disclosure of commissions

Just over half of those investors interviewed stated that they did not recall the amount of commission that was paid to their adviser. However, most assumed that there would be commission paid but did not express a desire to know the amount. Many investors said that the level of commission would not have made any difference to whether they invested in the scheme or not.

Although investors gave differing reasons for investing in the various schemes, the majority mentioned tax either exclusively or in combination with other reasons. This is important because, if tax was the main reason for investing in the schemes, it may explain the apparent lack of interest in the level of commission payments. Many of these same investors also, perhaps predictably, stated that they had read the entire offer document, even though they failed to recall the commission details contained within it.

Some investors were not aware that they were entitled to information concerning the level of commission payments but said they would bear it in mind for future investments.

A number of schemes separated commission payments and marketing costs within the offer document. These payments were portrayed as being for different reasons but in all cases were charged in full (eg 5% commission plus 5% marketing costs always charged as 10%). ASIC is concerned that these marketing costs are frequently paid irrespective of the level of marketing that has occurred. In some instances, this could mislead the investor into thinking that a lower level of commission was being paid to the adviser.

Again, perhaps predictably, the large proportion of investors who cannot recall any commission disclosure is at odds with information provided by principals and representatives. As indicated, most investors focused primarily, if not exclusively, on the tax-effectiveness of their intended investment.

In contrast, most of the principals interviewed by ASIC said that they gave each investor an ASG which contained all the necessary information on commissions. This was in addition to any commission disclosure in the offer document.

Confusion over the type of advice given

ASIC found that some accountants may be giving unlicensed advice in some instances. Loan finance arrangements are possibly being used to initiate investment advice for commission.

A number of representatives stated that they gave ‘no advice’ or ‘limited advice’, even though they received the full commission. Many principals and representatives were confused when asked by ASIC about the type of advice being given to investors. Further, their own records and client advice documents were not always clear (and sometimes not supplied at all), so it would be difficult for investors to understand what type of service had been given. In other situations it may have been deliberate. In one example that has been referred for further investigation, the principal said that ‘no advice’ had been given in relation to any of the investments made in the specific scheme, but the notes on the representative’s file record a discussion that took place concerning the investor’s expectations and preferred products.

Supervision of representatives

ASIC found that some licensees (mainly responsible entities) did not insist on formal qualifications for their authorised representatives.

In some cases there was a serious lack of supervision by the licensee. The areas of concern include:

- infrequent (sometimes non-existent) review of a selection of the adviser’s client files;
- no record of any supervision activities; and
- lack of a regular formal supervision system or process.

This was often compounded by the poor quality of compliance manuals or, in some cases, the complete lack of compliance documentation. There was inadequate record-keeping by both licensees and their representatives in relation to maintaining compliance with internal training obligations.

‘Know your client, know your product’

ASIC found that, generally, investors were not always given advice in accordance with s851 of the Corporations Act.

In some cases, investors became aware of investment opportunities in schemes following a newspaper or television advertisement or a newsletter article (distributed to investors in previous projects) and would then phone for an offer document. In one case, an investor overheard a conversation in the local hotel. Following receipt of the offer document, the investors would usually contact the adviser if they had any questions. If the questions related specifically to the project, the adviser would answer them. If they were of a more general nature, investors were told to seek independent advice. In situations where advice was given, the adviser often provided a selection of tax-effective investment options which, at times, included a recommendation about these selected schemes.

Loans facilitating the investment in some schemes were taken out by a number of investors. It was also apparent that related companies of the licensee sometimes provided loan financing for investments in these schemes. Also, in some cases, remuneration was evident for referrals to financial institutions. One adviser used two institutions — a building society with which the principal had an arrangement and a finance company that rebated 30% of the client's application fee to the adviser.

The level of borrowing shows that most of the investors who took out loans did so for a large percentage of their total investment. ASIC initially presumed that in order to facilitate this scale of borrowing, the advisers would have made a detailed assessment of the individual investor's circumstances, which would strongly indicate that a personal securities recommendation had been given. However, where an adviser had told ASIC that 'no advice' or 'limited advice' was given, ASIC was then able to interview some investors who confirmed that no personal financial details were taken and that they availed themselves of the finance option (which was detailed within the offer document) either because it was tax-effective or to alleviate any cash-flow constraints.

Recordkeeping

ASIC found that many of the client adviser files inspected contained very little information. This low level of detail was unexpected by ASIC and necessitated a large number of client adviser files being referred for adviser interviews, to confirm the type of advice provided to clients and whether it was appropriate.

In Western Australia, one principal had no files for 20 clients who had invested in a scheme. In another case, a principal said that it sent ASGs to all investors but it did not have any copies of these on file. Another principal confirmed it had not provided ASGs, even though this was contrary to the procedure laid out in its own policies and procedures manual.

4 Conclusions

ASIC believes there appears to be a correlation between primary production scheme promoters paying high commissions to advisers and those advisers providing inappropriate financial advice when they recommend those products to clients. In ASIC's view, this correlation indicates that there may be instances of a failure by advisers to manage conflicts of interest, where their personal interests in recommending a product supersede the client's need for good and appropriate advice.

As a consequence of the issues and conduct identified in the course of this project, ASIC will consider (in conjunction with the Commonwealth Treasury), whether policy or law reform is required in any of the following areas.

Policy/law reform considerations

Registration of schemes

The registration phase of agricultural schemes highlights regulatory problems which may require ASIC policy change or law reform. In the course of this project, ASIC observed the following:

- In many schemes, investors acquire no assets other than rights and have little or no ability to remove the responsible entity or its agents.
- The scheme assets are held by the responsible entity. If it becomes insolvent, investors may not be able to obtain anything in a winding up.
- Many schemes appear to have little realistic commercial value because only a small amount of the funds invested into the scheme is actually contributed to the core activities of the scheme. Schemes can fail for this reason.
- Some schemes feature related party transactions between the scheme promoter and associates where money is paid in advance for outsourced services to be provided in the future.

Recommendation 1

The scheme constitution should set out in a comprehensive and clear manner, investors' rights and interests. The compliance plan should articulate how these are to be established (contracts, registered titles) and the time frame for this to happen. This should ordinarily be a period of some months after the offer document has been placed on the market. As at the date of this report, ASIC is currently discussing with interested parties how best to ensure that the disclosure requirements are consistent with the temporal consumer protection safeguards encompassed in responsible entities' licence conditions. The offer document should also set out the arrangements in full to allow investors to understand exactly what rights they have and to allow the ATO to review and ensure that the arrangements fit within the terms of any product ruling.

Offer documents and market information

Some industry analysts have suggested that primary production schemes often feature:

- high fee levels;
- a doubtful market for produce;
- long-dated projections;
- management inexperience;
- low returns; and
- fundamental oversights, such as a failure to ensure the security of water supply or obtain licences.

The offer documents reviewed by ASIC projected high returns but, in many cases, ASIC found that the calculations and key assumptions underpinning those projections were not supported by an appropriately qualified independent expert. ASIC's policy on the use of hypothetical assumptions underlying projections in disclosure documents is now set out in Policy Statement 170 *Prospective financial information* [PS 170].

In some offer documents reviewed by ASIC, no financial information was presented to clarify how much of the available capital was being contributed to the core activities of the scheme. ASIC also detected a lack of uniformity and consistency in the presentation of financial information that permits consumers or analysts to compare schemes and to make a judgment about the commercial value of a scheme.

Recommendation 2

ASIC considers that it could benefit investors if there was some form of consistent and standardised presentation of financial information, aligned to the process followed by industry analysts. In particular (and subject to the provisions of [PS 170]), where projections are to be presented, consideration ought to be given to whether all offer or disclosure documents might properly present projections about the pre-tax (cash on cash) and ungeared basis in a consistent and standardised format to assist investors to assess the commercial soundness of the relevant project.

If this proposal were to be adopted, ASIC considers that the financial projections in an offer or disclosure document might be more easily and carefully assessed before taking into account the effects of taxation and financing (interest on debt). By assessing a project independently of tax and how it has been financed, the merits of the underlying earnings or cash flows from actually doing the project may be clearer. That is, they are not potentially clouded by tax or financing implications, the effects of which can differ from one entity to the next depending on their tax situation and financial structure.

The inclusion of 'health warnings' in offer documents as to the risks of speculative investments is not one which is currently being proposed by ASIC. However, the issue remains under review, as ASIC continues to monitor market developments and any particular risks to consumers.

Many of the offer documents reviewed by ASIC did not disclose commissions or, where they did, did not disclose dollar amounts. In some cases, part of the commission was described as a marketing fee when, in fact, the entire commission and marketing fee was paid to advisers regardless of the extent of any marketing.

Recommendation 3

Except in instances where the law already requires disclosure of commissions which affect the return to investors, ASIC believes consideration might be given to the development of some form of industry best practice regarding the disclosure of commissions in offer documents.

Projections in offer documents commonly included allowances for tax deductions, but ASIC detected poor disclosure about the tax position and the fact that each taxpayer is in a different situation. ASIC's review suggested that interests in schemes are sometimes sold using projections based on a table that assumes each investor is on the highest marginal tax rate.

ASIC also found that there were rarely warnings about the ATO's ability to issue an amended assessment for four years post-investment (or six years if the anti-avoidance provisions of the *Income Tax Assessment Act 1936* (ITAA) apply) if it does not accept a deduction. Further, investors were rarely warned that:

- Pt IV of the ITAA can apply to deny deductions where the scheme's sole or dominant purpose is to obtain a tax benefit; or that
- the ATO gives attention to avoidance indicators like excessive fees, a small percentage of funds going into the core business, round robins, non-recourse loans and doubtful profitability.

ASIC is concerned to note that there was apparent confusion about its regulatory role in this part of the managed investments sector. Some promoters suggested that ASIC approved or endorsed the offer document, when that is patently not the case.

Sales practices

The findings of this project confirmed anecdotal information provided to ASIC that some promoters do employ high-pressure sales tactics, encouraging investment in schemes using promotional material that focuses on the before- and after-tax savings. In many cases, accountants invited clients to these promotional seminars, but failed to give appropriate warnings to their clients about the suitability of the scheme for their individual circumstances.

Conduct of advisers

ASIC is concerned about instances of unsatisfactory compliance by advisers with the requirements to disclose commissions and to comply with the 'know your client /know your product' obligations at law. Many representatives ASIC reviewed did not know the difference between not giving advice, giving general securities advice and making a personal securities recommendation.

Furthermore, ASIC found that many principals did not appear to have systems in place to ensure that their representatives complied with legal requirements. ASIC noted that there were many instances where neither the principals nor their representatives kept proper books and records and could not demonstrate which type of advice had been given and how the relevant representative had complied with the legal requirements.

Where client adviser files contained advice, ASIC found that many did not contain information and calculations supporting the recommendation to invest in a primary production scheme.

Enforcement action

While the focus of this project was not to investigate suspected breaches of the law, but rather to identify compliance deficiencies in relation to good advice and disclosure practices, ASIC did encounter some limited instances where it suspected a breach of the law may have occurred. As a result, ASIC is now investigating certain promoters and advisers of these schemes. ASIC will publicise the outcome of those actions once they are completed.

By way of example, these matters involve:

- a large responsible entity (appointed to 20 schemes) which had failed to supervise a number of representatives who had provided inappropriate advice and failed to disclose commissions;
- a large stockbroker who failed to keep client files, believing that they were not giving advice;
- a responsible entity who failed to supervise a representative who owned an accounting practice. The representative was acting outside the scope of his authority, believing that he was not giving advice;
- a financial planner attached to an accounting practice who placed 50 investors into a scheme and had not undertaken client fact finds; and
- accounting firms which held licences and placed 19 and 25 clients (respectively) into schemes but did not keep any files, believing that they were not giving advice.

Appendix 1: Consumer survey

As part of this project, but independently of its own surveillance, ASIC commissioned a consumer survey of 100 investors who invested in some of the primary production schemes targeted in the campaign. The survey was conducted externally by a consumer testing organisation not associated with ASIC. The purpose was to ascertain the level of investor understanding of:

- commissions paid to advisers;
- the effectiveness of disclosure of commissions; and
- disclosure of the main risks associated with investing in primary production schemes.

The survey also covered a general review of the dominant considerations that investors had when deciding to invest in the schemes.

The survey results suggested a number of trends that were consistent with the information gathered from ASIC's surveillance campaign. The key trends noted by the consumer survey were as follows:

- many investors cited tax benefits as the main reason for investing;
- investors generally obtained an offer document;
- investors often used financial advisers before making an investment; and
- most investors did not know exactly how much commission was being paid to advisers.

Tax benefits

Tax advantages were the major attraction of primary production scheme investment (42%), followed distantly by the requirement for future income (26%). Investors felt reasonably familiar with the returns and tax benefits sections of the offer document.

In ASIC's experience, it is unusual for investors to complain about these schemes unless the tax-effectiveness of their investments is threatened.

Offer document

Some 23% of investors said they did not receive an offer document prior to investing, while 70% recalled receiving an offer document prior to investing, either from the financial adviser or the scheme promoter or its representatives. Of those investors who received an offer document, 39% claimed they read everything in the offer document, and only 8% said they did not read the offer document at all.

Use of financial advisers

One in two investors said that they first heard about the relevant primary production scheme from their financial adviser. However accountants, family, friends and advertisements also played a role. Some 55% of investors said that they spoke to a financial adviser prior to investing. The financial advisers explained the operation, returns and tax benefits to about 95% of investors; the risk of losing the investor's money was only explained to 76% of investors.

Ninety per cent of investors said that at least some primary production investment scheme risks were disclosed to them, mainly by the financial adviser and in the offer document. The disclosed risks were:

- adverse factors (eg rainfall) 80%
- losing money 57%
- scheme collapse 9%
- ATO disallowance of the tax deduction 37%

For about 50% of the investors, this risk perception had not changed from the time prior to investing to the time of the survey.

For those for whom the risk perception had changed, it mainly decreased. Several factors were now seen to be less of a risk than before, namely:

- losing money 24% lower
- adverse factors 9% lower
- scheme collapse 7% lower

Amount of commission

Of those investors who spoke to an adviser, 58% were aware that (some of) the money would be used for paying a commission, 78% thought that money would be spent on management fees and 84% said they would have invested even if they had known about a commission being paid to the adviser. Of those investors who were aware that a commission was paid to the financial adviser, 88% could not recall the actual percentage of that commission. Knowledge of the extent of management fees was low, but 83% said they would have invested in any case.

Conclusion

The results concur with ASIC's concerns that the majority of investors encouraged to invest in a scheme do not know exactly how much commission is being received by advisers. Further, it appears that the majority of investors did not recall being warned about the possibility of the ATO disallowing tax deductions.

Appendix 2: Outline of FSR disclosure regime

The *Financial Services Reform Act 2001* (FSR Act) commenced on 11 March 2002, replacing Chapters 7 and 8 of the *Corporations Act 2001* (Corporations Act) with a new Chapter 7.

These changes:

- establish a new Australian financial services (AFS) licensing regime;
- impose uniform disclosure requirements for financial services and products provided to retail clients;[12] and
- set out new conduct requirements for participants in the financial services sector.

This appendix[13] only deals with the FSR disclosure requirements, ie the legal requirements under the FSR regime for licensees and their authorised representatives to disclose to retail clients certain information about their:

- services (in a Financial Services Guide);
- advice (generally in a Statement of Advice); and
- products (in a Product Disclosure Statement).

Advisers on registered managed investment schemes will generally need to provide their retail clients with all three of these disclosure documents, as well as having appropriate compensation (s912B) and dispute resolution (s912A) arrangements in place.

Financial Services Guide

A Financial Services Guide (FSG) is a document that explains the financial services offered to retail clients by AFS licensees or their authorised representatives. It is similar to the Advisory Services Guide (ASG) required under the pre-FSR regime.[14] Generally, an FSG must be given to a retail client before the financial service is provided.

An FSG must include:

- how the adviser operates, including who will provide the financial service, the kinds of financial services being provided and for whom the adviser acts in providing the financial service;
- how the adviser is paid, including any commissions and other benefits;
- any interests, associations or relationships that might be expected to influence the provision of the financial services; and

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[12] 'Retail client' is defined in s761G and Pt 7.1, Div 2 of the *Corporations Regulations 2001*. It replaces the previous definition of retail investor: reg 7.3.02B.

[13] The information in this appendix provides an overview of the disclosure framework under the FSR regime. It does not constitute legal advice.

[14] See the section on 'Legal requirements on advice and disclosure' in part 1 of this report.

- details of any appointments to act on behalf of other licensees (including binders): s942B and 942C.

The information in an FSG must be current and presented clearly and concisely, with enough detail for a client to make an informed decision about whether to acquire the service.

Penalties apply for defective FSGs and for the failure to provide an FSG.

Statement of Advice

A Statement of Advice (SOA) is a written statement that must be provided when an adviser operating under an AFS licence provides personal advice to a client. Personal advice is financial product advice that takes into account the client's personal objectives, financial situation and particular needs.

There is no equivalent under the pre-FSR regime, other than the general requirement to comply with s851 and the licence conditions prescribed by reg 7.3.02C and 7.3.02D of the former Corporations Regulations.

An SOA must include:

- a statement of the advice given to the client;
- the information on which it is based;
- how the adviser is paid, including any commissions and other benefits that might reasonably be expected to influence them;
- any interests (whether pecuniary or not, direct or indirect) and any associations or relationship that could influence the provision of advice; and
- a suitable warning if the advice is based on incomplete or inaccurate information: s947B and 947C.

The information in an SOA must be presented clearly and concisely, with enough detail for a client to make an informed decision about whether to act on the advice.

An adviser may dispense with an SOA if the client requires urgent advice, but a written SOA should be sent within five days: s946C(3).

Penalties apply for defective SOAs and for the failure to provide an SOA.

An SOA is not required where only general advice is provided; however, the adviser must warn the client about the limitations of the advice provided: s949A.

Product Disclosure Statement

Product issuers must provide a Product Disclosure Statement (PDS) for 'new' financial products (including interests in managed investment schemes), ie those of a kind issued for the first time on or after 11 March 2002. Interests in existing schemes and other financial products issued before 11 March 2002 remain subject to the pre-FSR disclosure regime outlined in part 1 of this report until the end of the transition period (ie 10 March 2004), or earlier if the product issuer opts into the FSR regime.

A PDS is a point-of-sale document prepared by or on behalf of the person providing the financial product: s1013A. Generally, it should be given to a retail client at or before the time a recommendation is made to acquire a financial product or an offer is made to issue or arrange for the issue of a financial product and before the client acquires the financial product: s1012A(3).

It must set out:

- contact details for the issuer and seller of the product;
- the significant benefits of the product;
- the costs payable in respect of the product;
- commissions that may impact on the returns;
- any other significant characteristics or features of the product;
- significant taxation implications;
- any significant risks associated with the product;
- information about the dispute resolution system for the product;
- information about any cooling off regime that applies in respect of the product; and
- any other information that might have a material influence on the decision to acquire the product: s1013D and 1013E.

If the product has as an investment component, the PDS must also include information on the extent to which labour standards or environmental, social or ethical considerations have been taken into account in the selection, retention or realisation of the investment: s1013D(1)(l).

A PDS does not need to be lodged with ASIC unless it is for a listed managed investment product (ie one that can be traded on a financial market). However, for other financial products, an 'in-use' statement must be lodged with ASIC no later than five business days after a PDS is first given to someone in a recommendation, issue or sale situation.

Penalties apply for defective PDSs and for the failure to provide a PDS.

More information

See the following ASIC policy statements, guides and media/information releases:

- Policy Statement 130 *Managed investments: Licensing* [PS 130]
- Policy Statement 131 *Managed investments: Financial requirements* [PS 131]
- Policy Statement 132 *Managed investments: Compliance plans* [PS 132]
- Policy Statement 133 *Managed investments: Scheme property arrangements* [PS 133]
- Policy Statement 164 *Licensing: Organisational capacities* [PS 164]
- Policy Statement 168 *Disclosure: Product Disclosure Statements (and other disclosure obligations)* [PS 168]
- Policy Statement 169 *Disclosure: Discretionary powers and transition* [PS 169]

- Policy Statement 170 *Prospective financial information* [PS 170]
- Policy Proposal Paper *Licensing: Financial product advisers — Conduct and disclosure* (December 2002)
- *Licensing and disclosure: Making the transition to the FSR regime — An ASIC guide* (October 2001)
- *Financial advisers: What type of AFS licence authorisations and assessment process do you need to apply for? An ASIC guide* (Version 2, November 2002)
- *Responsible entities & investor directed portfolio services operators: What type of AFS licence authorisations and assessment process do you need to apply for? An ASIC guide* (November 2002)
- [IR 01/05] ASIC provides guidance for preparers and reviewers of prospective financial information included in disclosure documents, 7 February 2001
- [IR 02/25] Out-of-date PDS applications: Reducing risks for issuers, 19 November 2002
- [MR 01/112] Further intervention by ASIC on fundraising disclosure, 30 March 2001

The status of ASIC policies since the commencement of the FSR Act is summarised in Policy Statement 167 *Licensing: Discretionary powers and transition* at [PS.167.51].

The media releases [MR 99/11] and [MR 00/209] referred to in part 1 of this report still apply.