ASIC

Australian Securities & Investments Commission

REPORT 30

Disclosure of soft dollar benefits

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Contents

Executive summary

The financial advice sector is an important part of the financial services industry regulated by ASIC.

A key principle of the Corporations Act is that consumers must be in a position to decide whether to rely on advice. This means that consumers should be made aware of any benefits their adviser might receive as a result of giving advice. Consumers need to know if an adviser has a conflict of interest.

The Act assumes that consumers want to know how much they are paying for advice (both directly and indirectly)

This research report explores *soft dollar benefits* in the financial planning industry. We use the term 'soft dollar' to cover any benefit received by a financial planning firm or its representatives or associates, other than a basic cash commission or a direct client fee.

In this research project, ASIC looked at a sample of investment product providers and financial planning firms to see what types of soft dollar benefits are being offered and how they are disclosed.

The report examines current industry practice (December 2003 to March 2004) and only covers legal requirements and conduct after the *Financial Services Reform Act* transition. We surveyed the types of benefits and how firms disclosed them, but we did not seek to measure the prevalence of the various benefits.

ASIC would like to thank all the firms that provided assistance with this project.

Types of benefits

The report identifies eleven categories of soft dollar benefits. Eligibility for the benefits is generally based on the volume of funds directed to particular products or brands, or on the revenue generated by an adviser.

Some benefits are offered by product providers or the advice licensee and mainly go to individual advisers. Examples include subsidised business equipment, overseas conferences and increased commission rates. The value to an individual adviser ranges from a minor gift worth $50 to bonuses worth tens of thousands of dollars.

Some benefits are paid by product providers to advice licensees or related companies. These included sponsorship of the licensee's conference and fee-sharing arrangements. These benefits can be worth millions of dollars per year to a licensee.

Disclosure

If soft dollar benefits are accepted, the law generally requires that they be disclosed in the Financial Services Guide (when the client is choosing an adviser) and a Statement of Advice (when advice is given).

Some firms are to be commended for clearly explaining soft dollar benefits in consumer friendly language. They explain benefits succinctly but also give sufficient detail and put the benefits in context. In this report we have highlighted some features of good disclosure to assist industry.

Other firms use vague disclosure and leave their clients in the dark about the implications of these incentives. In a few cases, firms had not disclosed interests where disclosure appeared to be required.

Good disclosure need not add substantial length to documents and, in some circumstances, it can reduce the length. The research revealed several instances where shorter disclosure was both legally compliant and easier for consumers to understand. Simple incentive structures are generally simpler to disclose. If firms have complex incentive schemes, there may be inherent challenges in disclosing them effectively.

Future action

Where we observed disclosure that appears inadequate, we will request that the relevant firms review their documents and make any necessary changes. This is consistent with ASIC's policy of assisting industry to implement the Financial Services Reform Act. However, we reserve the right to take legal action in appropriate cases.

ASIC will also consider a more formal surveillance campaign next financial year to ensure firms are disclosing soft dollar benefits appropriately.

The Financial Planning Association and the Investment and Financial Services Association have jointly released a proposal to reduce conflicts of interest by banning some forms of soft dollar benefits. ASIC supports this initiative.

A Introduction

Aim of the project

The financial advice sector is an important part of the financial services industry. For example, financial planners advise on about 80% of the funds flowing into retail managed funds, and the Financial Planning Association estimates financial planners have $560 billion under advice.

A key principle of the *Corporations Act* is that consumers should be in a position to make informed financial decisions. The Act relies on effective disclosure to achieve this objective. One aspect of this principle is that consumers must be made aware of any conflicts of interest that their adviser might have so that they can decide whether to rely on the advice.

Conflicts of interest can increase the risk that advice might not be entirely in the client's best interests.

Consumers have the right to know how much they are paying for advice (directly and indirectly). Most soft dollar benefits are ultimately derived from consumers' investments or premiums. If consumers know that some of their money is being used for other purposes, they may be in a stronger position to negotiate a better deal and to shop around.

Scope of this report

This research explores a broad category of benefits called *soft dollar benefits* (sometimes called *soft dollar commissions*). In this report we use the term to mean all benefits except:

- direct client advice fees, and
- basic monetary commissions that financial advisers and their licensees may receive if they recommend certain products.

Thus 'soft dollar benefits' includes some monetary payments as well as non- monetary benefits.

This report focuses on retail financial advisers (generally financial planners) and their licensees, who provide personal advice on issues such as superannuation, managed funds and life insurance. The licensee (sometimes known as a 'dealer group') is the firm that is responsible for the advice given by its representatives.[1] ASIC's research focuses on this sector as we understand soft dollar benefits are common. However, the

[1] In this report, 'licensee' refers to a licensee of retail financial advisers of managed funds, etc; not other licensed entities.

same principles apply to other regulated financial advisers, such as specialist insurance advisers.

Some soft dollar benefits are paid by product providers or advice licensees and go to individual advisers, particularly if they reach sales thresholds. Such benefits include:

- being paid higher levels of commission;
- invitations to overseas conferences or holidays;
- free office equipment and services; and
- offers of shares in financial services companies.

Other benefits flow to the planner's licensee or its parent company. These include profit-sharing arrangements with product providers and sponsorship payments.

Aim of the research

This research report:

- describes the types of soft dollar benefits being provided to financial planners and their licensees;
- explores how conflicts of interest arise from these benefits,
- examines how these benefits are being disclosed to consumers, and
- comments on the features of good disclosure.

The soft dollar benefits reviewed in this report are significant for two reasons. First, the law requires advisers and their licensees to disclose conflicts of interest to clients. Clients are then on the alert and can consider whether to accept the advice in the light of the conflict. Relevant conflicts may include soft dollar benefits, commission payments, and ownership links.

Second, the legal disclosure requirements are intended to ensure clients can see how much they are paying for advice (both directly and indirectly). The cost of the advice can include direct advice fees, commission payments and soft dollar benefits.

Clear disclosure can therefore increase economic efficiency, by both improving financial decisions and increasing market forces on the cost of advice.[2] This increased efficiency can benefit both the individual consumer and the financial system as a whole.

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[2] Under the *ASIC Act* s. 1(2), ASIC's goals include 'to maintain, facilitate and improve the performance of the financial system and the entities within that system in the

We believe it is important to research soft dollar benefits because:

- There is little public information about the range of soft dollar benefits. The total value of benefits is commercially significant and some benefits (such as 'fee rebates') may be expanding.
- The need to disclose soft benefits seems less well understood in the industry compared with normal commissions. Several ASIC projects in 2002–03 found that only a minority of financial plans disclosed soft dollar benefits, although anecdotal evidence suggests they were widespread at the time.

Project methodology

The project sought to gain a broad perspective on what benefits are paid within the managed funds advice industry and how they are disclosed.

1 We gathered information from a sample of 13 product providers to discover the range of benefits they offered.[3] The firms included large, medium and small product providers, as well as firms aligned to advisers and non-aligned product providers. The sample included promoters of agricultural schemes.

2 We surveyed nine financial planning licensees to see what benefits were received and how they were disclosed in Financial Services Guides (FSGs) and Statements Of Advice (SOAs). Most of these firms received benefits from the providers mentioned above. The firms included large and medium-sized licensees (including banks), and both aligned and non-aligned firms.

3 We obtained detailed information about adviser conferences from a sample of 12 firms.

4 In addition to the FSGs collected from firms in steps 1–3, we also gathered FSGs from a wider range of firms. In total, we received FSGs from 32 firms/groups.

5 We conducted interviews and informal discussions with a range of industry participants. These discussions gave us a better understanding of the context under which benefits were paid.

This approach meant that we knew what kinds of benefits were being paid to most firms surveyed and could compare this with what was being disclosed. We were not limited to the firm's own interpretation of what needed to be disclosed.

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interests of commercial certainty, reducing business costs, and the efficiency and development of the economy'.

[3] The sample number refers to company groups. If a group has four licensed subsidiaries, it is only counted as one in the sample.

For each category of benefits, we sought information on:

- Who gives the benefit?
- Who receives the benefit?
- What is the eligibility formula or criteria?
- What is the maximum value of the benefit?
- Is the potential benefit disclosed to clients? If so, how?

Apart from the specific information requested, we had broad discussions with a range of firms on the context of benefits and general industry practices. ASIC would like to thank the relevant firms for their assistance with this project. As the project focused on broad industry practices, individual firms are not identified in this report.

The information was current in December 2003 to March 2004. All the disclosure documents we analysed were intended to comply with FSR Act requirements.

This research was not intended to be a comprehensive survey of the prevalence of various benefits or the overall level of compliance with disclosure obligations.

Related ASIC work and legislative developments

ASIC has recently undertaken several other projects about conflicts of interest and disclosure. A current legislative development is also relevant.

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. Our 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.

Policy Statement 175

In June 2003 ASIC published Policy Statement 175 *Licensing: Financial product advisers – Conduct and disclosure* [PS 175], which gives guidance on remuneration disclosure and best practice for FSGs and SOAs under the FSR Act provisions.

Policy proposal paper: managing conflicts of interest

In October 2003 ASIC published a policy proposal paper entitled *Licensing: Managing conflicts of interest*. The paper gave draft guidance on the new conflicts management obligation for licensees proposed under the Commonwealth Government's Corporate Law and Economic Reform Program (CLERP 9) proposals.[4] Our final policy on managing conflicts of interest will be published in the coming months (following the finalisation of the CLERP 9 legislation).

Preferential remuneration report

In April 2004 ASIC reported on a surveillance project on remuneration arrangements that gave preference to 'in-house' products. The project examined how preferential remuneration arrangements were disclosed.

Dollar disclosure amendments

Treasury has proposed amendments to the Corporations Regulations that govern when costs, fees and benefits need to be disclosed in dollar terms in a Statement of Advice and some other documents.[5] The proposals include allowing ASIC to grant exemptions in strictly limited circumstances. The provisions are expected to commence on 1 July 2004 and include a short transition period.

[4] see *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2004*.

[5] The Department of the Treasury, Draft Corporations Amendment Regulations for consultation (Revised Batch 8 – Dollar disclosure), released 2 June 2004.

B Legal obligations

This report focuses on the rules for Financial Services Guides (FSGs) and Statements Of Advice (SOAs) in Part 7.7 of the *Corporations Act 2001*. We refer to the law as at 12 March 2004 (i.e. after the *Financial Services Reform Act* transition period but before the effective date of the proposed dollar disclosure amendments[6]). All of the advice-giving entities considered in this research had transitioned to Australian Financial Services Licences.

This section gives an overview of how firms must disclose soft dollar benefits. A more detailed description is in Appendix 1.

Corporations Act disclosure obligations

When a potential retail client approaches an adviser, the adviser must give the consumer a *Financial Services Guide* (FSG). This helps the consumer make an informed decision on whether they should seek advice from the particular adviser or firm, and how much it would cost if they did. The FSG must disclose information about the adviser, licensee or related entities on:

- monetary and non-monetary benefits attributable to the advice service (and any other services), and
- relationships with the issuers of any financial product that might be capable of influencing advice.

When a retail client gets personal advice, the adviser must provide a *Statement Of Advice* (SOA). This documents the advice and helps a consumer make an informed decision about whether to rely on the advice. An SOA must disclose information about the adviser, licensee or related entities on:

- monetary and non-monetary benefits;
- other interests; and
- relationships with the issuers of any financial product

that might be capable of influencing that specific advice.

Before a consumer acquires a product, he or she should receive a *Product Disclosure Statement* (PDS). The PDS must include information about remuneration if it might affect the consumer's financial benefits from the product.

[6] The Department of the Treasury, Draft Corporations Amendment Regulations for consultation (Revised Batch 8 – Dollar disclosure), released 2 June 2004.

The broad principle is that the consumer should be alerted to the cost of the advice and the extent of the adviser's conflicts of interest. Apart from soft dollar benefits, other disclosed conflicts would include commissions and ownership links. The consumer can then make a more informed decision on whether to:

- choose another adviser at the outset;
- decline all or part of the advice if they are uncomfortable about the extent of the conflict;
- make further inquiries about the rationale for the recommendations; and/or
- negotiate for some (or all) of the benefit's value to go to the client rather than to the adviser or licensee.

Relevant entities

Conflicts of interest must also be disclosed if they affect entities related to the adviser or the adviser's licensee. These related entities include:

- a body corporate that is related to the licensee (such as a subsidiary or another member of a corporate group),
- an *associate*, such as another entity with whom the licensee is acting in concert (in respect of benefits).

A conflict of interest is equally relevant when the benefit flows to the related entity. For example, it was been suggested to ASIC that many advice licensees run at a loss if they are within a larger financial services group. The group makes a profit from managing funds and views the advice subsidiary merely as a tied 'distribution channel'.

Level of detail required

Where information must be disclosed, the required level of detail is what a retail client would reasonably require in order to decide:

- whether to acquire financial services (i.e. seek advice) from this adviser (information in an FSG).
- whether to act on the advice (information in an SOA).

These general obligations are subject to some more specific requirements in the Regulations.

Capable of influencing the advice

In an FSG and SOA, disclosure of some conflicts of interest are only required where they might reasonably be capable of influencing the adviser in providing the advice.

In our view, the capacity for soft dollar benefits to influence advice is not just related to the financial planner's thinking in preparing the advice. It can also extend to other factors that can influence the advice, like the licensee's approved or preferred product list. The preparation of this list may be influenced by which benefits the licensee is likely to receive.

Similarly, the ‘capacity to influence advice’ would also extend to incentives that could influence the pattern of advice given to the adviser’s or firm’s clients as a whole. For example, a volume bonus may create an incentive to direct a large proportion of clients to just a few fund managers.

The advice capable of being ‘influenced’ is also not simply limited to the choice of Product A over Product B. For example, the advice capable of being influenced may also include strategic advice, use of preferred product lists or gearing levels.

‘Clear concise and effective’ disclosure

The information required in an FSG or SOA must be presented in a clear, concise and effective manner.

C Findings: specific benefits

For each of the specific benefits discussed in this report, we explore:

- the types of benefits paid;
- who pays the benefits and who receives them;
- the conditions on which the payments are made;
- the commercial context of the benefits;
- the monetary value of benefits; and
- whether disclosure would generally be required.

Summary of benefits

The research identified eleven kinds of benefits.[7] Eligibility for benefits is often based on the volume of funds directed to particular products or brands, or on overall revenue generated.

Some benefits are offered by product providers or by the advice licensee and mainly go to individual advisers:

1. Free or subsidised business equipment or services, such as computers, software, and industry association membership fees.
2. Hospitality, such as tickets to sporting events.
3. Adviser conferences.
4. A higher share of commissions paid to an adviser .
5. Higher commission rates based on volume.
6. ‘Marketing support’ payments.
7. Shares (or options) in the product provider or advice licensee.
8. Buyer of last resort agreements.

Two types of benefits are paid by product providers to advice licensees:

9. Cash sponsorship of a licensee’s adviser conference.
10. Loans.

The final benefit is paid by product providers to advice licensees or related master trust / wrap / multi-manager operators:

11. ‘Fee rebate’ or profit sharing arrangement.

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[7] Some of the benefit categories might not be considered ‘soft dollar’ benefits in a technical sense. However, in this report we use the term to cover all ancillary benefits.

1 Free or subsidised services and products

Some product suppliers and advice licensees offer a range of free or subsidised services or office products to advisers who meet sales volume or revenue volume targets. Examples of such benefits observed by ASIC include:

- computers, software, etc.
- office equipment (e.g. fax machines)
- research services (e.g. fund performance and rating)
- insurance, personal banking, etc.
- membership of industry associations
- subsidies for promotional events for clients

These are distinct from services that are provided as part of the licensee–representative relationship and that are unrelated to product sales volumes.

Most benefits observed in this category seem to be valued in the range $250–$5,000 per adviser.

Benefit example 1 – Discounted software

AAA Financial Planning provides its Authorised Representatives with access to financial planning software. Each representative is eligible to receive a reduction on the annual cost of the software (to a maximum of $5,000) as a result of having certain levels of funds under administration with ZZZ Platform (part of the AAA group).

One scheme we observed works like a rewards or loyalty scheme. Rewards points are based on the volume of funds invested, and the adviser can choose from a wide range of benefits. Most are work related, such as office equipment, educational courses and membership of industry associations. Other benefits are not work-related, such as a bar fridge, golf clubs or a diamond necklace.

In some cases the eligibility criteria are quite simple (such as having more than $10 million funds under administration), but in others the formula is complex because different products have different weightings.

The types of benefits we observed under this heading are attributable to the advice service, material in value and are capable of influencing advice, as they are linked to sales volumes. Disclosure is required in both the FSG and (if a relevant recommendation is made) in the SOA.

2 Hospitality and awards

Some advice licensee and product providers provide a range of hospitality and similar benefits, which may include meals, tickets to sporting events, organised golf days, gifts of wine or awards. Some benefits would be very attractive to some individuals, such as an invitation to a corporate box for the AFL grand final or tickets to the Olympics.

Some benefits were described to ASIC as being part of a relationship building strategy. Some were incentives for high-volume performance. One award observed was in recognition of long service.

We observed individual benefits worth up to $5,000 per adviser, but benefits worth less than $1,000 appeared to be more common. An adviser might get several different hospitality offers or awards in one year, so we could not determine what the total value might be.

Most of these programs appear to have no explicit criteria. Benefits are given at management discretion to maintain or foster important relationships.

Disclosure requirements would depend partly on the value level of the benefits. For many of the situations observed by ASIC, it would probably be adequate for an FSG to give generic disclosure about the type of benefits that have been received (and/or are likely to be received) and the maximum value. SOA disclosure would depend more on the circumstances, including likelihood of being received.

3 Adviser conferences

Advice licensee and product providers organise a wide range of adviser conferences. This section considers three types of conference:

- Open educational events and non-subsidised events
- Reward-focused luxury events
- Events with a modest subsidy

Open educational events and non-subsidised events

At one end of the conference spectrum are short educational events (up to a full day), often in the adviser's home state. The content of these events is solely education and training, with no hospitality or entertainment. They are open to all advisers, and may even be compulsory in some cases.

Also at this end of the spectrum are multi-day conferences where the adviser or licensee pays the full cost and the invitation is not dependent on a sales record.

In the circumstances we observed – where the event has a genuine educational or training purpose – disclosure of these events does not appear to be required in the FSG or an SOA.

Reward-focused luxury events

At the other end of the spectrum are luxury international conferences that are part of adviser incentive schemes. These are free to the adviser, but cost the organising firms between $7,000 and $24,000 per adviser for a 5–11 day event. (In contrast, unsubsidised conferences cost about $1,200 per adviser.)

Invitations to these conferences are based largely (or entirely) on the volume of revenue or sales generated by advisers: the formulas appear to mirror the adviser’s profitability for the firm. Some schemes use a ranking system (e.g. top 50 earners). Others set a qualification hurdle (e.g. $500,000 revenue; $17 million in master trust for a partly paid invitation or $33 million for a fully paid invitation).

Apart from the main conference, several firms offer an ‘elite extension’, which gives the top 10 or 20 advisers additional days at an exclusive mini-conference, with an even higher standard of hospitality and travel.

Venues for the conferences include tourist destinations, such as:

- a cruise ship in Alaska
- Colorado Springs, with elite extension to San Francisco
- Florence, with elite extension to Monte Carlo
- South Africa with elite extension to Mauritius
- Vancouver and Whistler, Canada, with elite extension to Montreal
- Vienna
- Switzerland and Dubai (combined)
- London, with elite extension to St Petersburg
- Copenhagen, Denmark, with elite extension to Salzburg, Austria
- a cruise ship travelling to New Caledonia and Vanuatu
- Hyu An and Bangkok, Thailand.

The business / education portion of such conferences ranges from 25% to 75% of the overall event, with the remainder being leisure activities. An extensive leisure program is also provided for spouses in parallel to the conference. Entertainment includes gala dinners at top restaurants, full-day tours to tourist sites and special entertainment. Some sessions contain content on financial services issues; others focus on motivation or networking. There is no indication in the programs that attendance at conference sessions is compulsory.

Extract from a brochure to advisers describing a Northern Hemisphere conference

Our '[*Destination*] Bound' Business Conference is really about mixing business with fun – the short series of conference workshops leave ample time for exciting offshore excursions and other leisure activities.

In one case a company flew 100 advisers and their spouses to a Northern Hemisphere city for a four-day gathering. The business content of the conference was two pre-lunch sessions. Twenty advisers and their spouses had an additional three days on a side trip to another country, purely for leisure purposes.

The promotional material shows the 'top earner' conferences are a key cultural tool. The material distributed to advisers clearly describes the overseas conferences as a reward for past achievements and an incentive for future achievements. They define success and high achievement as being measured by the volume of sales and high earnings.

Promotional brochure to advisers

Enter AAA's 2003 Super Race by writing AAA superannuation business between 1 April and 31 July 2003 and you can be in the running for outstanding rewards and bonuses.

As the first bonus points campaign for the 2003/2004 League of Honour program, participating in the Super Race is a great way to kick start your points accumulation for qualification to the 2005 International Study Tour to [*destination*].

From our discussions with industry, it appears that the status of being labelled as a 'top adviser' in front of their peers is at least as important to many advisers as the financial benefit of a free overseas trip. The firms also appear to use incentive programs as an important tool to motivate and retain top revenue earners.

Qualification rules for one large product provider included:

Qualification is a measure of sales and marketing achievement. This must be demonstrated by a regular and ongoing business relationship manifested by the sale of AAA products throughout the conference qualifying period.

Some firms have recently added satisfactory compliance as a threshold qualification factor. While this is to be applauded, the use of sales volumes as one selection factor means the benefit still has the potential to influence advice.

Unless the adviser has no realistic prospect of qualifying, disclosure of such benefits would be required in the FSG and (if a relevant recommendation is made) in the SOA. The benefit is attributable to the advice service, the value is material and qualification depends on the overall pattern of the advice given. It appears capable of influencing advice.

In some firms, an invitation to the top conference is based on the general manager's discretion, rather than a specific formula. It appears likely that sales volumes and profitability would still be a factor in the selection of most delegates. If this is the case, disclosure would still be required.

Events with a modest subsidy

In the middle of the spectrum are multi-day conferences open to all advisers in the group.

For large licensees, the location is normally a major Australian city or resort, or a nearby low-cost tourist destination (Bali, Christchurch, Fiji), where the typical program is two-thirds business and one-third leisure. Spouses are often invited. Costs are in the range of $2,000 to $5,000 per adviser. The licensee or product provider may cover part of cost. For conferences like this, the licensee or product provider commonly subsidises travel, accommodation or conference costs on a sliding scale, depending on the adviser's volume of sales.

This conditional subsidy appears capable of influencing advice and must be disclosed in the FSG and (where a relevant recommendation is made) in SOAs. Brief disclosure would generally be adequate if the amounts involved are modest.

4 Adviser's higher share of commissions

Most product providers make commission payments to the advice licensee, not the individual adviser. The licensee typically takes a percentage (the 'licensee share') and has an agreement to pass the rest to the individual adviser (the 'adviser share'). The licensee share is typically 10–20% and is used to cover head office expenses and profit. The proportion is normally on a sliding scale – the higher the commission generated by an adviser, the higher the adviser's percentage share.

Benefit example 2 - Adviser's share		
Adviser's gross revenue (fees + commissions)	**Adviser's share**	**Licensee's share**
< $50,000	70%	30%
$50,000 – 150,000	80%	20%
$150,000 – 250,000	85%	15%
>$250,000	90%	10%

ASIC noted various arrangements whereby the licensee would increase the adviser's share of commissions if certain business priorities were met. These included recommending in-house products and reaching revenue or funds under management (FUM) targets.

Other arrangements achieved a similar result by reducing charges to the adviser rather than increasing the commission share.

Disclosure of commissions is required in the FSG and SOA. Reference to the adviser's share of commission may be part of a wider explanation of commission-based remuneration.

5 Volume bonuses

A volume bonus (or 'override') is where a higher rate of commission is paid if the individual adviser or licensee achieves certain volume levels for a product. In some cases the bonus may increase the rate of commission payable by about one-tenth (e.g. increase trail commission from 0.45% to 0.5% per year).

For an in-house product, the volume bonus results in a higher commission rate for the individual adviser. For an external product, the bonus increases the commission rate paid to the advice firm. Part is then distributed to the individual adviser according to the adviser-split formula.

In contrast to a tiered volume bonus, some fund managers negotiate a higher commission rate with the advice licensee, based on expected fund flows. A licensee will be able to negotiate a higher commission rate and/or other soft dollar benefits if it is directing a high volume of funds to a particular provider.

Volume bonuses create a dynamic where advisers and their licensee have an incentive to direct clients' money to a smaller range of product providers in order to maximise their remuneration. Our discussions with advice licensees indicated that such channelling did sometimes occur in practice.

In a recruitment brochure directed at potential advisers, one advice licensee described a kind of volume bonus as follows:

> **Benefit example 3 – Volume bonus**
> Whenever you invest funds in our AAA Master Trust, you gain access to the AAA Profit Share system, so you can share in the profitability of the entire trust. Every year, we pay our AAA financial planners a profit share sum based on the total value of the funds they have directed to AAA Master Trust (over a pre-determined minimum). This is a powerful way for you to increase your earnings.[8]

In their discussions with us, several fund managers expressed unease about volume bonuses. These fund managers preferred to negotiate a flat commission rate, based on funds flow. They worried about the potential of a volume bonus to influence advisers and increase the risk of inappropriate advice, especially where an adviser or firm was close to the threshold.

In our view, a benefit from the cumulative pattern of advice has the potential to influence advice, even though it does not relate to a single piece of advice.

Disclosure of a volume bonus is required in the FSG and SOA. In some cases this may be part of a wider explanation of commission-based remuneration.

6 Marketing support

Some agricultural schemes offered additional remuneration to the adviser under the label of 'marketing support'.

The level of marketing support is negotiated between the product provider and each advice licensee: it is paid where the licensee will

[8] Although called 'profit share', this is actually an adviser-level volume bonus.

actively promote the scheme to its clients. The rate appears to be determined by the expected volume of sales. In some agricultural schemes, marketing support may increase the initial commission from 5% to 8% or even 10%.

Benefit Example 4 - Separate marketing support

The AAA adviser will receive 5% commission from investments in XYZ. The adviser may also receive marketing fees of up to 5%.

Terms like *marketing support* give the impression that the product provider is covering the cost of marketing to clients, such as mail-outs or brochures. Some Product Disclosure Statements (PDSs) refer to covering the direct costs of marketing. In fact, this marketing payment often appears to be just sponsorship for the licensee's conference so that the product provider has access to advisers. In some other arrangements, marketing support is just a volume bonus (i.e. a higher commission rate) where a higher level of sales is achieved. Where it is just commission or conference sponsorship under another name, the term *marketing support* may be misleading.

One industry participant expressed the view that a separate marketing support payment is a just way of disguising a high level of commission by splitting it into smaller components.

Some advisers disclose marketing support in the SOA as an additional payment.

Example 5 - Marketing support separate			
AAA Agricultural scheme: $10,000 investment	Initial commission	5%	$500
	Marketing support	5%	$500
Total			$1,000

Another firm's SOA about the same investment simply combined the two amounts and disclosed the total benefit received.

Example 6 - Marketing support combined			
AAA Agricultural scheme: $10,000 investment	Initial commission	10%	$1,000

The disclosure of marketing support of this type is required in both FSGs and (where a relevant recommendation is made) in SOAs.

7 Equity or options

Advisers can be rewarded for meeting specific sales volumes with free (or discounted) options or shares in the fund manager, platform provider or advice licensee. Sometimes the reward is free units in the investment being recommended.

Several agricultural schemes raised the possibility of options in their PDSs, but sample firms reported that they had not followed this path.

One platform provider told ASIC they offered equity to advisers, based on the level of funds in the badged master trust. The benefit was valued at $10,000–$75,000.

Some previously 'non-aligned' advisers and licensees are being offered (or are actively seeking) an ownership stake in the platform (i.e. master trust or wrap account) where they direct their client funds. ASIC was informed that some advisers have changed licensees largely in order to get an ownership stake in a platform. This gives the potential for capital gain, not just a share of annual fees.

We are advised that some advisers and licensees have been strongly influenced by precedents where it has proved very profitable to hold equity in a platform. For example, one small group of advisers created an early platform product and built up the funds under management. A few years later they sold the platform to a bank for several hundred million dollars.

Several advice licensees reward advisers with shares in the licensee company (or the holding company). These are licensees that typically have arrangements to get a revenue share from in-house or badged investment products in addition to the usual licensee share of commissions. This means advisers build equity in a saleable asset that is growing in value, not just an income stream from their advice services. This represents a major change in the business model for advisers. One licensee reported that some advisers had left in order to get access to equity schemes at rival firms.

Direct or indirect equity in a product provider represents an additional conflict because advisers have an incentive to recommend the manager's products to keep the share price high.

In some cases the shares (or options) are given for free; in other cases, at a discount to the market price. Alternatively, the reward may be allowing the adviser to buy shares (presumably at a discount to the real value, as there is no open market). Part of the long-term value may be the possibility of an ASX listing or takeover by a big fund manager.

A volume-linked incentive through shares or options requires disclosure in both the FSG and (if a relevant recommendation is made) in the SOA.

8 Buyer of last resort agreement

Some advice licensees offer their advisers a buyer of last resort agreement. This guarantees the adviser a minimum sale value for their financial planning practice, even if they cannot find a buyer on the open market.

The formula for the sale price is based on multiples of the practice's annual revenue in each category, and some buyer of last resort agreements apply a higher multiple for 'in-house products' than for external products.

Benefit example 7 - Buyer of Last Resort

AAA Financial Planning provides a buyer of last resort option, which is subject to certain conditions. This offer allows the Adviser to sell his current client base to AAA Financial Planning. The value of the sale is based on a multiple of ongoing revenue generated from a financial product. The multiple can range from 1 to 2 times for non-AAA Group product and 2 to 3 times for AAA Group (including PPP Master Trust) products.

An established single adviser practice might sell for $200,000. Theoretically an adviser could increase the sale price by $50,000 by transferring a large proportion of clients to in-house products.

A 'brand neutral' buyer of last resort agreement does not give advisers any additional incentive compared with maximising the sale price on the open market. However, the presence of a higher multiple for in-house products appears to be a factor capable of influencing advice and must be disclosed.

A buyer of last resort agreement with a bias to certain brands should be disclosed in broad terms in the FSG and in an SOA (where a relevant recommendation is made).

9 Sponsorship of advice licensees

A widespread practice has emerged of advice licensees seeking 'sponsorship' payments from fund managers and platform providers. The product providers are those who currently sell products through the licensee or hope to in the future. Business development and distribution managers for product providers report that they receive many requests for financial sponsorship.

The following is an example of how a larger licensee might offer sponsorship opportunities to product providers.

Benefit example 8 – Sponsorship by product providers

Silver sponsor - $10,000
Send a representative to the firm's annual adviser conference.

Gold sponsor - $30,000
Send 2 representatives to the firm's annual adviser conference, present a session, have a display stand and have naming rights over a social event.

Platinum sponsor - $50,000
as above, plus present sessions at professional development days and be featured in client newsletter.

A mid-sized licensee might raise $150,000 in sponsorship from a dozen product providers ($5,000–$20,000 each). A large licensee might raise a half a million dollars from 20 sponsors ($15,000–$50,000 each). For some licensees, the sponsorship money covers part of the conference cost. For one licensee observed by ASIC, the sponsorship money exceeded the direct cost of the conference.

Each sponsor hopes to boost (or maintain) their volume of sales by ensuring that advisers are comfortable and familiar with the company and its products. Some licensees insist that sponsors conduct presentations only on generic technical issues; other licensees allow specific product promotion.

Product providers make a business decision about whether they expect the sponsorship cost will be justified by an increased level of sales.

At another level, we detected some undercurrents of implicit understandings about mutual support – 'you scratch our back and we'll scratch yours'. We observed:

- A sponsorship request from a small licensee that discussed the expected level of funds to be 'allocated' to each fund manager over the next three years.
- Conference sessions and written programs that included requests for advisers to support the conference sponsors.
- A belief among product providers' that sponsorship is part of a successful relationship with a licensee. Some providers also

suspect that sales volumes and their status on the informal 'preferred product list' would be jeopardised if sponsorship and other payments were reduced.

A likely consumer question is: 'Has this brand been included in the preferred product list because it is one of the best, or is it an average brand that was prepared to pay sponsorship money?'

Factual information is not available on whether sponsorship actually affects advice or listing on preferred product lists. However, large sums of money are involved, and licensees have mechanisms for preferring certain funds, if they wish to do so.

On the other side, fund managers do consider future fund flows when deciding on sponsorship. If fund flows from a licensee do not meet expectations, the fund manager is unlikely to act as a sponsor next time. Even without a specific agreement between a licensee and a fund manager about volumes, sponsorship creates a potential conflict of interest.

Recent publicity about sponsorship arrangements between a mortgage broker and banks suggest the issue is not limited to financial planning firms.

Sponsorship is a relationship that appears capable of influencing advice and on this basis must be disclosed in both FSGs and (where a relevant recommendation is made) in SOAs.

10 Loans

ASIC observed several cases in which advice licensees (or related entities) had received loans from product providers.

In one case, a product provider gave loans with subsidised interest rates to advice licensees. In another case, the interest rate on the loan varied, depending on the level of funds under management that the licensee had with the product provider.

In another case the product provider gave loans to advice licensees at or near commercial terms. Future commission payments were often used as the security for the loan. Loan amounts between $50,000 and $5 million were observed. Even if the loan was on commercial terms, the availability of the credit might create an incentive to favour that product provider over others.

Benefit example 9 - Loan from fund manager

AAA has a loan facility from XYX Fund Management. When the loan is used, interest is affected by the total funds AAA's clients have with the XYX Group. If total funds are less than $300 million, a commercial rate of interest is charged. If total funds exceed $300 million, no interest is payable. The loan facility of up to $4.6 million is available to meet any immediate operational costs that are not met through general revenue and to meet unanticipated contingencies. The value of the waived interest is up to $350,000 per year.

A significant loan, interest subsidy or loan guarantee from a product provider is a benefit and/or relationship that must be disclosed in the FSG and, if the products of that provider are recommended, in the SOA.

11 Fee-sharing and fee rebates

ASIC's research revealed a range of fee-sharing arrangements between entities involved in advice and funds management. These are often described as *fee rebates*. Relevant examples include arrangements where:

- an underlying fund manager pays a 'fee rebate' to a platform provider or multi-fund manager,
- a platform provider or fund manager pays a 'fee rebate' to an advice licensee based on funds invested directly with it,
- an underlying fund manager pays a 'fee rebate' to a licensee based on total funds invested with it (regardless of whether invested directly or via one or more platforms).

In this report these arrangements are called *fee-sharing* arrangements. Some licensees and platforms pass the rebate on to each client. A conflict of interest only arises where the benefit is not passed on.

The annual amount of the benefit the adviser receives is based on a percentage of funds under management (FUM). ASIC observed arrangements of 0.05%–0.50% of FUM per year. Sometimes the rate is tiered, with a higher percentage being paid at higher FUM levels.

Benefit example 10 - Fee-sharing agreement

The AAA Group is entitled to receive an annual payment from PPP Master Trust of up to 0.50% of all amounts held in PPP Master Trust products by AAA Group clients.

For example, a wholesale equity fund manager might charge a fee of 0.8%. A fee-sharing agreement for 0.2% would mean that the consumer still pays 0.8%, but the fund manager only keeps 0.6% and the advice licensee gets an extra 0.2%.

To put this in context, an agreement to pay 0.2% of FUM means a payment of $2 million per year for each $1 billion of funds under management. At least 45 financial planning firms have more than $1 billion under advice – the largest has $13 billion.[9]

Our research also revealed fee rebates from insurance companies based on the volume of premiums, but we did not explore these arrangements in detail.

Business context of revenue from non-commission sources

Advice licensees have two interests in fee-sharing arrangements.

First, licensees have an interest in maximising their ‘slice of the pie’. The total fees paid by a consumer are split among the adviser, the advice licensee, the platform provider and the underlying fund manager. Some licensees try to maximise their profitability by capturing some of the share that goes to platform providers and underlying fund managers. Fee-sharing arrangements are one way to achieve this.

Second, advice licensees may have an interest in maximising the proportion of income that does not have to be shared with advisers. Commission payments are traditionally shared with advisers, but other income sources may not be. These other income sources include fee-sharing arrangements with product providers (including profits from ‘badging’ their own products). For example, one licensee made 45% of its income from the licensee’s share of commissions. The other 55% came from fee-sharing arrangements with product providers. This amounted to many millions of dollars. This has the combined benefit for the licensee of being both additional revenue and revenue that does not need to be shared with advisers.

The evidence available to us suggests that fee-sharing deals do sometimes affect the selection of funds or fund managers. This particularly applies to master trusts, wrap accounts and multi-manager funds. Some product providers say they first select a shortlist of acceptable funds within each category and then negotiate with the funds. They may choose the fund or funds that offer the provider the best financial benefit. Fund managers told ASIC of examples where they

[9] Table in *Independent Financial Adviser* (IFA) magazine, 5 April 2004.

suspected funds had failed to get onto a menu (or were dropped) because they have refused to pay enough.

Where fund managers are pressured to give fee rebates to advice licensees or platform providers, one response is to increase the administration fee to maintain profit levels.

The consumer relies on the adviser to make an independent assessment of the platform menu or the blended fund (based on, for instance, performance and value for money). If the adviser or licensee has a direct or indirect financial interest in the fund or menu selection, this would be a conflict of interest.

In summary, where the adviser or licensee or a related entity has a fee-sharing arrangement with a platform provider or fund manager, this appears to be a benefit capable of influencing advice. It must be disclosed in the FSG and (if a relevant recommendation is made) in the SOA.

Where the full amount is rebated to the client and not retained, the benefit does not need to be disclosed.[10]

Use of the term *rebate*

The use of the term *rebate* in this context may be misleading and deceptive. The Oxford English Dictionary defines a rebate as 'a partial refund to someone who has paid too much money for tax, rent, or a utility'.

Some funds use the term *rebate* where the amount is credited to the client's account. This accords with the dictionary definition.

An issue arises where the term *rebate* is used to describe an amount retained by the product provider or advice licensee. In this situation, the payment is akin to a commission payment. This may create confusion with both the normal usage mentioned above and the dictionary definition. As many consumers would consider that they pay the fund management fee (directly or indirectly), it may be misleading to characterise a retained portion as a partial refund.

12 Other benefits and interests

During our research we found some other types of benefits and interests. As they were not within the main focus of this project, they were not researched or reported in detail, but we have noted them below.

[10] ASIC Policy Statement 175, para. 128.

Shelf fees to platform provider

Platforms (such as master trusts, wrap accounts and portfolio services) are administrative services that allow an investor to conveniently access a wide range of financial products. A platform might have a modest range of funds on its menu (e.g. 20) or it might have a wide range (e.g. 200+).

ASIC is aware that some platforms charge fund managers a ‘shelf fee’ to be included on their menu. This is similar to the fees supermarkets charge suppliers to put their stock in high-profile shelf positions. Industry participants mentioned shelf fees of $1,000–$5,000 per fund per year.

Where the arrangement involves the platform provider receiving a percentage of funds invested (as opposed to a flat fee), this is dealt with under ‘Fee Sharing’ in section 11 above.

Licensee sale arrangements with new parent

When an advice licensee is bought by a product provider or another licensee, the contract terms may affect future benefits. For example, a particular financial planning firm was sold to a large financial services conglomerate. ASIC understands that a performance payment (above the sale price) to the continuing directors was partly related to the profitability of the conglomerate.

It was also suggested to us that there may be instances where the sale conditions require that planners attempt to transfer clients to the new owner’s investment platform.

D Our observations

This section makes broad observations about soft dollar benefits and disclosure. It also provides some comments on more effective disclosure.

Influence on advice

We heard frequent evidence from industry that conflicts of interest are not just theoretical. There is significant evidence (both direct and implicit) that in some instances soft dollar benefits do influence advice and product selection.

Revenue sources such as volume bonuses, fee rebates and equity links can be major elements in a licensee’s whole business model. These ‘soft dollar benefits’ can actually make up the majority of a licensee’s revenue. The desire to maximise this revenue means soft dollar benefits can influence the selection of approved products and platforms. For example, some licensees appear to channel a large percentage of client funds through the one investment vehicle in which they have a profit share, presumably to maximise commission and profit.

Payments by fund managers can be a factor when selecting fund managers to menus for wrap accounts, master trusts and funds of funds.

Indirect evidence also suggests incentive schemes influence individual advisers: firms would not spend millions of dollars on such schemes if they had no effect.

Economic significance of benefits

Many consumers need to seek advice because financial and tax matters are inherently complex and there is a huge variety of financial products on offer. This puts financial planners in a unique position as gate-keepers between consumers and managed funds. To some extent, fund managers are competing to attract advisers to their products rather than purely competing to offer the best benefit to the end consumer.

Most basic commissions and soft dollar benefits come indirectly from investment fees charged to consumers. To a degree, managed fund providers are able to charge higher fees (above their own costs) and use the extra money to create incentives for financial planning firms that have the capacity to influence advice. The exception is where funds pay no commissions or soft dollar benefits and advisers are paid by their clients on a fee-for-service basis.

Rejection of benefits

Some financial planning firms have taken the decision that they will not accept soft dollar benefits. The reasons they cite include the following:

- Such payments undermine the impartial professional status of the adviser.
- Acceptance necessitates the need for complex and potentially embarrassing disclosure to clients.
- Even where benefits are disclosed, clients cannot judge whether the benefit has influenced the advice.

For example, one mid-sized advice licensee recently announced that it would not accept any conference sponsorship. The advisers decided that they would prefer to carry the entire cost themselves rather than create a conflict of interest. They explain their policy in their FSG as follows:

> Many product providers offer incentives such as overseas trips and tickets to conferences in an attempt to influence advisers into recommending their products to clients. AAA Financial Planning and our advisers believe clients should be placed first and products recommended because they are in the clients' best interests as opposed to those of the adviser. To ensure clients are able to rely on our recommendations as being free from such influence, AAA Financial Planning have introduced a policy prohibiting the receipt of these types of incentives.
>
> This policy prohibits AAA Financial Planning staff, advisers and member firms from receiving incentives it feels have a real potential to influence recommendations. Specifically, AAA Financial Planning has prohibited the receipt of:
>
> - Trips whether overseas or within Australia,
> - Tickets to conferences,
> - sponsorship payments for its conferences from product manufacturers.

Simplification of benefits

When firms are designing soft dollar arrangements (or deciding whether to participate in a scheme), they need an arrangement that can be explained to clients. The law does not exempt firms from disclosure obligations merely because they have entered into complex arrangements.

During the research project, several product providers and advice licensees told us they were simplifying or reducing soft dollar benefits.

This was partly driven by the increased public focus on conflicts of interest. Some firms also thought the disclosure of complex arrangements would be difficult and preferred to end the arrangement rather than risk causing confusion or uncertainty amongst their clients.

Current disclosure practices

The research project made a broad check of how well firms are disclosing soft dollar benefits and found that industry practice varies widely. Some firms are to be commended for the way they effectively disclose all soft dollar benefits. Other firms provide only vague disclosure. A couple of firms make no mention of some conflicts of interest. It is particularly unsatisfactory that disclosure is patchy on some of the larger soft dollar benefits, such as fee rebates. These payments involve hundreds of thousands, or even millions, of dollars.

Reviewing disclosure

When reviewing examples of disclosure in this project, we took account of disclosure principles and *Corporations Act* obligations.

ASIC has previously set out Good Disclosure Principles in relation to PDSs.[11] We took these principles into account where they were relevant to FSG and SOA disclosure.

As stated above, we took account of the legal obligations in the *Corporations Act* and *Corporations Regulations*, but we did not seek to assess whether each example of disclosure was legally compliant in all respects. The project was not aiming to be a compliance audit, but rather to identify the range of benefits being offered and the approaches to disclosure across the industry. A judgement about legal compliance depends on the individual circumstances of each case.

The following sections use examples to discuss the style of disclosure we observed. The examples have been modified and simplified for ease of presentation, and focus on the style of disclosure.

Features of more effective disclosure

The disclosure examples that appeared to be more effective communication had several features in common. The more effective examples gave the reader (where relevant) a broad understanding of:

context – how is the benefit relevant to the consumer?

scale – how big is the potential benefit?

[11] see ASIC Policy Statement 168, pages 11–18.

eligibility – under what circumstances would the adviser or licensee get the benefit?

source – who pays the benefit? If the benefit system creates a preference for certain providers, who are they?

Not all these factors were relevant in every case and the appropriate level of detail depends on the circumstances, including whether the disclosure is at the FSG stage or the SOA stage. The better examples also featured a consumer-friendly writing style.

Effective Disclosure

Disclosure was particularly effective where it gave the consumer the *context* of the payments, not just the bare facts. For example, one FSG explained clearly that certain arrangements are incentives.

> **Example D1 (FSG)**
>
> **Relationships and Incentives**
>
> AAA Financial Planning is part of the HIJ Group, which also includes ZZZ Funds Management. HIJ Group and AAA Financial Planning provide your Adviser with the following incentives to recommend ZZZ products:
>
> • *[description of benefits followed*].

On the other hand, disclosure was less effective where it presented bare facts but did not explain the implications, as in Example D2:

> **Example D2 (FSG)**
>
> AAA Holdings, the holding company of AAA Financial Planning, owns a majority share of ZZZ Investment Services.

If the associated company ZZZ is not a well-known name, it would be more useful for the explanation to include how this relationship might be relevant to the consumer. For example, ZZZ might be their preferred master trust.

Disclosure was more effective where it gave the consumer an idea of the *scale* of the likely benefit to the adviser or licensee. The client should have a factual basis to judge whether the conflict provides an incentive for bias.

Example D3 (FSG & SOA)

Your Adviser may qualify for other benefits:

• prizes, awards, hospitality events (e.g. tennis, football, etc) to the value of $5,000 per annum.

For miscellaneous hospitality and prizes of modest value level, Example D3 gives a reasonable level of detail about the benefits and their value (especially at the FSG stage). If the potential benefits are paid from only one source (or just a few), the identity of the source may also be relevant.

Example D4 (SOA)

Your Adviser is eligible to win a prize to the value of $5,000 in a competition for recommending the PPP Superannuation Master Trust.

Example D4 concisely communicates the key information about this benefit.

The exact value of a soft dollar benefit is often not known at the time of disclosure, especially at the FSG stage. Some firms indicated the scale of the benefit by disclosing the method of calculation, as in the example below:

Example D5 (SOA)

The AAA Group is entitled to receive an annual payment from PPP Master Trust of up to 0.5% of all amounts held in PPP Master Trust products by AAA's clients.

Example D5 gives simple information about how the maximum potential benefit would be calculated. A worked example would also be helpful however.

Example D6 (FSG)

Your adviser may receive a Volume Bonus based on the adviser's Funds Under Management within AAA Group products. The bonus is a percentage of the standard ongoing commission.

Adviser's Funds Under Management	**Bonus percentage**
> $2.5 million	3%
> $5 million	6%
> $7.5 million	10%
> $10 million	14%

For example, if an adviser's clients had $8 million with AAA Group and the adviser's ongoing commission was $40,000 per year, the volume bonus calculation would be:

$40,000 x 10% = $4,000 Volume Bonus per year.

In a more complex scenario, Example D6 gives the *source* of the benefit, the *eligibility criteria* and how the benefit is calculated, with a worked example.

Less effective disclosure

Example D7 (SOA)

Each AAA adviser is paid a base salary which may be increased depending on the adviser's level of sales and meeting AAA's staff performance criteria.

Example D7 is less effective (especially at the SOA stage) as the consumer is given no indication of the potential scale of the bonus: is the maximum bonus 5% of the adviser's remuneration or could it be 90%? If the bonus formula is biased towards in-house products, this would also be relevant.

Example D8 (FSG)

AAA Financial Planning may receive benefits or payments from product issuers to assist in training our advisers or marketing their products.

> **Example D9 (FSG)**
>
> AAA Financial Planning receives rebates from various product providers. Your adviser does not receive a direct share of these amounts.

Examples D8 and D9 are poor, as they give no idea of the scale of the benefit, the source or the eligibility criteria.

> **Example D10 (FSG)**
>
> If your adviser generates certain levels of funds in the administration platforms preferred by AAA Financial Planning, the adviser may benefit from various rebates and fee waivers. The level of funds required and the value of the benefit may vary from time-to-time.

Example D10 is vague on almost all aspects. It does not disclose the preferred platforms, the level of funds required to qualify for the benefit, how the benefits are calculated or an example of the potential value. The fact that the benefit formula may vary in the future is no excuse for failing to give relevant information, such as a range or indicative amounts.

Some disclosure was vague even at the SOA stage, where the circumstances should allow more specific disclosure, possibly in dollar terms. This is a condensed version of disclosure in an SOA:

> **Example D11 (SOA)**
>
> Your Adviser may also be entitled to receive additional pecuniary or non-pecuniary benefits resulting from promotional, performance related and/or loyalty programs that may be conducted by AAA Financial Planning or financial product issuers. These benefits cannot be quantified at any given time and are generally not directly related to any one product or sale. The benefits to your adviser may be greater if your financial products and services are provided by one of the AAA Group Companies.
>
> Your Adviser will provide you with further explanation on request.

This example only discloses the mere possibility of soft dollar benefits and the possibility of a bias to in-house products. The SOAs from other firms provided more specific disclosure. We also note that all firms were able to give *ASIC* a clear description of how each benefit was calculated. The consumer should not have to request a meaningful explanation.

Many documents said that a benefit *may* be received. For some soft dollar benefits, there may be instances where the entity does not yet know whether the eligibility criteria will be met. However, it would be inappropriate to say a benefit 'may be received' if the entity already knows it will be receiving the benefit (eg under fee-sharing arrangements).

Some SOAs included a standard list of disclosures, many of which would not be relevant to the particular advice. This practice may clash with the requirement that information in FSGs and SOAs must be presented in a ‘clear, concise and effective’ manner. If the adviser does have an interest, it must be disclosed. If an adviser does not have an interest, the irrelevant reference actually reduces the clarity of the document.

Silence

In a few documents, there was no disclosure of some soft dollar benefits or other interests which ASIC knew were relevant. A particular area of neglect was where firms have taken loans from product providers.

Wording problems

Disclosure documents should be carefully worded.

We consider that the use of industry jargon can be confusing for consumers. For example, referring to benefits ‘based on the level of new business’ or ‘trail’ may not effectively disclose to consumers how the benefits are calculated. Such terms may also not effectively disclose the link between the advice and the benefit that may accrue to the adviser or the licensee.

Some disclosure appeared to have been worded to make the soft dollar benefit sound more palatable to the consumer, but at the risk of being misleading. Examples included:

- referring to ‘brokerage’ when the adviser was not acting as a broker and the benefit was actually commission;
- saying revenue sharing payments ‘are paid by the product provider and are not deducted from your investment’ when, indirectly, they do come from the fees on the client’s investment.

Consequences of non-disclosure

Failure to make appropriate disclosure in an FSG or SOA can lead to:

- penalties,
- liability to compensate the consumer for losses,
- forfeiting of undisclosed benefits to the consumer, and/or
- revocation of the consumer's contract to purchase financial products.

Complexity of disclosure

Several firms raised concerns that detailed disclosure of all benefits might result in a much longer document.

Whilst some documents used a lot of words and a formal, opaque style, they actually told the consumer very little. Other documents managed to disclose all the key information in a succinct, consumer friendly style while still meeting legal disclosure obligations.

Overall, we did not observe any problem with the proper disclosure of soft dollar benefits adding significantly to document length.

Responsibility for disclosure information

In most cases we observed, the licensee took responsibility for drafting generic disclosure text for the FSG and SOA. Where individual circumstances varied, the adviser could add or delete sections where relevant. In a few cases, the licensee handed responsibility to the adviser, with an instruction to 'add disclosure of conflicts of interest as relevant'.

The FSG and SOA must contain information about conflicts affecting the adviser, employer, licensee and related entities. The licensee may have conflicts of interest that the adviser is not aware of, and vice versa. It is important that both the adviser and the licensee take all reasonable steps to ensure all relevant information is included.

It may also be a breach of a licence obligation if licensees fail to adequately supervise disclosure by their authorised representatives.

E Industry developments

IFSA and FPA proposals

The Investment and Financial Services Association (IFSA) and the Financial Planning Association (FPA) have existing guidelines on soft dollar benefits. For example, the IFSA 1999 guidelines say acceptable soft dollar benefits include third party research and technical analysis software and that unacceptable benefits include office equipment, travel, accommodation and entertainment costs.[12] ASIC understands that this Guidance Note applies to fund managers as recipients of soft dollar benefits (from their own stockbrokers), not as providers of benefits.

The FPA Code of Ethics says:

> **'Rule 106** In the provision of any written recommendation (or a transaction affected by Rule 118) a member must disclose the following particulars to the client in writing:
>
> - remuneration, fees, commissions or any other pecuniary or non-pecuniary benefit whether direct or indirect, received or receivable by the member, the member's Principal, or an associate in connection with the financial planning service;
> - any other benefit reasonably capable of influencing the making of the recommendation;
>
> The disclosure of particulars must be expressed as a minimum in percentage terms and included in the recommendation prepared and issued by the member.
>
> These particulars should be expressed in dollar terms where practicable.'

This FPA rule was introduced in May 1997 and is similar to the new Corporations Act provisions. Judging by the examples of disclosure we have seen, there appears to have been significant non-compliance with this Rule.

In late 2003 IFSA and the FPA commenced a joint project on issues related to soft dollar benefits. In December 2003 they released a proposal for an industry code of practice on 'alternative forms of remuneration' (ie soft dollar benefits).[13] The draft code covers certain benefits from fund managers and platform providers, but not benefits from advice licensees to their own advisers. Under the proposal, some forms of soft dollar benefits, such as overseas conferences, would be banned. Some other

[12] IFSA Guidance Note no.10–soft dollar dealing.

[13] See www.fpa.asn.au

benefits (such as hospitality) would be detailed in a public register held by each advice licensee and product provider. The proposed code would be in addition to legal disclosure requirements.

ASIC commends initiatives in this direction.

F Conclusions

Importance of disclosure

The financial advice sector is an important part of the financial services industry. This importance is likely to increase as superannuation grows and product diversity increases.

The *Corporations Act* seeks to ensure that consumers are in a position to make informed financial decisions. Consumers assume advisers are in a position to give impartial advice, and they need to know if the adviser has a conflict of interest that might distort advice. Soft dollar benefits are one form of conflict of interest.

Range of benefits

Our research revealed that product providers offer a wide range of soft dollar benefits to advisory services firms and individual advisers. Advisory services firms also offer a wide range of soft dollar benefits to their advisers. Overall, the research has explored 11 different types of soft dollar benefits. These vary in value from a gift of wine up to sources of revenue that can give millions of dollars to an advice licensee.

Our research shows that soft dollar benefits have the potential to influence advice (directly or indirectly). Some of these benefits mean financial planning firms and planners have a financial incentive to recommend one strategy or product over another. Product providers presumably offer soft dollar benefits in an attempt to alter the behaviour of advisers and/or their licensees.

Disclosure

If licensees and advisers accept soft dollar benefits, the law generally requires that they be disclosed in the Financial Services Guide (when the client is choosing an adviser) and a Statement Of Advice (when individual advice is given).

We looked at a sample of firms to see how soft dollar benefits were being disclosed, which involved law and practice *after* the transition to the FSR Act but before the effective date of the dollar disclosure amendments.

Some firms made good disclosure. They explained benefits succinctly, and also gave enough detail for clients to understand their significance. In a few cases, firms had not disclosed conflicts where disclosure seemed to be required. In many of the observed cases, firms had disclosed the possibility of soft dollar benefits, but had omitted or been vague about key information. In these cases, a consumer would be aware of the possibility of soft dollar benefits, but would not know:

- under what circumstances the adviser or licensee would get a benefit, or
- the potential magnitude of the benefit.

Overall, we did not observe any problem with the proper disclosure of soft dollar benefits making documents too long.

Reduction of conflicts

We welcome efforts by industry associations and firms to reduce conflicts of interest. Although disclosed conflicts of interest are permitted under the *Corporations Act*, some soft dollar benefits have a strong potential to increase costs and distort advice.

Future ASIC Action

The firms surveyed in the research had only recently transitioned to the new regime under the FSR Act. Given this, it is not surprising that there is significant variation in how disclosure obligations have been implemented. However, despite the clear wording of the Act, the Regulations and ASIC policy statements, some firms have wrongly assumed that soft dollar benefits need be disclosed only in a broad, generic way.

This research paper is intended to give the whole industry further assistance, with examples of good and poor disclosure. This is consistent with ASIC's policy of assisting industry during the implementation of the FSR Act, although we will take action in appropriate cases.

Where we have observed disclosure that appears to be inadequate, we will be writing to the firms with a request that they review their documents and make any necessary changes.

We will consider conducting a formal surveillance next financial year to ensure disclosure of soft dollar benefits meets legal requirements.

Appendix 1. Legal obligations

Outline of the *Corporations Act* disclosure requirements

This section gives an overview of when firms must disclose soft dollar benefits. The requirements are in Part 7.7 of the *Corporations Act 2001* and in the *Corporations Regulations 2001*. ASIC's policy on these provisions is set out in Policy Statement 175.

The FSG must disclose:

- all remuneration, commissions and other benefits attributable to the provision of any of the authorised services (e.g. advice), and
- associations and relationships with the issuers of any financial product that might be capable of influencing advice. [14]

An SOA must disclose:

- remuneration, commissions and other benefits;
- other interests; and
- associations and relationships with the issuers of any financial product

that might be capable of influencing the advice (or any other authorised service). [15]

Relevant entities

The *Corporations Act* requires disclosure of conflicts of interest that affect a range of entities related to the adviser or the adviser's licensee. In most situations, the relevant entities are:

- the providing entity (in most cases, an individual adviser);
- where the providing entity is a licensee, or a related body corporate, an employee or director of either the licensee or a related body corporate;
- where the providing entity is a representative, any employer or authorising licensee of the providing entity, or employee or director of any authorising licensee; and
- any 'associate' of these relevant entities (e.g. parent company, subsidiary company, or perhaps a strategic partner).

[14] *Corporations Act*, s. 942B and s. 942C.

[15] *Corporations Act*, s. 947B & 947C.

The definition of an *associate* is quite broad.[16] For example, an *associate* of a corporate licensee would include:

- the parent company or holding company;
- another subsidiary of the parent company;
- a subsidiary company and a subsidiary of a subsidiary;
- a director or secretary of a related body corporate; and
- another entity with whom the licensee is acting in concert (in respect of receipt of remuneration, commissions and other benefits).

Level of detail required

FSGs

In an FSG, the level of detail to be disclosed is what a retail client would reasonably require for the purpose of making a decision whether to acquire financial services from the providing entity.[17]

The Corporations Regulations impose additional requirements for the disclosure of benefits (but not mere relationships) attributable to the advice. If the amount of a benefit is not known when the FSG is given to the client, the FSG must include:

> 'a description of the means by which the remuneration, commission or other benefits are to be calculated or provided';[18]
>
> '[this] must, to the extent relevant, include a statement of a range of amounts or rates of remuneration, commission or other benefits'. [19]

The FSG must also include:

> 'written details of when and how the remuneration, commission or other benefits are payable'. [20]
>
> 'Ranges, rates, comparisons, simple tables and formulae should normally be included in the FSG to ensure that the information is presented in a clear, concise and effective manner. Normally, worked dollar examples should be included in the FSG (where actual amounts cannot be ascertained at the time the FSG is provided). To comply with the law it is insufficient to merely state in the FSG that

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[16] See *Corporations Act* ss 10 – 17.

[17] *Corporations Act* s 942B (3) and s 942C (3).

[18] *Corporations Regulations*. Reg 7.7.07 (2) (b).

[19] *Corporations Regulations*. Reg 7.7.07 (3).

[20] *Corporations Regulations.* Reg 7.7.07 (2) (d).

a benefit will or may be received and that clients can ask for further details to be provided.'[21]

SOAs

In an SOA, the level of detail required is what a retail client would reasonably require for the purpose of deciding whether to act on the advice.[22]

This general disclosure standard is subject to specific requirements in the Regulations. The total amount of commission, remuneration and other benefits must be disclosed, if it can be identified at the time. If the total cannot be identified, the SOA needs to describe the method of calculating the benefits. Percentages or worked dollar examples should be included if appropriate.[23] For soft dollar benefits, the 'method of calculating' requirement will often be relevant.

Revised regulations for dollar disclosure requirements in SOAs have been released for consultation, and new Regulations are expected to commence from 1 July 2004 (with a short transition period). The revisions focus on disclosure of dollar amounts.

'Clear concise and effective' disclosure

The information required in an FSG or SOA must be provided in a clear, concise and effective manner.[24]

When and how benefits are payable

The *Corporations Regulations* require that FSGs and SOAs include 'written details of when and how the remuneration, commission or other benefits are payable'.[25] We interpret this to require details of:

- the pre-conditions or qualification criteria for the benefit, and
- the form in which the benefit is received (if non-monetary) or the path by which the benefit is passed (where this is relevant).

[21] ASIC Policy Statement 175, para 39.

[22] *Corporations Act* s.947B (3) and s. 947C (3).

[23] *Corporations Regulations* Reg 7.7.11(2)–(3) and 7.7.12(2)–(3). See also Reg 7.7.13. A revised regulation for SOAs is expected to commence on 1 July 2004.

[24] *Corporations Act* s. 947B(6) and s. 947C(6).

[25] *Corporations Regulations* reg 7.7.07 (2) (d); reg 7.7.12 (2) (b).

Consequences of non-disclosure

A 'defective' FSG or SOA is one that does not contain the required disclosure, or it is not presented in a clear, concise and effective manner. In some circumstances, failure to make appropriate disclosure is an offence. Non-disclosure can also lead to consumer remedies. If a client suffers a loss because they were given a defective FSG or SOA, they may be able to recover damages from the authorised representative or licensee (depending on who was responsible).[26] In addition to awarding damages, a court may also make an order:

- declaring a contract for a financial product or service to be void;
- for the return of money;
- for payment of interest.[27]

Consumers may also have remedies in wider circumstances under the common law of fiduciary duties.[28]

Differences from pre-FSR requirements

Most of the disclosure required under the FSR Act was also required under the prior law. Nevertheless, the FSR Act legislation incorporates several changes in benefit disclosure:

- Part 7.7 covers a wide range of financial products. Unlike the old s849 requirements, it is not restricted to securities.
- Section 947B covers payments to the adviser, the licensee and any associates of either. The old section 849 covered only payments to the adviser and any associates.
- Part 7.7 contains a 'level of detail' requirement. If information must be disclosed in a FSG or SOA, it must be to the level of detail that a consumer would reasonably require.
- Required information must be presented in a clear, concise and effective manner.

Other laws

Several other laws may also be relevant to the disclosure of soft dollar benefits:

- Proposed amendments to the *Corporations Act 2001* and licence conditions relating to management of conflicts of interest (CLERP 9).[29]

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[26] *Corporations Act*, s. 953B.

[27] *Corporations Act*, s. 953C.

[28] E.g. *Russell Fraser Henderson & Ors v Amadio Pty Ltd & Ors* [1995] 1029 FCA (23 November 1995).

- The *Australian Securities and Investment Commission Act*, relating to misleading and deceptive conduct.[30]
- *Corporations Act 2001* and license obligations to act ‘honestly, efficiently and fairly’.
- State Crimes Acts relating to corrupt secret commissions.[31]
- Common law relating to fiduciary duty.

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[29] *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2004*.

[30] E.g. s. 12DA.

[31] E.g. NSW *Crimes Act* ss. 249A – 249J; Victorian *Crimes Act* ss. 175–179. See, for example, *Russell Fraser Henderson & Ors v Amadio Pty Ltd & Ors* [1995] 1029 FCA (23 November 1995).

Appendix 2. Glossary

In this report, terms have the following meanings:

‘**advice**’ means financial product advice.

‘**adviser**’ means a person who provides financial product advice. All advisers must be either a licensee or a representative of a licensee.

‘***Corporations Act***’ means the *Corporations Act 2001* and includes the regulations made for the purposes of the Act. We refer to the law as at 12 March 2004 (i.e. after the full implementation of the *Financial Services Reform Act* amendments).

‘**financial product**’ means a facility through which a person makes a financial investment, manages financial risk or makes non-cash payments. Common financial products include listed shares, managed funds, superannuation, insurance and bank accounts.

‘**FSG**’ means a Financial Services Guide. When a potential retail client approaches an adviser, the adviser must give the consumer an FSG. This helps the consumer make an informed decision on whether they should seek advice from the particular adviser or firm, and how much it would cost if they did.

‘**licensee**’ means a person or legal entity that holds an Australian Financial Services Licence. In this report we use ‘licensee’ to refer to a licensee that is responsible for retail financial advisers such as financial planners. In the industry these licensees are sometimes referred to as 'dealer groups'.

‘**PDS**’ means a Product Disclosure Statement. A PDS must be given to a retail client in relation to the offer or issue of a specific financial product.

‘**product provider**’ means the issuer of a financial product. Common product providers include fund managers, master trust operators and life insurance companies.

‘**SOA**’ means a Statement of Advice. When a retail client gets personal financial advice, the adviser must provide an SOA. This documents the advice and helps a consumer make an informed decision about whether to rely on the advice.

'**soft dollar benefits**' (sometimes called 'soft dollar commissions'). In this report we use the term to mean all benefits except:

- direct client advice fees, and
- basic monetary commissions that financial advisers and their licensees may receive if they recommend certain products.

Thus 'soft dollar benefits' includes some monetary payments as well as non- monetary benefits.