



**ASIC**

Australian Securities & Investments Commission

## REPORT 474

# Culture, conduct and conflicts of interest in vertically integrated businesses in the funds-management industry

March 2016

### **About this report**

This report is about Australian financial services (AFS) licensees in the funds management industry with multiple business divisions.

It highlights the key issues that were identified in our review of the management of conflicts of interest in these businesses, and outlines our responses to these issues.

### About ASIC regulatory documents

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- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
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**Information sheets:** provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

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### Disclaimer

This report does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

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## Executive summary

- 1 In 2014 and 2015, we conducted a review of the management of conflicts of interest in a number of diverse funds-management businesses that may be characterised as ‘vertically integrated’.<sup>1</sup> The review covered the period from 1 July 2013 to 30 September 2015 (the relevant period).
- 2 By ‘vertically integrated’ we mean businesses whose operations include at least two of the following functions:
  - (a) investment management;
  - (b) acting as a responsible entity or wholesale trustee;
  - (c) acting as a trustee of a registrable superannuation entity;
  - (d) operating a platform (e.g. investor directed portfolio services (IDPS) or IDPS-like structures); and
  - (e) acting as custodian, which may also include an investment administration (back-office) function.
- 3 Significantly, we excluded from our review the deposit-taking, insurance and financial advice business divisions. Our review is distinct from other work conducted by ASIC in the funds-management area, including enforcement actions.
- 4 We were specifically concerned with how such businesses identify and manage conflicts of interest and the associated risks (conflicts management), as well as what the organisation’s avoidance or management of those conflicts implied about the organisation’s culture.
- 5 In general, we found that financial services organisations demonstrated a commitment to maintaining and reviewing policies and information barriers, with some focus on training. However, we found that on matters of outsourcing, product selection, remuneration and board membership, there may be areas where financial services organisations could better demonstrate a commitment to managing and, where appropriate, avoiding conflicts of interest. Our view is that:
  - (a) businesses may be adopting a set of policies without sufficiently embedding the expectations of the policies in the business; and
  - (b) in some instances, conflicts of interest may not have been adequately managed, leading to concerns that an appropriate and, in some cases, necessary outcome may be to restructure business units, roles and remuneration structures to prevent the conflict of interest arising.

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<sup>1</sup> See the appendix for more information on the methodology of our review.

- 6 We have prepared this report to inform the financial services industry about our observations of ‘good practice’ in relation to conflicts management, including what we consider to be appropriate systems and approaches to ensuring a culture that promotes compliance: see Section D. It also identifies some areas of weakness and areas for improvement.
- 7 Our report is directed at entities with an Australian financial services (AFS) licence. It is not directed at registrable superannuation entity (RSE) licensees that do not have an AFS licence and is not concerned with the activities of AFS licensees that are not covered by their AFS licence. RSE licensees should refer to the guidance of the Australian Prudential Regulation Authority (APRA). Nonetheless, some of our observations and recommendations may be of interest to them.
- 8 The report reflects our conclusions and observations of industry practices. It is not intended to imply any new regulatory requirement or standard.
- 9 We have limited this report to the areas of concern and matters of good practice that we identified. This report is not intended to be:
- (a) a comprehensive summary of all responses received as part of our review; and
  - (b) an audit of compliance with [Regulatory Guide 181](#) *Licensing: Managing conflicts of interest* (RG 181), although we consider that there are some important lessons derived from our review that relate to the requirements set out in RG 181.

## A Background

### Key points

This section outlines the background to our review, including the regulation of conflicts management obligations. Specifically, it considers the management of those conflicts of interest in entities with a vertically integrated business in the funds-management industry.

## Regulation of conflicts management

### ASIC's requirements

- 10 The principal obligation of an AFS licensee is set out in s912A(1)(aa) of the *Corporations Act 2001* (Corporations Act), which states that a licensee must:
- have in place adequate arrangements for the management of conflicts of interest that may arise wholly, or partially, in relation to activities undertaken by the licensee or a representative of the licensee in the provision of financial services as part of the financial services business of the licensee or the representative.
- 11 Our guidance on s912A(1)(aa) is set out in RG 181. RG 181.15 states that 'conflicts of interest' are circumstances where some or all of the interests of people (clients) to whom a licensee (or its representative) provides financial services are inconsistent with, or diverge from, some or all of the interests of the licensee or its representative. This includes actual, apparent or potential conflicts of interest. Further, we stress that a licensee's obligation to manage conflicts of interest does not depend on whether its clients are retail or wholesale: RG 181.22.
- 12 RG 181 details our expectations for conflicts management and provides examples of situations where an entity may elect to manage, disclose or avoid the conflict.
- 13 We state in RG 181.10 that:
- what constitutes adequate conflicts management arrangements will depend on the nature, scale and complexity of the licensee's business. In many cases, a licensee may be able to comply with the law's requirements in a number of different ways.
- 14 All licensees, including those with a vertically integrated business, must assess the adequacy of the arrangements they currently have in place to manage conflicts of interest: RG 181.12(a). The assessment must take place:
- (a) initially on commencement of operations; and
  - (b) periodically thereafter.

- 15 Merely having a conflicts management policy is not sufficient. To be adequate, the policy must be implemented and maintained: RG 181.34.
- 16 In addition, where an entity within the business acts as a responsible entity, s601FC(1)(c) states that they must:
- act in the best interests of investors and where there is a conflict between the interests of members and if there is a conflict between the member's interests and its own interests, give priority to the member's interests.
- 17 Also, where a director of a company has a material personal interest in a matter and that matter relates to the affairs of the company, the director must give the other directors notice of the interest: s191(1), unless s191(2) says otherwise. Standing notice may also be provided: s192. For public companies, a director who has a material personal interest in a matter at a directors' meeting must not be present at the meeting or vote on a matter: s195(1),<sup>2</sup> subject to certain exceptions in s195(2) and (3).

### APRA requirements

- 18 APRA has released [Prudential Standard SPS 521](#) *Conflicts of interest* on the management of conflicts of interest. This took effect on 1 July 2013 and has strengthened the legal obligations of superannuation trustees regarding managing conflicts of interests and related party transactions. SPS 521 requires that the board of an RSE licensee take ultimate responsibility for having a conflicts management policy that is appropriate to the size, business mix and complexity of an RSE licensee's business operations. [Prudential Practice Guide SPG 521](#) *Conflicts of interest* (PDF 239 KB) provides supporting guidance on APRA's view of sound practice, including the importance of a strong conflicts management culture, the role of the conflicts management policy, issues to consider in developing the policy, registers of relevant duties and interests, and the avoidance and management of conflicts of interest.
- 19 APRA also released a report on the key findings and consideration of APRA's thematic review into the superannuation industry's implementation of SPS 521.<sup>3</sup> Among other things, APRA's review revealed:
- (a) significant differences in the quality of conflicts management across the industry and the need for many RSE licensees to improve their practices in relation to conflicts management;
  - (b) a strong correlation between sound risk culture and effective implementation of the new conflicts management requirements; and

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<sup>2</sup> Section 194 provides an equivalent replaceable rule for proprietary companies.

<sup>3</sup> APRA, '[Conflicts of interest thematic review](#)', *Insight*, vol 1, 2015.

- (c) that those RSE licensees with a less robust risk culture and risk management framework tended to adopt a more minimalist approach to implementing the prudential requirements, designed simply to comply with, rather than meet the spirit and intent of, the requirements.
- 20 We regulate the financial services business of AFS licensees that is covered by their licence. APRA is responsible for regulating RSE licensees. Both APRA and the Corporations Act impose a conflicts management obligation and, fundamentally, the principles of conflicts management are consistent.

## Why we undertook this review

- 21 Our review was motivated, in part, by our findings in [Report 408](#) *Review of the implementation of RG 148 Platforms that are managed investment schemes* (REP 408), which was published in September 2014. The report identified that one area that warranted further attention was conflicts management, particularly in relation to vertically integrated structures in the funds-management industry.
- 22 [ASIC's Strategic Outlook 2014–15](#) identified that structural change in the financial system—through the development of market-based financing, largely driven by superannuation growth—is one of the key challenges in the current regulatory environment. The Financial System Inquiry also identified that high concentration and trends towards increasing vertical integration in some sectors of the financial system have the potential to limit the benefits of competition in the future.<sup>4</sup>
- 23 In 2015, we reiterated, in our [Corporate Plan 2015–16 to 2018–19: Focus for 2015–16](#), concerns that vertical integration in the wealth industry can contribute to conflicts of interest and low investor confidence.

## Our work on culture and conduct

- 24 We have expressed concern about the risk of inappropriate, unethical or unlawful behaviour on the part of an organisation's management or employees, characterised as 'conduct risk'. Work in this area has resulted in ASIC articulating the 'Four Cs' elements to conduct risk management. In summary:
- (a) *Communication*—Expectations around conduct need to be clearly, proactively and regularly reiterated across all levels of the organisations to ensure that it is 'front of mind'.

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<sup>4</sup> Financial System Inquiry, [Financial System Inquiry: Final report](#), report, 7 December 2014.



- (b) *Challenge*—Existing practices should be continually challenged to determine whether the conduct and behaviours are appropriate.
- (c) *Complacency*—Organisations should not be complacent and think that, because something hasn't happened yet, it won't happen.
- (d) *Consequences*—Consequences of non-adherence to an institution's code of conduct, policy and procedures need to be clear, and staff should see these being enforced. Conversely, rewards for staff who have demonstrated themselves as good conduct or culture role models need to be rewarded, and other staff should see these individuals being rewarded.

- 25 ASIC's Corporate Plan further noted that where culture, incentive structures and systems are poor or misaligned, the conduct of gatekeepers we regulate can conflict with clients' interests and can lead to unfair outcomes.
- 26 Regulators internationally consider that at the root of many conduct risks is the exploitation of conflicts of interest that have been built into financial sector structures, processes and management.<sup>5</sup> Failure to manage these conflicts can lead to consumer detriment and so has been the subject of much regulatory focus.
- 27 In our review, we gave particular focus to the cultural response of the organisation to conflicts management. For example, we reviewed whether:
- (a) the organisation had a culture of adopting generic policies designed merely to satisfy a regulatory requirement, without tailoring the policies to the business and embedding the key messages of the policy into the culture, systems and processes of the business. In this case, we would consider that the organisation did not demonstrate all Four C elements of conduct risk management;
  - (b) there was a strong awareness of and organisational response to the matter, so that the requirements were 'front of mind' for directors and employees and embedded into the culture of the organisation, from the top down and across all levels; or
  - (c) there was some evidence of the culture outlined in paragraph 27(b), with identifiable areas of improvement required.
- 28 We see poor culture as both an indicator and driver of poor conduct. How an organisation identifies and manages conflicts of interest is one way of gauging that organisation's culture. By emphasising cultural improvements in the firms and industries we regulate, we expect to disrupt the kinds of systemic conduct that is driven by poor culture.

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<sup>5</sup> For example, see Financial Conduct Authority (UK), [FCA Risk Outlook 2013](#), March 2013.

29 Our work on culture has led to the development of seven key indicators of culture. These are set out in Table 1.

**Table 1: Indicators of culture**

Indicator	Explanation
Indicator 1: Tone	'Tone from the top'—what is the attitude of the CEO, board and senior management? For example, what drives business decisions and what is the attitude to risk management?
Indicator 2: Spread	Does this 'tone' cascade down to the rest of the organisation?
Indicator 3: Business practices	How is the tone translated into business practices?
Indicator 4: Accountability	Is there accountability?
Indicator 5: Communication and challenge	Is there open communication and effective challenge of the business practices, procedures and messaging?
Indicator 6: Recruitment, training and remuneration	Is the conflicts management policy supported by recruitment, training and remuneration?
Indicator 7: Governance	What is the governance framework?

## Vertically integrated business structures in the funds-management industry

30 There are competitive advantages associated with operating a vertically integrated business in the funds-management industry, including readily available product distribution channels, revenue cross-subsidisation, supply chain management and economies of scale. Nonetheless, we have identified that the vertically integrated business model gives rise to inherent conflicts of interest, and consequently there may be a divergence in many areas of the financial services organisation between the interests of:

- (a) each business division;
- (b) the same entity acting in different capacities;
- (c) employees and directors acting in different roles or for different entities within the same corporate group;
- (d) the entity and the interests of customers and investors; and
- (e) employees and directors and the interests of customers and investors.

- 31 Significant consolidation has taken place in the funds-management industry in Australia. In 2014, the four major banks accounted for around 60% of total industry revenue.<sup>6</sup> We expect that there will be further industry consolidation over the period to the financial year 2018–19, as banks are likely to continue to increase their interests in smaller fund managers and superannuation funds.
- 32 Vertical integration in banking and other financial products along the distribution chain will continue to pose challenges. For example, platform operators that are also advisory dealer groups are in a position to direct many clients to in-house products.<sup>7</sup>

## Our key aim

- 33 ASIC’s key aim in this report is to help industry:
- (a) identify and understand the risks associated with the different types of business, and ensure that these risks are managed appropriately; and
  - (b) foster and demonstrate a culture that recognises and deals effectively with conflicts of interests to consider the long-term interests of clients. Such policies should be embedded into the financial services business and be ‘front of mind’ across all financial services business divisions, directors and relevant staff.
- 34 An adequate conflicts management policy, including an organisational awareness of conflicts of interest, can help mitigate the risk of adverse impact of conflicts on clients. Sound arrangements increase consumer protection and maintain market integrity. Without adequate conflicts management, AFS licensees whose interests conflict with those of the client are more likely to take advantage of that client in a way that may harm the client or diminish confidence in the licensee or market.
- 35 There are several possible structures within a vertically integrated business. Ultimately the arrangements to manage conflicts of interest will reflect the business structure. For example, the conflicts management will be driven by:
- (a) the type and scale of the businesses operated by the entity (e.g. advice, superannuation, responsible entity, custody, insurance, investment administration);
  - (b) the common staff, responsible managers and directors of each business unit; and
  - (c) the reward and remuneration structures of the business.

<sup>6</sup> ASIC’s *Strategic Outlook 2014–15*, October 2014, p. 5.

<sup>7</sup> ASIC’s *Strategic Outlook 2014–15*, October 2014, p. 5.

## B ASIC's findings: Types of conflicts of interest

### Key points

As part of our review, we asked entities to identify the types of conflicts of interest they encountered as part of their business. This section summarises their responses.

### What we did

- 36 We engaged with 12 financial services organisations, holding AFS licences, that are part of a vertically integrated group in the funds-management industry. We obtained details of how they manage the conflicts of interest associated with their vertically integrated businesses and interests, as well as copies of relevant policies and examples of the practical operation of those policies.
- 37 We also reviewed the overall culture of the organisation, as demonstrated by the seven indicators of culture that we refer to in Table 1. To an extent, all indicators may be relevant in considering an issue.
- 38 It is apparent that additional conflicts of interest may arise where an AFS licensee is part of a larger group of companies with different financial services businesses. As a result of the structure, and the economies and efficiencies of scale achieved through that structure, it may be that it is more challenging for the entity to identify and manage situations where the different parts of the business are conflicted with the interests of the same clients or clients in other parts of the business. Equally, a vertically integrated structure may have the benefit of resources or structural arrangements that avoid or mitigate the potential impact of particular conflicts of interest.
- 39 As suggested by the relationships and business arrangements within the diverse financial services organisations, conflicts of interest arise due to conflicting duties owed by different parts of the business to different clients. The following examples of conflicts identified provide a broad coverage and are not intended to be exhaustive.

### Product manufacturing versus product distribution

- 40 An important commercial objective of a product manufacturer is to sell in-house products. Where relevant, it may be more convenient and cost effective for the manufacturer to sell these products via in-house channels,

such as related platforms, dealer groups and financial advisers. This interest conflicts with the interest of investors to be offered a range of suitable investments, which may include non-related products and not include or be limited to in-house products.

- 41 The product manufacturer may require or influence related platforms, dealer groups and financial advisers to include the in-house funds on their product list:
- (a) without adequate due diligence; or
  - (b) in priority to unrelated products that may be more appropriate for those investors.
- 42 Further, an investor has an interest in ensuring that the performance of their portfolio is reviewed and the portfolio composition adjusted when appropriate. This interest may conflict with the product manufacturer's interest to ensure that the investor remains invested in in-house products.

## Outsourced services

- 43 Related entities may be appointed by a responsible entity, wholesale trustee or RSE licensee to provide services such as administration, investment management, custody or insurance. By retaining a related service provider, revenue for the financial services group may be maximised. There may also be other monetary and non-monetary advantages that result from retaining a related service provider. This may conflict with the interests of clients in the selection of the more suitable provider of administration, investment management, custody or insurance based on a range of identifiable criteria, including price.
- 44 Similarly, a common external third-party service provider used by other related entities may be engaged, to take advantage of certain monetary or non-monetary advantages enjoyed by the group or for convenience.
- 45 In both these scenarios, the interest of members may be compromised if:
- (a) a service provider assessment is not conducted, as it is already determined that the related service provider will be used;
  - (b) the assessment is conducted without using an objective set of criteria that is applied uniformly to all potential service providers;
  - (c) the engagement is not conducted on an arm's length basis, adequately documented or monitored during the term of the engagement, as it would be for an unrelated third-party provider; or
  - (d) there is no independent oversight of the service provider, leading to abuse such as extracting more fees or otherwise breaching implied or express terms of conditions of the engagement.

## Fiduciary duties versus duties to shareholders

- 46 As a trustee, a responsible entity has fiduciary duties to the members of its registered schemes. An IDPS operator that is a trustee has fiduciary duties to its clients. When exercising its powers or performing its duties, a responsible entity must act in the best interests of members and, when there is a conflict with its own interests (i.e. its shareholders' interests, including in deriving fee income for itself or its group), it must act in the interests of the members. Officers of responsible entities have a similar duty to preference the interests of the members of the responsible entity's registered schemes. The duties of every AFS licensee must be performed, even if this not in the licensee's own interests or the interests of the shareholders of the licensee. The AFS licensee must have adequate arrangements to manage any conflict arising in its financial services business so that it ensures that it will meet its duties, despite the conflict.

## Benefits and remuneration

- 47 Incentives can exacerbate underlying conflicts of interest—for example, by rewarding business development strategies that focus on short-term sales targets or imposing implicit or explicit pressure on the salesforce to promote particular products.
- 48 At an organisational level, conflicts of interest can arise if the licensee receives and is able to retain soft commissions, benefits or fees for services provided or products manufactured by related entities, but such monetary or other benefits are not received for services or products from unrelated entities.
- 49 At the employee level, a conflict of interest could also arise when similar incentives or an inappropriate remuneration structure encourages the employee to promote group-manufactured products or platform products in priority to a third party's products, which may not be in the best interests of the client.
- 50 Better design and alignment of remuneration and transparency that facilitates more rigorous scrutiny by investors, auditors and regulators can mitigate the behaviours and processes that allow a failure to manage these conflicts of interest to become profitable for the licensee or representative and costly for consumers.

## Director and responsible person duties and ownership interest in the group

- 51 Directors and responsible persons may hold concurrent directorships within the financial services group and/or have ownership interests in the group. A director may also hold concurrent directorships outside the financial services

group, which may also create a conflict of interest. The director or responsible person might encounter conflicts of interest with their duties to different groups of clients when considering their duties to the organisations in the group of which they are directors, and their ownership interest.

- 52 Directors holding concurrent positions in related entities may influence discussions or decisions relating to related entities.

## Situations requiring the creation of an information barrier

- 53 An information barrier is any physical or virtual barrier within an organisation that is established to prevent exchanges or communication that could lead to conflicts of interest. For example, the investment trading arm of a responsible entity needs to be separated from the back-office functions of the custodian or investment administrator—that is, the portfolio manager should not book and settle their own trades.
- 54 Fundamentally, there should be information barriers established when the integrity of the information or the interests of one set of clients would be compromised, or would have the potential to be compromised, if the information passed between different entities, business divisions or individuals. Information barriers may need to be established to minimise the risk of market misconduct (in breach of Ch 7, Div 2) and insider trading (in breach of Ch 7, Div 3).
- 55 At RG 181.36 we state that:
- information barriers may allow a licensee to insulate one group of staff from the information or other circumstances that give rise to a particular conflict, so that the group is not affected by that conflict. To be effective, such barriers must actually prevent information being passed to the relevant group of staff.
- 56 The nature of the information barrier depends on the types of business that the entity operates.

## C ASIC's findings: Conflicts management

### Key points

This section sets out our findings from our review. In general, we found that financial services organisations demonstrated a commitment to maintaining and reviewing policies and information barriers, with some focus on training. However, we found that on matters of outsourcing, product selection, remuneration and board membership, there may be areas where financial services organisations could better demonstrate a commitment to managing and, where appropriate, avoiding conflicts of interest.

### Conflicts management policies

- 57 We found that all financial services organisations reviewed were able to demonstrate that they had current policies that set out the principles for managing conflicts of interest within the entity.
- 58 Frequently, the conflicts management policy was an umbrella policy, supplemented by multiple supporting policies—for example:
- (a) group compliance;
  - (b) trading and information barriers;
  - (c) staff remuneration;
  - (d) gifts and bribes;
  - (e) staff training; and
  - (f) board meetings and voting.
- 59 Some policies necessarily were longer and contained more information where there were a greater number and diversity of business units.
- 60 However, we noted that many conflicts management policies were generic and high level in nature, and that only a few organisations appeared to specifically consider and address the key conflicts of interest of their organisation and discuss how those conflicts should be managed. For more information, see our findings on the implementation of conflicts management policies and the culture of organisations at paragraphs 119–122.

### Reviewing and updating conflicts management policies

- 61 All financial services organisations appear to update their conflicts management policies frequently, and to have done so recently. We understand that the review period for the policies appeared to be at least



annually, or more frequently if necessary, with only one respondent stating that the review period was two years. It is encouraging that organisations appear to commit the time and resources to review policies with reasonable regularity.

- 62 We observed that some organisations engaged in thorough and extensive reviews, including across many business divisions, reflecting any changes in the business structure and any failures that had arisen in the time period, regardless of the frequency of review. The review undertaken by some organisations may motivate the entity to revisit fundamental business decisions, such as the decision to use particular related service providers or an internal default cash option.

## Training of staff

- 63 It appears that all financial services organisations provide some form of training on conflicts management to staff:
- (a) predominantly at induction, with recertification generally required after a period of two years; and
  - (b) often online, rather than face to face.
- 64 A majority of organisations indicated that they provided conflicts management training to board members. In addition, board members also receive periodic training specific to their role.

## Understanding by staff

- 65 The common method of disseminating information about managing conflicts of interest to staff is by making the conflicts management policy readily available, generally by hosting it on the entity's intranet site.
- 66 Most organisations supplied compulsory training on commencement, with some form of assessment required at completion, as well as ongoing specific training for staff and responsible managers.
- 67 Many organisations also require attestations from statutory role holders (e.g. responsible officers) on appointment and subsequently that they have read and understood the conflicts management policy.

## Announcements to staff

- 68 We asked licensees whether in the relevant period they had made any announcements to staff about conflicts management to raise awareness of good governance and appropriate conduct—for example, in the form of staff

updates and reminders. Most licensees indicated that they had made some kind of announcement to staff about conflicts of interest.

69 The announcements were made by various means, the most popular of which appear to be:

- (a) email notifications to all staff; and
- (b) publication of information about conflicts of interest issues and conflicts management policies on the intranet.

70 Other means of making such announcements included:

- (a) formal training sessions; and
- (b) presentations on conflicts management at the annual conference.

## Performance rating and remuneration of staff

71 All organisations stated that, while conflicts management training and compliance is not directly tied to a staff's performance rating or remuneration, it would be considered as part of the employee's overall performance and behaviour assessment. For example, non-completion of mandatory learning topics or repeated failure of those topics would be reported to managers and addressed through performance management. Ultimately, training and compliance breaches may be reported to risk and compliance committees.

72 One organisation noted that a serious incident of non-compliance may reduce bonuses or other incentive payments, and may ultimately lead to an ineligibility for salary advancement or career progression.

73 Several organisations stated that the remuneration policy itself is subject to a number of guiding principles, including that remuneration structures are supported by a governance framework that avoids conflicts of interest, defines clear accountabilities and ensures that appropriate 'checks and balances' are in place.

74 Our review was not specifically focused on remuneration policies and practices. However, we are concerned that there was limited evidence that remuneration structures adequately consider conduct, compliance training and behaviour as a determinant of remuneration, bonuses, salary advancement or other reward. We consider that compliant behaviour is a key aspect of performance. We may conduct a further review of remuneration practices in the financial services industry.

## Reporting lines

- 75 We asked licensees to explain the internal structures and reporting lines that exist within the licensee (such as the organisational structure, physical layout and reporting processes) in the context of conflicts management.
- 76 Most licensees explained that they use a combination of methods—such as organisational structure, physical layout and reporting processes—to assist in managing conflicts of interest, and as part of establishing information barriers: see paragraphs 80–83 for our findings on information barriers.
- 77 Many licensees stated that their structure and reporting lines are organised along specific investment and core business functions. Each investment and core business function has a separate reporting line to the managing director. Some licensees:
- (a) separate functions—for example, by separating:
    - (i) fund operations from financial planning; and
    - (ii) research, data reporting, fund accounting and investment management from each other;
  - (b) also separate the functions in a legal sense—for example, by requiring certain different functions to be conducted in different legal entities that have their own AFS licences; and
  - (c) use physical barriers to assist in separating functions.
- 78 Several respondents referred to the management of conflicts of interest at the board level—for example, by having a majority of independent directors on their boards.
- 79 Two respondents specifically mentioned their implementation of the ‘three lines of defence model’ in managing conflicts of interest. This model means:
- (a) taking ownership of risks at the operational level;
  - (b) an independent compliance function within the organisation having oversight of risk management activities; and
  - (c) internal and external audit functions providing independent assurance over the risk and control framework.

## Information barriers

- 80 The nature of the information barrier depends on the nature and size of the businesses that the entity operates. Some examples of different information barriers are provided at paragraph 82. An entity will need to consider the types of business it operates to determine where a barrier needs to be established and maintained.

- 81 Businesses appeared to take their obligations in relation to information barriers seriously.
- 82 We observed the following examples of information barriers operating in practice:
- (a) A platform operator and responsible entity of several feeder funds is structured so that none of the funds directly invest in listed or other securities and none of the staff are involved in the selection of listed or other securities. Nonetheless, the entity recognises that the decisions of model portfolio managers could have an effect on market price and therefore be market sensitive. The entity recognises the risks and has implemented:
    - (i) restrictions on access to information that could lead to conflicts of interest (e.g. information about trading directions by investment managers);
    - (ii) prohibitions on communication of price-sensitive information across information barriers (e.g. communication by custody staff of a large client order to non-custody staff is strictly prohibited); and
    - (iii) compulsory training for all staff regarding the non-communication of non-public, price-sensitive information.
  - (b) An entity that has a funds-management arm as well as a custody and separate responsible entity business recognises that an information barrier must be established, to limit the flow of information from and within the funds-management arm. Certain staff (e.g. legal) may remain permanently behind the information barrier. Other staff may be brought ‘over the barrier’ in advance of or after obtaining inside information.
- 83 There may be practical challenges in smaller organisations where:
- (a) the premises may be smaller, leading to difficulty in physically separating different business units; and
  - (b) a smaller number of staff may result in employees operating in multiple and potentially conflicting roles.
- 84 Nonetheless, the requirement to have adequate arrangements to manage conflicts of interest arising in the financial services business must be met by smaller as well as larger AFS licensees. The entities that we identified that had effective information barriers imposed stricter access requirements, which may have entailed reconfiguring the physical premises or employing additional staff if the conflicts of interest cannot otherwise be managed.

## In-house product selection

- 85 We asked organisations about the management of conflicts of interest (if any), associated with selecting an in-house product or manager on a platform investment menu or similar approved products list:
- (a) Many respondents explained that the process to be followed was governed by the appropriate policy documents, ranging from investment and investment governance policies to conflicts management and outsourcing policies. However, in some instances, these policies appeared to be broadly applied rather than involving any specific policy regarding in-house product selection.
  - (b) Most respondents stated that selection was made by the relevant committee and/or board, following a recommendation.
  - (c) Many, but not all, of the respondents purported to select and assess internal or related funds using the same selection and review criteria used to select and review external or unrelated funds.
- 86 Part of the process of selection also requires that products and managers are removed from approved product lists. Products and managers may need to be removed if circumstances are appropriate, taking into account the initial selection criteria and the change in availability of competing products or managers. Several respondents noted instances where products had been:
- (a) closed to further investment;
  - (b) terminated;
  - (c) removed from approved product lists; or
  - (d) added to the ‘watch list’ if the entity is not comfortable with the product and is considering removing it permanently, pending a change in circumstances.
- 87 We observed the following good practices for in-house product selection:
- (a) The due diligence process is conducted by a team of staff completely unrelated to the product manufacturing and advice areas, to ensure objectivity of the assessment. This maintains an arm’s length process for the due diligence and separate access to sensitive information.
  - (b) A formal research and rating process is established and applied to ensure that products offered by the licensee are assessed using the same criteria and review process as unrelated products and managers. Due diligence is conducted to at least the same level as would be conducted for unrelated products and managers.
  - (c) Given the significance of the review process, regular reports and updates are also provided directly to the board of directors. One financial services organisation stated that it additionally obtains external research advice for a related entity’s product as part of its due diligence

process. We stress that, for the organisation's conflicts management to have value, the external research house should act independently and should not be commissioned to act as part of the marketing strategy of the organisation.

- (d) Another financial services organisation requires all single manager funds, including those of a related entity's fund, to be researched by independent research houses and be found to be at least 'investment grade', as defined by that organisation. As above, the research house should not be commissioned to act:
  - (i) other than independently; or
  - (ii) as part of the marketing strategy of the organisation.
- (e) In an advisory services organisation that has a research unit, an external independent investment researcher is appointed to test the quality of the investment research and that their platform is otherwise 'benchmarked' to ensure it is competitive with industry peers.
- (f) Some financial services organisations have a mechanism (e.g. an independent team or committee) to monitor the investment product post-approval.

For a further discussion of what we consider to be 'good practice', please see Section D.

## Outsourcing services to related parties

88 All respondents noted that related party dealings are managed in accordance with the conflicts management policy. Most respondents appeared to demonstrate standard protocols regarding the engagement, such as requiring that:

- (a) some form of due diligence is conducted, generally at least to the same level as if the potential service provider was unrelated to the engaging entity;
- (b) the potential service provider is assessed as at least equivalent to comparable non-related service providers;
- (c) the transaction is at arm's length, on reasonable commercial terms;
- (d) the arrangement is documented, setting out the service deliverables in a service level agreement; and
- (e) some form of monitoring is conducted thereafter.

89 Some entities have implemented further steps to demonstrate due process, including requiring that:

- (a) the related parties have separate representatives and/or legal advisers;

- (b) an independent expert's opinion is obtained to assist the directors in determining whether the transaction is in the best interests of that entity;
- (c) each related party completes separate approval papers that are presented to separate approval committees or boards; and
- (d) the related party dealings may be recorded in a register or other database.

90 One AFS licensee, comprising a superannuation trustee business, administrator, and life and total permanent disability insurance business, demonstrated how relying on internal or related service providers can lead to members' interests being compromised.

91 Ostensibly to improve the insurance offering for impacted members, the life insurance business proposed to the superannuation trustee that certain:

- (a) features of the insurance for members be changed; and
- (b) other terms remain the same.

92 In practice, the administrator/insurer failed to ensure that the relevant terms remained the same and the improvements were actioned. The superannuation trustee also failed to identify that the insurance terms actually applied by the insurer were not correct. The trustee should have ensured there was:

- (a) appropriate initial due diligence and analysis of the negatives if the implementation was not properly performed. There was an undue reliance on certain representations (sometimes by omission) by the relevant responsible persons;
- (b) proper documentation of the arrangement, which should have recorded the understanding and the basis on which the trustee approved the member changes; and
- (c) appropriate monitoring, including by the trustee's own oversight committee, thereafter.

93 As a result, several relatively large insurance claims were incorrectly declined. The basis of the decisions did not appear to have been questioned. As a result, more than two years elapsed before the insurer identified the issue and notified the trustee. The insurer and trustee are currently undertaking a process of remediation.

94 In our view, the situation described in paragraphs 90–93 demonstrates the necessity for far greater and individualised methods of avoiding conflicts of interest where AFS licensees are depending on internal service providers. Our view is that the same outcome would be unlikely to occur if the trustee had been dealing with an external administrator/insurer. Often the licensees may not take the required steps that parties dealing at arm's length would take, as the commercial incentives are different.

- 95 We consider it is important that any related service providers are selected and assessed against a set of objective criteria that is applied in the same form to unrelated service providers. There should be no preference afforded to related parties, in relation to selection or contract terms, that could adversely affect the AFS licensee's performance.
- 96 It is also important that the same level of safeguards and supervision is applied to related service providers as unrelated service providers. We will continue to focus on outsourcing as part of our risk management work in the sector.

## Review of the default cash option

- 97 We asked all respondents whether they conducted a review of conflicts of interest (if any) arising from the licensee's default cash options that are with a related party bank or financial institution on its platform. Most of the respondents who operated default cash options with a related party described some form of review in installing the options. It was interesting that one of the respondents did not choose to mandate their internal bank as a default cash option, which showed that no automatic preference was given to its related party.
- 98 Some also conducted ongoing review and monitoring of matters, such as competitor bank rates, the service level of cash transactions, liquidity, credit and performance risk, and transition plans. The reviews were ongoing in some cases and others were quarterly or six monthly.

## Multiple directorships

- 99 Most organisations appeared to recognise the importance of avoiding conflicts of interest at the board level. Measures were required in terms of board composition itself—for example, regarding the proportion of independent and unrelated directors. We consider that the actual structure of the board must be addressed appropriately, so that any potential conflicts of interest for those with multiple and related directorships is minimised at the outset of their appointment, reducing the likelihood of having to subsequently manage a conflict of interest.
- 100 There appeared to be some use of committees to manage conflicts of interest and board consideration of potential conflicts.
- 101 Some organisations did not appear to explicitly consider the issue, leading to concerns that conflicts of interest arising from multiple directorships might be disregarded or minimised. We will continue to engage with these entities.



102 Another of our concerns was that respondents did not address how they reassess the knowledge or skill of remaining board members should a director be required to abstain from voting due to a conflict. We emphasise the importance of engaging a sufficient number of independent and unrelated directors so that the knowledge and skill of the board is not compromised in these circumstances.

## Board meetings

103 All respondents noted that ‘conflicts of interest’ was a standing agenda item at board meetings (this is in addition to the statutory obligation of a director who has a material personal interest in a matter to provide notice of that interest—s191, subject to s192). Board and committee papers, for example, follow protocols to ensure that the boards and committees consider the capacities in which the board or committee is being asked to act and whether the proposal or decision involves a related party. This is generally in the form of disclosure by directors of interests, which will then determine the person’s capacity to vote or not participate in the meeting.

104 Further, two entities reported that the board papers must demonstrate that management has considered conflicts of interest in formulating a proposal for consideration and board approval. We consider that this is good practice as it indicates that conflicts management is more likely to be embedded in board practices.

105 Other good practices that we observed include:

- (a) holding regular scheduled board meetings on a day that does not coincide with the holding company board meeting, to ensure that sufficient focus is given to the investors. The priority given to members’ interests as part of decision making for responsible entity decisions that present a potential conflict must be demonstrated in the meeting minutes;
- (b) having a majority of independent directors and being advised by an external risk and compliance committee on matters involving risk and compliance. The external risk and compliance committee comprises a majority of independent members, including an independent director; and
- (c) forming a conflicts management committee to designate a subset of the financial services organisation’s directors to act solely on behalf of the investors when a decision may be conflicted with their roles as directors of related entities.

106 However, the policies and procedures of most entities did not provide details on how challenging conflicts of interest should be assessed and treated, such

as in instances when directors face conflicting obligations to the financial services organisation and its shareholders, and to the organisation's clients. We consider that better training for directors would involve considering case studies of real-life situations and using other mechanisms that focus on identifying and managing conflicts of interest.

## Register of conflicts of interest

- 107 A register of conflicts of interest (conflicts register) is an important tool and should cover all potential, apparent or actual conflicts that arise in relation to the financial services business of the AFS licensee. We consider that conflicts registers are important, as:
- (a) they demonstrate a focus on identification and management of conflicts of interest;
  - (b) transparency can promote proper identification and management of conflicts of interest; and
  - (c) monitoring promotes adherence to good conflicts management.
- 108 We have noted that, for some financial services organisations, the register discloses the conflicts of interest but does not address how the conflicts are managed and monitored.<sup>8</sup> For the register to be used effectively, we consider that it should also record this.
- 109 It appears that in some AFS licensees no particular person, committee or division is assuming responsibility for the conflicts register, resulting in the risk of the register not being maintained.

## Disclosure of conflicts of interest

- 110 Most respondents noted that conflicts of interest pertaining to the structure of the organisation were generally disclosed in the Product Disclosure Statement (PDS), IDPS Guide, Financial Services Guide (FSG) and financial report.
- 111 Where the licensee has directors and responsible persons holding concurrent directorships or other positions of influence within related party entities, or with major service providers or distribution channels, there is often no disclosure to financial services clients. Two respondents stated that disclosure was made in documents provided to clients, with one of these

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<sup>8</sup> Note that if the entity is also an RSE licensee, it will be required to maintain a register of relevant interests and duties as an RSE licensee, as prescribed by reg 2.38(2)(1) of the Superannuation Industry (Supervision) Regulations 1994.

stating that disclosure was only made if specifically requested. Two other respondents said these conflicts of interest were not disclosed publicly but internally, with one disclosing it in certain reports.

- 112 Respondents indicated that if incentives, such as tickets to conferences and prizes, are offered to the licensee's staff by product providers listed on a platform operated by the licensee, the record of non-monetary benefits received was included only in an internal register.

## Identifying any non-compliance

- 113 Most organisations did not appear to perform any form of specific compliance audit of their conflicts management policy. Rather, there appears to be a wider approach to conflicts management as part of the overall risk management framework. It appears that, for most organisations, this involves some form of:
- (a) incident and breach reporting processes;
  - (b) maintenance of an incident and breach reporting register;
  - (c) compliance checklists, usually periodic checklists, attested by members of the management team;
  - (d) declarations of conflicts of interest by each of the following:
    - (i) directors at board meetings;
    - (ii) management at management meetings; and
    - (iii) in some form, officers, staff and contractors in a periodic conflicts declaration;
  - (e) an internal audit review of compliance policies; and
  - (f) a limited external assurance review by external auditors, to the extent required by s601HG (for responsible entities) and notional s912AD(33), inserted by [Class Order \[CO 13/763\]](#) *Investor directed portfolio services* (for IDPS operators).

## Ensuring effectiveness of conflicts management policies

- 114 It is apparent that some entities understand the challenge in ensuring the effectiveness of the conflicts management policy, and recognise that it is not sufficient to merely adopt a policy.
- 115 Most organisations stated that the conflicts management policy is reviewed annually, taking into account breaches that have occurred during the year and any systemic issues. Many undertake external reviews of the policy

every three years, particularly if they are also regulated by APRA. Thereafter, appropriate enhancements are made to ensure the effectiveness of the policy.

- 116 Some organisations have an assessment program or audit check to test the key controls for managing business risks and regulatory obligations on a regular basis, including the identification and management of conflicts of interest, or to check on compliance with the requirements. The organisation documents common conflicts of interest and controls to manage those conflicts.
- 117 Other practices involved embedding controls in business processes and procedures, and having clearly defined roles and responsibilities, including at the most senior positions, in relation to conflicts management.
- 118 The outcomes are reported to the executive management, risk and/or audit committees within the financial services organisation.

## Implementation of conflicts management policies and the culture of organisations

- 119 All the financial services organisations reviewed appear to recognise the importance of managing conflicts of interest for the benefit of its clients, and the organisation's reputation.
- 120 As stated at paragraph 57, we found that all organisations reviewed were able to demonstrate that they had current policies. However, for some financial services organisations, it was apparent that:
- (a) the relevant policies did not seek to apply the general principles of the policy to the specific business—that is, the relevant policies were generic in format, rather than tailored to meet the specific challenges and circumstances of each individual business; and
  - (b) the creation of the policies appeared to have been completed to satisfy a compliance obligation, rather than to change the behaviours and conduct of the business as a whole.
- 121 Our view is that those organisations that appear to have a stronger focus on and a robust approach to risk management generally are likely to demonstrate a strong culture of compliance, including prioritising effective conflicts management. Conversely, some organisations did not appear to demonstrate any real interest in or commitment to their conflicts management policy, which may be indicative of an organisation that:
- (a) has not provided sufficient focus on the risk management framework, including conflicts management;
  - (b) does not have a culture that prioritises effective conflicts management; and
  - (c) ultimately is more vulnerable to conduct risk.

- 122 In order for the policy to operate effectively, we consider that the business as a whole, from the top down, should be aware of the existence of conflicts of interest. Where necessary or reasonable, the business should initially be structured to avoid the conflicts arising and provide assurance that the potential for conflicts will not contribute to poor performance where these conflicts remain. This would include, among other things, managing (as far as possible) any potential conflicts of interest from:
- (a) business and reporting lines; and
  - (b) remuneration structures.

## Fiduciary duties versus duties to shareholders

- 123 If there is any business transaction with the related party, separate external legal advisers may be engaged to represent the interests of the financial services organisation's clients and the related party, and to give an opinion on whether the information available would support the licensee in demonstrating that the terms and conditions of the transaction are reasonable and on an arm's length basis.

## Examples of conflicts management from licensees reviewed

### Examples of priority being given by licensees to investors

- 124 We asked licensees to provide a recent example from the relevant period of a conflict of interest considered by the licensee and show how the licensee gave priority to the interests of the clients over that of the licensee. All but two of the licensees were able to identify recent examples where a significant conflict of interest was required to be managed.

A summary of the examples follows.

#### Example 1

- 125 The licensee entered into two related party transactions involving the sale of separate interests in a property portfolio that it held on behalf of clients to a fund holding for other clients. The protocols for managing the conflicts of interest were governed by the licensee's conflicts management policy, including the recording on the conflicts register.
- 126 To ensure that priority was given to the interests of clients, the conflicts of interest were managed by the licensee:
- (a) establishing separate internal teams and external advisers;

- (b) establishing separate property investment committees, comprising comparably qualified and experienced individuals representing the separate clients' interests; and
- (c) implementing appropriate information barriers to control the disclosure of confidential information between the respective teams.

### Example 2

127 The licensee identified incidents relating to the failure to accrue and pay a substantial amount in performance fees for two investment funds. This was appropriately reported to ASIC as a significant breach. The interests of the licensee were to be paid the performance fees owed from the two funds, which conflicted with the interests of investors, some of whom had acquired an interest in the fund after fees should have been paid. After review, the decision by licensees' management was to give priority to the interests of the investors and forego the performance fees.

### Example 3

128 The licensee assesses the performance of investment managers and the funds that they manage against approved objective criteria. The criteria apply equally to related party and external investment managers (and the funds that they manage). Each quarter the performance of all investment managers and their funds are reviewed by a committee against the criteria. If an investment manager or a fund does not meet the criteria, or the committee has specific concerns with a fund, the fund may be added to the 'watch list' for additional monitoring.

129 The licensee committee recently required the addition to the watch list of two funds that are managed by a related party. The licensee committee monitors all funds on the watch list and may make a decision to:

- (a) close the funds to further investment;
- (b) terminate the funds; or
- (c) remove the funds from the list, if the licensee committee is comfortable that they are appropriate investment options for members and investors going forward.

130 Where any fund manager or fund ceases to meet the criteria, the licensee will decide to undertake one of the above measures, which may result in the loss of revenue for the licensee. In this way, priority is given to the interests of members and investors over the interests of the licensee.

### Example 4

131 An item on the board agenda involved the consideration of the establishment of a new fund, with a potential investor being a related party of the licensee.

- 132 In this case, one of the directors of the licensee board is also a director of the related party licensee. In advance of the meeting, a decision was made that the director would not:
- (a) receive any board papers about this agenda item;
  - (b) attend the board meeting on this agenda item; or
  - (c) vote on this agenda item.

- 133 At the licensee board meeting, the director declared their potential interest in the matter and advised the board that they would not participate in the matter.

#### **Example 5**

- 134 The licensee board, as responsible entity for various unit trusts, considered a proposal to introduce new banking arrangements for cash held in the trusts' accounts, which are maintained by the trusts' custodian. The proposal sought to engage a related party of the licensee for particular cash accounts, for which the related party would receive a fee.

- 135 The relevant conflicts of interest were identified during the development of the proposal and managed in accordance with the licensee's conflicts management policy. In particular, the agreement by which the services would be provided by the related party in return for a fee for service constituted a related party transaction, which required the completion of a checklist. In this instance the board papers identified the related party issues, and described the measures that would be taken to ensure that the related party transaction would occur at arm's length, as detailed in the checklist. The licensee would also be required to form the view that it was in the best interests of members of the registered scheme.

- 136 The minutes of the meeting show the directors' consideration of the potential conflict, and that the transaction would only be approved once the requirements of the conflicts management policy, including the checklist, had been satisfied.

#### **Example 6**

- 137 The licensee stated that, as part of the terms and conditions of its platform products as set out in the PDSs and IDPS Guide, the licensee agreed that clients must always be given priority in participation in any offers of securities made as a result of holding securities on the platforms. The licensee may only participate as principal where the investor or member has decided not to participate. These offers of securities occur on at least a weekly basis. In this way a potential conflict of interest was avoided as long as the licensee met its agreement.

**Example 7**

138 The licensee considered a conflict of interest when it became the investment manager of a registered scheme rather than outsourcing this function. A prior assessment was completed to determine if, as a result of this decision, there was some chance that a perception may exist that the licensee would favour its interests, rather than the interests of unitholders.

139 The licensee considered that the perception of conflict was balanced by the following:

- (a) the outsourced provider had not performed as expected or in line with stated investment objectives;
- (b) the licensee had demonstrated that it was capable of managing the asset class;
- (c) the licensee was supported by strong front-office, middle-office and back-office capability; and
- (d) as the product issuer, there was an expectation that the licensee would act as investment manager.

140 The licensee considered that these factors aligned with unitholder interests and, as such, there was no obstacle.

141 The licensee also considered that it was in the best interests of unitholders for the licensee to be the investment manager rather than outsource that function.

**Examples where a conflict of interest should be avoided**

142 We also asked licensees to provide examples where the board and/or relevant committee determined that a conflict of interest could not be managed under the conflicts management policy and should be avoided. Most licensees did not provide any examples or stated that they had no such conflict of interest arise during the relevant period. However, there were two noteworthy responses:

- (a) a licensee director resigned as a director of several related licensee companies. The director had been offered a directorship of a competitor. It was determined that the conflict could not be managed and that they would resign from their position; and
- (b) a licensee had implemented governance changes, through the appointment of independent non-executive directors who were not directors of related licensee companies, to reduce the need to withdraw a proposal because of a lack of a quorum of non-conflicted directors.



## D Good practice recommendations and further work

### Key points

The following section sets out what ASIC considers to be some good practices in relation to the management of conflicts of interest by vertically integrated businesses within the funds management industry. Further, we discuss how industry may respond to the findings in this report. It is not intended to supersede the guidance in RG 181 but rather to provide examples of how issues that are specific to vertically integrated businesses within the funds management industry can be managed.

- 143 Through our review, we have identified the following practices, which we consider to be good practice, in complying with the obligations in s912A(1)(aa) and RG 181. Except where stated, the matters apply to all types of AFS licensee and are not limited to those with a vertically integrated structure. Ultimate responsibility rests with the board, when the licensee is a company. Also, to the extent of their relevant functions, responsibility for the roll-out lies with the relevant delegate committees, any the compliance committee, senior managers, and compliance and other staff.

### Good governance principles

- 144 The conflicts management policy is effectively embedded into all financial services business operations, with a commitment from the board and senior staff to develop and maintain a culture of awareness of conflicts of interest. For example, entities use standard templates for board agenda and committee papers that include prompts to identify and consider conflicts of interest.
- 145 The business takes into account the ‘Four Cs’ elements of managing conduct risk:
- (a) *Communication*—The conduct expectations of the conflicts management policy are communicated to all levels of the organisation to ensure it is ‘front of mind’. The communication strategies ensure the message is embedded from the level of the CEO and board to each level below. It is not sufficient to adopt a policy without communicating and enforcing the requirements of that policy.
  - (b) *Challenge*—Organisations are continually re-thinking and, if appropriate, changing business models, board and employee roles, and incentive practices that create conflicts of interest, to ensure that conflicts do not result in poor conduct.

- (c) *Complacency*—Policies and conduct are continually reviewed, enforced and validated to address key risks.
- (d) *Consequences*—There are consequences for both appropriate or exemplary conduct and for poor conduct.

146 There is a broad approach to the identification of conflicts of interest that captures the potential and actual conflicts that might arise, as well as the potential and actual conflicts of directors, responsible managers and staff. To promote confidence and reduce legal and regulatory risk, organisations also consider the perception of conflicts of interest from the perspective of external stakeholders.

## Good governance processes

### Key characteristics

- 147 To meet the good practices we observed, conflicts management processes would have the following characteristics:
- (a) The conflicts management policies and procedures are approved by the board of the financial services organisation.
  - (b) Conflicts of interest are a standing item at both board and board committee meetings, with meeting participants being required to make a declaration of relevant interests and duties at each board and committee meeting.
  - (c) Financial services organisations' boards consider any material contracts with related parties. Agreements with related parties are reviewed by legal and compliance advisers before being presented to the board for approval.
  - (d) Financial services groups have a risk management team that is independent of the business teams, and provides regular reporting on operational risk (which covers complying with conflicts management obligations) to the audit and risk committees of the financial services organisation.
  - (e) There is a formalised mechanism to review conflicts of interest and escalate significant issues. Frequent reporting is provided to the organisation and senior management or the board on conflicts of interest matters.
  - (f) On a day-to-day basis, employees are responsible for reporting all potential, apparent or actual conflicts of interest to appropriate parties, including the employee's manager and, except for minor matters or where the manager is affected, designated risk and conflicts management personnel. Where appropriate, the risk and conflicts

management personnel assess the conflict and work with other areas as appropriate to manage and monitor the conflict disclosed.

- (g) Conflicts management committees are used on an ad-hoc basis to deal with complex or structural issues—for example, where a relationship with a related party results in inherent structural conflicts of interest, or where a perception of a major conflict of interest might arise.
- (h) A periodic review of open conflicts of interest is carried out to ensure that the context has not changed and the measures taken to manage the conflicts remain adequate.

### **Investment selection and retention**

148 In addition to the good practice observations we make at paragraph 87, we also consider the following practices demonstrate good practice for responsible entities and IDPS operators:

- (a) A formalised due diligence process is conducted in the selection of investments or investment manager, including related entities and their products.
- (b) The potential investment or investment manager is reviewed against a consistent set of selection criteria.
- (c) The organisation’s management committee, an investment committee, or the board will evaluate and determine whether to approve the product or investment manager.
- (d) Any revenue sharing arrangement and other terms agreed with a related party is on the same or more attractive commercial terms as it would be with a third party that is not from the group.
- (e) The recommended investments and the investment manager continue to be assessed against an objective set of criteria to determine whether they should remain on the approved products list.

### **Outsourced services**

149 Where the entity outsources services to any service provider, each service provider—including the related entity or a common external party used by the group—undergoes the same outsourcing due diligence review process and industry benchmarking of the pricing, capability and suitability of the related party. There are agreed protocols for selection, comparison and assessment of material services.

150 In vertically integrated group structures, the licensee has input and influence over shared services provided by the group, as would apply in an arm’s length arrangement.

151 Related party arrangements that affect performance of duties by the AFS licensee are entered into via a formal agreement that is executed on an arm's length or more favourable basis. Service providers under such arrangements are monitored against the standards as set out in the service level agreements.

152 Where relevant, and in relation to a financial services business covered by an AFS licence, the licensee is able to demonstrate that related party products or services are not offered or acquired in priority to other products or services that are on better terms or better meet the selection criteria.

### **Licensee duties versus duties to shareholders**

153 AFS licensees are able to demonstrate that, where required to give priority to the interests of clients over other interests, they have done so.

### **Training, benefits and remuneration**

154 Training of all staff, including board members and senior staff, is required to ensure expectations for conflicts management are understood and applied throughout the licensee's operations.

155 Training is conducted periodically, not just at induction, and is sufficiently tailored to capture the types of roles particularly affected by conflicts of interest.

156 In relation to board directors, we consider it important for directors to receive appropriate face-to-face training about conflicts of interest, and the procedure for declaring and managing personal conflicts, as we observed with some of the entities we reviewed.

157 In relation to remuneration and benefits, licensees review their remuneration and benefits structure regularly to ensure that they do not provide incentives for the employee of the organisation to favour a related party.

### **Disclosure**

158 Certain disclosure about the financial services organisation's ownership structure, remuneration and business relationships with related parties is provided to clients in the FSG. In addition to mandatory disclosure, other disclosure should be made where, from a practical and realistic perspective, they will promote accountability and deter poor conduct arising from conflicts of interest.

159 Internally, employees and directors are required to disclose conflicts of interest matters and receipt of gifts and benefits (including 'soft dollars') in the appropriate registers.

160 We consider it good practice to regularly review registers to ensure their accuracy, currency and relevance. In their review, organisations consider more broadly the types of actual and potential conflicts of interest that must be recorded on the conflicts register. For example:

- (a) interests for responsible persons other than directors, including employment arrangements and incentives provided; and
- (b) gifts.

### **Information barriers**

161 Some of the common barriers that we consider appropriate include, depending on the nature and size of the business:

- (a) structural separation of the business—for example, a separation of the platforms, investment management, insurance, advice and custody businesses. Critically, the reporting lines need to provide a structural information barrier between these businesses and the entities they support;
- (b) separation of the investment research function from other functions;
- (c) restriction of user access to technology based on the user’s business unit and role. The level of access that is provided to individuals is checked and validated frequently (e.g. every six months);
- (d) establishment of information barriers when required so that the flow of information between business units is restricted where there is a need to maintain the confidentiality of information and to ensure that related party transactions are conducted on an arm’s length basis. Individuals will be brought ‘over the barrier’ only as required, using barrier-crossing procedures;
- (e) separation of boards and committees when appropriate. The board is separated into sub-committees when required to reflect distinct roles in relation to particular proposals. It also seems appropriate that directors, particularly independent directors, of one entity are not also directors of another entity that has an inherent conflict with the first entity—for example, for an entity providing services to another.

### **Cash default option**

162 There is a separate, periodic formal review process to ensure the continuation of any cash default option offered is consistent with the licensee’s duties and the selection criteria it has adopted.

## Director and responsible person duties and ownership interest in the group

- 163 In addition to the observations we make in paragraph 104–105, we consider it good practice to require directors of the board to disclose any conflict of interest at the start of each board meeting, as we observed with some of the entities that we reviewed. The conflicted director will either be required to excuse themselves from the meeting or be allowed to be present though they will not be voting on the conflicted matter. Papers may also be withheld from being distributed to the director as needed.
- 164 In relation to multiple directorships, boards assess the extent to which multiple directorships involve, or could be perceived to involve, conflicts of interest and be able to demonstrate how the best interests of clients remain at the forefront of decisions being made by directors holding multiple positions. We consider that approach good practice and note that some boards already do this. Similar considerations prevail where a director also holds senior or other positions within the financial services industry.
- 165 Where abstention is deemed an appropriate response to such a conflict, licensees are able to demonstrate that board effectiveness is unimpeded by the absence and that critical decisions can continue to be made.
- 166 The licensee can enhance the conflicts management policy by providing a mechanism for directors to assess independent advice about their circumstances, to ensure that all relevant declarations in relation to actual and potential conflicts of interest are made.

## Further work

- 167 A failure to identify and manage conflicts of interest is and may lead to significant breaches of the Corporations Act and other duties, and result in reputational and financial damage. As stated in our Corporate Plan, poor conduct by gatekeepers, including inadequate management of conflicts of interest arising from remuneration and related party transactions, a lack of competence and the misuse of role for improper gain, can result in significant investor and creditor loss. Further, as stated, we will continue to publish reports on surveillance outcomes and may articulate standards and expectations to increase industry understanding of the impact of conflicts of interest and industry commitment to address these.
- 168 All AFS licensees, not limited to those that are vertically integrated or those within the funds management industry, are encouraged to consider their arrangements in light of this report, specifically the good practice recommendations. Licensees may wish to consider:

- (a) their own approach to conflicts management, in the light of the report and findings; and
- (b) whether an industry standard or other guide should be developed to help industry to identify and manage conflicts of interest, as well as to drive a cultural response to conflicts management.

## Appendix: Methodology

169 We selected 12 AFS licensees to take part in our review of conflicts management policies. Each licensee was selected primarily on the basis that it operated a vertically integrated business in the funds-management industry, as discussed in paragraph 2. The review was conducted in two stages.

### Stage one

170 In stage one, we used ASIC's information-gathering powers under s912C of the Corporations Act and s30 of the *Australian Securities and Investments Commission Act 2001*. We provided the sample entities with a questionnaire requesting their responses to high-level questions focusing on the following:

- (a) how they would define vertical integration in a funds-management context and whether they would consider their business to be vertically integrated;
- (b) the revenue from in-house products compared to externally created products and other product information; and
- (c) their conflicts management policies.

### Stage two

171 In stage two of the review, we also used ASIC's information-gathering powers to request information and supporting documents, including the relevant policies, relating to:

- (a) management and staff awareness of conflicts of interest;
- (b) controlling and avoiding conflicts of interest;
- (c) review of the conflicts management policy and how that policy is understood by staff;
- (d) the robustness of particular systems for managing conflicts of interest, including examples of managing conflicts of interest;
- (e) corporate governance;
- (f) managing the selection of in-house products to be offered on the particular platform and the procedures to be followed;
- (g) disclosing conflicts of interest; and
- (h) training regarding conflicts of interest.



- 172 The respondents were asked to provide supporting documentation and examples, as well as respond to around 40 questions.
- 173 The findings in this report are based on the responses provided by the financial services organisations to ASIC. Our review is not intended to be an audit of compliance by the financial services organisation with its obligations under the Corporations Act and ASIC guidance.

## Key terms

Term	Meaning in this document
AFS licence	An Australian financial services licence under s913B of the Corporations Act that authorises a person who carries on a financial services business to provide financial services  Note: This is a definition contained in s761A.
AFS licensee	A person who holds an AFS licence under s913B of the Corporations Act  Note: This is a definition contained in s761A.
APRA	Australian Prudential Regulation Authority
approved products list	A pre-selected list of financial products, determined by the AFS licensee, and considered suitable for potential investment by investors
ASIC	Australian Securities and Investments Commission
authorised representative	A person authorised by an AFS licensee, in accordance with s916A or 916B of the Corporations Act, to provide a financial service or services on behalf of the licensee  Note: This is a definition contained in s761A.
client	Includes a retail client as defined in s761G of the Corporations Act and Div 2 of Pt 7.1 of Ch 7 of the Corporations Regulations
conflicts management policy	The policy of an AFS licensee that sets out how it manages potential, apparent or actual conflicts of interest that arise in relation to a person or organisation
conflicts of interest	Circumstances where some or all of the interests of people (clients) to whom a licensee (or its representative) provides financial services are inconsistent with, or diverge from, some or all of the interests or duties of the licensee or its representatives
conflicts register	A register of potential, apparent or actual conflicts of interest that arise in relation to a person or organisation
Corporations Act	<i>Corporations Act 2001</i> , including regulations made for the purposes of that Act
custodian (in relation to a platform)	A person (who may be the platform operator, but not the platform investor) that holds property through a platform
financial service	Has the meaning given in Div 4 of Pt 7.1 of the Corporations Act

Term	Meaning in this document
financial services business	A business of providing financial services Note: This is a definition contained in s761A. The meaning of 'carry on a financial services business' is affected by s761C
Financial Services Guide (FSG)	A document required by s941A or 941B to be given in accordance with Div 2 of Pt 7.7 of the Corporations Act Note: This is a definition contained in s761A
IDPS	Investor directed portfolio service, as defined in [CO 13/763]
IDPS Guide	A document provided by an IDPS operator instead of a PDS to help retail clients decide whether they should use the IDPS
IDPS-like scheme	Investor-directed-portfolio-services-like scheme, as defined in [CO 13/762]
operator (of a platform)	A public company that is a holder of an AFS licence that is authorised to operate a platform or a function that forms part of the platform
platform	Investor directed portfolio services (IDPS) and IDPS-like schemes Note: This term does not extend to nominee and custody services, as defined in RG 149, superannuation master trusts or other superannuation funds, self-managed superannuation funds or managed discretionary account services, as defined in RG 179.
Product Disclosure Statement (PDS)	A document that must be given to a retail client in relation to the offer or issue of a financial product in accordance with Div 2 of Pt 7.9 of the Corporations Act Note: See s761A for the exact definition.
relevant period	1 July 2013 to 30 September 2015
representative of an AFS licensee	Means: <ul style="list-style-type: none"> <li>• an authorised representative of the licensee;</li> <li>• an employee or director of the licensee;</li> <li>• an employee or director of a related body corporate of the licensee; or</li> <li>• any other person acting on behalf of the licensee</li> </ul> Note: This is a definition contained in s910A
RSE licence	Registrable superannuation entity licence (granted by APRA)
RSE licensee	A person who holds a registrable superannuation entity licence (granted by APRA)
s912A(1)(aa) (for example)	A section of the Corporations Act (in this example numbered 912A(1)(aa)), unless otherwise specified

<b>Term</b>	<b>Meaning in this document</b>
SPS 521 (for example)	An APRA prudential standard (in this example numbered 521)
watch list	A list of financial products that require close surveillance to determine whether it remains appropriate to include each of those products on the approved products list
wholesale trustee	A trustee of a unit trust that is not a registered scheme because all the members are wholesale clients

## Related information

### Headnotes

AFS licensees, benefits, conduct, conflicts management policy, conflicts of interest, conflicts register, culture, director, disclosure, financial services, information barrier, outsourcing, remuneration, related entity, responsible entity, responsible person, RSE licensees, training

### Legislative instruments

[\[CO 13/763\]](#) *Investor directed portfolio services*

### Regulatory guides

[RG 181](#) *Licensing: Managing conflicts of interest*

### Legislation

*Australian Securities and Investments Commission Act 2001*, s30

Corporations Act, Ch 7, Divs 2 and 3, s191, 192, 195(1), 195(2), 195(3), 601FC((1)(c), 601HG, 912A(1)(aa), and 912C

Superannuation Industry (Supervision) Regulations 1994, reg 2.38(2)(1)

### Consultation papers and reports

[REP 408](#) *Review of the implementation of RG 148 Platforms that are managed investment schemes*

### Prudential standards and guidance

[SPS 521](#) *Conflicts of interest*

[SPG 521](#) *Conflicts of interest* (PDF 239 KB)

### Other documents

ASIC, [Corporate Plan 2015–16 to 2018–19: Focus for 2015–16](#)

ASIC, [ASIC's Strategic Outlook 2014–15](#)

APRA, '[Conflicts of interest thematic review](#)', *Insight*

Financial Conduct Authority (UK), [FCA Risk Outlook 2013](#)

Financial System Inquiry, [Financial System Inquiry: Final report](#)