

□ FINANCIAL SERVICES REFORM

Regulation of loyalty schemes under the FSR regime

The Australian Securities & Investments Commission (ASIC) has released a policy proposal paper setting out how it proposes to regulate loyalty schemes issued under non-cash payment (NCP) facilities and low value NCP facilities.

An NCP facility is a facility through which payment can be made otherwise than through the physical delivery of Australian or foreign currency. The proposals will apply to a variety of loyalty schemes including airline frequent flyer programs, hotel loyalty schemes and credit card loyalty programs.

NCPs are subject to general licensing and disclosure obligations in the *Corporations Act 2001*, however ASIC has provided interim relief from these provisions for loyalty schemes on a case-by-case basis.

ASIC intends to give conditional class order relief from licensing provisions (including the requirement to obtain an AFSL) and ongoing disclosure obligations in recognition that the nature, scale and complexity of some loyalty schemes is such that it may not be appropriate for the licensing regime or the product disclosure obligations to apply in full.

Under ASIC's proposal, loyalty scheme issuers who are eligible for licensing relief will have conditions imposed on them including requirements to:

- maintain an internal dispute resolution system and belong to an external dispute resolution scheme;
- hold on trust for clients, in a separate account, an amount sufficient to enable the issuer to fulfil all obligations to all clients under the loyalty scheme – this amount cannot be discounted on the basis that the issuer considers that some of the obligations will not in fact be required to be performed, for example, because points may expire; and
- give clients 30 days written notice of any material changes to the terms and conditions of the loyalty scheme.

The extent of relief from the product disclosure requirements is currently under consideration. However, whether or not relief from giving a product disclosure statement (PDS) is given, issuers of loyalty schemes will be required to meet certain minimum product disclosure requirements. Issuers will need to disclose in a clear, concise and effective manner aspects of the loyalty program such as:

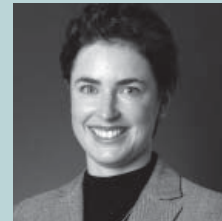
- the key terms and conditions of the loyalty scheme;
- how any disputes will be dealt with;
- whether the issuer subscribes to any relevant code; and
- that the issuer is not subject to the licensing or specified disclosure requirements of the Corporations Act.

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introduction



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In the February issue of our Financial Services Law Bulletin our lead article discusses the policy proposal paper released by the corporate regulator, ASIC, which sets out how it proposes to regulate non-cash payment facilities, such as loyalty programs operated by many airlines, financial institutions and tourism operators. You'll need to be quick if you'd like to comment on the impact of this proposal, with submissions from the public due by 25 February.

Another regulatory deadline to note is the submission of claims and policies data by the general insurance industry to APRA's National Claims and Policies Database facility by 28 February. Under the general insurance reporting standards introduced last year, all authorised general insurers are obliged to submit data for public liability and professional indemnity claims and policies. This data will be publicly released with the aim of identifying trends and improving the affordability and availability of public liability and professional indemnity insurance in the Australian market.

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The policy proposal has important implications for loyalty scheme issuers. These include:

- financial implications resulting from holding potentially significant amounts of money in a separate account;
- potential difficulties in calculating the amount to be held in the trust

account, particularly where overseas corporations are involved;

- amending compliance procedures and ensuring all documentation is compliant with the new conditions including, possibly, compliance with the PDS regime.

There is a fundamental question: will the trust account requirement mean that the

concession won't work in practice? ASIC is seeking comments from the public on the impact that the policy proposals might have. Comments on the proposal paper are due by 25 February 2005.

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□ DISCLOSURE

Perfecting your PDS

At the end of last year the Australian Securities & Investments Commission (ASIC) provided guidance for product issuers preparing product disclosure statements (PDSs) after reviewing various PDSs prepared pre-11 March 2004 and observing that there were a number of problem disclosure areas for product providers.

in brief

Super fee disclosure

Draft regulations have been released by the government which introduce requirements for the disclosure of fees and charges in PDSs and periodic statements for superannuation and managed investment products. These give effect to the fee disclosure package required by the choice of superannuation fund reforms and include:

PDSs

- standardised fee template;
- separate section containing additional information about fees and costs;
- illustrative example of fees and charges;
- consumer advisory warning box.

Periodic Statements

- item showing the approximate amount of management costs not paid directly out of the member's account (in dollars);
- single dollar amount showing the fees a member or product holder has paid during the period;
- transactions to be itemised and described consistently; and
- a brief description of each transaction.

By now, you should be well familiar with the requirement for your PDSs to be clear, concise and effective. But exactly what does this mean? And do you have a "problem disclosure area"?

The ASIC guidance highlights a number of compliance issues that product issuers should consider to ensure that their PDSs meet the content and presentation requirements of the law.

For a PDS to be clear, concise and effective, ASIC encourages product issuers to take into account the following suggestions:

- information must be worded clearly and concisely, meaning that jargon should be avoided if possible and terms clearly defined within the PDS;
- navigational aids (e.g. tables of contents and clear signposting) can help consumers to find information in the PDS more effectively;
- an executive summary highlighting important information is a useful tool, particularly in long documents;
- reference to additional information elsewhere in the PDS or in other documents must not be misleading, and cross-referencing page numbers, for example, must be accurate; and
- disclosure of information about product risks should have equal prominence to information about product benefits.

In respect of disclosure of fees and costs, ASIC has observed that areas of concern include:

- **Misleading omissions:** a managed fund's significant fees table in its PDS indicated that the withdrawal fee was "nil". However, the constitution allowed the withdrawal fee to be 4% and the PDS did not disclose this fact. The table did not disclose that nil contribution fees could be increased

with notice, and the PDS implied that the contribution fee could only be increased with members' approval.

- **Breach of differential fees relief:** a PDS provided for differential fee treatment of investors in breach of the terms of ASIC's differential fees class order relief.
- **Inadequate disclosure of buy-sell spreads:** a PDS failed to disclose the buy-sell spread in the fees section of the PDS, how the buy-sell spread was applied to a particular investor, and how it related to other fees charged in respect of the product.

In ASIC's view, some of the concerns would not arise if industry fully complied with ASIC's preferred Fee Disclosure Model (which is likely to be mandated by the government in the future).

In respect of past performance and future forecasts, ASIC has observed that areas of concern include:

- **Future forecasts:** a PDS contained statements made about the future performance of the fund without including any reasonable basis for making those statements.
- **Hypothetical returns:** a PDS contained graphs depicting the indicative performance of the investment, which were misleading because they compared actual performance of underlying investments with the gross hypothetical returns derived from other information and strategies for investment.
- **Past performance figures:** ASIC cautions that past performance figures should not be based on hypothetical or reconstructed past performance, nor should they be used to overstate performance where market changes mean future returns will be

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□ CORPORATE GOVERNANCE

Real improvements in shareholder involvement?

Government releases draft reforms: On 7 February 2005 the Federal Treasurer released draft legislation in the form of the Corporations Amendment Bill (No. 2) 2005 for consultation with industry.

According to the media release by the Parliamentary Secretary to the Treasurer, Chris Pearce, the reforms are designed to make it easier for shareholders to participate in corporate governance processes while “striking a more appropriate balance between the rights of different groups of shareholders”.

While it may be easier for shareholders to participate in corporate governance processes, shareholders will lose the benefit of the current “100 member rule” under which members can call a special general meeting at the request of only 100 shareholders. Under the proposal, at least 5% of total voting shareholders will be required to convene a special general meeting.

Other corporate governance aspects dealt with in the reforms include:

- enhancing the rights of minority shareholders to put resolutions on meeting agendas;
- requiring proxy holders to exercise votes as instructed by shareholders; and
- requiring company member statements to be distributed along with meeting notices.

Submissions on the Bill to be accepted up until 1 April 2005.

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in brief

Managing conflicts

Since 1 January 2005, all Australian Financial Services Licensees (AFSLs) are required to comply with the s912A(aa) requirement of the *Corporations Act 2001* to have adequate arrangements to manage conflicts of interest. AFSL holders such as general and life insurers, brokers and agents need to carefully consider these new requirements and may need to carry out a review of remuneration policies and conflict management policies to ensure compliance.

We have experience in advising and preparing effective policies which will not only satisfy your compliance obligation, but will assist you in effectively dealing with such activities in a practical and commercial manner.

For further information, please contact one of our financial services team.

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significantly less. Further, a PDS should include appropriate warnings, and information about the impact of changes in strategy, such as the appointment of a new investment manager.

Among other things, ASIC has also highlighted the lack of disclosure regarding socially responsible investment. Under section 1013D(1)(l) of the *Corporations Act 2001* there is a

minimum requirement that, for investment products, there is disclosure of the extent to which labour standards or environmental, social or ethical considerations are taken into account in the selection, retention or realisation of the investment. Accordingly, in ASIC's view, if product issuers choose **not** to take into account labour standards or environmental, social or ethical considerations, this fact must be stated in the PDS.

Product providers should ensure that their processes and procedures for sign-off on disclosure material are up-to-date, and take into account ASIC requirements.

A PDS that is less than perfect runs the risk of being “defective” in ASIC's eyes and being the subject of a stop order or a claim for compensation from investors.

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□ NEWS IN BRIEF

FSR in brief

Random inspections by ASIC just around the corner

Now that we are approaching the third anniversary of FSR, with approximately an additional 360 AFS licences issued by ASIC since the end of the transition phase, ASIC is increasing its focus on compliance and risk management, in addition to the continued monitoring by its surveillance teams of general industry compliance. ASIC has indicated that it will commence conducting random checks on the compliance and risk management arrangements of AFS licensees over the coming months. Licensees should ensure that there is strict compliance with legislative and ASIC policy requirements in this regard. For assistance in reviewing your compliance and risk management procedures and processes, please contact one of our financial services team.

Licensing relief for Securitisation Special Purpose Vehicles

ASIC has issued a Class Order 04/1526 Securitisation Special Purpose Vehicles, creating a conditional exemption for securitisation special purpose companies and trustees from the requirements to hold an AFSL. The exemption applies to entities which are established for the limited purpose of securitising a particular sponsor's assets. The order came into effect on 11 January 2005 and revokes the interim relief provided under [CO 03/1098] from 1 July 2005.

AFS licensing relief

On 23 December 2004 ASIC released Class Order 04/1570 Licensing relief for some overseas dealers or market makers in derivatives and foreign exchange contracts (CO 04/1570) which relieves some overseas wholesale financial service providers dealing in foreign exchange contracts and making markets in derivatives and foreign exchange contracts in Australia, from the requirement to hold an AFSL. The relief applies to foreign companies that meet the requirements in Regulation 7.6.04(1)(ma) under the *Corporations Act 2001*.

Promotional material in PDS

ASIC has released an advice on the inclusion of promotional material in the PDS for a superannuation product. The PDS for a superannuation fund may include promotional material. The material must be worded and presented in a clear, concise and effective manner and must not be misleading or deceptive.

Insurance in brief

Insurance Contracts Act 1984 Review

The final report of the second stage of the Review of the *Insurance Contracts Act 1984* was released by the Parliamentary Secretary to the Treasurer recently. The report indicates that the Act strikes an appropriate balance between the interests of insurers and consumers and operates satisfactorily. The report makes a number of recommended changes to the Act including:

- recognition of developments in the insurance market;
- clarification of certain provisions in light of judicial interpretation and certain anomalies.

A draft Bill is being prepared by the government and will be open for public comment. The draft Bill will take into account subsequent consultations on s 54 of the Act and will include proposed amendments to this section.

APRA proposes Compliance Committee for foreign & life insurers

APRA has released a draft discussion paper, *Draft Prudential Standard for Eligible Foreign Life Insurance Companies – Compliance Committee*, which proposes establishing a committee for life insurance branches registered in Australia. The purpose of the committee is to provide greater assurance that branches will comply with the prudential requirements for entities registered to conduct life insurance business in Australia.

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