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☐ PRUDENTIAL REGULATION

Financial Sector Legislation Amendment (Simplifying Regulation and Review) Bill 2007

The Treasury has released an exposure draft of the Financial Sector Legislation Amendment (Simplifying Regulation and Review) Bill 2007 (Bill) for public comment. The Bill responds to comments raised in relation to the Streamlining Prudential Regulation: Response to Rethinking Regulation Paper (Paper) and the Review into Part 23 of the *Superannuation Industry (Supervision) Act 1993*.

Some of the key changes proposed under the Bill include:

- streamlining breach reporting;
- protection for whistle blowers;
- Australia Prudential Regulation Authority (APRA) discretionary powers in relation to prudential standards;
- APRA appointment and removal of auditors and actuaries;
- replacing RSE licence numbers with the entity's ABN; and
- simplification and harmonisation of regulation for life companies.

However, the Bill has not addressed certain issues such as the definitions of "responsible person" and "responsible officer", which were raised in the Paper.

The Bill proposes changes to various pieces of legislation including the *Corporations Act 2001*, *Insurance Act 1973*, *Life Insurance Act 1995* (LIA) and the *Superannuation Industry (Supervision) Act 1993* (SIS).

Submissions to Treasury in response to the draft Bill closed on 30 May 2007.

Streamlining breach reporting

The Bill proposes key changes to section 912D of the *Corporation Act 2001* in relation to the obligation on financial services licensees to notify the Australian Securities and Investments Commission (ASIC) of breaches or likely breaches of obligations under the Corporations Act. A financial services licensee must lodge a written report with ASIC within 10 business days (as opposed to five business days currently) after becoming aware of a breach or likely breach.

The Bill also addresses the overlap in reporting requirements between APRA and ASIC. An APRA authorised licensee who is required to lodge a report on a breach matter with

continued on page 2 >

in this issue

introduction

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Welcome to the latest issue of our *Financial Services Law Bulletin*. This issue covers regulatory changes to prudential regulation, compensation arrangements for AFS licensees and anti-money laundering. We also highlight why extradition costs cover is increasingly required by insureds. As we go to press, the proposed legislation on the regulation of direct offshore foreign insurers has been released. We will send a separate update on that shortly. Clearly we live in interesting times.

Financial Sector Legislation Amendment > from page 1

ASIC is deemed to have lodged the report if the report is received by APRA, in accordance with an agreement between APRA and ASIC under which APRA is to act as ASIC's agent in relation to reporting requirements.

Furthermore, the reporting obligation does not apply to an APRA regulated licensee if the auditor or actuary of the licensee provides APRA with a written report about the breach within 10 business days upon the licensee becoming aware of the breach.

Similarly, the Bill amends the *Insurance Act 1973* by inserting a requirement that any person who has reasonable grounds for believing that a general insurer, Non Operating Holding Company (NOHC) or subsidiary has materially failed to comply with prudential standards must give APRA a written report about the failure within 10 business days.

The Bill further aligns APRA and ASIC reporting requirements by listing factors to identify when a failure to comply is "material":

- the number or frequency of similar failures;
- the impact of failure to comply on the entity's ability to conduct its business;
- the actual or potential financial loss arising from the failure; and
- any matters prescribed by the regulations.

This reporting obligation will operate in addition to:

- an updated obligation that requires an auditor or actuary who has reasonable grounds for believing that an insurer, NOHC or subsidiary has breached or faces significant risk of breaching its authorisation conditions or becoming insolvent to immediately notify APRA in writing; and
- a new obligation that requires immediate notification to APRA in the event that a general insurer has breached or will breach financial obligations to policyholders or minimum capital requirements.

Furthermore, under a new offence a director or senior manager could face up to 12 months imprisonment if they are aware that there are reasonable grounds for believing that a breach may have occurred and they inform the auditor or actuary that APRA has been informed but the insurer, NOHC or subsidiary has not actually done so.

Whistleblower protection

The Bill proposes to introduce a new Part VIA to the Insurance Act, which identifies that an officer or employee of a prudentially regulated body corporate or a person or an employee of a person who has a contract for supply of goods or services with such a body corporate, may qualify for protection under the Act. Disclosure of information may qualify for protection if:

- the disclosure is made to APRA, an auditor or member of the audit team, senior manager, director or person responsible for receipt of this kind of disclosure;
- the person provides their name to APRA or the relevant disclosee before disclosing the information;
- the person making the disclosure either considers that the information provided will assist the disclosee to perform their obligations to the body corporate or under the *Financial Sector (Collection of Data) Act 2001*; and
- the person discloses the information in good faith.

A person who qualifies for protection will not be subject to any civil or criminal liability and actually causing or threatening to cause detriment to a whistleblower is deemed an offence punishable by payment of a fine up to $2,750 or six months imprisonment or both. Lastly if a person commits such an offence and a person other than the whistleblower, suffers damage due to the person's actions, they are liable to compensate the aggrieved party.

Discretionary decisions under prudential standards making powers

The Bill proposes to improve APRA's ability to tailor prudential regulation by providing that APRA may revoke or vary prudential standards except in relation to in-house capital adequacy models. Furthermore, an instrument made under this section will have the force of law except in relation to in-house capital adequacy model standards and, standards with respect to one or more specified general insurers, authorised NOHCs or subsidiaries.

Appointment and removal of auditors and actuaries

It is proposed that APRA's powers in relation to approving and revoking auditor and actuary appointments will be repealed. In future, APRA may only refer auditors or actuaries it considers not to be fit and proper or to be failing to perform their duties adequately, to professional associations. This amendment responds to feedback from the industry that the Board of Directors of regulated entities, rather than APRA, need to have greater control over the appointment and removal of auditors and actuaries.

Changes to the *Life Insurance Act 1995*

Part 5 of the LIA, which concerns solvency and capital adequacy standards, is to be repealed in its entirety.

Part 6, which relates to the financial management of life companies, is to be radically pared back to allow APRA to set and impose prudential standards. As part of this change, the repeal of Division 4 will result in the abolition of the Life Insurance Actuarial Standards Board on 1 July 2011.

Divisions 5 (Actuarial Investigations & Advice), 6 (Annual Returns), 7 (Miscellaneous i.e. approval of certain reinsurance arrangements) and 8 (APRA's power to make exemption

continued on page 5 >

☐ EXTRADITION

Developments in international extradition arrangements

Extradition has become a topic of debate, particularly with the recently publicised cases in Australia and abroad. The implications are significant and one reason why extradition costs are increasingly covered under directors and officers liability policies.

In Australia, the extradition process is governed by the *Extradition Act 1988* (Cth) and is based upon the United Nations Model Treaty on Extradition. The Extradition Act sets out a number of mandatory requirements which must be met before Australia can make an extradition request to another country. Although Australia's treaty partners have the obligation to consider a request by Australia, in the absence of a treaty, it is a matter for the domestic law in the foreign country to determine whether the country can agree to Australia's extradition request. Similarly, Australia is able to receive an extradition request from any country that isn't an "extradition country" under the Act. At present, Australia has 34 bilateral treaties on extradition and 17 inherited extradition treaties and is also a party to 19 multilateral treaties which include extradition obligations.

Once an extradition request is received in Australia from a foreign country, the Minister of Justice has the discretion to accept the request where certain criteria have been met. This includes where the person is an 'extraditable person' (the person has been convicted in a foreign country or that country has issued an arrest warrant), there is an extradition offence (it is punishable by at least 12 months imprisonment), and the requirement of dual criminality is satisfied (the conduct would be an offence in both Australia and the foreign country).

The Australian Act does not require a full brief of evidence from a requesting country in support of an extradition request. It mirrors the *UK Extradition Act 2003* in that it merely requires that the requesting country provide a statement of the offence and the applicable penalty, the warrant for arrest and a statement setting out the alleged conduct constituting the offence in an extradition request. This standard of information is called the 'no evidence' standard, i.e. the information required for extradition does not need to include actual evidence of the alleged offence, and is congruent with the international trend towards simplifying extradition matters which is included in the United Nations Model Treaty on Extradition. Furthermore, the Government confirmed that this standard will continue to apply in its response to the Joint Standing Committee on Treaties Report on Extradition (Report 40) on 13 May 2004. However, in both Australia and the UK, this standard has been the topic of judicial debate.

There have been several examples of recent extraditions from the UK to the US which have been criticised for their lack of evidence, including the NatWest Three bankers extradited to the US to face charges of fraud. In that case, the accused argued that as they were British citizens and the victim of their alleged criminal conduct was a British bank, they should be prosecuted by UK authorities. However, the English High Court of Appeal ruled that there was no rule of law which forces the UK authorities to pursue criminal proceedings and thereby upheld the US prosecutor's application to extradite the three for trial on US fraud related charges. Critics attacked the extradition system between the UK and the US as one-sided because the US had yet to ratify a treaty between the two countries.

However, on 26 April 2007, the UK and US ratified a bilateral treaty to ensure more effective arrangements. The treaty's new provisions include defining an extraditable offence, removing US statute of limitations issues whereby extradition to the UK could be barred if the offence was not prosecutable due to a lapse of time since it was committed, and redressing the unequal balance that existed under the previous treaty. Prior to ratification, the British authorities were required to provide the American courts with evidence of "probable cause" if they wished to extradite someone and the US was required to provide prima facie evidence when requesting the extradition of people from the UK. Now, the country seeking extradition must provide "a statement of the facts of the offence(s)" (Article 8, para. 2(b)). However, there is an additional requirement on the UK only to provide "...such information as would provide a reasonable basis to believe that the person sought committed the offence" (Article 8, para. 3(c)). In effect, the evidence requirement on the US has been dropped altogether while the UK must still provide evidence to the standard of a 'reasonable' demonstration of guilt.

In Australia, the extradition process has also been the subject of recent debate. In January 2006, Dragan Vasiljkovic was arrested in Sydney by the Australian Federal Police following the issue of a warrant for his arrest under the Extradition Act. The accused is a citizen of both Australia and Serbia, arriving in Australia with his family in 1954 and becoming an Australian citizen in 1975. It was alleged he carried out three offences against the Basic Criminal Code of the Republic of Croatia during the conflict between Croatian armed forces and Serbian Parliamentary troops in which he

continued on page 6 >

☐ ANTI-MONEY LAUNDERING

Anti money laundering reform

Money laundering involves the injection of funds generated from illegal activities into the banking system and other legitimate investment vehicles, in order to disguise the nature of their origins.

Anti-money laundering laws are designed to prevent this by establishing an 'audit trail' or transaction history, to provide evidence linking criminal acts and their organisers. It is estimated that $7.7 billion of overseas money is laundered into Australia and $6.1 billion is laundered to overseas.

The *Financial Transaction Report Act 1988* (FTR Act) previously governed financial transaction reporting and customer identification requirements. The reform of the Australian anti-money laundering regime follows an international directive on money laundering from the Financial Action Task Force (FATF), of which Australia is a founding member. FATF is an inter-governmental body now comprising of 33 member countries. It sets international standards and develops and promotes policies to combat money laundering and terrorism financing. In 1990, the FATF issued a set of 40 recommendations. In June 2003, FATF revised the global anti-money laundering standards, known as the Forty Recommendations.

In Australia, the implementation of these recommendations manifested in a draft exposure bill released on 17 December 2005 and a second draft, released on 13 July 2006 along with sample rules. The *Anti- Money Laundering and Counter-Terrorism Financing Act 2006* (Cth) (AML/CTF Act) was introduced in December 2006 and is to be implemented in four stages between 12 December 2006 and 12 December 2008. The requirements currently in force concern record keeping, electronic funds transfer instructions and providing registrable designated remittance services.

This means that reporting entities, i.e. business that provide any of the designated services specified in the AML/CTF Act, must retain these records in accordance with the Act. Any person other than an Authorised Deposit Taking Institution (ADI), bank, building society, credit union or person specified in the AML/CTF rules cannot provide a registrable designated remittance service (DRS) without having first registered with the Australian Transaction Reports and Analysis Centre (AUSTRAC). This provision has been in effect since 13 December 2006. The DRS include accepting money or property to be transferred to someone else or making money or property which is being received from a third party available to someone else. The Act also imposes obligations requiring institutions involved in electronic funds transfer instructions to obtain and include in those instructions certain customer information. Businesses that are providing such services and have not registered with AUSTRAC are in breach of the AML/CTF Act.

In addition to the 2006 Amendments, the *Anti-Money Laundering and Counter-Terrorism Financing Amendment Act 2007* (Cth) (Amendment Act) came into force on 12 April 2007. Significant amendments made in this Act include:

- requiring licensee arrangers to make suspicious matter reports;
- permitting licensee arrangers, if they are members of a designated business group, to adopt the designated business group's joint AML/CTF program;
- amending the absolute liability offences to strict liability offences;
- allowing review by the Administrative Appeal Tribunal of some decisions made by AUSTRAC;
- limiting the scope of certain designated services to accounts that are held with financial institutions but extending the scope of those designated services to include signatories/additional card holders;
- extending the definition of "complete payer information" in electronic funds transfer instructions to include details of country and town, city or locality of birth; and
- excluding electronic funds transfer instructions from the electronic funds transfer instruction obligations.

The final AML/CTF rules dealing with matters such as designated business groups, correspondent banking, applicable customer due diligence and AML/CTF programs were made by AUSTRAC on 10 April 2007. Furthermore, the Government has confirmed that reporting entities can use agents to carry out any of their obligations under the Act and that agency agreements need not be in writing. The obligation on the board and senior management or a reporting entity to approve and have ongoing oversight of its AML/CTF program has been facilitated in that where the reporting entity is part of a designated business group and had a joint AML/CTF program the obligation can now be discharged by the governing board and senior management of the main holding company of the group.

AUSTRAC will release further guidance on a number of issues and additional AML/CTF rules are to be introduced by AUSTRAC. From September 2007, AUSTRAC will release a regulatory guide progressively. It is proposed that the first compliance reporting period under the Act will cover the period from the 13 December 2006 to 31 December 2007. The deadline for lodging reports will be 31 March 2008.

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☐ TORT REFORM

Justice Ipp criticises tort reform

Justice Ipp last month told the Australian Insurance Law Association (AILA) Qld Insurance Law intensive that the law is not treating all citizens equally, and that Australia needs a fair, reasonably harmonious set of laws of negligence.

In 2002 Justice Ipp chaired a Review of the Law of Negligence, which inquired into the law of negligence and developed a series of proposals for reform. Among the proposals were limitations on legal costs and the introduction of caps and limitations on the award of damages, as well as threshold requirements. When the proposals were released, the then Assistant Treasurer, Helen Coonan, commented that "the proposed changes are about reforming a system which has become unaffordable, and meeting the expectations of the community while balancing the interests of those who are injured with those of the community at large".

However, last month Justice Ipp told the AILA intensive that reforms implemented in 2003 went "substantially further" than his panel had recommended. Justice Ipp also observed current debate directed towards the unfairness created by different negligence-related laws. Currently there are three separate and inconsistent compensation systems in NSW: the *Civil Liability Act 2002*, the *Workers Compensation Act 1987* and the *Motor Accidents Compensation Act 1999*. Depending on which of these Acts a claimant falls under, which in turn depends on where and in what circumstances an accident occurs, a claimant will have different threshold tests and different compensation payments apply to them.

Justice Ipp also commented that the *Civil Liability Act 2002* (NSW) gave greater protection to public authorities than was recommended, which is "substantially inconsistent with the notion that government authorities should be treated before the law in the same way as an ordinary citizen".

Justice Ipp suggested that insurers and lawyers need to unite and to approach state and federal governments to achieve "a greater degree of harmonisation". He said that inconsistencies between the laws were "the bane of the law of negligence" and have been fuelled by political influences of different groups. Justice Ipp made similar comments in April 2007, when he remarked that some statutory barriers facing plaintiffs were "inordinately high" and that "public authorities are given a host of novel and powerful defences that are in conflict with the notion that the Crown and government authorities should be treated before the law in the same way as ordinary citizens". Justice Ipp also commented that it was difficult to accept that public sentiment would allow all the reforms "to remain long-term features of the law".

Others, including other members of the judicature, have also suggested that the pendulum of reform has swung too far. It will be interesting to see if, or when, it starts to swing back.

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Financial Sector Legislation Amendment > from page 2

orders) will also be repealed from the date of Royal Assent. From that time, reinsurance arrangements will be governed by a new Division 5 (Miscellaneous), which covers:

- the method of valuing policies;
- the right of policy holders to see the financial returns of life companies; and
- APRA's ability to refer issues to the CALDB or others if it thinks the auditor has not met their professional responsibilities under the prudential standards.

These changes will result in APRA taking responsibility for setting and enforcing prudential standards for life companies and will bring the model for regulation of life companies closer to the general insurance model.

Changes to the SIS Act

Identification numbers

The Bill removes section 29DC from the SIS Act in relation to the specification of a unique RSE licence number and class of licence, substituting that identification number with the entity's ABN.

Breach notification

The notification requirements have been altered so that an RSE licensee must give particulars of material breaches of licence conditions no more than 10 business days (instead of 14 days) after the entity becomes aware that the breach has occurred.

Review of Part 23 – Financial Assistance Scheme

The Bill proposed to allow Self Managed Superannuation Funds (SMSF) to make

continued on page 6 >

Developments in international extradition arrangements> from page 3

was a Captain in the early 1990's. These offences carry a maximum penalty of 20 years imprisonment. The Croatian Court issued a warrant for Mr Vasiljkovic in December 2005 and Croatia authorities sought his extradition. A warrant was then issued by a Perth Magistrate in January 2006, thereby leading to the accused's arrest by Australian Federal Police whilst in Sydney.

The accused applied to the High Court of Australia to challenge his detention and the validity of Part II of the Extradition Act to the extent that it confers the power to deprive an Australian citizen of liberty other than in the exercise of the judicial power of the Commonwealth.Furthermore, he claimed that Part II of the Act, read together with the Extradition (Croatia) Regulations 2004 (Cth), was invalid as it confers a power to deprive a citizen of liberty other than upon a finding of a prima face case of the commission of offences alleged by the State seeking extradition.

On 15 June 2006, the validity of the Act was upheld by the High Court, on the basis that the Act and the Regulations for the Treatment of Fugitive Offenders, properly fell within Parliament's powers to make laws related to external affairs, conferred by section 51(xxix) of the Constitution. Despite the fact that Australia has no extradition treaty with Croatia, it was held that extradition does not rely upon the existence of a treaty and the Regulations declare Croatia to be an extradition country. The court held that the Constitution, either expressly or impliedly, did not prevent the "no-evidence" model of extradition from being a valid legislative choice. It was held that the choice made by a Magistrate to determine whether a person is eligible for extradition is an administrative rather than a judicial process, and where the Attorney General is satisfied that there is no extradition objection or that the person will not face torture, the death penalty or will not be tried for additional alternative offences, the person may be surrendered for extradition. The court determined that it is for Parliament to establish the criteria for eligibility for surrender and that the detention is not undertaken as punishment but as a necessary part of the extradition process based on a fear of flight by those facing extradition and to allow guilt or innocence to be determined in the requesting State.

As the High Court upheld the validity of the Extradition Act, the case was then heard in the Sydney Local Court, where Deputy Chief Paul Cloran held, on 12 April 2007, that the accused was eligible for surrender to the Republic of Croatia. The matter is now on appeal before the Federal Court.

Another recent case concerns Hew Griffiths, a 44 year old who was born in Britain but has lived in Australia since he was seven. He faces up to 10 years imprisonment and a fine of $US500,000 ($600,000) after pleading guilty in the US Federal Court in Alexandria, Virginia, to criminal copyright infringement charges. This case has set legal history as Griffiths has become the first Australian to be extradited to the US for intellectual property crimes. But it has also has raised concerns about the reach of US law and its impact on Australian citizens.

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Financial Sector Legislation Amendment > from page 5

applications for financial assistance if, at the time the loss was suffered, it was either a regulated superannuation fund or an approved deposit fund.

The prerequisites for making an application for assistance to the Minister have been altered so that a regulated superannuation fund or an approved deposit fund may make an application upon suffering loss and need not have experienced "difficulty in the payment of benefits". This change aims to ensure that Commonwealth-funded and State-funded superannuation schemes and, potentially, defined benefit funds, may make applications for assistance under Part 23. Previously, their size and funding arrangements may have precluded them from seeking assistance even though an eligible loss had been suffered, because payments could still be made easily from the large pool of funds available. The application of these changes is retrospective as well as prospective.

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☐ PROFESSIONAL INDEMNITY

Professional indemnity coverage required for financial services licensees

On 18 May 2007 Chris Pearce, the Parliamentary Secretary to the Treasurer, announced that a regulation to complement section 912B of the *Corporations Act 2001* (the Act) is expected to be made by 1 July 2007.

Background

Section 912B requires financial services licensees that provide financial services to retail clients to have compensation arrangements in place. These arrangements must be approved by Australian Securities and Investments Commission (ASIC) or satisfy the requirements set out in the regulations.

In 2002, ASIC "turned off" the requirement to comply with section 912B as a result of various factors, including the collapse of HIH and the hardship that the insurance market suffered globally in the wake of the September 11 attacks. This "turning off" will expire on 30 June 2007, and in anticipation of this deadline the Government released a draft regulation for public comment in November 2006.

The Government called for submissions in response to its paper on Compensation Arrangements for Australian Financial Services (AFS) Licensees and received numerous responses. Notable amongst these was the submission from the Insurance Council of Australia (ICA), which raised concerns about the degree of disclosure required within the financial services guide concerning the professional indemnity cover. The ICA noted that a requirement for such disclosure may cause confusion amongst clients as professional indemnity insurance is a specialised area of insurance and many licensees will find it difficult to describe their professional indemnity insurance arrangements in a "clear, concise and effective manner" that is suitable for public consumption.

Proposed regulation

Details of the proposed regulation have not yet been released. However, Mr Pearce indicated that the proposed regulation will provide for certain licensees (such as APRA authorised insurers) to be exempt, and require other non-exempt licensees to have professional indemnity insurance. In his press release, Mr Pearce also commented that "the regulation will reduce the possibility that affected licensees will not have adequate cover in place to compensate retail clients in the event of a successful claim".

A spokesman for Mr Pearce indicated that the ICA's views would be reflected in the new regulations.

Implementation of proposed regulation

The proposed regulations will be supplemented by guidance from ASIC, and a draft guidance note will be released for public consultation when the regulations are made. While the proposed regulations will be ready by 1 July 2007, Mr Pearce has stated that there will be a phase-in period of up to 18 months for financial services providers to secure professional indemnity insurance cover.

The Government and ASIC are also considering the appropriate transitional arrangements for licensees who have lodged security bonds with ASIC pursuant to prior requirements for compensation arrangements, and whether transitional regulations are needed to ensure the orderly discharge of those security bonds.

In his press release Mr Pearce commented that many financial advisors already have professional indemnity insurance in place, as it has become a standard element of best business practice in the financial services industry. The requirement for professional indemnity insurance, as proposed by this regulation, is intended to reduce the possibility that affected licensees will not have adequate cover in place to compensate retail clients in the event of a successful claim.

Mr Pearce said that investors need to be aware that there may be situations where claims cannot be met and that they can check that their financial advisor has appropriate compensation arrangements in place by referring to the Financial Services Guide.

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NEWS IN BRIEF

Consultation Paper on the Review of Prudential Decisions

On 31 May 2007, the Treasury released a consultation paper Review of Prudential Decisions, which responds to industry submissions on the review of decisions by the Australian Prudential Regulation Authority (APRA) and the process for that review. The initial proposals were made in the Government's December 2006 paper 'Streamlining Prudential Regulation: Response to Rethinking Regulation'.

The principal proposals in the consultation paper include:

- removing Australian Prudential Regulation Authority (APRA's) (and the Australia Taxation Office (ATO's) in the case of Self Managed Super Funds) discretionary disqualification powers in the *Banking Act 1959*, *Insurance Act 1973*, and *Superannuation Industry (Supervision) Act 1993*, and replacing them with a court-based disqualification procedure for individuals, using similar disqualification triggers to the current triggers. The introduction of court ordered disqualification provisions into the Life Act is also proposed;
- to streamline APRA's directions powers in the *Banking Act 1959*, *Insurance Act 1973*, *Life Insurance Act 1995*, and separately amend the *Superannuation Industry (Supervision) Act 1993*;
- the legislation will specify when merits review will be available for administrative decisions; and
- to continue with the original proposal of removing ministerial consent from certain APRA decisions.

The Treasury is seeking public submissions on the Consultation Paper by 29 June 2007. For further details, see the Treasury website and the Consultation Paper.

Source: www.treasury.gov.au, Consultation Paper.

Review of Financial Adviser Training Standards

Australian Securities and Investments Commission (ASIC) has begun a review of its policy on retail financial adviser training standards contained in Policy Statement 146. ASIC is currently meeting with key stakeholders with the aim of identifying the areas for review, and will release a public consultation paper in July.

The review is not intended to make fundamental changes to the current training standards. Issues that are likely to be addressed include:

- the suitability of current standards to certain types of entities including providers of general advice only and providers of advice on general insurance products;
- whether the knowledge and skills categories in the policy statement should be amended; and
- the use of ASIC's training register.

ASIC is inviting further information and contributions from industry.

Source: ASIC Information Release 07-18.

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