ASIC

Australian Securities & Investments Commission

Managing conflicts of interest in the Australian financial service industry

Paper presented by

Jeremy Cooper SF Fin, FAICD

Deputy Chairman

Australian Securities and Investments Commission

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1. Broad overview

Investment banks have innovated at a furious pace and changed the mix of their businesses. While banks like to say that they still rely on traditional investment banking, their profits increasingly come from other activities such as trading and principal investment. As *The Economist* rather cheekily noted 'the sharp suited investment bankers act as a sales force for less well dressed colleagues who work out how to make money from swaps, operations and direct investments'.[1]

Innovation has created a world often riddled with conflicts of interest. In some cases, it is difficult to tell whether a bank is looking after its own interests or the interests of its clients. In simple terms, a conflict of interest happens when an adviser can't really go into bat for a client because some other duty or interest is pulling them in another direction. An example includes competing with a client for an investment opportunity.[2]

New York Attorney-General, Eliot Spitzer, turned the heat on investment banks when he investigated their management of conflicts of interest in 2001–2002. The investigation netted a $1.4 billion dollar settlement and was started after Spitzer became aware that research analysts at Merrill Lynch had downgraded stock from a company, not because there was a change in opinion about the company, but because the company did not do business with Merrill Lynch.

Following action against Merrill Lynch, Spitzer spearheaded a joint investigation by state and federal regulators to examine whether other investment banks had also failed to manage conflicts of interest between their research and investment banking divisions. The widened investigation found that 10 banks had failed to manage conflicts.

In addition to paying a cash settlement, the investment banks the subject of investigation agreed to a number of structural reforms including:

- severing the link between compensation for analysts and investment banking;
- prohibiting investment banking input into analyst compensation and company coverage choice;
- creating a review committee to approve all research recommendations;
- requiring that upon discontinuation of research coverage of a company, firms will issue a final research report discussing the reasons for the termination;
- disclosing in research reports whether a firm has received or is entitled to receive any compensation from a covered company over the past 12 months; and
- establishing a monitoring process to ensure compliance with the terms of the settlement.

1 'On top of the world', *The Economist*, April 29th– May 5th 2006 p 11.
2 *Investment banks as fiduciaries: implications for conflicts of interest*, Andrew Tuch, (2005) 29 MULR 15.

2. Regulation of conflicts is not a new issue in Australia

While Spitzer's enormous cash settlement with the investment banks made conflicts of interest a hot new topic for the media, it is important to remember that regulation of conflicts of interest in stockbroking is not a new issue in Australia.

By way of example, under s 849 of the pre-FSR version of the *Corporations Law,*[3] securities advisers making personal securities recommendations were required to disclose both actual and potential material conflicts of interests which the adviser, or an associate, might have had in making the recommendation.

The disclosure required to satisfy the obligation in s 849 was quite explicit and included, in some cases, actual dollar disclosure. ASIC Policy Statement 122: *Investment advisory services: the conduct of business rules* (superseded in March 2004) said, in relation to the s 849 obligation:

> [PS 122.77] A securities adviser must give particulars of any material benefits, advantages and interests of the adviser and any associates of the adviser. Therefore, ASIC considers that any 'blanket' or 'generic' disclosure…would not comply with the s 849 obligation.
>
> [122.78] The adviser should disclose material benefits, advantages and interests in a manner that is clear and easy to understand for the client. The securities adviser must take into account the level of sophistication of the client when deciding on an appropriate level of detail and a suitable format.
>
> [122.79] For example, if the client is unlikely to be familiar with the concepts of percentages, it is advisable to disclose information in dollar terms.

There were two defences to a breach of s 849. The first was a general defence (s 850(1)) available when the adviser was not, and could not reasonably be expected to have been, aware of a benefit, advantage or interest when making the securities recommendation.

The second defence was a 'Chinese wall' defence (s 850(2)) available if the adviser was unaware of the benefit, advantage or interest, because of internal arrangements (eg a 'Chinese wall').

3. CLERP 9

A specific obligation for financial services licensees to have adequate arrangements in place to manage conflicts of interests was introduced as part of the CLERP 9 reforms. This was the Government's response to Sarbanes-Oxley.

In September 2002, the Government published its CLERP 9 Discussion Paper *Corporate Disclosure: Strengthening the Financial Reporting Framework*. The paper

3 And previously s 68C of the Securities Industry Codes.

had a chapter covering 'Analyst independence and the regulation of general advice' and proposed that:

> ASIC…be asked to provide guidance by policy statement on the level and manner of disclosure required…

under the general licensee duty to operate efficiently, honestly and fairly, which the paper said, includes an obligation to:

> ensure that conflicts of interest are disclosed adequately and managed effectively.

During the consultation phase on CLERP 9, ASIC argued that it was not enough to rely on the 'efficiently, honestly and fairly' obligation and that the legislation should specifically provide for an integrated approach consisting of:

- restrictions or prohibitions on certain conduct which cannot otherwise be effectively regulated by management or disclosure;
- a general obligation on licensees to manage conflicts of interest when providing research reports; and
- a specific obligation on licensees to disclose conflicts of interest when providing research reports.

The Government decided to impose an obligation[4] on the entire financial services industry to have adequate arrangements for managing conflicts of interest, rather than just focussing on a particular issue (ie analyst research) or a particular sector (eg stockbroking).

This was a unique approach and probably finds its genesis in the logic of the Wallis Committee report[5], that there should be uniformity of regulation in financial services as far as is practicable. The United States and the United Kingdom, for instance, concentrated heavily on the independence of investment research, but stopped short of imposing general obligations in relation to conflicts.

4. ASIC's response: the balance between education and enforcement

To date, ASIC's activity in overseeing the management of conflicts of interest has involved a balance between education and enforcement. These activities span the gamut of the financial services industry and are summarised below.

4 Section 912A(1)(aa) of the Corporations Act became effective 1 January 2005.

5 Financial System Inquiry (chair: Stan Wallis), *Final Report*, AGPS, Canberra, March 1997, http://fsi.treasury.gov.au/content/FinalReport.asp

Research analyst independence in Australia

In 2003, ASIC reviewed research analyst independence and the role analysts play in promoting securities in financial markets. The aim of this work was to review:

- the practices and activities of research analysts in Australia;
- standards of conduct and supervision of research analysts; and
- the adequacy of then current regulatory requirements.

Broadly, the research practices of eight investment banks were reviewed with four of those entities then selected for closer examination.

While identifying areas for improvement, the review did not identify the same corporate failings or misconduct as had occurred in the US, nor did it indicate that any of the misleading selling practices then being investigated in the US were present domestically.

Commenting on the results of the review in February 2005, ASX CEO Tony D'Aloisio said that there were two principal things that could explain ASIC's findings. First, investment banks cannot risk a conflict of interest tainting their reputation if they are to win business in what is, in Australia, a very competitive environment. Second, Australia is a relatively small market for analysts compared to the US. In this competitive environment, analysts are unlikely to take risks that could 'taint' or 'compromise' their reputation.[6]

IOSCO report on analyst conflicts of interest

Shortly after ASIC released its review of analyst independence in Australia, the Technical Committee of the International Organisation of Securities Commissions (IOSCO) published a statement of principles for addressing 'sell-side' securities analyst conflicts of interest. The statement of principles covers the following key issues:

- analyst trading and financial interests;
- firm financial interests and business relationships;
- sell-side analysts' reporting lines and compensation;
- outside influence;
- integrity and ethical behaviour; and
- investor education.

As a member of IOSCO and a keen contributor to the statement of principles (former ASIC Chairman David Knott was Chair of the Committee) ASIC sought to harmonise its regulatory approach to analyst conflicts of interest with international principles.

6 'Conflicts of Interest for Analysts' – Comments by Tony D'Aloisio, Chief Executive Officer and Managing Director, ASX in response to a paper by Professor Jill Fisch Corporate Law Teachers Association Conference, Sydney 7th February 2005.

Managing conflicts of interest: an ASIC guide for research report providers

In November 2004, ASIC published guidance to help research report providers manage their conflicts of interest. The guide takes into account other regulatory developments, including IOSCO's statement of principles.

Policy Statement 181 Licensing: Managing conflicts of interest

In August 2004, ASIC released Policy Statement 181 which sets out:

- our general approach to compliance with the statutory obligation to manage conflicts of interest
- guidance for licensees generally on controlling and avoiding conflicts of interest; and
- guidance for licensees generally on disclosing conflicts of interest.

In controlling conflicts of interest, we expect that licensees' arrangements will enable them to:

- identify the conflicts of interest relating to their business;
- assess and evaluate those conflicts; and
- decide upon, and implement, an appropriate response to those conflicts.

Licensees must have written conflicts management arrangements. They must also keep written records of how they manage conflicts of interest (for example, records of disclosures made and actions taken over any breaches of their policies and procedures).

Part of managing conflicts of interest is making appropriate disclosures to clients. While disclosure alone will often not be enough, disclosure is an integral part of managing conflicts of interest.

Licensees should ensure that clients are adequately informed about any conflicts of interest that might affect the provision of financial services to them. This means providing clear, concise and effective disclosure so that clients can make an informed decision about how the conflict might affect the relevant service. We expect disclosure by licensees to focus on material conflicts.

The conflicts management obligation itself applies equally to services provided to retail and wholesale clients. We recognise that the disclosure needed to comply with the law for a wholesale client will sometimes be less detailed than for a retail client. What constitutes appropriate disclosure to any given client will depend on all of the facts and circumstances, including:

- the level of financial sophistication of the client;
- the extent to which other clients (especially retail clients) are also likely to rely, directly or indirectly, on the service;
- how much the client already actually knows about the specific conflict; and
- the complexity of the service.

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Not all conflicts can be controlled and where a conflict will have a serious potential impact on a licensee or its clients the only way to adequately manage the conflict will be to avoid it. In such cases, merely disclosing the conflict and imposing internal controls will be inadequate.[7]

Conflict management in the insurance industry

Australian law imposes strict requirements on insurance brokers to tell clients about remuneration incentives received from insurers. In June 2005, ASIC released the results of a review of the remuneration practices of general insurance brokers.

While the review did not find any evidence of the kind of systemic abuses uncovered in the United States, it did identify some deficiencies in relation to Australian brokers' management of conflicts of interest and disclosure of remuneration. The review also highlighted the inherent conflict in the practice of paying volume bonuses or other types of contingent remuneration to brokers.

We found that more than half the brokers reviewed had contingent remuneration arrangements in place and most of those brokers placed a significant proportion of their business with insurers that paid volume bonuses.

Where contingent and preferential remuneration arrangements are significant to broker revenue or profit, merely disclosing the conflict and imposing internal controls to manage the conflict might not be enough. In such cases, the only way to adequately manage the conflict might be to avoid it.

Shadow shopping—correlation between conflicts and bad advice

In April this year, ASIC released results of its shadow shopping survey.

Designed to assess whether the advice given to consumers after the introduction of Super Choice complied with the law.

The survey assessed 306 examples of advice given to real consumers between June and December 2005.

As part of the survey, we looked at whether the advice involved an actual conflict of interest, that is:

- the adviser would get higher remuneration if the advice was followed (eg via a trailing commission); and/or
- the adviser recommended a product from a company associated with the adviser's licensee (ie an in-house fund).

Interestingly, we found that advice that was clearly or probably non-compliant was about six times more common where the adviser had an actual conflict of interest by

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7 ASIC's discussion paper, Managing conflicts of interest in the financial services industy, contains a number of examples of conflicts that should be avoided. See for example case study A2.

reason of their remuneration arrangements. Where the adviser had a remuneration conflict, 28% of the advice clearly did not have a reasonable basis and a further 7% probably did not. In contrast, where the adviser did not have a conflict, the percentages were 5% and 1% respectively.

Non-compliant advice was three times more likely where the adviser recommended an associated product.

It is clear from the survey that there is a much higher risk of inappropriate advice where the adviser is conflicted. Licensees and advisers have traditionally relied heavily on disclosure to manage these conflicts. However, disclosure is not, by itself, always an adequate response if the conflict still leads to advice that is inappropriate or compromises the client's interests.

Discussion paper incorporating 24 case studies

In April this year, ASIC released a discussion paper called *Managing conflicts of interest in the financial services industry*. The discussion paper uses case studies illustrating real or perceived conflicts of interest across the financial services industry to explain ASIC's views on how those conflicts should be managed.

One of the case studies that has so far generated a reasonable amount of comment involves a scenario where an investment bank IPOs a client and then acts as 'house broker'. Meanwhile, the bank's research staff regularly issue positive research on the company. In our discussion paper, we say that this conflict of interest can be managed by internal controls and disclosure. Our suggestion is that the research should disclose the bank's role in the IPO and any continuing advisory roles. We also think that the research should disclose details of fees received (ie dollar disclosure) and to be received from the company and any retainer.

Banks have argued that disclosure of exact fees is impracticable. Given the drafting of former conflicts of interests provisions of the law (like s 849 of the pre-FSR *Corporations Law*) there might be a case to introduce some defences to non-disclosure like a defence for an unknown conflict on the other side of a Chinese wall.

5. Is the sky really falling in?

There has been a lot of noise from parts of the financial services industry about the obligation to manage conflicts of interest. But we think the changes are a relatively small price to pay for investors having confidence in the Australian financial services industry.

If you think about the enormous changes that have occurred in our financial markets in the past 25 years, the introduction of the conflicts management obligation is a mere blip on the radar.

In 1981, a share trade would cost 2.5% in brokerage. What's more, that was mandated in the listing requirements (as they were then called). You had to pay

stamp duty of 60 cents per $100 of value on top of that and a share transfer form had to be signed by both the buyer and the seller. You had to find all the share certificates that related to the trade; sometimes settlements would take weeks or months if scrip were missing. The exchanges were State-based and were structured as companies limited by guarantee. Until October 1990, our various exchanges were open outcry and keen young men wrote all the bids in chalk on blackboards. In 1985, I was involved as a very junior member of the legal team advising the Melbourne Stock Exchange (as it then was) in a legal dispute about who shouted what order first to buy shares in David Syme & Co Ltd.[8]

In 1987, Australia experienced the biggest IPO (then an unheard of term) being a strange vehicle called Cumberland Credit Limited, a cashbox that raised $200m from scratch to spend on (you guessed it) strategic and undervalued investments as yet not identified.

Merchant bankers, at some point, became investment bankers.

Also, a funny North American concept called 'due diligence' crept into our lives—with devastating consequences to our sanity and the birth rate of a whole generation of lawyers and investment bankers.

Then, miraculously, our exchanges followed the example set by the OMX Group in Sweden and de-mutualised and self-listed on a new exchange called ASX. Then we got rid of scrip and moved through FAST and then to CHESS; not to mention SEATS. Now we are seeing our equities and futures exchanges merge.

Today, the landscape is awash with new techniques for swapping risks, nearly all managed investments seem capable of being classified as hedge funds and the level of participation of Australian investors in listed equities continues to be at an all time high. Today, 44% of adult Australians directly own shares, whereas 25 years ago the figure was more like 5%.

So, compared to those changes, the requirement to have adequate arrangements for managing conflicts of interest seems much less challenging.

6. Is ASIC driving for structural change?

No. There is no magic in the 'cottage industry' approach to financial services and, in any event, it is not for ASIC to dictate how the financial services industry is structured. There are a lot of economies of scale that benefit all participants in having a fair degree of consolidation.

Having said that, boutiques with access to the necessary capital and know-how have a big advantage in being able to avoid conflicts.

Those organisations who choose to offer services that create conflicts must realise that they are playing with risk. Handling conflicts is really a risk management exercise. If

8 *Bell Group Ltd v Herald and Weekly Times Ltd & Ors* [1985] VR 613; (1985) 9 ACLR 697.

you are relying on a Chinese wall, you must accept the risk and consequences of its failure and you must be able to price that risk into your decisions about when to rely on the wall and when to avoid the conflict altogether.

7. Conclusion

Market pressure[9], coupled with sound regulation, are important tools in the fight against conflicts of interest. We also need to acknowledge that operating a business that naturally creates conflicts increases reputational risk; often to dangerous levels.

By its nature, the management of conflicts is much more of an art than a science and certainly cannot be left to endless prescriptions from the regulator. Organisations will come to learn that while technology and systems are essential, some of the skills needed are nebulous and rely on 'feel'. You have to be able to 'get it', to recognise a conflict or a potential conflict when it arises; a bit like knowing the difference between a zebra and a horse with black and white stripes painted on it – very easy, but try writing a set of rules for an organisation to follow to arrive at the right answer.

Jeremy Cooper
26 May 2006
Melbourne

[9] Stephen Bartholomeusz, 'Value Added: Market driven discipline an effective way to keep conflicts under control', *The Age*, 26 April 2006