



ASIC

Australian Securities & Investments Commission

CONSULTATION PAPER 171

Strengthening the regulation of research report providers (including research houses)

November 2011

About this paper

This paper sets out our proposals for updating our guidance on research reports in Regulatory Guide 79 *Managing conflicts of interest: An ASIC guide for research report providers* (RG 79). Our proposals are based on a recent ASIC review of the research house sector.

We seek feedback from research report providers (including research houses), financial advisory firms, industry associations and other interested parties on our proposals.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- 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
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Document history

This paper was issued on 14 November 2011 and is based on the Corporations Act as at the date of issue.

Disclaimer

The proposals, explanations and examples in this paper do not constitute legal advice. They are also at a preliminary stage only. Our conclusions and views may change as a result of the comments we receive or as other circumstances change.

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The consultation process

You are invited to comment on the proposals in this paper, which are only an indication of the approach we may take and are not our final policy.

As well as responding to the specific proposals and questions, we also ask you to describe any alternative approaches you think would achieve our objectives.

We are keen to fully understand and assess the financial and other impacts of our proposals and any alternative approaches. Therefore, we ask you to comment on:

- the likely compliance costs;
- the likely effect on competition; and
- other impacts, costs and benefits.

Where possible, we are seeking both quantitative and qualitative information. We are also keen to hear from you on any other issues you consider important.

Your comments will help us develop our policy on research reports. In particular, any information about compliance costs, impacts on competition and other impacts, costs and benefits will be taken into account if we prepare a Regulation Impact Statement: see [Section G Regulatory and financial impact](#), p. 42.

Making a submission

We will not treat your submission as confidential unless you specifically request that we treat the whole or part of it (such as any financial information) as confidential.

Comments should be sent by 3 February 2012 to:

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What will happen next?

Stage 1	14 November 2011	ASIC consultation paper released
Stage 2	3 February 2012	Comments due on the consultation paper
	February–April 2012	Drafting of regulatory guide
Stage 3	May 2012	Regulatory guide released

A Background to the proposals

Key points

Conflicts of interest have been an issue for providers of investment research for some time in Australia and overseas.

ASIC has recently reviewed practices in the research house sector. As a result, we believe there are some areas where our existing guidance and expectations should be revised or supplemented.

We are publishing this paper to consult on our proposals for updating Regulatory Guide 79 *Managing conflicts of interest: An ASIC guide for research report providers* (RG 79) to ensure it covers all of the current issues in the research industry.

Research in the financial services context

- 1 Australian and overseas experience has shown that there is considerable potential for conflicts of interest in the production of investment research. There has been a large amount of concern here and overseas to ensure that the integrity of the research process is not compromised by conflicts of interest. In Australia, this led to detailed surveillance on the securities research industry in 2003: see our surveillance report *Research analyst independence* (REP 24), issued 22 August 2003.¹
- 2 Parliament responded by introducing the conflicts management obligation as part of the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (CLERP 9 Act). To support this new obligation, we published Regulatory Guide 181 *Licensing: Managing conflicts of interest* (RG 181) in 2004.
- 3 Due to the heightened interest in conflict of interest issues in the research industry, we also published additional guidance for this sector later in 2004: see Regulatory Guide 79 *Managing conflicts of interest: An ASIC guide for research report providers* (RG 79).²
- 4 On 22 May 2008, the then Minister for Superannuation and Corporate Law, Senator Nick Sherry, announced that Treasury and ASIC were to review the regulation of credit rating agencies and research houses and report to the Australian Government within six months. Research houses are organisations that provide research reports, generally about managed funds

¹ Go to www.asic.gov.au/reports to download a copy of this report.

² Go to www.asic.gov.au/rg to download a copy of RG 79 and other ASIC regulatory guides.

and superannuation products (but also about some other investment products). Research houses are a subset of the category of research report providers for the purposes of RG 79 and this paper.

- 5 In November 2008, Treasury and ASIC released a joint report, *Review of credit rating agencies and research houses* (REP 143) on the outcome of this review.³ The then Minister stated, in a media release on 13 November 2008, that:

ASIC will also require research houses to issue a similar annual compliance report [to that required for credit rating agencies] which *will cover* management of conflicts of interest and the procedures, methodologies and assumptions that result in research house advice.⁴

He also ‘confirm[ed] that all research houses are required to have an AFSL [Australian financial services licence]’.

- 6 In our submission to the 2009 Parliamentary Joint Committee on Corporations and Financial Services (PJC) Inquiry into Financial Products and Services in Australia, we stated:

The Government may also wish to consider whether ... fees paid to other financial services providers, such as fees paid by product manufacturers to platform providers and research houses, should be reviewed. Shelf fees paid to platform providers have the potential to influence the range of products a client has access to on a platform. Remuneration of research houses is commonly paid by the product issuer, which creates an obvious conflict of interest and has the potential to distort the quality of research reports often used by advisers in making product recommendations to clients. A user-pays model for research house remuneration might help improve the quality of the research used by advisers.⁵

- 7 On 23 June 2011, the Parliamentary Joint Committee on Corporations and Financial Services resolved to:

inquire, and report by 24 November 2011, into the collapse of Trio Capital and any other related matters, with particular reference to: ... 10. the role of ratings agencies and research organisations in product promotion and confidence.⁶

- 8 We lodged our submission to and appeared at hearings of the PJC Inquiry into the Trio Capital collapse in September 2011.⁷

³ Go to www.asic.gov.au/reports to download a copy of this report.

⁴ See The Treasury, *Improved Australian controls for credit rating agencies and research houses*, Media Release, 13 November 2008.

⁵ See *PJC Inquiry into Financial Products and Services in Australia: Submission by the Australian Securities and Investments Commission*, August 2009, at paragraph 190.

⁶ See Parliamentary Joint Committee on Corporations and Financial Services, *New inquiry into the collapse of Trio Capital*, Media Release, 1 July 2011.

⁷ http://www.aph.gov.au/Senate/committee/corporations_ctte/trio/submissions.htm.

Existing law and policy

- 9 Under the *Corporations Act 2001* (Corporations Act), licensees are obliged (among other things) to have adequate arrangements for the management of conflicts of interest that may arise wholly, or partially, in relation to the provision of financial services by the licensee, or a representative of the licensee, as part of the financial services business of the licensee or the representative (the ‘conflicts management obligation’): s912A(1)(aa).
- 10 Other licensee obligations also deal with or relate to the conduct of research report providers, including:
- (a) the obligation to do all things necessary to ensure that their financial services are provided efficiently, honestly and fairly (s912A(1)(a));
 - (b) the obligation to comply with financial services laws and to take reasonable steps to ensure their representatives do likewise (s912A(1)(c) and (ca));
 - (c) the obligation to have adequate compliance arrangements (reg 7.6.03(g) and Pro Forma [PF 209]);
 - (d) the obligation to have adequate resources, be competent, and ensure representatives are adequately trained and supervised (s912A(1));
 - (e) where retail clients are involved—the obligation to give clients a Financial Services Guide (FSG);
 - (f) where general advice is given—the obligation to warn clients that the advice does not take into account a client’s objectives, financial situation or needs (s949A); and
 - (g) a range of prohibitions, including those for misleading or deceptive conduct in the provision of financial services, dishonest conduct, unconscionable conduct and insider trading (see Regulatory Guide 181 *Licensing: Managing conflicts of interest* (RG 181) at RG 181.17).
- 11 The conflicts management obligation and the obligation to operate efficiently, honesty and fairly are interconnected. A licensee is unlikely to comply with the obligation to operate efficiently, honestly and fairly if they have inadequate conflicts management procedures. Conversely, having adequate conflicts management arrangements will help licensees comply with their other obligations, including the obligation to operate efficiently, honestly and fairly.⁸

⁸ See RG 181.18.

The research industry

- 12 The conflicts management obligation applies to all licensees, including providers of research, and relates to the integrity of their research. What an individual licensee needs to do to comply with the obligation varies according to the nature, scale and complexity of its financial services business.
- 13 RG 181 sets out:
- (a) our general approach to compliance with the conflicts management obligation in s912AA(1)(aa);
 - (b) guidance for licensees generally on controlling and avoiding conflicts of interest;
 - (c) guidance for licensees generally on disclosing conflicts of interest.
- 14 It also includes some issues for licensees to consider in complying with these obligations.⁹
- 15 RG 79 is specifically targeted at those licensees who are research report providers:
- It is directed towards traditional providers of research on investment products—known variously as research analysts, securities analysts *or research houses*—and the research reports they traditionally provide.¹⁰
- That is, research houses and the research they publish are a subset of the wider category of ‘research report providers’ (which also includes stockbroker and securities analysts) recognised by ASIC since 2004.
- 16 In the section on controlling and avoiding conflicts of interest, RG 79 gives guidance on:
- (a) documentation;
 - (b) monitoring compliance;
 - (c) communication;
 - (d) information barriers;
 - (e) approval before distribution;
 - (f) provision of non-research services;
 - (g) benefits and remuneration;
 - (h) trading restrictions;
 - (i) reports based on ‘reasonable grounds’; and
 - (j) reports for ‘proper purpose’.¹¹

⁹ See the Schedule to RG 181.

¹⁰ See RG 79 at paragraph 1 (emphasis added).

¹¹ See Section 2 of RG 79.

- 17 In the section on disclosing conflicts of interest, RG 79 gives guidance on:
- (a) interests;
 - (b) benefits;
 - (c) associations and relationships;
 - (d) assistance provided by product issuer;
 - (e) who wrote the report and when;
 - (f) the reasons for opinions and recommendations;
 - (g) additional disclosure issues.¹²
- 18 In the context of expert or professional opinions, cases decided under the false, misleading or deceptive conduct provisions in the *Australian Securities and Investments Act 2001* (ASIC Act) and the (then) *Trade Practices Act 1974* have held that a statement of opinion by a person in their professional capacity involves an implied assertion that the opinion has a reasonable basis, is the result of the exercise of due care and skill, and is able to be relied upon.¹³ An opinion given in circumstances that suggest that the opinion was based on ‘the exercise of certain expertise ... carries with it the implication that it is based on rational grounds and accordingly will breach the prohibition if it has no reasonable basis’.¹⁴ This is especially true where the person giving the opinion holds themselves out as ‘having special skill in relation to the ... subject’ of the opinion.¹⁵

ASIC’s current review

- 19 Most recently, industry and consumer representatives have raised concerns with ASIC about whether research houses are managing their conflicts adequately, and otherwise providing high quality, appropriate and compliant services.
- 20 During the recent financial crisis, some of the investment products that failed were covered by research houses. Some of these products were highly rated or had positive recommendations published about them at or close to the time they collapsed.
- 21 Some retail clients and their professional advisers have raised concerns with ASIC about whether the opinions and recommendations expressed by those research houses were appropriate. We understand many retail clients and their advisers rely, at least in part, on expert research in making investment decisions and formulating financial advice. We are considering whether the current regulatory requirements for research houses are adequate in the light of recent events.

¹² See Section 3 of RG 79.

¹³ *MGIGA Ltd v Kenny & Good Pty Ltd* (1996) 70 FCR 236.

¹⁴ Lockhart C, *The Law of Misleading or Deceptive Conduct* (Butterworths, 1998) at [4.36]; *RAIA Insurance Brokers Ltd v FAI General Insurance Co Ltd* (1993) 41 FCR 164; *Chiarabaglio v Westpac Banking Corporation* [1989] ATPR 40-971.

¹⁵ Lockhart at [4.36].

22 As a result, we undertook a review of the research house industry. This was to identify current regulatory issues within the research house sector and to determine whether further regulatory action or guidance is warranted. The project involved a review of current literature, industry and mainstream press publications. We also met with a number of research houses and groups representing both preparers and users of research. The findings (including areas of regulatory interest and concern) are summarised below.

23 The proposals in this paper are based on our discussions with providers and users of research.

Scope and implementation of ASIC's guidance

24 ASIC staff met with six research houses and with four associations representing both providers of research and key user groups (e.g. the financial planning industry) in order to identify and explore regulatory issues in the sector.

25 Two of our key findings were that:

- (a) awareness by research houses of our current regulatory policy on research industry issues was limited; and
- (b) our existing policy needed to be revised and updated more generally to respond to the current issues in the research industry.

26 Based on our findings, there are:

- (a) some new issues we believe it is appropriate for us to give guidance and express expectations on; and
- (b) some issues we previously expressed views on that is appropriate for us to refine and update.

27 We are publishing this paper to consult on strengthening our current regulatory policy to ensure it covers all of the current issues in the research industry: see paragraphs 43–45 and Sections C–F of this paper. At the same time, we will also be raising awareness of our expectations, through targeted education and surveillance activities: see Section B of this paper.

Role of research in the market place

28 Many users of research are financial advisory firms, who typically use research to identify products to be considered for inclusion on approved product lists. This then affects which products are recommended to their clients.

29 While the degree of reliance on research among advisory firms differed from firm to firm, it was generally agreed that sole reliance on research in constructing approved product lists is not appropriate. However, some

advisers believe that the important role of research in the market place is not appropriately recognised in law, or by dispute resolution bodies. Some advisers said they are also aware of other advisers placing excessive reliance on research services when preparing their work.

- 30 Research houses have a ‘gatekeeper’ function in the market place. In particular, research can influence which products individual advisers recommend to their clients, including through the process of constructing approved product lists. On that basis, research quality and transparency is important in ensuring that clients receive appropriate advice.

Conflicts of interest

- 31 Research houses’ businesses can present a number of conflicts of interest. These can broadly be categorised as:
- (a) *revenue model conflicts*, arising from the fact that product issuers often pay research houses to produce product ratings;
 - (b) *ancillary business conflicts*, which arise when a research house (or an associated company) operates a business that complements, but could also make preferential use of, the research house’s research (e.g. associated companies that operate a managed fund); and
 - (c) *analyst conflicts*, which may arise between individual research staff, the research house, the commissioning clients and end-users.
- 32 In general, research houses recognised the existence of conflicts of interest in their business and had some processes in place to manage them. These processes varied substantially in their sophistication and effectiveness. There was also variation between types of conflict. Research houses were most aware of revenue model conflicts and somewhat less so of ancillary business conflicts. Analyst conflicts, while recognised, generally had not resulted in any formal practice of analyst rotation.
- 33 In the case of revenue model conflicts, two research houses claimed to avoid this conflict entirely, by not accepting payments from product issuers. These research houses contended this makes their research far more reliable and credible than that of their competitors. Payments from product issuers were considered the most serious conflict of interest by most of the stakeholders we met with.
- 34 Users of research were also aware of conflicts of interest, in particular revenue model conflicts. Research users were concerned that research houses as a sector were not effectively managing their conflicts of interest.

Quality of research

- 35 Most research houses appear to have fairly rigorous research processes in place that include ratings committee sign-off or peer review. Senior research staff members are also usually qualified and experienced.
- 36 However, users of research raised concerns about whether the skill and experience of, especially more junior, research analysts is sufficient to conduct effective analysis of the financial products. Users of research also queried whether research houses devoted sufficient resources to individual reviews or reviewed an appropriately wide range of products (some users thought the range was too narrow, others too wide). There was also concern about the depth of 'due diligence' actually conducted by research houses.
- 37 A number of users of research house services expressed concern or disappointment that some investment products that have collapsed in recent years were the subject of positive research at or close to the time of their collapse. The users believed that this indicated a problem with the quality of the research reports and underlying research process. This may also indicate a wider issue with the expectations of some users that research houses can accurately forecast or predict (and therefore avoid) product collapses.
- 38 Users of research argued that liability for deficient advice should be extended to research houses on the basis that their general advice and product recommendations, in whole or in part, are relied upon by advisers when preparing advice to retail clients. To the extent that the law does not already achieve this, it is a matter for law reform.
- 39 The conduct and regulation of research houses has been an area of increasing focus. The role of research houses in providing a third party assessment of products is an important one. Some recent, high profile corporate collapses and product failures have highlighted the need for greater scrutiny in the role of research houses in providing reliable information to advisers (and, directly or indirectly, to retail clients).
- 40 Research houses all stated that they conduct regular, systemic reviews of ratings by sector, at least every two years. They also claim their agreements with product issuers require issuers to inform them of any material changes and that ratings are then reviewed. Users of ratings were concerned, however, that these reviews and updates did not occur in a sufficiently timely manner.

Methodology and transparency

- 41 There is often a lack of transparency about the methodology used to arrive at product recommendations, opinions and ratings. At present, there are no industry-wide standards for the disclosure of research methodology or, indeed, of the meaning of particular ratings. For example, it is not always

made clear whether ratings are opinions about the absolute quality of a product or its quality relative to peers in a particular category. Recent corporate collapses have also highlighted issues around the appropriate use of research as part of the advice process.

- 42 There appeared to be a general expectation gap between users of research and research houses concerning the nature and purpose of research. There is also a lack of consistency in the presentation of research ratings, which makes meaningful comparison difficult.

Proposed update to RG 79

- 43 While our most recent activities have focused on research houses, the issues of conflicts of interest, quality of research, and methodology and transparency apply to *all* research report providers. Indeed, at different times, different categories of research report providers have received attention in the context of market developments. When RG 79 was originally drafted, securities analyst research was a common area of concern.
- 44 Recent product failures have drawn attention to the particular role of research houses in the market place. As mentioned earlier, our findings from recent experience in this segment of the research industry sector indicate that:
- (a) awareness by research houses of our current regulatory policy on research industry issues was limited; and
 - (b) our existing policy needed to be revised and updated more generally to respond to the current issues in the research industry.
- 45 With the benefit of this work, we are now in a position to update our guidance to the research industry generally. We are publishing this paper to consult on strengthening our existing regulatory policy to ensure it covers all of the current issues in the research industry. Our existing guidance in RG 79 covers research published by *all* research report providers (including stockbrokers and investment banks), and this will continue to be the case with the proposed revisions to RG 79 in this paper.

B Scope and implementation of ASIC's guidance

Key points

Research houses are research report providers within the meaning of RG 79.

We propose to refine and supplement our guidance in RG 79 to address some issues arising from our recent review of the research house sector.

We also propose that research report providers lodge a compliance report with ASIC every two years to report on their compliance with the law and our guidance in this area.

Scope of our guidance

Proposal

- B1** We propose to retain the definitions of 'research report' and 'research report provider' in RG 79: see paragraphs 48–49 of this paper.

Your feedback

- B1Q1 Do you agree with this proposal? If not, why not?
- B1Q2 Should these definitions be extended to include research on other products (e.g. banking or insurance products)?
- B1Q3 Should these definitions be extended to include research that does not amount to advice (e.g. factual information collected together by research report providers and presented in comparison tables)?
- B1Q4 Does this proposal raise any practical problems for licensees who distribute research originally prepared by another licensee (see paragraph 54 of this paper)?

- B2** We propose to exclude credit ratings provided by credit rating agencies from the definition of 'research report' in RG 79.

Your feedback

- B2Q1 Should credit ratings be included in the definition of research report? Why or why not?

Rationale

- 46 The Corporations Act does not define research as a particular financial service distinct from 'general advice'. Therefore, no specific licence authorisations are required to operate a research business. However, research report providers need to obtain an Australian financial services (AFS) licence authorising them to provide general advice.

47 In our joint report with Treasury on our review of credit ratings agencies and research houses, we noted that there is no established definition of a ‘research house’. Rather, research houses can be broadly defined as firms that provide objective and independent ratings, recommendations or opinions on financial products.¹⁶

48 In the absence of an established legal definition of ‘research reports’, we propose to retain the following definition in RG 79:

For the purposes of this guide, a research report is general advice that:

- (a) is in writing;
- (b) includes an express or implicit opinion or recommendation about a named or readily identifiable investment product; and
- (c) is intended to be, or could reasonably be regarded as being intended to be, broadly distributed (whether directly or indirectly) to clients (whether wholesale or retail) in Australia.

Note 1: Investment products include securities, warrants traded on a financial market, managed investment products, superannuation products and investment life insurance products. Reports about whether to buy, sell or hold these products prepared by research analysts, securities analysts or research houses are typical examples of “research reports”.

Note 2: The expression “broadly distributed” includes, but is not limited to, publication.

It does not include any of the following:

- (a) general advice that is provided only to an individual or small number of related clients (e.g. a family);
- (b) general advice that is provided only to related bodies corporate of the licensee;
- (c) general advice that is only about products issued by the licensee or its related bodies corporate;
- (d) a communication or piece of information that does not constitute general advice;
- (e) advice that does not contain any express or implied opinion or recommendation to buy, sell or hold a named or readily identifiable investment product;
- (f) advice that is merely a re-statement, summary or extract of another research report that has already been broadly distributed (whether in Australia or elsewhere and whether by the licensee or another person);
- (g) personal advice; or
- (h) advice that is not provided in Australia.¹⁷

49 In general, research report providers (including research houses) provide an assessment of financial products and make recommendations concerning those financial products to assist both financial advisers and potential investors, to make an informed investment decision. Reports may be

¹⁶ See REP 143 at www.asic.gov.au/reports.

¹⁷ See RG 79 at paragraphs 1.1–1.2.

provided to the public, or just to subscribers (who may be wholesale clients, retail clients or both). RG 79 states:

For the purposes of this guide, and subject to paragraph 1.4, a research report provider is a licensee that provides research reports to other persons (clients). This includes the situation where the licensee causes or authorises another person (such as an authorised representative of the licensee) to provide research reports to other persons (clients). A person that does not hold an Australian financial services (AFS) licence is not a research report provider for the purposes of this guide.

If a research report prepared by one licensee (A) is provided to other persons (clients) by another licensee (B) then, for the purposes of this guide, A is the research report provider, and not B (regardless of whether B puts its own name on the research report), but only where:

- (a) A's licence covers the provision of the financial service;
- (b) A causes or authorises B to provide the advice contained in the research report to other persons; and
- (c) no material changes to the advice contained in the research report are made by B.

Where any of these conditions is not met, B will be the research report provider. In any event, it is important to note that both A and B must consider the obligation to comply with the conflicts management obligation and should, in this regard, be guided by [RG 181].¹⁸

- 50 Our primary interest for the purposes of this consultation paper are firms who provide assessments, opinions, recommendations or ratings for managed investment and structured investment products. We have not included internal research functions within fund managers or investment banks (as the definition is limited to general advice intended to be broadly distributed outside the organisation that created it).
- 51 We have limited the definition of research report to material that meets the definition of general advice. It does not include material that does not constitute general advice (e.g. because it is merely factual). Whether a particular research service (e.g. a comparison website) contains material that is or includes general advice depends on the circumstances. We seek feedback on whether the definition of research report should be extended: see questions B1Q2–B1Q3.
- 52 We are considering a separate review of industry practices in the comparison site sector in the near future. This would include looking at whether there are issues of quality, disclosure and conflicts of interest in research and comparison services for non-investment products (e.g. comparison websites covering general insurance, banking and consumer credit products).
- 53 Most research houses we have spoken with focus primarily on qualitative and quantitative research into the expertise and effectiveness of fund managers, their investment strategies and product structures. They cover securities, managed funds, superannuation products and structured products.

¹⁸ See RG 79 at paragraphs 1.3–1.4.

- 54 We are aware that in some cases research report providers permit other people to adopt and (re)distribute their research (with or without attribution of the original licensee). In such cases, we expect any disclosures of conflict of interest by the original research report providers to be repeated in the new research reports. The licensee who originally prepared the research will be considered the research report provider for the purposes of RG 79 (and this paper).¹⁹ This will continue to be the case under any updated version of RG 79. We seek feedback on whether any aspects of the proposed guidance in this paper raise significant practical issues for licensees who distribute research originally prepared by another licensee.
- 55 Credit rating agencies have traditionally been subject to a discrete regulatory regime. While many of the issues relating to credit rating agencies overlap with those of research houses, the work of credit rating agencies is geared primarily towards wholesale investors. In addition, credit ratings agencies are subject to their own specific and detailed regulatory requirements under the International Organization of Securities Commission (IOSCO) *Code of Conduct Fundamentals for Credit Rating Agencies* (IOSCO Code)²⁰ and tailored licence conditions administered by ASIC. These requirements cover the issues in RG 79 and this paper as far as they are relevant to credit ratings. Therefore, we propose to exclude credit ratings from the definition of research report for the purposes of this paper.²¹

Status and location of our guidance

- 56 We generally give guidance to assist people in complying with the law. It helps licensees understand our administrative approach to the law, and also guides our surveillance and deterrence decisions. We currently administer the law in relation to research report providers in accordance with RG 79. We will continue to administer the law in accordance with our regulatory guidance and expectations in this area, as updated following this consultation process.
- 57 We currently take the guidance and expectations in RG 79 into account in administering the law, including considering whether to take action in relation to any particular licensee. In our view, licensees whose arrangements are not consistent with the guidance and expectations in RG 79 are less likely to be complying with their obligations (in particular, the conflicts management obligation) and will be exposed to a greater risk of regulatory action.

¹⁹ See RG 79 at paragraph 1.4.

²⁰ <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD271.pdf>.

²¹ We propose to exclude credit ratings rather than credit rating *agencies* themselves, as over time their services might extend beyond credit ratings.

- 58 We published RG 79 in 2004 to give specific guidance to the research industry on the law and our expectations. While recent issues with research houses have led to this current project, many of the issues are similar to those that led to RG 79. We consider that it is most efficient to update RG 79 more generally to incorporate the new guidance and expectations we are consulting on in this paper. This will provide greater guidance on the law and our expectations to the whole of the research industry, including research houses. It will also reduce uncertainty and confusion for industry in having multiple guides to consider on research-related issues.
- 59 Following this consultation process, we will amend (and, if necessary, further consult on) the update to RG 79.

Implementation and monitoring

Proposal

- B3** We propose to require *all* research report providers to lodge a compliance report with ASIC every two years. We propose to implement this requirement through a new AFS licence condition.
- B4** The compliance report should describe the measures that the research report provider has implemented to address the key issues in RG 79 (as updated following this consultation process): see the appendix to this paper.

Your feedback

- B4Q1 Should research report providers be required to lodge a compliance report with ASIC? Why or why not?
- B4Q2 Should the compliance report be lodged every two years? Should it be lodged more or less frequently, or only as requested by ASIC? Please give reasons.
- B4Q3 Should the compliance report apply to all research report providers, or only a sub-category (e.g. research houses, securities analysts)? Please give reasons, including how the sub-category would be defined.
- B4Q4 Should the compliance report not be required under an AFS licence condition, but instead provided voluntarily as 'best practice'? Please give reasons.
- B4Q5 Should research report providers be expected to report against all of the key issues in RG 79? Please give details.
- B4Q6 Should aspects of the compliance report be publicly available? If so, which aspects? Please provide reasons.
- B4Q7 For licensees, how much it would cost your firm to prepare and lodge a compliance report every two years, based on the draft requirements in the appendix to this paper? Please provide estimates.

Rationale

- 60 As discussed above, we will be raising awareness of our expectations in RG 79 and RG 181 through targeted education and surveillance activities.
- 61 After publication of the updated RG 79, we will monitor compliance with the guidance and expectations in that guide. We expect this will include a specific surveillance project about 12–24 months after publication of the updated guide.
- 62 A mandatory annual compliance report was proposed by Senator Sherry in 2008 and a similar approach is currently being developed for credit rating agencies: see Consultation Paper 160 *Credit rating agencies: IOSCO Code Annual Compliance Report* (CP 160).²² It may be beneficial to impose similar requirements for some or all research report providers.
- 63 Our preference is for a compliance report to be lodged every two years, as a condition on the AFS licences of all research report providers. Imposing the requirement by AFS licence condition would mean that lodging the compliance report was compulsory.
- 64 We believe a system of reporting every two years appropriately balances the cost of providing the information against the benefit to be gained from improved transparency and regulatory compliance in the industry.
- 65 While it will not have the same content as the credit rating agency annual compliance report, the compliance report to be lodged by research report providers should have a similar amount of detail and be structured in a similar way. We propose to specify a list of matters or topics that the report needs to address: see the appendix to this paper.²³
- 66 Similar to the credit rating agency annual compliance report, this will be a list of the main issues and topics contained in the updated guidance published for research report providers. For example, it is likely to cover:
- (a) research methodology and processes;
 - (b) internal conflicts management procedures;
 - (c) research publication and distribution;
 - (d) conflicts disclosure to users;
 - (e) monitoring and updating research;
 - (f) staff training and supervision;
 - (g) compliance and risk management; and
 - (h) managing research quality and transparency.

²² Go to www.asic.gov.au/cp to download a copy of this consultation paper.

²³ See also Appendix 1 to CP 160.

- 67 In the proposed compliance report, research report providers will need to describe the measures that they have implemented that ensure compliance with the law, based on our updated regulatory guide.
- 68 The compliance report would be lodged with ASIC. We envisage some aspects of the compliance report may be made publicly available, such as how the research report provider is remunerated and how it manages conflicts of interest.
- 69 If this proposal is adopted, we would receive the information in these compliance reports from each research report provider every two years. This information would be used by us to:
- (a) monitor the research industry,
 - (b) enable us to periodically publish some summary level information about current issues and practices in the industry to inform participants; and
 - (c) identify areas of greater regulatory risk where our surveillance resources may need to be allocated.
- 70 The compliance reports would support but not replace other reporting requirements in the law (e.g. the breach reporting requirement in s912D).

C Conflicts of interest

Key points

Some conflicts of interest should be avoided entirely.

Other conflicts of interest can be managed through:

- organisational structure, internal processes and business model; or
- meaningful disclosure.

We propose to provide guidance on how these strategies can be used to minimise conflicts of interest in the research context.

Managing conflicts of interest

- 71 The issue of conflicts of interest is central to some of the concerns raised about research report providers. Generally, conflicts of interest can be described as a situation in which one's private interest could conflict with the obligations to or interests of others. More specifically, RG 181 states:
- For the purposes of this policy, 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 representatives. This includes actual, apparent and potential conflicts of interest.²⁴
- 72 In the research context, concerns about conflicts of interest underlie many issues. This includes questions about how research report providers set up their business model and derive their revenue, the independence of the research and rating process, and the remuneration of research staff.
- 73 Ensuring that conflicts of interest are properly managed in the research process will reduce the risk that licensees breach the conflicts management obligation in s912A(1)(aa).

²⁴ See RG 181.15.

Organisational structure, internal processes and business model

Proposal

- c1** We propose to update RG 79 to provide guidance that research report providers (including research houses) should:
- (a) ensure robust segregation between ancillary business units (e.g. consulting and funds management services) and the research business;
 - (b) not publish research on their own (or a related entity's) products;
 - (c) have a rigorous research process that ensures they have adequate information about the product and product issuer they are assessing; and
 - (d) publish or otherwise make available *all* research for a reasonable period of time.

Your feedback

- C1Q1 Do you agree with segregation of business units? If not, why not?
- C1Q2 What, if any, further guidance is needed on what would satisfy 'strict and formal segregation' for physical and electronic separation?
- C1Q3 Should research report providers refrain from publishing research about any products that are competitors with products issued by the research report provider (or any related company)? Why or why not?
- C1Q4 Are there any situations where a robust agreement with product issuers is not appropriate or possible (e.g. where a product issuer declines to cooperate with the research report provider)? What procedures are necessary to ensure the reliability of research in such cases?
- C1Q5 Do you agree with our proposal on making research available for a reasonable period of time? If not, please explain why.
- C1Q6 What other internal procedures are necessary for managing potential conflicts of interest?

- c2** We also seek feedback on whether conflicts of interest associated with product issuers *paying* for research:
- (a) can be effectively and robustly managed (in which case, please explain how the conflict can be managed); or
 - (b) should be avoided entirely.

Your feedback

- C2Q1 In what ways can conflicts associated with issues paying for research be robustly and effectively managed?
- C2Q2 Is avoiding conflicts associated with issuers paying for research the most appropriate way to manage them? If not, why not?
- C2Q3 Are there any instances where avoiding such conflicts is not possible? Please give details.

Rationale

- 74 The way in which a research report provider's business is structured may increase or reduce the incidence of conflicts of interest. As well as managing conflicts of interest at the organisational level, there are a number of internal procedures that research report providers can use for this purpose. Strategies include:
- (a) separating business units;
 - (b) not publishing research on the research report provider's (or a related entity's) products;
 - (c) using contractual agreements to improve the research process;
 - (d) publishing all (including adverse) research;
 - (e) rotating research analysts; and
 - (f) selecting a business model that minimises conflicts.

Separating business units

- 75 The main objective of having strict and formal segregation in the organisational structure of research report providers is to improve the objectivity and independence of the research process and its outcome.
- 76 The role of relationship management staff may call for more engagement with product issuers. For example, for a research process and outcome to be genuinely objective and independent, research staff cannot take on the role of relationship management with clients they are providing research on.
- 77 Research staff remuneration should not include measurements that relate to business development objectives.²⁵ For example, a research analyst's remuneration should not be tied to the revenue the research report provider derives from a product issuer that the analyst covers or has regular interaction with.
- 78 The way research report providers remunerate their staff should be structured to minimise the risk of conflicts of interest materialising. This approach is consistent with approach taken in the IOSCO Code. Many of the issues facing credit rating agencies also exist in the research industry generally. In this case, we consider it appropriate to draw analogy from the IOSCO Code.
- 79 Strict and formal physical and electronic separation may help prevent inadvertent exchange of information that may influence the objectivity and independence of a research process. These include both physical and organisational information barriers (sometimes known as 'Chinese walls').

²⁵ See RG 79 at paragraph 17.

- 80 Modern communication systems mean that physical separation of business units is not enough. Research report providers need to ensure that electronic systems are also segregated. For example, they need to ensure that electronic access to data, working files and draft research is restricted and such material is not accessible to staff working in non-research business units.
- 81 Where a research report provider also offers ancillary services that may be in conflict with its research function, the need for strict and formal segregation is more urgent. For example, where a research report provider provides research and funds management services, the risk (or the perception) of conflicts of interest is higher compared to where it only offers research services.
- 82 Information barriers are needed to minimise the risks of material information being used in a way that may not be in the best interests of clients of the firm's main research services. Providers of research reports are already required to have a written policy, including the use of information barriers, about how they manage conflicts of interest.²⁶
- 83 RG 79 also requires providers of research reports to have a person or separate unit responsible for monitoring their compliance with conflict management arrangements.²⁷
- 84 Our proposal is consistent with obligations imposed on research report providers, as AFS licensees, to have adequate arrangements for managing conflicts of interest: s912A)(1)(aa). It will also facilitate research report providers' compliance with the requirement to provide their services efficiently, honestly and fairly: s912A)(1)(a).²⁸

Not publishing research on own products

- 85 We think research report providers should not publish research about their own (or a related entity's) products. For example, if a research report provider is researching its own product, there is a risk that the analyst would engage a lesser degree of objectivity in their enquiries and analysis, particularly if there is a prior knowledge that the research would be published. Some research report providers refrain from publishing research on any direct competitors to their own product, to avoid any appearance of bias.
- 86 Depending on how an organisation is structured, a critical finding on a product issued by a related company of the research report provider might bring detrimental consequences (be it in monetary forms or otherwise) for the research report provider or its employees.

²⁶ See RG 79 at paragraphs 2.9–2.12.

²⁷ See RG 79 at paragraphs 2.7–2.8.

²⁸ See also RG 79 at paragraphs 2.11–2.13.

Using contractual agreements to improve research process

- 87 The quality of research begins with the quality of information from which research report providers will make their assessments. In addition to publicly available information, research report providers may require product issuers to provide them with some other information. The cooperation is arguably even more crucial if the product is not publicly listed or the issuer is not publicly listed.
- 88 Research report providers can improve their access to information about investment products by entering into agreements with product issuers which require the issuer, among other things, to provide all necessary information to enable proper assessments. This includes ensuring that the issuer advises the research report provider of significant changes as and when they arise to ensure currency of the research report.
- 89 Other internal procedures, such as the use of peer review process in assessing the rigour and soundness of a research process, can also be used to help manage conflicts of interest. Due to its relevance to the issue of quality of research, we discuss this topic further in Section D.

Publishing all (including adverse) research

- 90 Research report providers differ in their publication policy. While some choose to publish all research irrespective of the rating, others have historically chosen to publish a piece of research only if certain rating criteria are met. 'Investment grade' products are generally the threshold for published ratings. This could mean any negative or adverse ratings may not be published.
- 91 Refraining from publishing adverse research does not provide a good indication of the broad coverage of the products reviewed by a research report provider. During our preliminary consultation with several research houses we came across cases where a poor rating, although published, was only published for a very short period of time.
- 92 We believe that all research, however adverse or negative, should be published for a minimum reasonable period of time, even when the issuer objects (e.g. because of an adverse finding). As a general rule, we suggest research be made available for at least 30 days. Where research is made available to subscribers only, it is still important that all research (including adverse research) is made available to those subscribers.
- 93 By publishing all ratings, research report providers will reduce the perception of conflicts of interest associated with the research process. In particular, it reduces the risk of issuers 'shopping' around for the best research report and arranging for only that research to be published.

- 94 The IOSCO Code states:
- Except for “private ratings” provided only to the issuer, the [agency] should disclose to the public, on a non-selective basis and free of charge, any rating regarding publicly issued securities, or public issuers themselves, as well as any subsequent decisions to discontinue such a rating, if the rating action is based in whole or in part on material non-public information.²⁹
- 95 We consider that this is a suitable standard to guide research report providers and should apply to those that issue research about financial products that are available to the public. However, we understand that many research report providers do not typically make their research available to all members of the public, but rather paying research subscribers.

Rotating research analysts

- 96 Rotation of research analysts may be useful in reducing the risks of a research analyst becoming too familiar or close to the products and the issuers of the products they are reviewing, which may give rise to conflicts of interests.
- 97 If a research report provider decides not to rotate analysts in its practice, it should state how it manages any possible conflict. For example, a research report provider might be too small for analyst rotation or believe that the benefits of analysts developing specialist knowledge and expertise in particular industries exceed the risks involved. In this case, the research report provider should set out how any conflicts will be managed.

Selecting a business model

- 98 The issue most commonly raised with us by all stakeholders was who should pay for research—that is, whether research should be paid for by product issuers or users of research. It has been argued that a research report provider can enhance its objectivity and independence by placing its relationship with product issuers at arm’s length.
- 99 Based on our review of research houses to date, there appears to be a strong correlation between the business model adopted by a provider and the prevalence of more positive ratings (i.e. recommended or highly recommended). It appears that providers who are primarily remunerated by the product issuer issue positive ratings to a significantly higher percentage of products reviewed than those primarily remunerated by subscribers.³⁰
- 100 All research houses we spoke to, regardless of their business model, agreed that issuers paying for research was an important and serious issue. A

²⁹ See the IOSCO Code at paragraph 3.4.

³⁰ Source: Leng Yeow, ‘Ratings model conflict query’, *Australian Financial Review*, 26 August 2010, p. 43; ‘Analysing the raters’, *Money Management*, 10 March 2011, p. 22; Leng Yeow, ‘Tensions Rising’, *Asset Magazine*, August 2011, p. 17.

number of stakeholders told us they believed this was such a significant and potent conflict of interest that it could *only* be managed by avoiding the conflict entirely by not accepting payment for research by a product issuer. We are seeking feedback on whether this is the most appropriate way in which such conflict can be properly managed.

Disclosure of conflict management policy

Proposal

- c3** We propose to update RG 79 to provide guidance that research report providers (including research houses) should disclose in plain English a summary of how they manage conflicts.

Your feedback

- C3Q1 Do you agree with this proposal? If not, why not?
- C3Q2 What other types of disclosure are necessary for managing potential conflicts of interest?

Rationale

- 101 Some conflicts of interest should be avoided entirely. For example, we are proposing guidance that a research report provider should not publish research about its own (or a related entity's) products: see proposal C1. Other conflicts may be able to be managed by using adequate controls (such as organisational structure) and appropriate disclosure.³¹ All AFS licensees must have a written conflicts management policy.³²
- 102 All material conflicts must be disclosed to users of research services. RG 79 requires research report providers to generally disclose to all clients:
- (a) any material interests they have in financial products that are the subject of the report;
 - (b) any benefits they are likely to receive from the report;
 - (c) any relationship they may have with the product issuer;
 - (d) any help they receive from the product issuer;
 - (e) the date the research report was written and the person taking responsibility for it; and
 - (f) the reasons behind the opinions and recommendations in the research report.³³

³¹ See RG 79 at paragraph 2.1 and Section 3.

³² See RG 181.44 and RG 79 at paragraph 2.6.

³³ See RG 79 at paragraph 3.4.

- 103 Disclosure of conflicts of interest must be made in plain, easy to understand English. The disclosure must be drafted clearly and designed in a way that is likely to attract the reader's attention.
- 104 A reader of the disclosure should be able to form a clear understanding of the risks involved in using the research report provider's service or product, and assess whether it is a risk the user is willing to take.
- 105 Improved disclosure will also help align the expectations of users of research to those of research report providers themselves. For example, disclosure can be used to clarify for users the purpose and nature of a particular piece of research, and how it should be used.

D Quality of research

Key points

Research is relied upon by both retail clients and wholesale clients (e.g. licensees and institutional investors). As such, quality of research is a paramount issue.

Quality of research depends on appropriate resourcing, research structure and processes, and good disclosure.

We propose to update our guidance in RG 79 to highlight these issues.

The role of research

- 106 A primary role of a research report provider is to produce research. Research is relied upon by both retail clients and wholesale clients (e.g. licensees and institutional investors). As such, quality of research is a paramount issue.
- 107 Research is promoted as an expert service to assist intermediaries and clients in making decisions about investment products. It is important that research does (and is seen to) demonstrate such expertise.
- 108 Ensuring that research is of a reliable and robust quality will reduce the risk that licensees breach:
- (a) their general AFS licence obligations (s912A(1)); and
 - (b) the prohibition on misleading or deceptive conduct (see paragraph 18 of this paper).

Resources and structure

Proposal

- D1 We propose to update RG 79 to remind research report providers (including research houses) that they should:
- (a) ensure their (human and other) resources are adequate to allow them to effectively analyse the financial products covered;
 - (b) adequately train and supervise their analytical staff, including implementing a proper sign-off process.

Your feedback

D1Q1 Do you agree with this proposal? If not, why not?

D1Q2 What (if any) other guidance should we give to improve the quality of research?

D1Q3 What (if any) additional guidance should we give on staff training and experience (in addition to our existing guidance on these topics)?

Rationale

109 As financial products grow in their complexity, concerns have been raised about the sufficiency of skills and experience of research analysts, particularly junior analysts.

110 As discussed in Section A, a number of users of research house services expressed concern or disappointment that some investment products that have collapsed in recent years were the subject of positive research up to or near the point of their collapse.

111 Because research that can be relied on is the primary output of research report providers, the quality of research is and should be of paramount concern to research report providers and their users.

Adequacy of resources

112 To analyse financial products well, research report providers need to allocate adequate resources to each research task. This includes allocating enough staff with suitable qualifications for the research task (see paragraphs 116–118) and setting appropriate timelines for the completion of tasks.

113 AFS licensees have general obligations under s912A(1) of the Corporations Act to:

- (a) do all things necessary to ensure that the financial services covered by their licence are provided efficiently, honestly and fairly;
- (b) comply with the conditions on their licence;
- (c) take reasonable steps to ensure that their representatives comply with the financial services laws;
- (d) have adequate financial, technological and human resources to provide the financial services covered by their licence and to carry out supervisory arrangements;
- (e) maintain the competence to provide the financial services covered by their licence; and
- (f) ensure that their representatives are adequately trained and competent to provide those financial services.³⁴

³⁴ See Regulatory Guide 104 *Licensing: Meeting the general obligations* (RG 104) and Regulatory Guide 105 *Licensing: Organisational competence* (RG 105) at www.asic.gov.au/rg.

- 114 Human resources are a key input to research report providers' process and output. Research report providers should allocate sufficient resources to support the effective performance of their research staff and price their research services accordingly.
- 115 Research report providers cover a substantial number of financial products of varying complexity. Careful consideration needs to be given to balancing the commercial imperative to provide broad product coverage with the need to maintain the quality of research output and the allocation of adequate staff time to each research report.

Staff qualifications

- 116 Research report providers should ensure that they allocate research tasks to staff with suitable qualifications and experience for the particular task. For example, some research houses have advised us that their analysts hold bachelor degrees and postgraduate qualifications and experience from many sectors including the accounting, finance and legal sectors.
- 117 In light of continuing product innovation and developments in financial markets, research report providers should continue to train and supervise the work of their research analysts, particularly junior staff. This can be done by setting up mentoring and supervisory arrangements and ongoing training and development initiatives.
- 118 Some research houses have argued that the requirements set out in Regulatory Guide 146 *Licensing: Training of financial product advisers* (RG146) are not adequate to meet the level of competency required for analysts to perform credible research. However, RG 146 is a minimum general standard for advisers and we expect licensees to augment it where necessary.

Research sign-off process

- 119 RG 79 already requires a sign-off process be incorporated into a research report provider's work process. It is important that all research be subject to proper evaluation (e.g. via a peer review process) and a proper approval process involving a committee of senior research staff.³⁵
- 120 Research reports should be based on 'reasonable grounds'. It is important that the content of each research report reflects the view of the research report provider, and it may be misleading for a research report provider to publish a report containing views it does not agree with.³⁶ A proper sign-off process would reduce the incidence of this risk.

³⁵ See RG 79 at paragraph 2.13.

³⁶ See RG 79 at paragraphs 2.26–2.27.

Disclosure of services and products

Proposal

- D2 We propose to update RG 79 to provide guidance that research report providers (including research houses) should make the following information publicly available and direct readers to this information in each research report:
- (a) the nature of research service they offer and their areas of expertise;
 - (b) a list of all financial products currently covered, including those that are considered or rated below investment grade;
 - (c) their spread of rating each financial year; and
 - (d) a comparison of the performance of products given each level of rating or recommendation against relevant benchmarks.

Your feedback

- D2Q1 Do you agree with this proposal? If not, why not?
- D2Q2 What other disclosure practices would be helpful in improving the quality of research reports?

Rationale

- 121 Disclosure practices can help improve the quality of research and users' understanding and use of it.
- 122 Research report providers should be clear about the nature and scope of their research service. Research is taken to be an expert service to assist intermediaries and clients in making decisions about investment products. As such, it is important that research does (and is seen to) demonstrate such expertise. For example, research houses should be clear about the extent to which they are promoting themselves as experts and the basis for this (e.g. the level of expertise, qualifications and experience they and their staff possess).³⁷
- 123 RG 79 already requires research report providers to consider making available to their clients, whether or not in research reports:
- (a) the status of current research reports;
 - (b) the financial products they research on from time to time;
 - (c) the proportion of each type of recommendation they make that has been given to product issuers that are corporate clients (compared to other product issuers); and
 - (d) information about the relative performance of their research recommendations in the market.³⁸

³⁷ This information about the nature of the research services could be included in the research report provider's FSG (if any) or on its website.

³⁸ See RG 79 at paragraph 3.15 and paragraph 3.8 of the IOSCO Code.

- 124 Better disclosure of the above will help reduce any expectation gaps that a user of research reports may have from reading the report and the actual offering of the research report provider. Based on recent experience, we propose to update RG 79 to make it clear that this important information should be provided by *all* research report providers in the future.
- 125 We understand that many research report providers filter the financial products in the market in order to form smaller portfolios of products that they provide more detailed research about. The selection process may often be a qualitative one, and users of the research should be made aware of this.
- 126 Research report providers should publish on their website a list of all financial products they currently cover. This list should include all products that are below the research report provider's 'investment grade' (or similar) rating and not given a more specific rating. This information will give users of a research report provider a more holistic view of the available products, and align its risk profile if necessary.
- 127 Research report providers should publish the spread of their ratings (i.e. how many products or what percentage received each type of rating during the relevant period). This will give users of their reports another tool to gauge the quality and reliability of a particular research report provider.³⁹
- 128 Importantly, research report providers should publish sufficient information to allow users to form a view about the research report provider's own performance and therefore the quality of their research. A user of research reports will benefit from having access to a comparison between the performances of products at each rating level against a relevant benchmark.⁴⁰
- 129 Research report providers can assess their own performance by back-testing their past ratings to examine correlations between the ratings and the actual performance of the products over for at least one year after the research is published. The assessment should be done regularly and the information be made available to the users of their reports by the same method that their research is generally distributed.
- 130 Publishing information about their own performance will improve research report providers' accountability to users of their service and will encourage competition between research report providers on matters of quality and reliability.

³⁹ We understand that some research report providers provide higher ratings or more positive recommendations more frequently than others. This is an important piece of information for users of these services.

⁴⁰ For example, they could publish for the previous three years the average performance of all equity funds given their highest rating against the ASX 200 benchmark, the average performance of all equity funds given the next highest rating against the benchmark and so on. We expect that for robust research houses, higher rated products would, over the longer term, outperform lower rated products.

- 131 The above proposals aim to improve the user's understanding of the product or service they are getting, and the risks involved in using them. Research report providers must ensure that the reports are prepared using a reasonable basis and sound methodology.
- 132 Publishing information about research report providers' own performance will show to users of research the extent to which research report providers actually deliver on the service quality promised or promoted in their reports.
- 133 The combination of the above factors will serve as incentives for research report providers to continuously improve the quality of their research. This will benefit not only the direct users of their research, but also improve the overall quality of the research sector.

E Methodology and transparency

Key points

Research report providers should maintain and follow a robust methodology in their research.

It is also important that the research methodology be transparent to users. This helps bridge the expectation gap between users and research report providers and assists the public in assessing the levels of quality of research.

We propose to update our guidance in RG 79 to cover these topics.

Methodology

Proposal

E1 We propose to update RG 79 to give guidance that research report providers (including research houses) should follow and publish (in summary form) a robust methodology for assessing or rating products.

Your feedback

E1Q1 Are there any practical problems with adopting and publishing robust research methodology?

Rationale

134 There are differences in methodology used by research report providers. However, most use a combination of qualitative and quantitative research techniques and follow a research sequence. Qualitative research generally uses the skill sets of analysts conducting fundamental analysis to form an opinion about the investment merits of the product. Quantitative research is generally based on past performance of the funds, which includes factors such as historical returns, volatility, performance ratios, age of fund and size of fund.

135 Allowing for differences in how products are reviewed and ranked, there appears to be similarity in the building blocks of research methodology. The methodology commonly consists of some or all of the following:

- (a) initial desktop research and having product issuers complete questionnaires developed by the research report provider;
- (b) meeting with key staff at the product issuer;
- (c) assessment of research;

- (d) review either by peers, senior analysts or through a committee;
- (e) initial product view and rating; and
- (f) final outcomes of the research.

136 While the elements used in the methodology vary with different emphasis and controls, the combination of the sum of these elements is essentially what distinguishes one research report provider from another.

137 From our review, we observed that the main difference lies in the rating process. For example, research houses currently use different symbols and labels to classify and rate products, ranging from stars to letters. The decision on what labels or symbols to use is merely a business decision and simply helps to differentiate between product rating levels.

138 Quite often, although products are rated using the same ranking scheme, there are inherent differences in the products. Similarly, when rating fund managers, there is no single or agreed method for classification of the type of fund manager within the ‘investment universe’.

139 This can lead to confusion among the users about:

- (a) whether a product rating should be seen as an absolute conviction about the quality of a product, or a relative one against its peer group; and
- (b) whether the user can compare different research report provider’s classification of products.

140 The lack of consistency in definitions of ranking classification has also affected the ability of users to make an accurate judgement of the quality of research.

141 More information on the product performance (e.g. spread of ratings, performance of ratings against the benchmark) needs to be disclosed to assess the quality of the research: see proposal D2.

142 From our review, the regularity and robustness of the systematic reviews differed among research houses; however, they were conducted at least once every two years.

143 Our intention is not to prescribe the way research report providers approach investment research. We do not expect all research report providers to adhere to the same methodology. However, we expect transparency in the methodology adopted and how it is applied.⁴¹

144 We expect research report providers to publish (in summary form) and follow a robust methodology. We expect that this will include an explanation of their rating system, including the definitions, criteria and assumptions used.

⁴¹ See paragraph 3.5 of the IOSCO Code.

Clarity and transparency

Proposal

- E2** We propose to update RG 79 to give guidance that research report providers (including research houses) should:
- (a) ensure each piece of research expresses an unambiguous view on each product researched, and uses clear, transparent and easily understood language;
 - (b) where research ratings or recommendations are based on past performance, ensure the report carries a past performance warning;
 - (c) for each research report, either:
 - (i) include a 'use by date' and a warning that the research should not be relied upon after this time; or
 - (ii) monitor and update the report periodically and also in response to significant developments affecting a particular product or issuer; and
 - (d) ensure that each research report clearly and prominently states who commissioned it and who paid for it.

Your feedback

E2Q1 Do you agree with our proposals? If not, please explain why.

Rationale

- 145 RG 79 states that to improve the effectiveness of conflicts of interest disclosures and appropriate use of research reports, research report providers should take reasonable steps to ensure that their recommendations are clear, unambiguous and transparent.
- 146 We believe that the market will benefit if research report providers increase the transparency and clarity of their investment research. This will help:
- (a) boost levels of confidence among users of research;
 - (b) build a level of trust between the research houses and the users;
 - (c) provide a level of accountability to the users; and
 - (d) be a measure of quality of research.
- 147 We already expect that research report providers will ensure that:
- (a) the reasons behind their opinions and recommendations are clear in their research report; and
 - (b) their recommendations are clear, unambiguous and transparent.⁴²

⁴² See RG 79 at paragraphs 3.13 and 3.17.

- 148 Based on recent experience, we propose to refine RG 79 to make it clear that this important information should be provided by *all* research report providers in the future. This will help clients form a view about the research report and whether to rely on it.
- 149 Where research ratings are based on past performance, the report should carry the standard past performance warning (i.e. past performance is not an indication of future performance). It is important that clients do not place undue reliance on past performance information, directly or indirectly via qualitative research. For more information on the use of past performance information, see Regulatory Guide 53 *The use of past performance in promotional material* (RG 53).
- 150 Users of research have an expectation that the research that they are acquiring from a research house is kept up to date. Any research past its ‘use by date’ should be updated or withdrawn. Ratings that are not monitored or updated can be misleading unless research report providers prominently state that a rating is valid only for a specified limited time and will not be updated.
- 151 Research reports are prepared based on information available at the time of preparation. It is important that it is clear on the face of the research over what period a reader can rely on it. For example, the report could state a ‘use by’ date, or state whether or not the report is being monitored and kept up to date.
- 152 Research report providers should provide a clear indication of the type and classification of products and whether they are being rated relative to a peer group. For example, most research houses classify managed funds into specific peer groups to simplify the comparison of funds. These groups are defined by selecting funds which are similar in terms of asset class, asset size, investment objectives, risk, and investment style. Research reports should make it clear whether any opinions, recommendations or ratings are relative to a peer group or to the market overall.⁴³
- 153 We expect research report providers to state clearly who commissioned the report it and who paid for it. For example, where a report was commissioned and paid for by the product issuer, the report should clearly and prominently disclose this, preferably on the front or covering page of the report.

⁴³ For example, a report should make it clear whether a particular product is ‘highly recommended’ relative to the market as a whole, or only relative to a particular peer group (e.g. equity funds).

F Users of research

Key points

Users of research are generally financial advisory firms and industry associations. There appears to be an ‘expectation gap’ for these users when it comes to the role of research report providers.

We propose to give guidance that licensees providing financial product advice should conduct careful due diligence on any service providers (including research report providers) that they intend to make use of as part of their advisory practice.

Financial advisory firms

- 154 Our discussions with financial advisory firms and their industry associations confirmed that research is used in the preparation of financial advice given to retail clients. In particular, financial advisory firms use research to identify products that may be suitable for inclusion on approved product lists. Research is also used in the preparation of advice and in Statements of Advice (SOAs).
- 155 There were different degrees of reliance on research. Most advisers we spoke with insisted that research was used only as part of a rigorous assessment of the product by the planning firm.
- 156 Research report providers perform a ‘gatekeeper’ function in the market. As such, the quality of research and the conduct of research houses have a material impact on the integrity of the financial planning industry, and the quality of the advice they produce. Research is therefore an important consideration for ASIC in light of our priority to assist retail investors.
- 157 We also identified an apparent ‘expectations gap’ between financial advisory firms and research houses about the nature and role of research in our review. In particular, advisers expressed a view that research houses should cover less products and undertake more in-depth research. By contrast, some research houses saw their role as providing product coverage for a range of products in each market segment and identifying the ‘best of breed’ products.
- 158 Financial advisers feel there are a number of issues surrounding the output they receive from research houses, mainly:
- (a) currency of research—some advisers felt that there are no adjustments to take into account the value of markets today based on past forecast. In addition, there is no lifespan of the research and outdated research is not taken off the website;

- (b) the quality of research is often criticised as advisers feel that junior analysts are put on research projects and are often unsupervised;
- (c) some advisers have indicated that products rated below ‘investment grade’ products were still recommended; and
- (d) research houses have in the past not updated product recommendations to reflect market changes. This has resulted in misleading information in the investment space.

Due diligence

Proposal

- F1 We propose to give guidance that licensees providing financial product advice should conduct careful due diligence on any service providers (including research report providers) that they intend to make use of as part of their advisory practice.

Your feedback

- F1Q1 Are there any practical difficulties you envisage that would follow our proposed guidance?
- F1Q2 Should ASIC’s guidance to users of research be contained in RG 79 or in one of our regulatory guides for financial advisers?

Rationale

- 159 Financial advisers are required to have a reasonable basis for any personal advice they give: s945A. Financial advisers cannot abrogate their ‘know your product’ responsibilities to research report providers. Financial advisers are expected to make their own enquiries and research into the products they give advice on (e.g. those on their approved product list). While advisers may rely to some extent on various service providers such as research houses, the adviser remains responsible to the client for advice they give.
- 160 It is important that licensees undertake appropriate *due diligence* before selecting any service provider on which they will rely in their preparation of financial product advice, as it may affect their ability to provide advice in an appropriate and compliant manner. For example, we expect advisers to take into account the business model and conflicts of interests associated with each potential service provider, as well as its performance over time. We also expect them to take into account the performance information we propose that research report providers make available: see proposal D2.
- 161 When using research, licensees should ensure that they have read and understood the research report before placing reliance on it. We expect licensees to critically evaluate research reports, including considering the assumptions that the report provider has made.

- 162 Financial advisers should be aware of the roles and limitations of third party service providers. We expect that these licensees will carefully consider, and document their reasons for, the research report providers they use. This includes but is not limited to how they design their approved product lists.
- 163 We are considering where best to publish our proposed guidance on due diligence for users of research services. It may be that it is best placed in one of our advice-related regulatory guides, such as Regulatory Guide 175 *Licensing: Financial product advisers—conduct and disclosure* (RG 175), rather than in RG 79.

G Regulatory and financial impact

164 In developing the proposals in this paper, we have carefully considered their regulatory and financial impact. On the information currently available to us we think they will strike an appropriate balance between:

- (a) improving the quality and transparency of investment research; and
- (b) not unnecessarily raising compliance costs.

165 Before settling on a final policy, we will comply with the Australian Government's regulatory impact analysis (RIA) requirements by:

- (a) considering all feasible options, including examining the likely impacts of the range of alternative options which could meet our policy objectives;
- (b) if regulatory options are under consideration, notifying the Office of Best Practice Regulation (OBPR); and
- (c) if our proposed option has more than minor or machinery impact on business or the not-for-profit sector, preparing a Regulation Impact Statement (RIS).

166 All RISs are submitted to the OBPR for approval before we make any final decision. Without an approved RIS, ASIC is unable to give relief or make any other form of regulation, including issuing a regulatory guide that contains regulation.

167 To ensure that we are in a position to properly complete any required RIS, we ask you to provide us with as much information as you can about our proposals or any alternative approaches, including:

- (a) the likely compliance costs;
- (b) the likely effect on competition; and
- (c) other impacts, costs and benefits.

See 'The consultation process' p. 4.

Appendix: Draft compliance report

168 This appendix is a draft of the requirements that could apply as part of a compliance report.

Completing a compliance report

As an Australian financial services (AFS) licensee, you must comply with the conditions of your AFS licence: see s912A(1)(b) of the *Corporations Act 2001* (Corporations Act).

Under condition [X] of your AFS licence, every two years you must give to ASIC a report compliance report that includes the information, statements, explanations or other matters specified by ASIC in writing relating to your compliance with certain licence conditions for the following periods:

- for each financial year, at the same time the licensee is required to lodge a balance sheet under Pt 7.8 of the Corporations Act; and
- for any period of time ASIC requests, by the date we reasonably request in writing the report to be lodged.

This appendix specifies the information, statements, explanations or other matters that must be included in each report made to ASIC outlining compliance with the law, licence conditions and Regulatory Guide 79 *Managing conflicts of interest: An ASIC guide for research report providers* (RG 79).

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We expect you to keep records to support any answer you provide as part of your compliance report. You may be required to produce such records on demand.

General instructions

Your compliance report must address topics drawn from the law, licence conditions and RG 79, which are listed below, by describing any implemented or planned measures that have the aim of ensuring compliance with the law, licence conditions and RG 79 under that topic.

Your description should:

- for each topic, be no more than four pages in length, except where exceeding this limitation is reasonably justified by the complexity of the description or topic;

- for any planned measures, explain when and how the measures will be implemented;
- include an explanation of how the relevant measure will ensure compliance with the law, licence conditions and RG 79;
- describe the resources, including the internal compliance resources, allocated to the measures;
- detail any testing and reviews of the measures that have been or will be conducted and the results of those tests and reviews;
- where a measure necessarily involves the disclosure of information, include a hyperlink that ASIC can access to such disclosed information;
- identify any failings of the measures against their aims and explain how those failings have been or will be addressed;
- identify by name any existing or planned policies or similar documents;
- only address any measure that has been implemented or planned, or any failing that has occurred, since your previous compliance report; and
- address the specific instructions, if any, given for a topic.

Compliance topics

Your compliance report must address the following topics:

- research methodology and processes;
- internal conflicts management procedures;
- research publication and distribution;
- conflicts disclosure to users;
- monitoring and updating research;
- staff training and supervision;
- compliance and risk management; and
- procedures for managing research quality and transparency.

Lodging your report

You can lodge your compliance report:

- by email;
- by mail; or
- in person at any ASIC office (www.asic.gov.au/asicoffices).

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 out a financial services business to provide financial services Note: This is a definition contained in s761A of the Corporations Act.
AFS licensee	A person who holds an Australian financial services licence under s913B of the Corporations Act Note: This is a definition contained in s761A of the Corporations Act.
ASIC	Australian Securities and Investments Commission
ASIC Act	<i>Australian Securities and Investments Commission Act 2001</i>
CLERP 9 Act	<i>Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004</i>
conflicts management obligation	The obligation in s912A(1)(aa) of the Corporations Act
conflicts of interest	As defined in RG 181.15: ...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 representatives. This includes actual, apparent and potential conflicts of interest.
Corporations Act	<i>Corporations Act 2001</i> , including regulations made for the purposes of that Act
Corporations Regulations	Corporations Regulations 2001
CP 160	<i>Credit rating agencies: IOSCO Code Annual Compliance Report</i> , an ASIC consultation paper issued in June 2011
financial product	A facility through which, or through the acquisition of which, a person does one or more of the following: (a) makes a financial investment (see s763B); (b) manages financial risk (see s763C); and/or (c) makes non-cash payments (see s763D) Note: This is a definition in s763A.
financial product advice	A recommendation, a statement of opinion or an interpretation of information, or a report of any of those things, that: (a) is intended to influence a person(s) in making a decision about a particular financial product or class of financial products, or an interest in a particular financial product or class of financial products; or

Term	Meaning in this document
	(b) could reasonably be regarded as being intended to have such an influence; but does not include anything in an exempt document Note: This is a definition in s766B.
Financial Services Guide (FSG)	A document that must be given to a retail client in relation to the provision of a financial service in accordance with Div 2 of Pt 7.7 of the Corporations Act Note: See s761A of the Corporations Act for the exact definition.
general advice	Financial product advice that is not personal advice Note: This is a definition contained in s766B(4) of the Corporations Act.
IOSCO	International Organization of Securities Commission
IOSCO Code	<i>Code of Conduct Fundamentals for Credit Rating Agencies</i> , revised version issued by IOSCO in 2008
personal advice	Financial product advice given or directed to a person (including by electronic means) in circumstances where: (a) the provider of the advice has considered one or more of the client's objectives, financial situation and needs; or (b) a reasonable person might expect the provider of the advice to have considered one or more of those matters Note: This is a definition contained in s766B(3) of the Corporations Act.
PJC	Parliamentary Joint Committee on Corporations and Financial Services
Pt 7.7 (for example)	A part of the Corporations Act (in this example numbered 7.7)
REP 143	<i>Review of credit rating agencies and research houses</i> , a joint report issued by Treasury and ASIC in November 2008
research report	As defined in paragraphs 1.1–1.2 of RG 79
research report provider	As defined in paragraphs 1.3–1.4 of RG 79
research staff	As defined in paragraph 1.5 of RG 79
retail client	A client as defined in s761G of the Corporations Act and Ch 7, Pt 7.1, Div 2 of the Corporations Regulations
RG 146 (for example)	An ASIC regulatory guide (in this example numbered 146)
s782 (for example)	A section of the Corporations Act (in this example numbered 782)
Statement of Advice (SOA)	A document that must be given to a retail client for the provision of personal advice under Subdivs C and D of Div 3 of Pt 7.7 of the Corporations Act Note: See s761A for the exact definition.