Transcript of an interview by Alan Kohler with Jeremy Cooper, Deputy Chairman, Australian Securities and Investments Commission.

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Conflict Cop

By Alan Kohler

Eureka Report editor James Kirby writes:

ASIC is to issue strict new guidelines for stockbrokers aimed at improving disclosure of possible conflicts of interest when they're assessing the performance of companies for private clients.

Under new guidelines revealed in this interview with *Eureka Report* publisher Alan Kohler, ASIC will demand that brokers disclose the dollar amount they receive in fees from companies they may be recommending to private investors.

Any broker recommending shares in a company while also picking up fees for work will have to reveal the amount of money received from the company in a research note, according to the deputy chairman of ASIC, Jeremy Cooper.

A review of disclosure guidelines has become pressing in recent months as big companies – such as Westfield and Telstra – increasingly hire many different broking companies on a single deal.

Under present regulations stockbrokers do not have to explicitly reveal the dollar income they receive from companies that they also assess for their clients.

Cooper said the regulator is also planning to enforce the new disclosure regime on stockbrokers who may be facing a conflict of interest in takeover situations. He suggested that if a stockbroker issues research on a company while simultaneously acting for the company in a takeover, the dollar amount of fees collected by the broker for takeover advice must be revealed on research documents.

"We want to give the retail consumer some idea of where the adviser sits in all this," says Cooper.

The regulator has also stepped up its attempts to improve standards among financial planners with a range of new initiatives to improve the introduction of Superannuation choice. Cooper also signalled the regulator is planning a crackdown on the sale of life insurance to low income consumers who do not need it.

Now, read on ...

Alan Kohler: I want to talk about ASIC's strategy in dealing with conflicts of interest among both stockbrokers and financial planners. First, can you give us the background of what's happening with stockbrokers?

Jeremy Cooper: Well, I guess it goes back to 2003 with the huge settlement that Eliot Spitzer, the New York Attorney-General, had basically with the whole of Wall Street. There were so many examples of wrongdoing, and conflict of interest was a big thing. In 2003, there was a large settlement done and the sum of $US1.4 billion was paid by those firms, which is a huge amount. The outcome was quite a prescriptive settlement and in fact they divided up that money and applied it to various specific measures. So Wall Street had quite a prescriptive regime imposed on them on conflicts of interest; such things as requiring Wall Street firms to spend money on getting independent research in on a five-year basis; and a whole lot of quite prescriptive rules about what brokers could and couldn't do in research.

AK: What did the Australian Government do in response to that?

JC: ASIC itself conducted surveillance in 2003 and this was consistent with work we've done in a range of areas. We found that although some of the issues were present, it was nowhere near as bad as on Wall Street, and we've had that example with insurance brokers and other participants here. So, with that in mind, when CLERP 9 was being worked on, the Government stopped short of taking the prescriptive approach, which is consistent with the Government's response to Sarbanes-Oxley across the board: they didn't have a set of black and white rules; instead, they were principles-based. There was some pressure from some quarters for the rules to be more prescriptive on conflicts, but they basically came out with a very simple system requiring financial services licensees to have an appropriate system for managing conflicts and that came in on 1 January this year.

Our job is to flesh out what that actually means across the various parts of the financial services landscape, and we issued some policy guidance towards the end of last year, which was fairly general. We did do a guide for research analysts but it's become obvious to us that we need to go down to a more — I guess I've been using the expression — "tabloid" level and articulate specific conflict situations across the industry and how they might be dealt with. There are really three ways that conflicts are dealt with: you disclose them, you manage them or you actually avoid them. And the big question out there is which are the ones that you absolutely have to avoid. This is complicated because there was pressure for the Government to specify which ones are so hard and so conflicted that they shouldn't happen. The Government deliberately took a "fuzzy law" approach, so it's up to us to try and work with industry to identify which ones they are.

AK: Maybe we can illustrate the issues by talking about Telstra. The Government has employed virtually every investment bank in the country to help sell T3. Is the conflict between selling T3 and providing research about Telstra one that absolutely has to be avoided, or managed?

JC: It's a deep conflict. Clearly, a financial institution, an investment bank that takes up an underwriting mandate, is acting for the seller — in this case the Government. They're earning large fees and their interests are very firmly directed in that direction so that when the very same organisation conducts research, or I guess even more importantly, gives personal advice to retail clients to effectively buy those securities, that's a very serious conflict. It's not an impossible conflict or one that has to be avoided, but it is one where there has to be meaningful disclosure to the retail client or to the consumers of the research, and I think we're going to be looking closely at a couple of things there. We're going to be looking to see in the lead-up to T3 that issuers of research have a reasonable basis for those reports, so that we're not seeing people conflicted by the desire to win a mandate issuing overly bullish research. We're certainly going to be looking at that.

AK: But how are you going to look at that? Are you going to check the research against your own view of Telstra's share price, or what?

JC: No, that's a bit difficult. I mean we're not investment advisers, but there are ways of calling for documentation and to see the build-up of the valuation and to have a look at the paperwork that surrounds research. We're not saying that we're necessarily expert in valuing Telstra, but it's important that the industry just be aware that that's our view; that research has to have a reasonable basis.

Getting back to the retail side, I think one of the problems has been that the sort of disclosure of conflicts has been a little bit foggy and a little bit meaningless. Let me give you an example, again going back to Wall Street. Under the prescriptive system that was imposed after the 2003 settlement, a Wall Street firm, in the T3 example we have been talking about, would really be required to be much more specific and say: "Yes, we do have a conflict here and you should consider that conflict in considering whether you want to follow our advice.” So it’s really sort of 'stamp on your forehead' type of disclosure in the US.

AK: You mean the retail dealer would have to say that on the phone to the client?

JC: That’s right. Or in a circular, for example. So I think the problem here has been that the conflict generally hasn’t been quite as clearly disclosed as you might have liked. The disclosure tends to be sort of pro forma, you get to the back of the research report and there’s a great big long explanation that the firm might have relationships or might have interests in these securities. We’re going to be looking for a clearer disclosure of what the conflict is, and for example what fees are being earned and just to give the retail consumer some understanding of where the adviser sits in all this. If I’m being advised to buy shares by a stockbroker who also happens to be engaged by the company in another capacity, like advising on a takeover defence, I might wonder why I’m also paying that broker a commission for buying the shares. So, if you get a phone call from a broker and the broker says; "Look, I think you should buy shares in XYZ; here’s our research and so on, but you need to be aware that we’re earning some pretty significant amounts of money. from XYZ. Our role is to help them with this takeover and therefore (following the US model) you might want to consider whether you should act on that advice because of our conflict". A bell might ring in that retail client’s head as to, “Well, should I be paying you a commission in this situation?” The client might say; "I’m perfectly happy to pay you a commission when you and I sit down and talk about what securities I should buy or sell, but when you’re in fact selling these securities because you have some other role, it opens up the possibility of a dialogue".

AK: Well what do you think? Should they be paying a commission to the broker in that situation?

JC: Well it’s really up to them, but it’s the engagement of the debate. We don’t seek to regulate what a client pays a broker, but it’s communicating the issues so that debate might be possible.

AK: Would you pay a commission in that situation?

JC: I have to be careful. I don’t deal in shares in my current role, but it's up to the client to decide if it's important to them. Maybe it's not.

AK: So let’s be clear about what you’re thinking about requiring. Are you going to require that in research published about a company, using T3 as an example, that the broker has a mandate to underwrite and sell, that not only the fact that the conflict of interest has to be revealed, but also the amount of the fees?

JC: Yes.

AK: The actual quantum of the fees?

JC: Yes. Often fees are complex to calculate and people will say, "We don’t know exactly how much it is". What's required is some sort of meaningful disclosure... It’s not a matter of every dollar and cent, but it’s meaningful, real, disclosure even if it’s a range. That’s what we’re looking for.

AK: And are you looking for that not only in printed research, but also in communication on the phone?

JC: The phone is more difficult and generally there is printed research on this kind of thing. I mean, we don’t want necessarily to increase the amount of disclosure that’s made over the phone down to having to mention the last dollars and cents and so on, but I think also another really important thing is where a mandate involves actually contracting to produce research we want that disclosed as well. So, if you’re going back to the T3 example, if you’re one of the mandated advisers and part of the package is that you agree that you will produce research, I think it’s important that retail clients know about that too.

AK: A lot of people get verbal research in the sense that they have phone calls with their broker who advises them — tells them what’s in the research. They haven’t read the research paper and they rely on being told. Is there any reason why you distinguish between printed and verbal?

JC: You have to be realistic about it. I mean, as a consumer myself, we all know that it’s very tedious to have to listen to lengthy disclosures made over the phone so I guess it’s a matter of telescoping down to the real issue, and the real issue is, “Look, in giving you this advice I have another role and you should be aware of it”, rather than sort of having to go through the whole thing. So I guess the question remains: are we saying that people have to quote the fee that they’re being paid over the phone? Even if they said, "We have an underwriting role here and therefore we have a conflict, and obviously we're being paid substantial remuneration". To me, that communicates the message, but we might need to look at the law to see whether it allows that flexibility.

AK: And will you be checking tapes [of brokers’ conversations] to see that that’s what is done?

JC: As a matter of principle I’m not a big fan of broadcasting exactly how we’re going to check on compliance with these things, but certainly we’ll be … I’m not saying we’re launching any particular sort of surveillance. We’re using T3 in this discussion as a sort of an example of a large transaction that’s coming up. But certainly we’ll be looking at how published research shapes up and in particular just whether there’s really a clear, concise and effective disclosure. I think at the moment some of the disclosures are falling a bit short. They’re too pro forma and they go on and on, and in all the sea of words you don’t actually get the message.

AK: Would it be fair to say that you will put a special effort into looking at T3?

JC: I think it’s maybe things like this, getting the messages out beforehand rather than having to spend huge amounts of taxpayers’ money in seeing that there is compliance after the fact. It’s often our preferred approach to make sure people are on message going into a transaction like that and then everyone’s a winner.

AK: What about mergers and acquisitions?

JC: In the context of those things where you might have a mandate to act for a target in a takeover, producing research in that situation can also give rise to a conflict. Particularly where a part of the mandate might be to produce research — and I guess realistically and commercially the target would be looking for the most bullish and favourable research it could get. So that puts a financial institution in a position of conflict

AK: So again in the merger and acquisition situation, would you be looking for the amount of any fee to be disclosed in the research as well?

JC: Yes. Because that clearly informs the consumer of that research and, frankly, it doesn't matter whether the consumer is a wholesale client or a retail client. The same information is relevant and so the fact of a mandate and the sort of basic level of the remuneration is relevant. Otherwise there's an opacity and a haziness about the disclosure.

AK: Leaving aside the question of the money and disclosure, what about situations where analysts are being pressured by the other side of the Chinese wall, the investment banking department and the client company, all the pressure is going the other way? What's ASIC's role in dealing with that kind of bullying or pressure?

JC: I suppose you've articulated a couple of different sources of that. We're in an era where reputation and brand and image are incredibly important, so a large corporation is always going to be seeking to have itself portrayed in the best light and realistically that's going to lead to pressure being put on people who write opinions about it. And that will be a daily issue. This is going to be no surprise to anyone in that business, so managing that pressure is going to be one of the things they do every day. However, where pressure is coming from the corporate finance or investment bank team into the research unit, again, that would be something that would have to be very carefully managed by the management of the organisation. That's where you run into the potential for conflict — for the Chinese walls to be breached or ultimately for conflicted research to be produced, and that threatens the viability of the organisation's financial services licence.

AK: Do you believe ASIC has a role in protecting research analysts from pressure?

JC: Not so much that, but ensuring that the organisation has the systems in place to provide financial services in a fair, efficient and honest way. I'm not sure it's our role to go in and arbitrate on those sorts of issues, but it's the outcomes — are they managing it properly, because the pressure's always going to be there. Are they managing that pressure properly and are we getting the right kind of outcomes?

AK: I suppose an investment bank only needs to sack one analyst after a downgrade of a client to get the message to all the other analysts as to what's expected of them?

JC: If that really were to occur … I mean, if it were the case that an organisation sacked a research analyst for an honest and perfectly reasonable "sell" recommendation, that would be first of all commercially a bad look, and second, depending on all the facts and circumstances, something that we would be interested in having a look at.

AK: Do you think there’s potential for pressure the other way, for investment banks to pressure companies using their research?

JC: Yes. The big analysts on Wall Street are almost God-like, depending on where you are in the economic cycle. And so I suppose that power could be misused so a powerful research analyst could say; "Look, if you don’t refer a sufficient amount of investment banking work to our organisation, I’ll start writing negative research". I’ve heard that talked about as an issue, but I’m not actually aware of any examples where that’s happened, but it’s certainly potentially a problem.

AK: These issues of two-way pressure both from companies, investment banks and the other way — are they going to be the subject of specific, as you call it, tabloid policy statements from ASIC?

JC: It hasn’t actually been on our list as a specific issue, I must say. I think because it’s such an obvious possible byproduct of the system, most organisations have the physical separation and have their minds around that issue. So it wasn’t something that was specifically on our list.

AK: Moving on to financial planners: there’s been what’s called the super switching surveillance, where you looked at superannuation recommendations from financial planners. The results of that were not very flattering of financial planners, so where to from here on that — on the question of conflicts among financial planners in general?

JC: I describe what we’re doing with financial planners as a journey in that I think people would fairly readily admit that we’re not at the place where we should be overall with the industry in terms of conflicts of quality of advice and disclosure. But it’s a matter of working sensibly with the people who can make the necessary changes so that we do arrive, that we get to a point in Australia where we really have the best system in the world. I think we’ve got the tools necessary to do that. I think we know what the issues are. As I say, I think we can be frank and say, “Look, we’re not quite there yet, [but] we know where we’re heading”. Very recently I’ve written to some of the key players in the industry, just exploring what the remaining issues are and how we’re going to solve them.

AK: In that correspondence, did you say what you believed the remaining issues are?

JC: Yes I did.

AK: And what are they?

JC: The sort of issues we were talking about … let's put it this way: there are two ways that someone in ASIC's position can go here. We can either conduct a war on this issue or we can articulate what the issues are and work with the people who've got influence over the industry to get to a constructive result. And we've chosen the latter. We don't think it's in the consumer's interests and we don't have the resources to be taking massive enforcement action, although we do take enforcement action. We go in a constructive way.

So what are the things that need to be done? Well, right at this minute the financial planners are working on exactly what we were talking about earlier on in terms of their own conflicts principles, as to what [those] within the Financial Planning Association regard as proper conflict management. We need to work further with industry on this vexed issue of how do you get information from certain superannuation funds in relation to the client's existing arrangements, how do you get that quickly is the issue to consider. What do they have and would they be better off switching into something?

There's a sort of a lack of standardisation in that process, and we're working cooperatively on that. There's also a question of what do you do with the person who's had a few odd jobs over the years and has five superannuation funds, all with very small value in them. How do you give realistic and cheap advice about consolidating those? At the moment, the system doesn't really allow an easy means of doing that. ASIC is going to have another look at its policy on what we call platforms, or the master trust products, because in some respects although that product is still perhaps more expensive than it's ultimately going to be, it does provide answers to certain regulatory issues.

For example, our caution about too many self-managed super funds being created in the wrong hands for people who don't have enough savings to justify them or don't have the time and knowledge to deal with them. A platform that gives the ability to have a fairly wide variety of investments but in the custody of professionals is fairly attractive from the regulatory point of view — subject to whether the client's getting proper disclosure and how much it costs. So we're going to look a little bit further at that.

We'll also be raising and putting on the table the difference between appropriate culture and compliance. One of the issues we're seeing out there is that everybody in the financial services landscape says to us, "Look, we've got compliance, we've spent a ton of money. We spent too much money on the legal advice and paperwork and words, and we've got every compliance system and process that's required". But sometimes what's missing is the culture: you've got a culture that's based on aggressive selling of products for commission. You bolt all this compliance on top of it and you've still got the same culture. And FSR mandates that it's really a change of a culture, from selling to advice and so we're putting this issue where we can …

AK: Could you explain that? What do you mean, FSR mandates a change of culture from selling to advice?

JC: There's no room in the system for people who just sell product. In designing FSR, the Government could have gone down the course of saying a financial adviser can be one of two things: they can be a person who gives advice on a reasonable basis — in other words, the system we have now; or so long as you've go a sufficiently clear sign to the consumer, you can be someone who just sells. Now we don't have that in our system; there is no ability for you to go into a retail client personal advice situation and say to a client, "I'm actually not giving you advice here, I'm just flogging you a product". So we don't actually have that system, but previously if you go back several decades to, say, the life insurance industry, that's how that industry was structured: you had people selling product on a commission basis. They weren't giving you advice; they were selling to you.

AK: Is it possible that a lot of people in the financial planning industry are just flogging product but are pretending to give advice?

JC: I wouldn't say that, but I think that's the cultural issue we're raising: that it's all very well to say, "We have compliance, we have the paperwork, we have the systems", but if the culture is still one where the behaviour rewarded is the maximum number of sales and the highest commission derived, well then there's still a cultural issue.

AK: So how do you police or monitor that?

JC: Well I mean, that's the issue we want to well and truly put on the table.

AK: So are you saying that you don't want financial planning firms to have bonuses paid out of sales — the quantity of sales?

JC: Well so long as they're giving appropriate advice to their clients and it all has a reasonable basis, then there's a happy outcome. After all, they are running a business, but where inappropriate advice is given; for example, people who are on very low incomes and have no need for life insurance — and this is a big issue out there as far as we're concerned, an issue in the industry — being recommended that they need life insurance for what appears to us to be solely to remunerate the adviser.

AK: But aren't you fighting a bit of an uphill battle in this business if planning firms are receiving sales commissions as their income?

JC: Look it's a journey. Things are changing. You're finding now that dealer groups are accepting that they should not disproportionately reward planners for flogging in-house product. That's already happening out there. We've seen change in soft-dollar commissions. It's just a matter of setting milestones, of talking about these cultural issues, getting the issues out on the table and having them dealt with. So if you look at the track record there are good things to point to. There are still remaining problems, but our job here is to get the Statement of Advice regime under control. We've attacked the 80-page monster. We've put out one already, the 12-pager, and we're talking to industry about some others. So we're dealing with that.

Certainly you're right that the trailing commission remains the way a lot of people are remunerated, but we're getting that issue on the table. We're making sure that consumers are aware of it. Already the industry is talking about "dialing up and downing down" fees. The ability of the consumer to say, "I don't want to pay a trailing commission. Let's talk about these fees. Let's have them broken down so that I can see what the product fee is, what the advice fee is and what I'm paying for administration".

AK: A lot of people - a lot of clients - don't know to ask these questions. Is it ASIC's role to ensure that whether you know what questions to ask or not, you still get the same information?

JC: I think you'd be able to show that consumers are becoming more aware. There's more digestible information out there just in the context of super choice. I think we've seen a level of common sense and availability of information. Over time, consumers will know a lot more about these things.

AK: Do you think that there's an issue with the names "financial planners" and "financial advisers"; that there's a difference between financial planning and stockbroking, where people who go to a stockbroker know that they're being sold something, whereas do you think there may be a problem with people not really understanding there is a sales function with planners and advisers?

JC: I suppose it's evolving and I think the Financial Planning Association has come a long way in a relatively short time, so that people do recognise what their role is. Make no mistake: there are lots and lots of good financial planners out there who do a very good job. The reason we're so keen on this journey is that they play a key function in the financial system. If consumers have access to good and un-conflicted advice and on commercial terms that are satisfactory to them, it certainly makes our life a lot more comfortable. Not that comfort's a big consideration at ASIC, but you get what I mean: that they really do play a key part in the system, particularly in relation to something like super choice, where if the right decisions are made then in the future retirees will have the right amount of superannuation savings.