



**ASIC**

Australian Securities & Investments Commission

## REPORT 318

# Response to submissions on CP 171 Strengthening the regulation of research report providers

December 2012

### **About this report**

This report highlights the key issues that arose out of the submissions received on Consultation Paper 171 *Strengthening the regulation of research report providers (including research houses)* (CP 171) and details our responses to those issues.

### 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.

### Disclaimer

This report does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

This report does not contain ASIC policy. Please see Regulatory Guide 79 *Research report providers: Improving the quality of investment research* (RG 79).

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## A Overview/Consultation process

- 1 In Consultation Paper 171 *Strengthening the regulation of research report providers (including research houses (CP 171))*, we consulted on proposals to update our guidance on research reports in Regulatory Guide 79 *Managing conflicts of interest: An ASIC guide for research report providers (RG 79)*.
- 2 We reviewed practices in the research report provider sector and found some areas where our existing guidance and expectations should be revised or supplemented.
- 3 This report highlights the key issues that arose out of the submissions received to CP 171 and our responses to those issues.
- 4 This report is not meant to be a comprehensive summary of all responses received. It is also not meant to be a detailed report on every question from CP 171. We have limited this report to the key issues.
- 5 For a list of the non-confidential respondents to CP 171, see the appendix. Copies of the submissions are on the ASIC website at [www.asic.gov.au/cp](http://www.asic.gov.au/cp) under CP 171.

### Responses to consultation

- 6 We received 27 responses to CP 171 from research houses, industry associations, banking entities, stockbroking firms, securities and advisory firms, compliance firms as well as individual submissions. We are grateful to respondents for taking the time to send us their comments.
- 7 The main issues raised by respondents related to:
  - (a) the scope of our guidance and definitions (e.g. for ‘research report provider’);
  - (b) the proposed compliance reporting requirement;
  - (c) managing conflicts of interest for ‘issuer pays’ research;
  - (d) research currency; and
  - (e) disclosures about research.
- 8 Generally, respondents were supportive of our proposals for improved guidance. However, given the spectrum of research report providers to which the guidance applies, there were concerns about some aspects of the proposed guidance as it applied to certain providers.
- 9 We have taken this feedback into account in our final updated guidance: see Regulatory Guide 79 *Research report providers: Improving the quality of investment research (RG 79)*.

## B Response to submissions on CP 171

### Key points

This section outlines the key issues raised in the submissions on CP 171, and our responses to those issues. It covers:

- the scope of our guidance and definitions;
- the proposed compliance reporting requirement;
- conflicts of interest;
- quality, methodology and transparency of research; and
- users of research.

### Scope of our guidance and definitions

- 10 The proposals in CP 171 had two objectives. These were to improve:
- (a) compliance among research report providers with our guidance; and
  - (b) the quality, integrity and transparency of the research reports that Australian retail and wholesale clients rely on to make investment decisions.
- 11 There was general support for maintaining the existing broad definitions of research report and research report provider. However, some respondents representing banking and stockbroking firms expressed concern at the scope of some of our proposals, the extent to which they applied to their research services and the potential impact on their businesses.
- 12 These submissions argued that our guidance should expressly distinguish between different types of research report providers so as not to impose a ‘one size fits all’ approach on diverse business models.

#### *ASIC’s response*

One objective of the proposals in CP 171 was to help research report providers comply with their existing obligations. We consider that there is a wide range of research report providers, with no neat demarcation between providers on the basis of the products they research or their business models. Consequently, we do not propose to amend the scope and application of our guidance.

We have kept the existing broad and inclusive definitions, which cover the spectrum of research report providers. This approach is consistent with our previous guidance and avoids the risk of regulatory arbitrage.

## Compliance reporting

- 13 Some submissions welcomed the proposed biennial compliance reporting requirement as imposing a discipline that would improve accountability and transparency in compliance processes. However, many respondents queried the merit of this requirement in meeting our objective of increased compliance and transparency.
- 14 Compliance reporting was seen as an untargeted measure that duplicated existing compliance obligations while imposing an onerous and costly administrative burden on Australian financial services (AFS) licensees who were otherwise compliant.

### *ASIC's response*

During the consultation process, it became clear that there was a lack of understanding and compliance with our existing guidance among some research report providers. The updated guide provides greater guidance on our expectations of providers to take a more active and diligent compliance role. We have included examples to show how research report providers can meet their obligations, taking into account different types of research and business models.

We intend to address compliance with our updated guidance through targeted surveillance activity. We consider this to be a more efficient way to address our compliance concerns at this time, rather than imposing a compliance reporting requirement. However, we may revisit the need for compliance reporting in the future based on our surveillance experience.

## Conflicts of interest

- 15 Previously, the main focus of RG 79 was on conflicts of interest. In CP 171, we consulted on whether some conflicts in the research context can be effectively managed or if they should be avoided entirely. Our proposals expressly asked for comment on whether conflicts associated with issuers paying for research can be effectively managed.
- 16 Respondents uniformly acknowledged that issuer pays research presents a clear conflict of interest. Most respondents considered this conflict could be managed with appropriate controls to prevent research report providers from being unduly influenced by other commercial imperatives of the business. Many respondents also noted that requiring avoidance of this conflict would have an adverse impact on the availability of research in the current market. Other respondents noted that there were a range of other business model conflicts that could have an equally deleterious effect on the quality and integrity of research.

### *ASIC's response*

Conflicts of interest, whether direct or indirect, can reduce the quality, integrity and reliability of research. It is important that research report providers have the independence to give product ratings or recommendations in an unfettered way. Regardless of the business model adopted by the research report provider, we consider robust and effective conflicts management to be an essential part of a providers' compliance and quality procedures.

Our guidance for AFS licensees on their general conflicts management obligations is set out in Regulatory Guide 181 *Licensing: Managing conflicts of interest* (RG 181). Conflicts management generally involves identifying, managing (by adopting appropriate controls including avoidance of conflicts that cannot be managed) and disclosing conflicts of interest.

Our updated guidance for research report providers in RG 79 does not mandate the avoidance of conflicts associated with issuer pays research. However, where a provider operates an issuer pays business model, we expect it to maintain robust controls to ensure fee and contractual arrangements, relationship management and/ or ancillary business units are kept separate from the ratings process and outcome, and to include clear disclosures for users of research that the research was commissioned and paid for by the issuer.

Our updated guidance sets out our expectations for all providers with business model conflicts (either direct or indirect) to manage those conflicts by:

- adopting an appropriate business model and ensuring the organisation is structured to minimise and manage real or potential conflicts;
- adopting robust research processes;
- having adequate controls in place to manage conflicts;
- avoiding conflicts that cannot be appropriately managed; and
- giving meaningful disclosures to help users of the research understand any conflicts, how they are managed and the extent to which users can rely on the research.

Conflicts management is only one element of our updated guidance that we consider will, in its totality, lift the quality and integrity of the investment research produced by research report providers.

This includes ensuring that business units are appropriately segregated to preserve the objectivity and independence of the research process and quarantining the research service from other business units with client relationship management responsibilities.

## Quality, methodology and transparency of research

- 17 We consulted on a number of measures to improve the quality of research. This included ensuring that research providers allocate appropriate resources to the research task, adequately train and supervise staff and adopt rigorous research processes.
- 18 The focus of many of our proposals was on having robust internal processes. Such processes are supported by giving users of research meaningful information to help them understand the research approach adopted by a given provider, the methodology employed and any strengths and limitations that apply.
- 19 These measures are intended to improve the ability of users of research to assess the quality of a research service and to determine the extent to which they can rely on it.
- 20 Respondents generally supported the proposals on resourcing, staffing and supervision arrangements that were consistent with our existing guidance. However, some respondents expressed concern about our proposals for public disclosures on the nature of the research service, methodology employed and the need to communicate research currency, for example.
- 21 Depending on the business model and researched product types, some submissions expressed concern that our proposals would involve publishing sensitive, commercial or proprietary information. They also indicated that our proposals on research currency were not appropriate for listed products when research may date very quickly subject to market events.
- 22 Some respondents asserted that wholesale clients understood the nature of research services and the additional disclosures were not necessary, or that the disclosures should be limited to the provider's clients, rather than being more widely distributed. Other respondents considered that research report providers should have the flexibility to determine how they meet the disclosure obligations and that any guidance should not be prescriptive.
- 23 There was in principle support among most submissions for our proposals to educate users about the meaning of ratings criteria and the scope and coverage of the research, and the desirability of users being able to compare the spread of ratings across providers and draw meaningful conclusions from that information. Other submissions expressed concerns about the level of detail required, the method by which this information should be made available and to whom, and the risks in how such information may be used or potentially misrepresented.



*ASIC's response*

We have updated our guidance in RG 79 to remind research report providers of our expectations for resourcing, staffing, supervision and training arrangements.

To improve the transparency of research, it is important that users of research have factual and relevant information available to give important context to the research so they can understand the research and decide whether to rely on it, and to what extent.

Research report providers should give sufficient information for users to form a meaningful view of:

- the author of the research and the date it was prepared;
- the methodology used;
- the scope and coverage of the research;
- the rating or classification scheme applied; and
- the spread of ratings produced over a given period, so users can form a holistic view of the research service.

Our updated guidance is intended to give research report providers flexibility in how they communicate this information to users and prospective users of their research services. For example, some disclosures are appropriate for the broader market and may be published on a website or in a Financial Services Guide (FSG), while others are specific to the research report.

Research ratings that are not monitored or updated can be misleading unless research report providers prominently state how currency will be communicated to users, including whether the research is being monitored or whether it will be updated in future. Where research reports and their recommendations are no longer current (e.g. where there have been material changes to the product or market), the research should be clearly flagged as historical and providers should indicate that the original recommendation no longer applies.

Our updated guidance allows research report providers to tailor how they communicate the currency of a piece of research. This recognises that some research is point-in-time research that may lose its currency very quickly, while other research providers claim that a piece of research is current on an ongoing basis.

We expect research providers to communicate the currency of their research to clients or subscribers in such a way that a reasonable investor can understand it. Regardless of business model, client base or researched products, currency should be clearly communicated and sufficient to ensure a reasonable investor is not misled.

## Users of research

- 24 In CP 171, we proposed to give guidance that AFS licensees providing financial product advice should conduct due diligence on service providers they intend to use as part of their advisory practice.
- 25 Most respondents supported the need for due diligence on the part of the advisory business. Some noted that they already conducted due diligence of research report providers and regularly reviewed other service providers. Others welcomed any guidance that set a minimum standard of due diligence, although some expressed reservations about the level of detail or level of prescription required.
- 26 Some submissions were of the view that guidance was needed in both RG 79 and Regulatory Guide 175 *Licensing: Financial product advisers—Conduct and disclosure* (RG 175). Most thought that guidance on this topic was most appropriate in RG 175.

### *ASIC's response*

RG 79 focuses on guidance for the supply side of the market—that is, providers of research reports. We expect our updated guidance in RG 79 will also help users of research by improving their ability to understand a research report and assess its value and the extent to which they can rely on it in making investment decisions.

Our updated guidance includes our expectations of research report providers in relation to users of research. We expect AFS licensees (including advice providers) to conduct due diligence in selecting third party research report providers. Such due diligence should include an assessment of the business model and conflicts of interest associated with each potential service provider. We expect this to include an assessment of the disclosures each research report provider makes about its business model, product selection and scope of research, ratings spread and conflicts management in accordance with our guidance.

Where advice providers are preparing personal advice, we expect them to make their own inquiries and research into the products they give advice on. For example, when using research, advice providers should ensure that they have read and understood the research report before relying on it. We expect advice providers to critically evaluate research reports.

While they may rely to some extent on various service providers, such as research report providers, advice providers are still responsible for the advice they give clients. More detailed guidance on our expectations of advice providers is set out in RG 175.

## Appendix: List of non-confidential respondents

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|---|------------------------------|
| • ACI Australia Limited                           | • Melbourne Compliance Forum |
| • Australian Bankers Association (ABA)            | • Select Equities            |
| • Australian Financial Markets Association (AFMA) | • St David's Road Advisory   |
| • Bell Potter Group                               | • Stockbroker's Association  |
| • Canstar   | • Van Eyk                    |
| • Financial Planning Association (FPA)            | • Westpac                    |
| • Launch  | • Zenith                     |
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