SECURITIES & DERIVATIVES INDUSTRY ASSOCIATION

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20 November 2002

The General Manager
Corporate Governance Division
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir,

Corporate Disclosure – Strengthening the financial reporting framework (CLERP9)

The Securities & Derivatives Industry Association (SDIA) is the peak industry body representing the interests of 74 stockbroking firms, which account for over 98% of market turnover in Australia. SDIA is working to ensure the smooth transition to FSR for its Principal Member firms.

We would like to raise with you two issues of particular concern to the stockbroking industry[1]:

- **Research Disclosure**
  SDIA strongly supports the principles-based regulation of equities research.

- **Retail vs. Wholesale Investors**
  The introduction of new sections in the legislation by the *Financial Services Reform Act 2001* has created anomalies with the definition of who is a retail client and who is a wholesale client. In effect, there are now several conflicting definitions. We believe this situation requires remedy through legislative reform.

The issues that we have identified are addressed in some detail below. We would be pleased to meet with you if you would like us to elaborate on any of the points made. Moreover, we would be happy to arrange for you and your staff to visit the offices of our members, so you can see first hand the environment in which advisers and analysts work.

1. RESEARCH DISCLOSURE (Refer: CLERP9 Discussion Paper, Part 7)

SDIA has been considering this issue since May 2001. As noted at paragraph 7.5.3 of the Paper, in November 2001, SDIA in conjunction with the Securities Institute of Australia, released its Best Practice Guidelines for Research Integrity (the "*SDIA/SIA Guidelines*").

The *SDIA/SIA Guidelines* (attached) set out 10 principles for best practice in research:

1. Putting the Interests of Investors First
2. Establishing Separate and Distinct Reporting Structures
3. Having Chinese Walls to Prevent Dissemination of Information

[1] SDIA would like to gratefully acknowledge the work of Ms Cilla Boreham, Corporate Counsel, JBWere in the preparation of Part 2 of this submission

4. Disclosure of Interests
5. Restriction on Trading
6. Remuneration Should not be Directly Linked to Revenue
7. Investment Recommendations Should be Unambiguous
8. Dissemination of Research
9. Statement of Firm's Policies and Procedures
10. Monitoring Compliance with Firm's Policies and Procedures

A recent survey of our members showed substantial uptake of the *SDIA/SIA Guidelines* in research departments.

Part 7 of the CLERP9 paper - "Analyst Independence and the Regulation of General Advice" - contains an extensive discussion of research issues. After commenting on recent US developments, it is observed (properly in our view) that:

> *In Australia, there has not been the level of problem or concern [as in the US] in relation to conflicts of interest and research practices.*[2]

Several conclusions are drawn in the discussion of the various issues, including:

- forced separation of research departments from other financial activities within firms is not supported, in favour of more effective management and disclosure (paragraph 7.4)
- licensees already have a general duty to ensure that conflicts of interest are managed and disclosed effectively (paragraph 7.5.1)
- enhanced legislative rules would be likely to impose higher compliance costs on licensees than the current general obligation to act "efficiently honestly and fairly" (paragraph 7.5.1)
- ASIC as part of its administration and enforcement of the general obligations of licensees could offer policy guidance to assist licensees in meeting their requirements (paragraph 7.5.1), and
- the misconduct provisions of the Corporations Act are sufficient to protect investors from conduct which undermines market integrity (paragraph 7.5.4)

Two specific proposals are made in relation to the research aspects of Part 7 of the paper[3]:

> ***Proposal 17.*** *There is a general duty on financial services licensees to ensure that financial services are provided 'efficiently, honestly and fairly'. Licensees should disclose any financial interest that they or a related party have in the subject of their advice or recommendation.*
>
> ***Proposal 18.*** *The Australian Securities and Investments Commission (ASIC) will be asked to provide guidance by policy statement on the level and manner of disclosure required under this general duty, following consultations with relevant stakeholders.*

SDIA has already publicly supported the government's approach to this topic[4], and is pleased to do so through the CLERP9 consultative process.

We note that the recent US regulation of this area (discussed at 7.1 of the Paper) already applies to most of our member firms that have offshore operations or affiliations. However, for member firms that are only publishing research in Australia, there is no reason to automatically follow US developments in this area, especially where policy and regulatory guidance already exists or is in the process of being considered by the Government and ASIC. The *SDIA/SIA Guidelines* already provide a framework for proper conduct in this area, and have been adopted by a significant number of our Principal Member organisations.

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[2] *CLERP9* paragraph 7.1 page 115
[3] *CLERP9* page 121
[4] *AFR* Letter to Editor 25 October 2002 by Brendan C. Egan, Chairman, SDIA

Moreover, from SDIA's membership of a working group convened by the International Council of Securities Associations on this subject, it is clear that the US situation is constantly changing. Recent announcements by the SEC, NYSE and NASD and SIA (US) (whose guidelines have been abolished) and the fact that 38 different US States are in various stages of consideration or investigation of the issue mean that even in the US the final position is unknown.[5]

A principles-based approach such as the *SDIA/SIA Guidelines* is to be preferred to the black-letter law approach taken or proposed by other regulators.[6] Having prescribed disclosures, for example, can lead to slabs of text in research reports that investors routinely skip, and thus can be counterproductive.

Indeed, ASIC already regulates licensees on a "principles" basis: it enforces the obligation to act "efficiently, honestly and fairly"[7]. There is no reason why this should change.

We support the Government's preference for a policy approach over legislative reform:

> *[ASIC] will be asked to provide guidance by **policy statement** on the level and manner of disclosure required under this general duty, **following consultations with relevant stakeholders** (CLERP9* Proposal 18) (emphasis added)

We prefer the view set out in the CLERP9 paper (at p.128):

> *...a general obligation to disclose conflicts of interest would avoid the need to anticipate and prescribe those matters that might constitute a potential influence on financial services or advice.*

We have already met with ASIC regarding its current research surveillance campaign, and look forward to working with ASIC on its new policy.

Other possible reforms: at paragraph 7.6.4 of the Paper, comment is sought in relation to two other possible reforms, namely,

- bringing the obligations for general advice in line with those for personal advice; and
- extending the range of conflicts of interest that are relevant.

We do not support bringing the obligations for general advice in line with those for personal advice. There is a clear distinction drawn in the *Corporations Act* between general and personal advice. This is appropriate, as not all comment on financial products is directed at an individual client. We do not see why in relation to research that may assist in giving such advice that the distinction between personal advice and general advice should be removed.

Consistent with *SDIA/SIA Guideline 4*, we would support the disclosure of material interests that may influence recommendations, including interests of analysts and investment banking or advisory relationships of the firm with the Issuer.

2. RETAIL *vs.* WHOLESALE INVESTORS (Refer: CLERP9 para.9.3, page 161)

The main focus of the *Financial Services Reform Act* is on the protection of retail investors. Many of the obligations imposed by the FSRA only apply where a retail investor is involved.

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[5] For instance, on 3 October 2002 the NYSE and NASD announced further tightening of their new rules regarding disclosure and separation of research from investment banking activities, which is an example of the changing nature of the US provisions.

6 For example, see ASX Draft Business Rule Guidance Note: *Independence of Research, Disclosure of Conflict Of Interest & Dealing Before Research Recommendations* dated 18 September 2002

[7] *Corporations Act* s.912A(1)(a) (formerly s.826(1)(j)&(k))

Accordingly, the initial assessment as to whether an investor is a "retail" or a "wholesale" investor is critical. We believe that the approach taken by the new legislation to this issue is flawed and the provisions of the Act are unworkable, for the reasons given below.

Who is a retail investor under the Act?

Unfortunately, the answer to this question depends on the circumstances of the product or service being offered. There are a number of different definitions of *retail investor*, and the relevant definition to apply depends on the relevant circumstances, discussed as follows:

- if the question is whether a broker can offer shares to a particular investor **without a prospectus** – the definition contained in section 708 of the Corporations Act applies;
- if the question is whether a broker can offer units in a **managed fund** to the same investor without a product disclosure statement, the definition in section 761G applies;
- if the question is whether a broker needs to give a particular investor a **statement of advice**, a **product disclosure statement** or a **financial services guide**, the definition in s761G also applies;
- but if the question relates to any kind of dealing in **superannuation products** – the client is *always* a retail investor.

This problem would perhaps be manageable if the definitions in s708 and 761G were substantially the same. Unfortunately, although they are similar, they are certainly not identical. For example:

- a person is a wholesale investor under s708 if they are able to provide an accountant's certificate confirming that they have had gross income for the last two years of at least $250,000, or they have net assets of $2.5m. However, the equivalent test in s761G provides that a client who provides such a certificate is not a wholesale investor unless it is also established that the product or service "is not provided for use in connection with a business" (how one determines whether, say, a share is being acquired "for use in connection with a business" is also quite unclear). So, it is possible that we may not be able to offer this person units in a listed property trust without a PDS, though we can offer them shares without a prospectus.
- a person is a wholesale investor under s761G if they acquire the relevant financial product "for use in connection with a business that is not a small business" (where the definition of "small business" turns not only on the nature of the business, but also on the number of employees). However, this category of investor is not a wholesale investor under s708, so although this investor can be offered managed funds without a PDS, he cannot be offered shares without a prospectus.
- a person is a wholesale investor under s708 if the relevant offer is made by a licensed dealer and that dealer has (broadly) satisfied itself that the investor is sufficiently sophisticated. There is no equivalent to this provision in s761G. So, we can offer this person shares without a prospectus, but not managed funds without a PDS.

From a practical perspective, what this means is that the "sophisticated investor register" which many broking firms currently maintain (based on the s708 criteria) will need to be split into two, or even three, separate registers. Care must be taken to ensure that the right register is used, depending on the correct characterisation of the relevant financial product. It also means that although one client may be "wholesale" for one purpose, they are not for another – though there is no apparent reason why this should be so.

We also note that we do not have the benefit of provisions that exist in other jurisdictions such as the UK and under a recent directive from the European Union[8], where it is possible for the client to consent to transition from retail to wholesale, thus saving licensees compliance costs.

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[8] *Conduct of Business Sourcebook* Rule 4.1 (UK); *Directive of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC* dated 9 August 2002 (EC)

Obviously there is an obligation placed upon the financial services provider to make the client aware of the protections foregone in changing their status from retail to wholesale.

We submit that the distinctions identified above are unworkable and appear to have no clear philosophical justification. We believe that legislative reform is required to remove these anomalies.

We are grateful for the opportunity to participate in the consultation process on this important area of reform. If you would like to discuss the matters raised in this letter in greater detail, please contact me at dclark@sdia.org.au.

Yours sincerely

Doug Clark
Policy Executive