

CHAPTER 10: MANAGEMENT OF CONFLICTS OF INTEREST BY FINANCIAL SERVICES LICENSEES

Overview

580. Developments in the global financial services industry have given rise to conglomerate firms — which may achieve cost efficiencies by providing a full range of services, and using employees in different capacities across the firm. In seeking these cost efficiencies, it was widely acknowledged by the financial services industry that scope existed for conflicts of interest to arise. Firms responded to these concerns by developing policies and procedures (for example, the establishment of Chinese Walls between different areas of their financial services business) for managing these potential conflicts of interest.

581. International experience with conflicts of interest — particularly that of the United States (US) in 2002 with respect to analysts — led the Australian Government to consider its own regulatory framework for managing conflicts of interest.

582. The UK and Australia have not found the same level of abusive practices as found in the US. However, as a result of international experience, there has been a general unease about analyst independence in Australia.

583. Under the current regulatory regime financial services licensees are required to ensure that financial services covered by their licence are provided 'efficiently, honestly, and fairly'. While industry has widely accepted that this would include managing conflicts of interest, the duty was not express in its application to conflicts of interest.

584. It was considered that any new provision should not be limited in application to analysts, but should also provide for financial services licensees more generally, as the potential for conflicts of interest to arise are not limited in application.

585. Consequently, under proposed paragraph 912A(1)(aa), financial services licensees will be subject to an additional licensing obligation, which specifically requires them to have adequate arrangements for managing conflicts of interest. This will include ensuring that there is adequate disclosure of conflicts to investors, who can then consider their impact before making

investment decisions. It will require internal policies and procedures for preventing and addressing potential conflicts of interest that are robust and effective. The obligation will apply to all conflicts of interest, other than those that occur wholly outside the financial services business of the licensee or its representative.

586. The additional licensing obligation will supplement the existing general duty of paragraph 912A(1)(a) to provide financial services 'efficiently, honestly and fairly'. It will provide a strong legislative basis for Australian Securities and Investments Commission (ASIC) to develop guidance and take enforcement action, while being consistent with a principles-based approach. ASIC guidance on the management of conflicts of interest will assist licensees to comply with their legal obligations. ASIC's policy proposal in this regard is expected to be released for comment in the near future.

Types of conflicts of interest that must be managed

587. There are three main types of conflicts of interest:

- conflicts within the financial services business (Category 1)
 - examples are conflicts within one area of the financial services business, such as dealing on behalf of various clients, or across different areas of the business, such as between publishing research in a client newsletter and market making;
- conflicts between something within the financial services business and something outside the financial services business (Category 2)
 - examples are where outside factors give rise to conflicts within the financial services business, such as a conflict of interest between the financial services licensee lending (as principal) to a particular enterprise and the financial services licensee underwriting a public offer for the same enterprise. Alternatively, a conflict may arise where the objectivity of research is compromised by the analyst's personal interests or relationships;
- conflicts outside the financial services business (Category 3)
 - where a factor outside the financial services business gives rise to a conflict with another factor outside the same financial services business. Examples include where those conflicts might arise between two non-financial services businesses of a merchant bank (for example; corporate lending and dealing on the bank's own behalf). Such conflicts are unrelated to the financial services business.

588. The purpose of proposed paragraph 912A(1)(aa) is to specifically require licensees to have adequate arrangements for managing Category 1 and Category 2 conflicts of interest. Licensees will not be obliged under the Corporations Act to manage Category 3 conflicts of interest, which occur wholly outside their financial services business. They may have other obligations to manage such conflicts.

