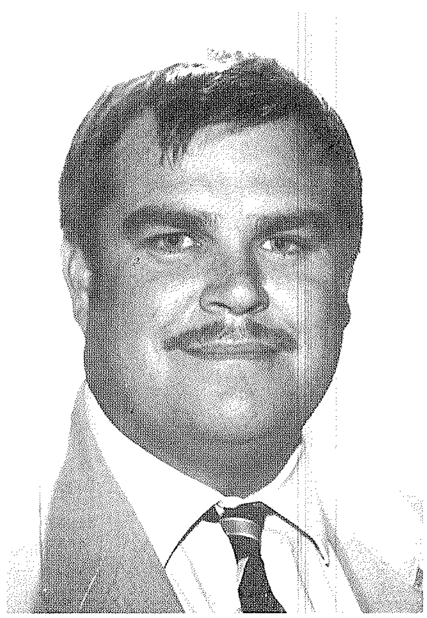
MAKING ADVISERS TOE THE LINE

LICENCE SHAKE-UP SHIFTS RESPONSIBILITY



by RICHARD COCKBURN

With the 'de-licensing' of representatives in the securities industry, principals will have to exercise great care in the recruiting, training and supervision of dealing and advisory staff.

Radical changes to regulations governing the securities industry flow from the introduction in November of part 8 of the Co-operative Scheme Legislation Amendment Act, which, among other changes, alters the basis of licensing in the industry.

The imposition of occupational licensing is generally a government reaction to an unsatisfactory state of affairs. In some cases the licensing is a direct response to consumer pressure – as, for example, in the case of second-hand car dealers or travel agents. In others, the licensing is imposed by the government in the interests of public safety or health – for example, the licensing of plumbers.

Occupational licensing is designed to raise, or at least maintain, a given set of standards in an industry. It seeks to do this by ensuring that only those with the appropriate skills, qualifications or experience are permitted to practise in the industry.

It is quite common to encounter considerable resistance to the introduction of occupational licensing, although much of this is without foundation. A properly conducted occupational licensing regime can significantly boost community confidence in the industry as well as raising standards within the industry itself. The result is usually beneficial both to the community at large and to the industry being regulated.

Unfortunately, this is not always the case. If the licensing system does not work in the eyes of the community or of the industry, it will be seen as just one more piece of government red tape or, put more brutally, a costly bureaucratic monster feeding on a struggling business community. Governments have recognised that occupational licensing is not always the most efficient method of achieving objectives.

The licensing of representatives in the securities industry is one of those areas where occupational licensing does not appear to have been a cost-effective method of achieving the objectives of investor protection and a general raising of industry standards.

In the late 1960s, the mining boom saw increased activity not only in share-buying but in new company floats. The securities industry found itself riding on the crest of a wave. The market reacted optimistically to all sorts of rumours.

On the collapse of that boom, the Commonwealth Senate appointed a committee to investigate alleged share-market manipulation and fraud. This committee (the Ray committee) expressed concern over the sudden rise of largely unregulated activities of a number of firms and companies loosely described as investment consultants, investment counsellors and investment advisers. It found that there were "no

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effective restrictions on this activity; practically anyone, regardless of their financial training or earlier experience in the industry, and no matter how limited their financial resources, could begin advertising, circulating newsletters and tipping sheets, producing charts and managing investors' portfolios".

In 1970, New South Wales, Victoria, Queensland and Western Australia introduced legislation to regulate the securities market. That legislation dealt with, among other things, the licensing of dealers and investment advisers. In the case of NSW it also extended to regulate the activities of stockbrokers. By the end of 1975 all states except South Australia and Tasmania regulated participants in the industry, including stockbrokers.

The inclusion of stockbrokers within this occupational licensing regime provides a good lesson for the future. If self-regulatory organisations are not effective, and seen to be effective, in maintaining industry standards and adequate levels of investor or consumer protection, then a full occupational licensing regime will be imposed.

NCSC view on licensing

A little over six years ago the National Companies and Securities Commission announced that it was reviewing the licensing provisions of the Securities Industry Act. The results of that review were published in 1985 in a Green Paper titled "A Review of the Licensing Provisions of the Securities Industry Act and Codes".

Its principal finding was that the securities industry licensing system was not working effectively to provide adequate investor protection. The commission recommended a number of courses of action, including:

- professional self-regulatory organisations should assume a more active role in determining the rules of conduct for the industry and ensuring that those rules are complied with;
- uniform educational entry standards should be required for licensees to enhance confidence;
- principals should assume more responsibility for their employees and representatives;
- greater emphasis should be placed on disclosure to clients and providing investment advice and products suitable to the individual needs of clients;
- a single category of licence, to be known as a securities industry licence, should be introduced; and
- the current exemption for life insurance offices and banks which carry on a business of dealing in or advising on securities should be ended.

The securities industry licensing system was not working effectively to provide adequate investor protection.

The review made a series of recommendations designed to encourage the establishment of self-regulatory organisations within the securities industry which would have the benefit of legislative backing. The commission's vision was that these self-regulatory organisations would be responsible for promoting educational and ethical standards within the industry.

One of the other major recommendations was the creation of the so-called "level playing field" which would have seen many of the investment packages promoted by the insurance industry come within the definition of a security.

In 1986, officers within the Companies and Securities Co-operative Scheme started work on what was to be called the Co-operative Scheme Legislation Amendement Bill 1987. That bill was to contain a number of recommendations from the licensing Green Paper. A combination of factors, but primarily the Commonwealth's announcement of its intention to unilaterally regulate to cover the field of companies and securities, brought about the demise of the proposed bill.

Not all of the recommendations in the Green Paper have been adopted. The NCSC found that the life insurance industry did not welcome the proposal to regulate the sale of some of its products under the Securities Industry Act. The result, however, has seen the superannuation and life insurance commissioner issue a set of draft guidelines which will ultimately have investment products promoted by life offices subject to the same disclosure requirements as products in the securities industry, even to the extent of disclosing commissions.

The NCSC's dream of self-regulatory organisations policing the industry has not become a reality – although the role of industry umbrella organisations will be significantly enhanced under recent policy announcements which see the Unit Trust Association, the Australian Finance Conference and the Trustee Companies Association assuming a monitoring responsibility for extended life prospectuses.

As a result of growing pressure, an amending bill for the scheme legislation was exposed for comment in 1988 and eventually the Co-operative Scheme Legislation Amendment Bill 1989 was passed by parliament.

One of the most significant compromises made in that bill was the decision by the Ministerial Council to adopt the licensing reforms as contained in the Corporations Act rather than the version which they had approved for the now-defunct 1987 bill. The differences between the two versions are now fairly academic. If and when the Commonwealth proclaims its Corporations Act, participants in the securities industry will have already made most of the major required adjustments.

The 1989 act contains a number of major changes in securities regulation. They are:

- the removal of representative licensing;
- the partial removal of existing exemptions from the licensing regime for banks and life offices; and
- greater disclosure requirements.

Removal of representatives licensing

The licensing of representatives by the Corporate Affairs office ceased on November 1. A representative's licence will be replaced by a "proper authority" issued by the principal. A proper authority is a copy of the principal's licence, endorsed by the principal, authorising that representative to act on its behalf.

The existing pre-licence vetting by the Corporate Affairs office ends and under the new regime principals will be responsible for the activities of their representatives. The legislation prohibits principals from entering into agreements which have the effect of avoiding liability for the activities of their representatives, although a principal is able to effect insurance or require indemnification from the representative (or from other licence-holders in the case of defaults by representatives acting for more than one principal).

The licensing regime for principals remains effectively the same, except that the securities industry regulations will impose statutory conditions in all principals' licences which require them to maintain certain minimum education and training programs for their representatives. The regulations are designed to ensure that only scrupulous and competent representatives operate and that the principals put in place adequate in-house training and supervision arrangements to provide investor protection. Self-interest will cause principals to take greater interest in the quality of their representatives and their in-house training.

Principals will have absolute discretion as to the appointment and removal of their representatives but this carries with it greater liability for their conduct. It would therefore be in the interests of all principals to evaluate their existing and future representatives very carefully.

Banks and life offices

The Green Paper recommended that the exemption in favour of life insurance offices in respect of both dealing and advising on securities should be removed. This was done in the interests of regulatory neutrality and would not have an impact upon life insurance offices unless they were dealing or advising on securities. It is to be remembered that life insurance products are excluded from the definition of prescribed interests and therefore are not caught within the definition of securities. A similar recommendation was made in relation to banks. These two industries had previously been exempt because of their own specialist legislation and prudential controls.

The amending act and proposed changes to the securities industry regulations implement these recommendations. Banks and life offices will lose their exemption from the current definition of investment adviser. The effect of this is that banks and life offices who deal in securities or give investment advice are required to have an appropriate licence, and employees conducting those activities need to hold proper authorities.

Some current exemptions will continue, giving banks some relief from the licensing provisions and from the need for their employees to hold proper authorities in respect of their traditional functions of advising on government and semi-government stock.

Disclosure requirements

The current section 65, requiring disclosure in written circulars recommending securities, and section 65A, the "Know Your Client Rule", have been replaced. Section 68C, which replaces section 65, goes much further in its disclosure requirements. Under the section:

- a securities adviser (being a dealer, investment adviser or one of their representatives) when making a recommendation either orally or in writing that a client may reasonably be expected to rely upon, must disclose any commission, fee or benefit which they or an associate will or may receive or any other interests which could reasonably be expected to influence the adviser;
- this does not require disclosure of the commission or fee that the securities adviser receives from the client; and
- the definition of associate in general adopts the wide definition of that term presently contained in section 6 of the act, although it does not catch a partner of the securities adviser not involved in the business of dealing in securities, or a co-director, unless they act jointly or under an arrangement between them in relation to the making of securities recommendations. A partner who carries on a business of dealing in partnership with the securities adviser will be an associate regardless of whether or not he or she acted jointly with the adviser in making the recommendation. A recommendation made by a representative will catch the principal as an associate of that representative – however, it will not be necessary to disclose a commission or fee payable by the client to the principal.

It is important to note that the disclosure requirement attaches to oral recommendations.

It is important to note that the disclosure requirement attaches to oral recommendations and applies to exempt dealers. The definition of associate is slightly wider than in section 65 because it specifically includes principals of adviser representatives and makes partners and directors of corporate advisers associates if they act with the partner in relation to making recommendations generally, rather than as at present in relation to the particular recommendation.

Section 65A has been reproduced as section 68E. The section requires a securities adviser who makes a recommendation to a person who may reasonably be expected to rely upon that recommendation to have a reasonable basis for making the recommendation.

The section is structured so that the adviser is said to not have a reasonable basis for making the recommendation unless the adviser has reasonably considered and investigated the subject matter of the recommendation.

As with the existing section 65A, failure to comply with this provision does not expose the adviser to a criminal sanction. Breach of the section gives rise to a liability to pay damages to the client and is likely to expose the licence-holder to disciplinary action by the commission.

The present qualified privilege available to a securities adviser making a recommendation, contained in section 65A(5), has been modified. The modification is important because a securities adviser will only obtain the benefit of qualified privilege in respect to defamation actions where the recommendation complies with the disclosure requirements of the new section 68C (disclosure of the adviser's interests) and section 68E (the Know Your Client Rule).

Other amendments

The commission has power to make a banning order, excluding a person from being involved in the securities industry either as a licence-holder or as a representative of a licence-holder. Such banning orders cannot be made until after the commission has given the

Continued page 21

BOOK REVIEWS

Swap Financing

By Satyajit Das

The Law Book Company, Sydney, $120.

Reviewed by JEFF GOSS and GLYNN GILL

The recent publication by The Law Book Company Limited of Satyajit Das's book on swap financing is a bold attempt to capture the historical growth, conceptual framework and intricacies of pricing of interest-rate and currency swaps, LTFX, FRAs, caps, floors and collars. This book is definitely not for the beginner!

Mr Das has launched himself with enthusiasm into a complex, and to the uninitiated often confusing, world of financial innovation. The intricacies of swap instruments are described in great detail and are illustrated by a lavish use of exhibits. However the exhibits are sometimes as complicated as the subject matter Mr Das has sought to describe, with the effect that they highlight a result referred to in the text without truly illustrating how the result was achieved. The occasional inconsistent use of terminology will tend to unsettle the newcomer to the topic.

Moreover, although Mr Das describes in extraordinary detail the variety of instruments available in the international swap market game, it is hard to find a concise record of the rules of the game and how it can be played.

Both the capital markets practitioner and the corporate treasurer will be looking for ideas and guidance in the chapters on pricing and utilising swaps, accounting treatment and taxation effects. It is a little disappointing that these practical matters alternate with the more esoteric chapters on the evolution and behaviour of markets. Perhaps they could have been brought together to assist the reader to focus on outcomes rather than general principle.

Mr Das's book will serve as a useful memoir for the experienced operator of the techniques available to date, how they incestuously inter-relate and how the comparative pricing techniques and imperfections in the market can provide arbitrage opportunity. □

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Economics

By Roger N. Waud, Anthony Hocking, Philip Maxwell and Josef Bonnici

Harper & Row, Sydney, $44.50

Principles of Money, Banking and Financial Markets

By Lawrence S. Ritter and William L. Silber

Basic Books, New York, $US36.95 (inquiries to William Collins Pty Ltd, Sydney)

Reviewed by E.F. GILLIN

Instructors, students and business people should find *Economics* of great interest. It is a magnificent textbook in the tradition of the local adaptations of two other great US economics texts – Samuelson and McConnell.

This adaptation is the work of Anthony Hocking of the University of Tasmania, Philip Maxwell of the Curtin University of Technology and Josef Bonnici of Deakin University, who have given Australian relevance to the popular US textbook of Roger N. Waud, of the University of North Carolina.

The book covers the general comprehensive field of economics while reflecting Australia's quite different institutional background and policy issues. Its 34 chapters cover such areas as employment, fiscal policy, international trade, inflation, economic stability, the price system and market structure.

A *Microeconomics Study Guide* and a separate *Macroeconomics Study Guide* to accompany the main textbook are available at $37.95 each. Also available are an instructor's manual, a test bank and transparency masters of about 90 graphs.

This strongly recommended book has already been adopted by a number of Australian universities and other tertiary institutions.

Ritter and Silber's *Money, Banking and Financial Markets* has been making money and banking interesting to US students for more than 15 years. This sixth (1989) edition continues their role as authors of one of the most engaging and authoritative books in the field.

With improvements in institutional and theoretical coverage, it represents a substantial overhaul of the text. New features include a chapter on rational expectations, special emphasis on international issues, an "epilogue" on careers in banking and financial markets and an extensive glossary.

Both authors are eminently qualified by virtue of their academic positions and the practical experience in US financial institutions. Lawrence Ritter is professor of finance and economics at the business schools of New York University and was editor of the *Journal of Finance*; William Silber, also a professor of finance and economics at New York University, was formerly a US presidential economic adviser. □

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TOEING THE LINE

From page 17

person an opportunity of a hearing. Banning orders must be published in the Commonwealth Gazette.

A banning order may include a provision that permits the person, subject to conditions or in specified circumstances, to do acts which they would otherwise be prohibited from doing. This would enable the commission, for example, to make a banning order against a former principal but enable him or her to continue to act in a limited way as a representative where a principal takes responsibility for that person's action. People subject to banning orders have a right to apply to the commission to vary or revoke their banning orders.

One other significant amendment relates to the change in the definition of "financial journalist". The definition has been extended to include persons in the electronic media who advise, analyse or report about securities for publication. These people must maintain a register of relevant interests in securities, whether or not they hold licences.

Part 8 of the Co-operative Scheme Legislation Amendment Act 1989 represents a significant deregulatory move. The future of deregulatory moves within the companies and securities area will depend in no small part on the success of this particular initiative. For principals in the industry, it provides on the one hand greater freedom and flexibility when dealing with their representatives – but on the other hand it imposes greater responsibility. □