The increasing use of investment advisers and securities dealers is a feature of heightened activity in the Australian financial and investment markets. Stringent provisions have been built into the Corporations Law to ensure protection for clients and the close supervision of dealers and their representatives. Derek Parker reports that the system is not yet perfect — as Australian Securities Commission investigations show — but the level of compliance with the regulations is improving.

The Corporations Law stipulates that any person who carries on securities dealing business or an investment advice business must hold an appropriate licence (sections 780 and 781). Regulatory oversight of licensees is performed by the Australian Securities Commission, which devotes considerable resources to the task, including the operation of an extensive surveillance program.

The ASC’s oversight of the industry is based on several principles drawn from the Corporations Law:
- clients are entitled to know with whom they are dealing;
- any personal interests of an adviser must be disclosed to the client;
- advice must be appropriate;
- there must be no erosion of the civil liberty provisions.

The ASC has issued a number of practice notes designed to provide further information to licensees about their obligations and to help them comply with the regulatory requirements.

Identification
Practice Note 18, Guidance on the Identification of Licensees and Authorised Representatives, sets out guidelines for the preparation of promotional material. To ensure that the client is aware of the identity and status of the dealer or adviser, the ASC believes that, as good practice, the promotional material of a licensee or representative should provide:
- the name of the licensee and the type of licence held;
- the relevant address of the licensee;
- the name and business address of the authorised representative;
- the fact that the person is an authorised representative or the holder of a proper authority.

Promotional material is taken to include letters, financial plans, forms, brochures, advertisements, signs, business cards and “with compliments” slips. (It is not necessary to include the address of the licensee or representative on business cards, compliments slips or advertisements in newspapers or the Yellow Pages.)

Practice Note 18 also states that the promotional material of an authorised representative should not give the impression that the representative is in fact a licensee. It also notes that the use of company names in promotional

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The value of non-cash benefits, such as subsidised office space or research support services, must also be disclosed.

Disclosure of interests

Practice Note 23, Client to be Told if Adviser's Interests May Influence Recommendation, relates to section 849 of the Corporations Law. It makes clear that a securities adviser is obliged, when making a recommendation, to disclose to the client information about benefits the adviser will receive in connection with the recommendation. The obligation to disclose applies whether the recommendation is made orally or in writing, face-to-face or by telephone, or to one person or a group of persons.

The benefits that must be disclosed include:

- commissions (unless from the client), whether direct or indirect, flat-rate, percentage, "generic", up-front or trailing (ie, where funds remain in an investment);
- benefits gained because the licensee is acting as a principal (ie, presenting offers as recommendations) would be misleading;
- benefits gained because a licensee is underwriting the issue of the securities or guaranteeing subscription or placement;
- benefits gained because the licensee has a material interest in the company in which the client is advised to invest;
- where the adviser has an interest in the securities and where the recommendation, if acted on, is likely to increase the price of the securities;
- where the adviser is related to the management company of a recommended trust.

The value of non-cash benefits, such as subsidised office space or research support services, must also be disclosed.

Practice Note 23 points out that the Corporations Law requires the disclosure of benefits accruing to an associate of the adviser, such as partners in a firm carrying on a business of dealing in securities, or the offices of the adviser (if the adviser is a corporate licensee).

Practice Note 17, Referrals to Securities Licensees and their Representatives, also deals with the issue of disclosure, noting that where a licensee or authorised representative has arranged to pay a fee or commission to the referring party, as a result of receiving business from the referral, details of the benefit should be disclosed by the licensee or authorised representative to the client.

Breaches of section 849 are punishable by a fine of $2,500 and/or six months' jail, and the ASC may take disciplinary action in connection with the licence held.

An adviser who breaches the section is also liable to compensate clients who suffer loss or damage because of the breach.

Appropriate advice

Practice Note 41, Adviser Must Have Reasonable Basis for Recommendation, reflects the requirements of section 851. The section, sometimes referred to as the "know your client and product" rule, creates a statutory obligation to undertake research about securities being recommended and requires an adviser to have regard to what is known about the person receiving the recommendation.

An adviser must ascertain that the recommendation is appropriate to the investment objectives, financial situation and particular needs of the client. Information that an adviser should obtain about the client includes:

- details of the client's need for income, capital growth, security, liquidity and flexibility to convert investments to cash, as well as the time period the client is planning for;
- the client's personal circumstances and individual values, and aversion to or tolerance of risk;
- details of substantial assets owned alone, jointly or in common with another person by the client;
- details of liabilities and potential liabilities of the client;
- current expenditure and income, and an indication of future income and expenses, as well as capacity to save, and tax status of the client;
- existing asset and income protection held by the client;
- the level and type of superannuation cover of the client;
- other client details such as age, family commitments and social security eligibility.

A recommendation must be based on research and analysis conducted by the adviser or obtained from external sources. The nature of the recommendation must be fully disclosed to the client, including information on:

- risks associated with the issuer, including the qualities and experience of the issuer;
- risks associated with the product, such as the quality of underlying assets and risk-return characteristics of the product;
- market and economic risks, such as economic cycles, volatility and other capital market factors;
- capital and income prospects.

Part of the ASC's surveillance program involves the examination of an adviser's client files, which should contain information explaining how, when and why particular recommendations were made to each client, as well as material on disclosure, client assessment and other pertinent matters.

The ASC believes that an adviser should at any time be able to provide sufficient written information about the securities recommended so that the basis on which those securities were considered appropriate for the particular client can be understood. It is expected that this information would usually be provided to the client before the client takes up the recommendation, and that it should be easily accessible in the adviser's client files.

How much information an adviser has about a particular client depends on the nature of the client and the ex-

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existing business relationship. For example, if the client has made use of the full portfolio planning services of the adviser over a number of years the adviser would have a clear picture of the client's investment needs and objectives.

In this case, the adviser may have all the information needed. However, the adviser should reassess the client's circumstances periodically to ensure that this information is current and comprehensive.

As securities licensees are liable for the conduct of their representatives, it is expected that they should apply sufficient control over their representatives to ensure that the representatives confine their advice to investments that have been adequately researched.

While there is no penalty stipulated by the Corporations Law for a breach of section 851, civil liability under section 852 applies. Also, if the ASC determines that a licensee or authorised representative has not complied with the section, it can take remedial action which may include revoking or suspending the licence, banning a representative or seeking changes to the licensee's methods of operation.

Civil liability

The civil liability provisions of the Corporations Law are an important part of the regulatory framework applying to securities dealing and advising, particularly with regard to the relationship between licensees and the representatives they authorise. Section 817 of the law states that a licensee is liable for a representative's conduct and section 821 provides that the licensee cannot generally contract out of the liability. Liability is retained even if the authorised representative acts illegally or outside parameters set by the licensee.

It is therefore directly in the licensee's interest to ensure that authorised representatives perform honestly and efficiently and that they are properly trained and supervised. The question of proper training and supervision is especially important, given the growth of large networks of authorised representatives, appointed by a single licensee or a small number of licensees, operating across states or the whole country.

The ASC does not take the view that appropriate training and supervision is impossible when there is a physical distance between licensee and representative, or where a licensee has appointed a large number of representatives.

Indeed, the ASC is aware that some licensees have developed sophisticated and effective arrangements for the training and supervision of authorised representatives.

But the experience of the ASC's surveillance program has shown that, in some instances, proper oversight does not take place.

The issues of oversight, training and supervision aside, the ASC has found that where an authorised representative is physically separated from the licensee, the representative can easily drift into the carrying on of business in their own right. Under the law, an authorised representative who generates a substantial amount of business largely without reference to the principal should be a licensee rather than a representative.

The ASC surveillance program has also revealed cases of franchise and agency agreements between licensees and representatives which interpose a company in the agreement, so that it becomes a three-party agreement between the dealer, the representative and the representative's company. It may also provide for some of the acts of the representative to be carried out by the company.

Such agreements clearly breach section 809 of the Corporations Law, which provides that a body corporate shall not act as a representative of a dealer. Typically, the effect of a three-party agreement is to cloud the arrangements to the extent that investors may not know whom they are dealing with.

Several of the three-party agreements examined by the ASC also purport to shift the responsibility of the dealer for the acts of the representatives to the company, in breach of section 821. The line of liability must remain clear.

While there have been no large suits against licensees under the Corporations Law regime, the experience of the United States is significant. According to Fortune magazine (October 1993), in the 18 months to 30 June 1993 a total of 6,464 claims were made against US brokerage firms (the equivalent of Australian advisers and dealers).

The total amount of damages claimed was $US2 billion. One-third of investors settled and more than half of the rest were awarded damages averaging 60 per cent of what they claimed.

Obviously, in a civil case seeking damages against an adviser, comprehensive client files would provide an important means of defence.

Surveillance program

Only a small proportion of authorised representatives — 495 out of 29,801 in 1992/93 — have been directly examined in the ASC's surveillance program. Because of the civil liability provisions of the Corporations Law and the consequent assumption that licensees will provide adequate oversight of their representatives, the focus of ASC activity is the licensees.

338 out of 1,678 were visited in 1992/93.

As a result, 11 licensees had their licences revoked, two licences were suspended, 17 licensees surrendered their licences and a further 24 had their licence conditions amended.

There were 158 other instances of minor remedial action, such as requiring undertakings from licensees to rectify particular matters.

Following visits to authorised representatives, four were banned from the industry and 183 others were subject to remedial action. In nearly all cases where the ASC has acted against an authorised representative, the licensee has also been subject to consequent remedial action, such as a revision of licence conditions.

In some instances, the ASC required licensees to establish a process for compensating clients who lost money as a result of defective advice. In other cases, licensees were required to appoint compliance officers to ensure that problems were addressed. A number of firms provided undertakings to the ASC regarding administrative changes.

Significant as these results may be, the view of the ASC is that, in the past 18 months, the level of legal compliance in the dealing and advising sector has improved. The ASC expects that this improvement will continue as licensees further develop compliance mechanisms and as the surveillance program identifies and removes persons who are unsuitable for the industry.