The Supreme Court of New South Wales

Corporate and Commercial Law Conference 2018

Directors' Duties, Corporate Culture and Corporate Governance

H Kevin McCann AM

Corporate Governance: Lessons from the Interim Report of the Financial Services Royal Commission

Co-sponsored by the Supreme Court of New South Wales, The Law Society of New South Wales and the Ross Parsons Centre of Commercial, Corporate and Taxation Law of the University of Sydney Law School.

Supreme Court of New South Wales Corporate and Commercial Conference 2018

Corporate Governance: Lessons from the Interim Report of the Financial Services Royal Commission

H Kevin McCann AM, Company Director

Table of Contents

1 Introduction

On the 26th of September 2018 Commissioner Hayne delivered an Interim Report of the Royal Commission into misconduct in the banking, superannuation and financial services industries.

In his Executive Summary the Commissioner noted:

> The Commission's work, so far, has shown conduct by financial services entities that has brought public attention and condemnation. Some conduct was already known to regulators and the public; some was not.[1]

My focus today will be on lessons learnt from how the breakdown in culture and governance at the four major banks (CBA, WBC, ANZ and NAB) and the AMP, led to misconduct and alleged illegal behaviour, revealed in the Report .

In writing this paper, I have also drawn on the APRA Prudential Inquiry into the CBA chaired by Dr Laker and delivered to APRA in April 2018[2], and speech and notes by Professor Graeme Samuel[3], a member of the CBA Panel.

2 Background

2.1 Establishment of a Royal Commission

Since 2014 there had been a persistent political pressure for a Royal Commission from Labour, the Greens, Independents and minor parties in the Senate and the House of Representatives. The enquiries and scandals which fuelled the demand included:

(a) **ASIC performance**

On 26 June 2014, a Final Report regarding the Performance of ASIC was published by the Senate Standing Committees on Economics. This Senate Inquiry found that misconduct by a CBA subsidiary (CFPL, between 2006 to 2010) included employees and intermediaries forging client signatures to facilitate profit-producing switches and unethical financial planning in the context of allocating the assets of conservative-risk clients (i.e. retirees) into high-risk

[1] Commonwealth, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Executive Summary* (2018) xix.

[2] Australian Prudential Regulation Authority, Prudential Inquiry into the Commonwealth Bank of Australia, (April 2018) 6 < https://www.apra.gov.au/sites/default/files/CBA-Prudential-Inquiry_Final-Report_30042018.pdf>.

[3] Professor Graeme Samuel, 'Presentation Notes' (Presented at the Consumer and Banking Association Conference, Melbourne, 22 October 2018)

products.[4] Such misallocation solely benefitted the adviser, given that CFPL recognised such conduct as high performance and awarded correlative bonuses. The Senate Inquiry recommended that a Royal Commission into these matters was warranted, particularly with the overriding objective of developing regulatory bodies (such as the Australian Securities and Investment Commission) into 'self-evaluating and self-correcting' organisations.[5]

(b) **Sedgwick Report**

The Australian Banker's Association (**ABA**) appointed Mr Stephen Sedgwick AO, the former Australian Public Service Commissioner, to conduct an independent review into remuneration practices in the retail banking industry (the review began in July 2016 and the final report was provided in April 2017). The thrust of the 21 recommendations made by the Sedgwick review was to recommend elimination of employee financial incentives directly relating to sales and "reducing the influence of sales in performance scorecards"[6] (as pertaining to retail bank staff).[7] This review noted that current remuneration practices in retail banking carry an "unacceptable risk of promoting behaviour that is inconsistent with the interests of customers and should be changed".[8]

(c) **BBSW litigation**

In 2016 ASIC instituted proceedings in the Federal Court against ANZ, NAB and Westpac, alleging attempted manipulation of the Bank Bill Swap Rate (**BBSW**) in an 'unconscionable manner' that was tantamount to 'market-manipulation' for monetary benefit.[9] NAB and ANZ settled with ASIC for $50 million in late 2017.[10] Westpac, which defended the rate rigging case, was found to have engaged in unconscionable conduct (it attempted to influence the BBSW) but not

[4] Economics References Committee, The Senate, *Performance of the Australian Securities and Investment Commission* (2014) 28.

[5] Ibid 16.

[6] Commonwealth, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report* (2018) vol 1, 306.

[7] Ibid 307.

[8] Ibid 306.

[9] Stephen Letts and Michael Janda, 'Westpac engaged in unconscionable conduct but failed to rig BBSW interest rate, court finds', ABC News (online), 24 May 2018 <https://www.abc.net.au/news/2018-05-24/westpac-rate-rigging-case/9794944>.

[10] Ibid.

in BBSW rigging (because it did not, in fact, influence the BBSW).[11] The Federal Court refused to endorse a $35 million penalty in an ASIC and WBC agreed settlement due to its inability to determine the nature of the breach of responsible lending laws.

In 2018, similar rate rigging proceedings brought by ASIC against CBA were settled for $25 million.[12]

(d) **APRA's Prudential Inquiry into CBA**

The APRA report delivered in April 2018 referred to a number of incidents involving the CBA which damaged its reputation and public standing, including:

- mis-selling of residential mortgages and margin loans to retail customers to invest in financial products recommended by Storm Financial (2008);
- fees for no service in financial advice (2012-2015);
- use of outdated definition of heart attack in insurance products sold by Comminsure (2016);
- anti-money laundering (AML breaches and Austrac Action (2017)); and
- mis-selling of credit card insurance (2013-2018).[13]

Initially the Australian Government resisted the appointment of a Royal Commission. However, in late 2017, the Chief Executives of four major banks wrote to the Treasurer in the following terms:

> In light of the latest wave of speculation about a parliamentary commission of inquiry into the banking and finance sector, we believe it is now imperative for the Australian Government to act decisively to deliver certainty to Australia's financial services sector, our customers and the community…
>
> However, it is now in the national interest for the political uncertainty to end. It is hurting confidence in our financial services system, including in offshore markets, and has diminished trust and respect for our sector and people. It also risks undermining the critical perception that our banks are unquestionably strong.

[11] Ibid.

[12] Australian Securities & Investments Commission, '18-341MR Court orders penalties and other relief against Westpac for BBSW conduct', ASIC, 9 November 2018 <https://asic.gov.au/about-asic/news-centre/find-a-media-release/2018-releases/18-341mr-court-orders-penalties-and-other-relief-against-westpac-for-bbsw-conduct/>.

[13] Australian Prudential Regulation Authority, Prudential Inquiry into the Commonwealth Bank of Australia, (April 2018) 6 < https://www.apra.gov.au/sites/default/files/CBA-Prudential-Inquiry_Final-Report_30042018.pdf>.

Following this letter and ongoing political pressure from the Opposition, Greens, Independents and members of the Government's back bench, the Treasurer established the Royal Commission on the 14th of December 2017.

2.2 Terms of Reference of the Royal Commission

The Terms of Reference of the Commission relevant to the issues examined in this paper are:

- Whether any conduct by financial services entities (including directors, officers or employees or anyone acting on behalf of those entities) might have amounted to misconduct.
- Whether any conduct, practices, behaviour or business activities by financial service entities fall below community standards and expectations.
- Is the above finding attributable to the particular culture and governance practices of a financial services entity or broader cultural governance practices in the relevant industry or sub-sector?
- The adequacy of existing laws and policies relating to the provision of banking, superannuation and financial services, the internal systems of financial services entities and the forms of industry self-regulation, including industry codes of conduct.
- The effectiveness and ability of regulators of financial services entities to identify and address misconduct by those entities.

The Letters Patent defined a financial services entity as "a person or entity required by Section 911A of the *Corporations Act 2001* to hold an **Australian financial services licence**, or who is exempt from the requirement to hold such a license by virtue of being an authorised representative."[14]

Misconduct is broadly defined in the Letters Patent as including four distinct kinds of conduct:

- conduct that 'constitutes an offence against a Commonwealth, State or Territory law, as in force of at the time of the alleged misconduct';
- conduct that is 'misleading, deceptive or both';
- conduct that is a 'breach of trust, breach of duty or unconscionable conduct'; and

[14] Commonwealth, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Executive Summary* (2018) 6.

- conduct that 'breaches a professional standard of a recognised and widely accepted benchmark for conduct.'[15]

The Letters Patent also directed the Commissioner to consider the implications of any recommended changes to the law, having regard to "the economy generally, for access to and the cost for financial services for consumers, for competition in the financial sector and for financial system stability."[16] This direction was supplemented by the requirement "to give priority to matters" that in the Commissioner's opinion, "have greater potential for harm if not addressed expeditiously".[17]

2.3 Methodology adopted by the Royal Commission

The Royal Commission made initial enquiries of 61 financial services entities. In addition members of the public were invited to make submissions to the Commissioner and almost 20,000 complaints were made about financial service entities.

As the major banks and AMP had paid hundreds of millions of dollars in remediation prior to the establishment of the Commission, the Commissioner resolved to proceed by way of Case Study of misconduct alleged against them so that the Royal Commission to date has mostly focussed on their misconduct.

The main criterion applied on case selection was whether the cases chosen were likely to permit identification and useful exploration of those issues having a wider application than the particular case. Were the cases particular examples of widespread or frequently occurring conduct? Did the cases raise issues that may be systemic?[18]

Concurrently to the above, the Commission commissioned research papers that related to the subjects dealt with in the Interim Report, including papers describing the features of the banking industry, features of the financial planning industry and the mortgage broking industry.[19] The background paper of Professor Hanrahan on the provision of financial advice has been extremely helpful in preparing this paper.[20]

---

[15] Ibid.

[16] Ibid 5.

[17] Ibid.

[18] Ibid 12.

[19] Ibid 14.

[20] Professor Pamela Hanrahan, 'Legal Framework for the Provision of Financial Advice and Sale of Financial Products to Australian Households' (Background Paper No 7, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, April 2018) 27.

3 Legal Framework

The Commissioner focussed on a limited number of sectors in the banking, superannuation and financial services industries in the Interim Report. Those which received greater consideration by the Commissioner included financial advice and consumer lending. This paper will focus on these sectors, in view of their importance to consumers in the banking, superannuation and financial services industries.

In this context it is important to understand the legal framework regulating financial advice and consumer lending, the relevant regulation which currently provides prudential and market conduct oversight of financial entities, their board members and executives and the regulatory tools available to the regulators to enforce compliance with the law and punish misconduct.

3.1 Financial advice

The legal framework that regulates the provision of financial advice has been characterised as a complex patchwork of legislation and the general law.

Professor Hanrahan has provided an outline of this framework in her comprehensive paper "Legal Framework for the Provision of Financial Advice and Sale of Financial Products to Australian Households: Background Paper 7".[21]

The relevant legislation includes the *Corporations Act 2001* (Cth) (***Corporations Act***) and the *Australian Securities and Investments Commission Act 2001* (Cth) (***ASIC Act***) and *The Australian Prudential Authority Act 1998* (Cth) (***APRA***) and *The Banking Act 1959* (Cth). This is supplemented by relevant general law including contract, tort and fiduciary duties. Recent reform, including the Future of Financial Advice (FOFA) reforms (discussed below), have led to a significant shift in regulation to a greater reliance on a range of regulatory levers instead of just a general licensing framework.[22]

[21] Professor Pamela Hanrahan, 'Legal Framework for the Provision of Financial Advice and Sale of Financial Products to Australian Households' (Background Paper No 7, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, April 2018).

[22] The Treasury, *Key Reforms in the Regulation of Financial Advice: Background Paper 8* (Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, 2018) 2.

(a) **Financial advice given to households**

Let me summarise here the regulation concerning the giving of financial product advice to households:

- The providers of financial services must be licensed (AFS Licensees).
- There are obligations on these providers to ensure they provide financial services efficiently, honestly and fairly.[23]
- An AFS licensee must also not engage in unconscionable conduct, must give priority to client's orders and must comply with requirements relating to dealing in markets.[24]

When providing financial advice, false or misleading statements, fraudulently inducing dealing, dishonest conduct and misleading or deceptive conduct are prohibited by the Corporations Act.[25] Unfair contract terms, unconscionable conduct, misleading or deceptive conduct and unfair sales practices are also prohibited by the ASIC Act.[26]

If the advice is provided pursuant to an agreement or retainer, general law contractual duties are enlivened including an implied duty of care. An advisor can therefore be liable for negligence.

(b) **Financial advice given to retail clients**

Where the financial product advice is given to retail clients, additional requirements are activated. In these circumstances, AFS licensees are required to have a complying dispute resolution system and compensation arrangements.[27] Further, the Corporations Act imposes mandatory disclosure requirements and general advice warning requirements on providers.[28]

[23] *Corporations Act 2001* (Cth) Pt 7.6. See, eg, s 912A.

[24] Ibid Pt 7.8, Div 7.

[25] Ibid Pt 7.10.

[26] *Australian Securities and Investments Commission Act 2001* (Cth) Div 2.

[27] *Corporations Act 2001* (Cth) Pt 7.6.

[28] Ibid Pt 7.7.

(c) **Personal financial advice given to retail clients**

Where personal financial product advice is given to retail clients, further mandatory disclosure requirements are imposed by the Corporations Act.[29] Pre FOFA reforms, the Registrable Superannuation Entity (RSE) Licensee must also have satisfied the 'suitability rule', which required the licensee to have a reasonable basis for giving personal advice to a retail client.[30] Post FOFA reforms, a series of performance obligations, including an obligation to act in the best interests of the client, and a ban on 'conflicted remuneration' now apply to providers.[31] Conflicted remuneration means any benefit given to a financial services licensee (or their representative) which could reasonably be expected to influence their recommendation of financial product to the retail client or their provision of financial product advice to the retail client.[32]

(d) **FOFA**

The FOFA reforms, which commenced on 1 July 2012, stemmed from the recommendations of the Parliamentary Joint Committee on Corporations and Financial Services in its 2008-2009 inquiry into financial products and services. The reforms introduced a new Part 7.7A of the Corporations Act, which contains performance obligations covering the provision of personal advice to retail clients and restrictions on conflicted remuneration.[33]

A core change was the obligation to act in the client's 'best interests' in relation to the advice. This can be satisfied if the adviser proves that it has acted in accordance with each of the seven "safe harbour" provisions in s 961B(2) of the Corporations Act (which includes steps like identifying the "objectives, financial situation and needs of the client that were disclosed to the provider by the client through instructions").[34]

[29] Ibid.

[30] Ibid.

[31] Ibid Pt 7.7A.

[32] Ibid s 963A.

[33] Ibid Pt 7.7A.

[34] Ibid s 961B.

There are lengthy and detailed provisions in the Act and Regulations on the content of a Financial Services Guide when the client is given personal financial advice[35]

Section 961B is a civil penalty provision, and a court may order a person to pay a pecuniary penalty of up to $200,000 where a breach to has occurred.[36] The first civil penalty imposed on a financial services licensee for breach of the best interests duty occurred in October 2017, where the Federal Court imposed a penalty of $1 million against Melbourne-based financial advice firm NSG Services Pty Ltd.[37]

The third 'tranche' of FOFA reforms, which seek to 'professionalise' the financial advice industry, were first enacted in February 2017 (during the operation of the Royal Commission), but will not come into full effect until 2025.[38]

3.2 Consumer Lending

The legal framework that regulates consumer lending has, at its core, the responsible lending conduct obligations in Chapter 3 of the *National Consumer Credit Protection Act 2009* (Cth)(**NCCP**). The key concept underlying these obligations is that a lender must not "enter into a credit contract with a consumer, suggest a credit contract to a consumer or assist a consumer to apply for a credit contract if the credit contract is unsuitable for the consumer".[39] This involves the lender making reasonable inquiries about the customer's financial situation and their requirements and objectives, taking reasonable steps to verify the consumer's financial situation and making an assessment about whether the credit contract is 'not unsuitable' for the consumer.[40]

---

[35] See footnote 38 Hanrahan 55/59

[36] Ibid s 1317G.

[37] Australian Securities & Investments Commission, *17-365MR Financial advice firm to pay $1 million penalty for breach of best interests duty* (30 October 2017) ASIC <https://asic.gov.au/about-asic/news-centre/find-a-media-release/2017-releases/17-365mr-financial-advice-firm-to-pay-1-million-penalty-for-breach-of-best-interests-duty/>.

[38] Professor Pamela Hanrahan, 'Legal Framework for the Provision of Financial Advice and Sale of Financial Products to Australian Households' (Background Paper No 7, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, April 2018) 12-14.

[39] Australian Securities & Investments Commission, *Credit licensees* (20 October 2014) ASIC <https://asic.gov.au/for-finance-professionals/credit-licensees/>.

[40] Ibid.

Contraventions of the responsible lending obligations give rise to liability for civil and, in limited circumstances, criminal penalties. A court may order a person to pay a pecuniary penalty of up to $220,000 where a breach is established to have occurred[41]. Customers may also seek damages and other compensatory orders where they have suffered loss as a result of a contravention.[42]

4 Regulation Applying to Board Members of Financial Services Entities

Apart from the duties of directors under general law, there is a specific regulation relating to corporate governance and directors of financial entities.

(a) Directors Duties

The Corporations Act provides for a series of 'directors duties',[43] which include:

- the duty to exercise their powers with the care and diligence of a reasonable person,[44]
- the duty to exercise their powers in good faith in the best interests of the company,[45] and
- the duty not to improperly use their position to gain an advantage for themselves or someone else or to cause detriment to the company.[46]

The nature of the duties is fully outlined in Ford, Austin and Ramsay's Principles of Corporations Law.[47]

In Australia, public company directors also face a significantly higher chance of being liable than US or UK directors for a breach of director's duties by failing to monitor corporate culture risks. Professor Jennifer Hill of the University of Sydney Law School's ground-breaking paper considered this issue.[48] Hill cites *ASIC v Adler* and Santow J's comments to argue that directors "can be liable under

[41] *National Consumer Credit Protection Act 2009* (Cth) s 167.

[42] Ibid ss 178, 179, 180, 180A.

[43] Directors duties are, of course, also derived from common law and equity.

[44] *Corporations Act 2001* (Cth) s 180.

[45] Ibid s 181.

[46] Ibid s 182.

[47] See Robert Austin and Ian Ramsay, *Ford, Austin and Ramsay's Principles of Corporations Law* (LexisNexis, 17th ed, 2018) Chapter 8.

[48] The paper is based on a speech delivered by Jennifer Hill at ASIC on 16 April 2018: Jennifer Hill, 'Are Directors Liable for Seriously Flawed Corporate Cultures?' (Speech delivered at the Law & Business Downtown Seminar, ASIC, 16 April 2018).

the duty of care and diligence for omissions, if they do not ensure that the company has appropriate compliance systems and acts in accordance with its authorised practices ".[49] She describes this as a responsibility for the directors to ensure the company is not engaging in "organisational hypocrisy" due to deficient corporate culture.[50]

The rise of "stepping stone liability" also suggests that directors may be liable for a breach of s 180 of the Corporations Act (care and diligence) where they fail to monitor managerial integrity or corporate culture issues.[51] This form of liability arises where the company breaches a provision of the Corporations Act and the directors have breached their duty of care by allowing the contravention to occur.[52]

(b) **BEAR**

The Banking Executive Accountability Regime (**BEAR**) regime was established under legislation (set out in Part IIAA of the Banking Act 1959 (Cth)) and is administered and enforced by APRA. It came into effect for the four major banks on 1 July 2018, and is due to commence for other ADIs on 1 July 2019.[53] The regime is intended to "establish clear and heightened expectations of accountability for ADIs, their directors and senior executives, and to ensure there are clear consequences in the event of a material failure to meet those expectations."[54]

BEAR establishes accountability obligations which apply to 'accountable persons', which includes directors of the board of an ADI. These obligations include the requirement to act with "honesty and integrity, and with due skill, care and diligence", deal with APRA in an open and cooperative manner and take reasonable steps to prevent matters arising that would adversely affect the ADI's prudential standing.[55]

---

[49] Ibid.

[50] Ibid.

[51] Ibid.

[52] Ibid.

[53] APRA, *Information Paper: Implementing the Banking Executive Accountability Regime* (APRA, 17 October 2018) 6.

[54] Ibid.

[55] *Banking Act 1959* (Cth) s 37C.

ADI's are also required to defer a prescribed minimum proportion of an accountable person's variable remuneration for a minimum of four years.[56] In conjunction with this, an ADI's remuneration policy must require a reduction in an accountable person's variable remuneration proportionate to any failure to comply with accountability obligations.[57]

(c) **APRA Prudential Standards**

APRA supervises Australia's banks and superannuation funds (excluding self-managed funds).[58]

The *APRA Act 1998* (Cth) states that 'In performing and exercising its functions and powers, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia'.

APRA Prudential Standard CPS 220 (**CPS 220**) commenced on 1 July 2017.[59] The Standard provides that the Board of a bank and insurance company has ultimate responsibility for having a risk management framework that is appropriate to the size, business mix and complexity of the institution or group it heads.[60]

The risk management framework must be consistent with the institution's strategic objectives and business plan. The board is responsible for the oversight of its operations by management.[61]

Further, the Board also must form a view of the risk culture in the organisation and the extent to which that culture supports the ability of that institution to operate consistently within that culture.

In practice this includes a requirement for the Board to approve a risk appetite statement, a risk management strategy, a business plan and to make an annual declaration to APRA on risk management in the institution.[62]

---

[56] Ibid Part IIAA, Div 4.

[57] Ibid.

[58] The Australian Prudential Regulation Authority, *Industry supervision* (2018) APRA <https://www.apra.gov.au/supervision>.

[59] Ibid.

[60] Ibid.

[61] Ibid.

5 Enforcement

Where members of the banking, superannuation and financial services industries do not comply with their legal obligations, the market regulator, ASIC and the prudential regulator, APRA can take enforcement action against entities and individuals.

5.1 ASIC

The ASIC Act directs ASIC to 'take whatever action it can take, and is necessary, in order to enforce and give effect to the laws of the Commonwealth that confer functions and powers on it'.[63] ASIC has a variety of enforcement remedies at its disposal to do just that.

ASIC can apply to the court, a civil pecuniary penalty for a breach of director's duties (up to $200,000)[64] A court, on ASIC's application, may also disqualify a person from managing corporations for a period that it considers appropriate.[65] The time of disqualification is at the discretion of the court, and disqualification periods ranging from 3 years to a life ban have been imposed.[66] A court may also order a person to compensate a corporation for damage suffered if that person contravened a civil penalty provision in relation to that corporation.[67]

An instance of a huge increase in penalties on banks is The *Treasury Laws Amendment (Strengthening Corporate and Financial Sector Penalties) Bill* 2018which provides for fines to be imposed on Banks of up to 10% of annual turnover (capped at $210 million per breach) if they do not comply with their obligations under s 912A of the Corporations Act (which contains the core obligations owed by each financial services licensee).[68]

ASIC is able to seek protective action, for instance disqualification from managing a corporation and public warning notices.[69]

---

[62] Ibid.

[63] *Australian Securities and Investments Commission Act 2001* (Cth) s 1(2)(g).

[64] *Corporations Act 2001* (Cth) s 1317G.

[65] Ibid s 206C(1)(a).

[66] *Re HIH Insurance Ltd (in prov liq); Australian Securities and Investments Commission v Adler* (202) 42 ACSR 80.

[67] *Corporations Act 2001* (Cth) s1317H.

[68] *Treasury Laws Amendment (Strengthening Corporate and Financial Sector Penalties) Bill* 2018 (Cth).

[69] Australian Securities & Investments Commission, *Information Sheet 151* (September 2013).

Preservative action can be taken to protect assets (for instance, via an injunction in court) and corrective action can be taken for corrective disclosure (for instance, to correct a misleading or deceptive advertisement).[70]

ASIC also has powers under s 50 of the ASIC Act to begin a representative action to recover damages or property for person who have suffered loss.[71]

5.2 APRA

The enforcement powers APRA possesses to protect the interests of depositors, policyholders and members of superannuation funds, include the power to:

- undertake a formal investigation into the affairs of an institution;
- impose conditions on an institution's licence;
- accept enforceable undertakings;
- take criminal action against persons or institutions; and
- seek restraining orders.[72]

Where an APRA regulated institution becomes aware that it has committed a breach (or will commit a breach) and that breach is 'significant', it must give APRA a written report about the breach. Failure to notify APRA of a breach of a prudential requirement is a strict liability offence and a penalty of $22,000 may apply.[73]

APRA can disqualify individuals from their positions within the industries supervised by APRA. Since 1 July 2008, any decision to disqualify an individual from holding a senior role has been made by the Federal Court of Australia, on application by APRA.[74]

Further, APRA can take a number of enforcement steps under the BEAR regime. If an ADI fails to meet its accountability obligations, APRA may apply to the Federal Court of Australia to seek the imposition of substantial civil penalties up to $210 million for a large ADI (entity with resident assets greater than $100 billion). There is no civil penalty liable under BEAR for individuals (although individuals may still be liable to civil penalties under the Corporations Act). However, in serious cases of non-compliance with accountability obligations, APRA may disqualify an individual from being an

[70] Ibid.

[71] Ibid.

[72] The Australian Prudential Regulation Authority, *Enforcement* (2018) APRA <https://www.apra.gov.au/enforcement>.

[73] See, eg, *Banking Act 1959* (Cth) s 62A.

[74] The Australian Prudential Regulation Authority, *Enforcement* (2018) APRA <https://www.apra.gov.au/enforcement>.

accountable person 'for a period that APRA considers appropriate'.[75] On APRA's Disqualification Register, there are ongoing disqualifications dating back to 11 June 2001.[76]

6 Legal Complexity

The Commissioner acknowledged the regulatory regime applying to the financial services sector is complex.[77] He has posed the rhetorical question, should the law be simplified?

> The law already requires entities to provide that services to be provided by entities are to 'efficiently, honestly and fairly'. … Passing some new law to say again do not do that, would act an extra layer of legal complexity to an already complex regulatory regime. What would that gain.[78]

In Chapter 10 the Commissioner returns to the issue again.[79]

- Does it impede effective conduct risk management?
- Does it impede effective regulatory enforcement?

7 Misconduct Identified

In general, the Commission suggested an environment of nonchalance towards compliance existed, which enabled the misconduct to occur:

> The evidence that was led in the first round of hearings suggested that the entities examined had done, and were doing, as little as they thought they have needed to do to meet their legal obligations, offering no (or at best, next to no) encouragement to or reward for staff or third parties to pursue the interests of the consumer. Compliance appeared to have been relegated to a cost of doing business. And, the case studies undertaken in the first round of hearings showed, that there had been occasions when profit has been allowed to trump compliance with the law, and many more occasions where profit trumped doing the right thing by customers.[80]

---

[75] *Banking Act 1959* (Cth) 37J(1).

[76] The Australian Prudential Regulation Authority, *Disqualification Register* (2018) APRA <https://www.apra.gov.au/disqualification-register>.

[77] Commonwealth, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report* (2018) vol 1, 290.

[78] Ibid XX.

[79] Ibid 339.

[80] Ibid 55.

7.1 Financial Advice

The Commission identified in this sector numerous acts of misconduct related to the operations of CBA, WBC, NAB, ANZ and the AMP. Particular instances of misconduct derived from Case Studies set out in Volume 2 of the Interim Report included:

(a) **Fees for no service**

Fees were charged to clients (by debiting accounts) in circumstances where no financial advice was provided to them and where the licensee and adviser was aware it could not be provided. The most blatant offender was the AMP. The case study on the AMP in volume 2 requires close reading, as it reveals instances where senior executives condoned the charging of fees when they were aware that no advice would be provided to the clients.[81]

Case studies revealed other entities failed to develop and enforce effective monitoring and checking procedures to prevent systemic misconduct by advisers.

(b) **Bad advice by advisers**

The case studies identified bad advice by advisers to clients from each of the entities which required remediation by licensees.[82]

(c) **Improper conduct by advisers**

This included dishonesty, deceptive and/or fraudulent and gross incompetence, which required remediation.[83]

(d) **Inadequate systems**

The case studies demonstrated that financial entities had inadequate systems, to service clients. AMP systems could not cease deductions for fees charged for no service. No effort was made to remediate the payments through manual processes. Nor did the entities have systems to establish if advisers were fulfilling their obligations so that detection of non-conformance did not occur.[84]

(e) **Misleading ASIC**

[81] Commonwealth, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report* (2018) vol 2, 123, 130, 132-3.

[82] Ibid 232.

[83] Commonwealth, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report* (2018) vol 1, 117, 121.

[84] Ibid 131.

The Commissioner found that the AMP had misled ASIC in relation to ongoing service fee conduct:

> There were senior persons within AMP (I make no finding more precisely than that) who knew of the charging of fees for no service and internal lawyers warned it was a breach of the law. Despite all this, AMP provided ASIC with information that was false or misleading. Senior management and executives who contributed to the misleading of ASIC over a two year period had knowledge of the true extent and nature of the conduct, and, in some cases, were warned by junior staff about it being a breach, but continued with a misleading narrative to ASIC.
>
> The culture and governance practices revealed the conduct reflects insufficient concern for adherence to the law. On the face of it, it reflects a persistent and prevalent attitude of senior persons within AMP that it is acceptable to deal with ASIC other than frankly and candidly.[85]

8 Home Lending

The four major banks CBA, WBC, ANZ and NAB acknowledged to the Commission that they had committed breaches of the NCCP Act in relation to home lending, credit cards and unsolicited offers of credit.

The Commissioner outlined that the determination of whether the loan is unsuitable required a number of steps including:

- making reasonable enquiries about the consumer's requirements and objectives in relation to the credit contract;
- making reasonable enquiries about the consumer's financial situation; and
- taking reasonable steps to verify the consumer's financial situation.

He emphasised the content of these three steps as important. The first two require reasonable enquiries; the third requires reasonable steps to verify.[86]

The Commissioner considered the banks had erroneously regarded the legislative requirements as satisfied if the borrower is an acceptable credit risk.

---

[85] Commonwealth, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report* (2018) vol 2, 144.

[86] Commonwealth, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report* (2018) vol 1, 23.

The Commissioner identified four misconduct issues in connection with financial institutions lending:

- Intermediaries/the confusion of roles and responsibilities.
- Customer needs/you need what we have to sell.
- Credit risk or unsuitable/lending is not unsuitable if the consumer is unlikely default.
- Processing errors, failure to deliver promise features of products sold.

> All the Banks acknowledged misconduct falling short of community standards and expectation with home loans, credit cards and 'processing errors'. [87]

- Additional insurance sold in conjunction with credit cards and home loans to customers who did not meet the criteria to claim under the policy.

9 Cause of financial service entity misconduct

Commissioner Hayne has a very clear view of the cause of financial services entities' misconduct and why it persisted over a number of years.

In his Executive Summary he states:

> Why did it happen?
>
> Too often, the answer seems to be greed – the pursuit of short term profit at the expense of basic standards of honesty. How else is charging continued advice fees to the dead to be explained? But is necessary then to go behind the particular events and ask how and why they came about. His conclusion was:
>
> (1) Banks and all financial services entities recognise that they sell services and products. Selling became the focus of attention. Too often it became the sole focus of attention. Products and services multiplied. Banks searched for their 'share of the customer's wallet'
>
> (2) From the executive suite to the frontline, staff were measured and rewarded by reference to profits and sales.
>
> (3) When misconduct was revealed it went unpunished or the consequences did not meet the seriousness of what had been done. The conduct regulator, ASIC, rarely went to court to seek public denunciation and punishment for misconduct. The Prudential regulator, APRA, never went to court.

[87] Ibid 55.

(4) Much more often than not, when misconduct was revealed, little happened beyond apology from the entity, a drawn out remediation program and protracted negotiations with ASIC of a media release, an infringement notice or an enforceable undertaking that acknowledged no more than ASIC had reasonable concerns about entities conduct, infringement notices imposed penalties that were immaterial for the large banks. Enforceable undertakings might require a community benefit payment but the amount was far less than the penalty that ASIC could properly ask a court to impose.[88]

In Chapter 10 he restated his view under Causes in more detail:

- conflict of interest and duty
- remuneration structure
- culture and governance
- regulatory response
- culture and governance.

In his consideration of causes of various forms of misconduct in the case of fees for no service he detailed five types of misconduct identified:

- licensees did nothing to prevent advisers having more customers on their books than they could monitor or advise annually;
- the services to be provided under ongoing service arrangements were and are still often neither well defined nor onerous;
- the fees charged under ongoing service arrangements were often charged invisibly as being deducted from the client's investment accounts;
- income from ongoing commissions was and still remains an important part of the revenue earned for financial advice;
- financial entities did not prevent the above misconduct and contain behaviour because they lacked the systems and processes to detect failure to provide services.

> Taken together these considerations and those identified by ASIC in 2016, point firmly to the simple conclusion that the root cause of the fee for no service conduct was greed: greed by licensees, greed by advisers.[89]

[88] Ibid xix.

[89] Ibid 130.

Advisers

In relation to inappropriate advice by advisers, he identified the causes as:

- if advisers stand to benefit financially from clients acting on advice given, the adviser's interests conflict with the client's interests;
- if licensees stand to benefit financially from clients acting on the advice that is given, the licensee's interests conflict with the client's interests.

The basic premise for the FOFA reforms was that there are conflicts of interest between clients on the one hand and advisers and licensees on the other. The lesser solution adopted was not to eliminate them but regulate them. He questioned if this solution had been successful and if it is the right solution.[90]

Improper Conduct

This required a consideration of prevention, detection and consequences.

Prevention

It is by education and training that advisers and staff more generally are made aware of why certain procedures are to be followed. In some cases the procedures may reflect legal requirements and in others they may reflect the particular requirements of the relevant licensee but in every case those who know why the steps are required are more likely to take them than those who know only that the relevant manual requires them.[91]

He concluded:

> When any entity provides financial advice whether it provides the advice by an employee or by an authorised representative, it is the voice of risk and the customer voice that must dominate. When considering the prevention of improper conduct and the promotion of desirable conducts it is these voices that must guide the entity. ...however it was the siren song in the voice of finance which prevailed...that leads to misaligned incentives. Far too often it has led to advisers preferring their own interests to the interests of the client.[92]

Detection

This requires regular audit of advisers files as well as consequence management.

Regulatory effectiveness

[90] Ibid 141.

[91] Ibid 142 – 143.

[92] Ibid 143.

The Commissioner regards litigation an essential deterrent in misconduct and deterrents require imposing penalties so that it was not in the interest of offenders to reoffend and which are set at a level to deter other members of the regulated community from engaging in the same conduct. Judicially determined outcomes also create a binding precedent upon which parties in the relevant sector can rely.

In relation to Regulator effectiveness he posed the following questions:[93]

- Should negotiations and settlement be the main approach to a regulator?

  (It is clear that he considers the approach to be flawed).
- Should a component of enforceable undertakings be the acknowledgement of specific wrongs? (Clearly, he believes yes)
- Late, self-reported breaches of the Corporations Act should generally attract legal sanctions unless some special circumstances apply. (He would say yes)
- Should banning orders be preferred to civil penalty proceedings in case of licensee/adviser misconduct (prefer civil penalties)

CBA Report

This Report provides a nuanced explanation of how it was that CBA, which was such a financial icon, financially successful with its innovative customer face technology, could have engaged in systemic misconduct. The panel concluded that the financial success of the CBA led to inadequate management of the non-financial risks (operational, compliance and conduct risks) which was a failure of corporate governance (oversight) at the board and senior executive level.

[93] Ibid 157.

10 Corporate Governance: Lessons from the Interim Report

10.1 Introduction

In the conclusion of the Interim Report the Commissioner draws together the causes of the conduct identified and criticised in his Report as:

- Conflict of interest and duty
- Remuneration structures
- Culture and governance, and
- Regulatory response

He does not seek to duplicate the work of the CBA Report and makes only passing reference to corporate governance and culture in the Interim Report:

> The governance and risk management practices of the entities did not prevent the conduct occurring.[94]

We await to see if this issue is dealt in more fully in the Final Report.

However, the Report does invite us to consider if there are reasons, not identified by the Commissioner, for the failure of executives of banks and the AMP to identify conduct risk, and by joining the dots recognise that misconduct in their organisations was systemic.

Lesson 1

10.1.2 Misconduct was Systemic

The Case Studies on financial advice established

> Clients of financial advisers or financial advice licensees being charged fees for services not provided to them is now rightly recognised to have been a large and endemic problem in the Industry [95]

While the misconduct identified by the Commission, was known to ASIC, the community and even participants in the sector were ignorant of its extent and pervasiveness . It revealed disregard by the major banks and AMP in assuming compliance with FOFA

[94] Ibid 301 – 302.

[95] Ibid 121.

NCCP and the Corporations Law and a gross failure to operate in accordance with the principles of commercial morality required by those laws.

The conduct rightly deserved the denunciation it received in the Report and from stakeholders.

The Commissioner was rightly critical of financial institutions who invariably responded to misconduct issues, when they emerged, by claiming that they were the isolated actions 'of a few bad apples' and not systemic issues.[96] Case Studies of responsible lending and financial advice, clearly demonstrated the contrary, that in fact the misconduct was systemic

While the failure of financial entities to recognise this cannot be excused, it was also due to the failure to maintain an adequate database of misconduct events across the Institution when CBA and NAB complained it was difficult to comply with information requests about misconduct to which the Commissioner observed :

> Taken together in the course of events and explanations proffered can only lead to the conclusion that neither CBA nor NAB could readily identify how or to what extent the entity as a whole was failing to comply with the law. If that is right neither the senior management nor the board of the entity could be given any single coherent picture of the nature or extent of failure of compliance and could only be given disjointed series of bits of information framed by reference to particular events.[97]
>
> The fact that generally similar conduct occurred in all of the major entities suggests the conduct cannot be explained as a 'few bad apples'. That characterisation serves to contain allegations of misconduct and distance the entity from responsibility. It ignores the root causes of conduct which often lie with the systems, processes and culture cultivated by the entity. It does not contribute to rebuilding public trust in the financial advice industry. The misconduct acknowledged by the major entities give rise to broader questions than those answered by the few bad apples response.

As recently as May 2018, the Chairman of the AMP, at its AGM, informed shareholders :

> A small number of individuals in our advice business made the decision not to follow policy, and inappropriately charged fees to customers when no service was provided.

In response, the Commissioner noted:

[96] Ibid 86.

[97] Ibid 10.

> Rhetoric of this kind is common and responses of this kind are revelations of wrongdoings are generally accompanied by apologies and undertakings to take steps to restore public trust...

At the recent Annual General Meeting of CBA , held in November 2018, the newly appointed Chairman of CBA frankly admitted there were 'neither systems nor processes in place to identify and fix the problems nor a sufficient sense of urgency to identify the root causes and take steps to prevent similar issues arising again'.

The CEO of the CBA finally admitted to the Commission that while it remediated issues, it neglected to identify the remedy for the root cause of the misconduct.

The CBA Report stated that public trust in banks has been severely damaged by a number of misconduct issues over the last 10 years and has been greatly compounded by the further revelations of the Interim Report.

The Deloitte Survey on Trust in Banks released 29 October 2018 revealed that the people surveyed had a low opinion of the ethical behaviour of banks and their conduct towards customers.

High level expressions of sorrow and regret from the Chairman and CEOs are no longer sufficient. Financial institutions whose misconduct has been identified must now acknowledge:

- that misconduct identified prior to and by the Royal Commission, was systemic and not due to individual bad apples,
- second that they failed to introduce the new cultural norms required to comply with legislation regulating responsible lending and financial advice.
- thirdly, that they now recognise they will approach dealing with their customers through the lens of commercial morality.
- Fourth, they failed to prevent, detect and appropriately punish misconduct because of a failure to identify the material conduct risks which they faced.
- Finally, that are now committed to comprehensive remediation of their corporate governance where it is required.

Lesson 2

10.1.4 Primary Cause of Misconduct

I agree with the Commissioner that there was failure of culture and corporate governance in financial entities which led to systemic misconduct. I disagree, , with his view that

greed, profit and remuneration were the primary factors behind the failure to prevent, detect and remedy, the misconduct, the Inquiry has revealed.

The CBA Report sets out the responsibilities of the Board in respect of prudent risk management.

> Ultimately, it is the Board of a bank that is responsible for its prudent risk management. The Board provides direction to senior management by identifying the principal risks facing the bank and by setting its risk appetite. The Board delegates to the Chief Executive Officer (CEO) and senior management primary ownership and responsibility for implementing sound risk management practices and controls in line with the risk appetite. It is management's job to provide leadership and direction to the employees in respect of risk management, and to control the institution's overall risk-taking activities in relation to the agreed appetite for risk. Thereafter, the Board assures itself on an ongoing basis that senior management is responding appropriately to these risks.
>
> In the wake of governance failings and shortcomings in risk behaviour and culture exposed by the global financial crisis, Board Effectiveness has come under heightened focus from regulators, globally and in Australia, and from stakeholders.[98]

A weakness in reporting affected the boards' ability to fulfil the vote set out above.

> The ability of the Board to effectively challenge senior management is influenced by the style of the chair and the expertise of the directors <u>but it also relies critically on Boards being provided with comprehensive reporting that clearly highlights matters warranting specific attention</u> (emphasis supplied). Internationally there has been considerable focus on the provision of comprehensive and tailored content to Boards to assist with, navigating the large quantities of information that are routinely considered by directors.[99]

Risk Management Reports to the CBA Board had limited detail on the risk profile of the organisation and the trajectory of <u>new and emerging risks</u> (emphasis supplied).

It is reasonable to assume that, as a result, the CBA directors were unaware of the emerging conduct risk from FOFA and NCCP on the provision of financial advice and credit. Nor did management provide the Board Risk Committee with the information required to determine the cultural change required to ensure an understanding of and compliance with the new behaviours expected towards the customers.

---

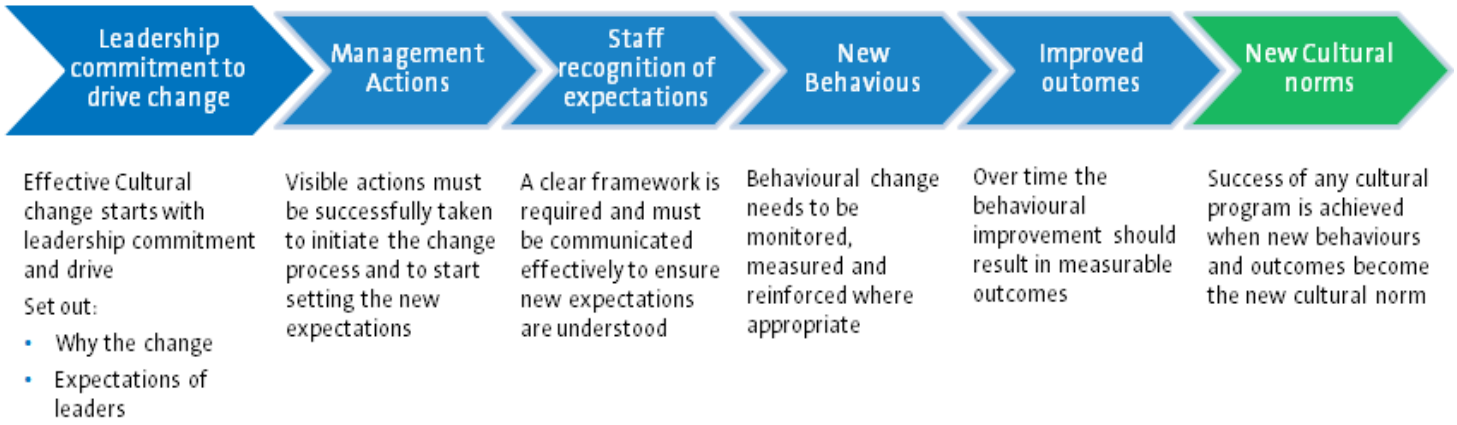
[98] CBA Expert Report 10.

[99] Australian Prudential Regulation Authority, *Prudential Inquiry into the Commonwealth Bank of Australia*, Final Report (April 2018) 15.

The policy behind the financial services legislation was that the providers should consider whether or not the services being provided were in the interest of the customer so that the mindset of the provider would be "should" the service or product be provided to the customer rather than "can we". Implementation of changes of this kind required strong executive leadership communicated through the levels of middle management. As we have seen in the Royal Commission financial entities did not approach the legislation with this mindset, but rather resorted to compliance box ticking which looked at the boundaries of whether the conduct could be undertaken.

My own experience is that boards and executive management underestimated the impact which FOFA would have upon their future in dealings with their customers. Firstly, the policy behind the new legislation requiring provision of advice in the best interest of the client was not explained, understood or implemented. Secondly, the changes of processes and documentation of financial advice was not adequately complied with. Executives did not ask the question "should particular conduct be pursued?" in future dealings with customers. Thirdly, change leadership was absent and the reliance on manuals did not provide employees with an understanding or commitment to the change.

I have set out below the cultural change roadmap required to implement the cultural, process and operational changes required to comply with the requirements of FOFA.



If the cultural change roadmap had been adopted by financial institutions at the outset of the reforms to adjust to the requirements of the relevant legislation, much of the misconduct which occurred.

Finally, the need for the Board to be proactive in the context of proposed legislative change is succinctly stated in the CBA Report.[100]

> An important function of the Board is to set the tone within the organisation. This tone at the top is established through internal and external communications and demonstrated through the practical actions taken by the Board in its supervisory duties. This includes the Board or its committee's treatment of a sense of urgency and is demonstrated through the rigor applied in monitoring and demanding mitigation of key risks and closure of control weaknesses. ... the Board did not have a highly visible presence and the lack of apparent urgency by the Board and its committees in dealing with the non-financial risk may have imparted a tone of inaction to the rest of the organisation. It is likely to deprioritise the importance of maintaining rigorous risk management practices and non-financial risks.

To avoid a repetition of the compliance issues which arose in relation to the legislative changes of FOFA, the Macquarie Group established a Governance and Compliance Committee which reviewed issues, development in corporate governance and the corporate governance framework, and included in its charter new standards arising from legislative change. It recognised the need to proactively identify changes required to culture and processes as a result of legislative reforms. I would recommend this model to all financial entities.

My diagnosis of the cause of the systemic misconduct of financial institutions in this context is an explanation and not a justification for the of the Boards and executives to provide leadership commitment to the change required to achieve new behaviours and outcomes as part of a new cultural norm.

Lesson 3

10.2 Remuneration

The Commissioner regards the remuneration arrangements made by the banks, with employees and intermediaries engaged in credit provision and financial advice, as a key cause of the misconduct and breaches the law identified.

> Every piece of conduct identified that has been contrary to law is a case where the existing Government structures and practices did not prevent the conduct occurring. The

[100] Ibid 96.

> cultural and conduct of the banks was driven by, and was reflected in their remuneration practices and policies.

While I consider the Commissioner has over-emphasised certain of the remuneration arrangements as a principal reason for misconduct, boards must carefully review incentives in remuneration arrangements in light of his criticisms

The CBA Panel in Part 8, did not share his view on remuneration. It focussed on how the CBA remuneration model could be improved to promote strong accountability and risk discipline. APRA and BEAR has regulated but not banned variable remuneration.

The Commissioner has a distinct distaste for variable remuneration which he regards as a root cause of misconduct.

> Is incentive remuneration necessary? Why do staff need incentives to do their job otherwise unless the incentive is directed to maximising revenue and profit. What is the point of allowing an incentive payment for doing the assigned task when it meets but does not exceed what is expected of the staff member.[101]

The Commissioner questions if customer facing staff should not be paid incentives, why should managers or those who manage the managers? Why will a change in the remuneration of front line staff affect the change in culture if more senior employees are rewarded for sales or revenue or profit?[102]

He recommends the connection between individual profit and entity profit must be severed and suggests the adoption of a flat share of a variable pay pool that varies with overall entity performance. On the other hand the Macquarie group profit pool rewards individual employees by reference to evaluation against required outcomes , financial and non financial, with senior executive payments deferred from 3 to 7 years.

(2) The major banks have changed their remuneration practices, so that customer facing staff are paid under a balanced scorecards system which has reduced focus on profit and revenue and pay more attention to the voice of risk and the voice of customers. The Commissioner, however, remains sceptical that these new arrangements will avoid the misconduct he has identified.

[101] Commonwealth, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report* (2018) vol 1, 317.

[102] Ibid.

(3) The Commissioner also criticises the use of malus clauses as a penalty for bad behaviour, misconduct or adverse risk consequences which he states may lead to concealment of misconduct in the future. Global bank regulators regard malus and clawback as essential tools for consequence management of misconduct.

While the Commissioner's views on remuneration has limited academic support they do not accord with shareholder or employee expectations or the models used by global corporations.

My experience as a chairman of major ASX listed companies is that employees do expect financial recognition for outstanding service whether it be superior service to customers, innovation or skill in dealing with competition or disruption and for their contribution to the financial or non-financial success of the Company.

For these reasons, I do not support his suggested remuneration model, or for any prescriptive legislative intervention, Boards must be allowed flexibility to set remuneration according to their circumstances, subject to the prudential oversight of APRA which can deliver this regulation more effectively than black letter law.

Lesson 4

10.3 Simplify the Law

The labyrinthine and overly detailed blizzard of provisions regulating financial advice and consumer responsible lending means it is easy to lose sight of the principles behind the regulations. Professor Hanrahan's paper on the legal framework on the provision of financial advice, runs to 113 pages!

The Commissioner considered in view of the complexity of the regulation financial services that a further layer of law regulation would add a new layer of compliance and complexity which should only occur if there's a clearly identified advantage.

The more complicated the law, the more easier it is for compliance to be seen as asking 'can I do this' and answering the question by ticking boxes instead of saying should I do this. What is the right thing to do and there is every reason to think the conduct examined this report has occurred when the only question asked is: 'Can I.?'[103]

[103] Ibid 290.

I agree with the Commissioner that the principles behind the Corporations Law, FOFA and NCCP firmly point towards a need to simplify the existing law and not add a new layer of regulation. It is apparent that the impact of simplification will have a positive effect on the economy generally, and improve access and the cost of financial services for consumers. Referral of the issue to the Law Reform Commission aided by experts from the financial services sector, regulators and academics is the next step. to fix the misconduct issue.

Lesson 5

10.4 Regulators response to misconduct

The report is highly critical of the approach of ASIC in enforcement for breaches of misconduct. The Commissioner contends, that when contravening conduct comes to ASIC's attention the regulator must always ask if it can make a case as being a breach, and if it can, why should it not be in the public interest to bring proceedings to penalise the breach. He considers financial entities have treated contraventions of the law as no more than a bargaining chip to procure agreement to remediate customers.

> Laws are to be obeyed and penalties are prescribed for failure to obey the law because society expects and requires obedience of the law.[104]

ASIC is likely to follow the litigation roadmap the Commissioner sets out in Part 8 of his Report.[105]

ASIC's new deputy chairmen Daniel Crennan QC has foreshadowed a tougher line with banks in an appearance before a parliamentary inquiry. Mr Crennan expected ASIC to take more matters to court and have less recourse to enforceable undertakings; in his own words, Mr Crennan stated, "They would be lucky if they get an EU".

I am disappointed the Commissioner has failed to make a more thoughtful examination of the merits of enforceable undertakings. In my experience they have been highly effective in enabling a company to undertake a cultural change roadmap to embrace the principles of FOFA and to get on promptly with remediation. Remediation has not been deliberately dragged out. Entities deal first with clients' complaints, next they review the files of their advisers regarded at risk and finally they review files of other clients as

[104] Ibid 277.

[105] Ibid 285 – 286.

required by ASIC. It is this latter step which may involve reviewing tens of thousands of files which takes time to establish if misconduct has occurred and what remediation, if any, is required.

Macquarie Group, in a recent submission to the Royal Commission stated:

> Undertakings can achieve effective regulatory outcomes and facilitate change more quickly and broadly within its business, than may be the case had a litigation route been pursued first or in the alternative. The enforceable undertaking it agreed to with ASIC following misconduct in its financial planning group gave it 'an opportunity to reflect more broadly on the adequacy of its compliance arrangements and to implement lasting changes in a relatively short period of time.

While the Commissioner's enthusiasm for litigated outcomes is supported by some academic literature that negotiated outcomes may promote laxity, it is not consistent with the UK Conduct Authorities approach where settlements appear to be commonplace.

I also note that Australia is considering Deferred Prosecution Agreements in areas outside financial services for serious corporate offences which require action almost identical to an enforceable undertaking.[106]

Graeme Samuel has expressed some reservations about the implications of the Commissioner's preference for litigated outcomes for misconduct.

> The court processes are a vital element of enforcement and a necessarily element in criminal proceedings but it suffers from the length and complexity of the legal process and there is sometimes uncertainty of outcome.

He raises some issues to consider if the regulators increase their resort to this process for enforcement. These include the need for a specialised group of judges with expertise in the complexities of corporate securities and financial services law and practice.

Secondly, he seeks a fast track process for regulator instituted action. Thirdly, he seeks judicial allocation of prosecutions between the federal and state courts. Finally, he acknowledges that there is a place for enforceable undertakings to achieve an efficient

[106] Phillip Hoskin, *Deferred Prosecution Agreement Scheme in Australia* (11 April 2017) KordaMentha <https://www.kordamentha.com/news-and-insights/Deferred-Prosecution-Agreement-Scheme-in-Australia>.

enforcement outcome that might otherwise take years to achieve through the courts appeals process.[107]

In conclusion, the perils of ASIC undertaking poorly prosecuted legal proceedings for misconduct has been illustrated in two recent cases involving WBC. In ASIC v Westpac 3 Beach J was required to determine the quantum of pecuniary penalty where ASIC sought a $58 million penalty and Westpac contended $3million was the appropriate penalty. He made the following observations on the ASIC position.

> "First, my task does not involve the luxury of applying any asymmetric rectitudinous philosophy to the penalty phase. For hard facts had to be and have been found. The task is to set a penalty appropriate to the facts as so found.…
>
> Second, the solution to this legal problem of identifying the maximal penalty applicable to Westpac's offending has not been greatly assisted by ASIC's approach before me, which has had all the irreconcilable atonality of a Schoenberg composition when compared to the case that it pleaded and substantiated at trial"[108].

In the second case between ASIC and Westpac the parties had agreed on a consent penalty of $35million in respect of an alleged breach of responsible lending. Justice Perram declined to consent to the orders for the penalty proposed on the basis that the parties had not identified the alleged breaches committed by Westpac. Gleeson SC who was appointed amicus curiae, opined it was not clear whether WBC had committed a breach, but if it had done so the penalty should be $100 million.

Lesson 6

10.5 Litigation

Misconduct leads to Class Action

A great tide of litigation following on from the Royal Commission has been forecast by observers. Unsurprisingly, Plaintiff class action firms have been the first to commence proceedings and there are seven class actions currently afoot, arising from revelations aired at the Royal Commission.

[107] Professor Graeme Samuel, 'Presentation Notes' (Presented at the Consumer and Banking Association Conference, Melbourne, 22 October 2018).

[108] ASIC v Westpac 3 (2018 FCA 1701)

The most relevant are five proceedings against AMP following the substantial fall in its share price, arising from its admissions at the Royal Commission that it had been charging customers for services that they did not receive and its false statements to ASIC.

The allegations include that:

- AMP contravened its continuous disclosure obligations under the Corporations Act and the ASX Listing Rules;
- AMP engaged in misleading and deceptive conduct in making statements to the market that it was compliant with its disclosure obligations, it had effective risk management systems in place to ensure compliance with relevant regulatory requirements and it was committed to conducting its business ethically and legally; and
- AMP's conduct amounted to unconscionable conduct.[109]

It can be assumed that further class actions will be instituted in the future.

Lesson 7

11 Implications for the Non-Financial Sector

Graham Bradley has described the CBA Report as:

> the most compelling analysis of corporate governance at a major public company ever published. Indeed its scope and public release are unprecedented. It will undoubtedly be influential in the approach and policies of corporate regulators around the world.[110]

Both the Interim Report and the CBA Report have profound corporate governance implications for companies outside the financial sector. Graeme Samuel, who was a member of the APRA Panel considers the CBA Report has lessons for corporate Australia generally. James Shipton, the new Chairman of ASIC has urged every listed company to read the report.

Both reports remind all boards that the need for effective oversight of non-financial risk and its prevention, detection and consequence management. Also, they are a lesson on the need to identify material legislative change affecting their sector and provide

[109] See, for example, 'Commercial List Statement', *Marion Antoinette Wigmans v AMP Limited*, Federal Court of Australia (2018/00145792), filed 9 May 2018, p 2-3.

[110] Graham Bradley. *Summary of key findings and implications of the APRA Report* (15 June 2018) Australian Institute of Company Directors (AICD) <http://aicd.companydirectors.com.au/advocacy/governance-leadership-centre/practice-of-governance/reflections-on-apra-report-on-cba>.

leadership in managing cultural changes required. The inquiry will encourage ACCC and ASIC to become more litigious in respect of misconduct in the areas they regulate.

Boards must remember that when stakeholders consider that misconduct, either actual or perceived, has occurred, trust in companies can evaporate. The flow on consequences are seen in the litigation, inquiries, regulatory and legislative action, which the major banks and the AMP have experienced today.

Companies, which have a consumer mass market-like retail energy, telecommunications are sectors at risk.

Finally, cultural change needs to be driven internally by board and management and not outsourced to consultants because that gives the best chance of being adopted and owned by the whole of the employees.[111]

Lesson 8

12 Directors

Given the increased responsibilities and regulatory oversight of non-executive directors, on the boards of financial entities, the question has been raised whether the present legal arrangement where a unitary board delegates the management of the business of a company to the Chief Executive, subject to board oversight, is still fit for purpose in these times.

I have discussed briefly in 4(a) the potential liability of directors under Section 180 of the Corporations Law for failure to ensure adequate risk management and to monitor compliance with it.

While these issues are a debate for another day, it does raise the issue of financial entity directors' workload.

When a company is in a crisis, directors inevitably face a heavier work load. As the financial sector is presently faced with a perfect storm, the work load of their boards will substantially increase.

I suggest a chairman of major banks should not chair another major ASX listed company and whether he or she has board roles in other major listed entities should be carefully

[111] Professor Graeme Samuel, 'Presentation Notes' (Presented at the Consumer and Banking Association Conference, Melbourne, 22 October 2018) 18 – 22.

considered by the Board. Significant workloads outside the listed company space ought to be taken into account when considering a director's work load.

I also suggest that the step taken by some financial entities to reduce non-executive director fees is a mistake. Their directors now face heavier workload following the Royal Commission and if this is combined with a reduction in other board roles they can take, quality candidates may find a board seat on a financial services entity unappealing. Moreover, non-executive director's fees are fixed and not variable, that is they do not increase or decline in relation to the profits or circumstances of the company.

The symbolism of the reduction in fees is not as important as the need to attract quality people to the boards of financial entities.

Lesson 9

13 Consequences of a failure to provide prudent risk management are significant.

The Royal Commission's Report's disclosure of misconduct by financial entities has eroded the trust of the community, their shareholders , politicians and media. The CBA Report asserts that CBA, the largest listed ASX corporation in Australia, was a financial icon but as a result of a series of misconduct issues, has now fallen from grace. The recent Deloitte Survey on Trust in relation to banks reveals there is a deep distrust of banks and financial institutions. Respondents to the survey believe that banks do not take into account customer interests nor are they open and honest. I have noted the consequences which arise when this occurs.

The banks and their directors and shareholders have also paid an enormous financial price for the misconduct exposed by the Royal Commission. The Chairman and Chief Executive of the AMP have been replaced and its board refreshed and a similar exercise has occurred at the CBA. There are class actions in train against the major banks and the AMP. The aggregate cost of remediation of past and future misconduct is estimated to be over $4 billion for the major banks while the AMP is still struggling to calculate its cost. The share price of the AMP and the major banks has also been materially impacted by the Commissioner's misconduct findings against them and a fear of more regulation.

Likely regulatory litigation by ASIC and more proactive oversight by APRA may distract board and management from strategy formulation and meeting the operational challenges from competitors and disrupters.

Stricter enforcement of responsible lending may increase consumer cost and credit availability.

Three of the banks have responded to the serious misconduct in their retail financial advice business by announcing their exit or likely exit from the sector. The CBA will also sell some of its mortgage broker businesses. Only WBC and AMP will remain in it.

CBA has entered into an enforceable undertaking with APRA in respect of the recommendations made in the CBA Report and other major banks and the AMP may be required to follow.

In light of all of these issues facing the boards and executives of the major banks and the AMP must accept the lessons of both the Interim Report and the CBA Report. They must

implement effective corporate governance and compliance using the CBA risk management and cultural roadmap and consider the recommendations and criticisms of the Commission, and begin the slow task of restoring trust with the their stakeholders.

In the future the voices of the customer and risk must join with the anthem of financial success.

Acknowledgments

The author would like to acknowledge the research support he has received from Allens in preparing this paper. In particular, from Michael Windeyer, Associate.

In the word processing of the document, my thanks also go to Leeanne Torrington who has laboured into the night and along with Elizabeth Williams, to decipher my amendments to the text.