Misconduct in Banking and Financial Services: Some aspects of the Hayne Royal Commission

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Abstract

This paper considers wider implications of misconduct in Australia's banking and financial services industries, highlighted by the Final Report of the Hayne Royal Commission issued in February 2019. The Royal Commission identified issues including widespread charges for services that were not provided, continuing conflicts of interest affecting financial advisers and an insufficient focus on conduct risks, and recommended a range of further reforms to the regulatory regime and to enforcement approaches. The paper seeks to identify the wider implications of these developments, where the Australian regulatory regime contained many features consistent with international best practice and financial services regulators had already focused on misconduct risks, particularly for retail investors. Why did a sophisticated regulatory regime fail to deliver its intended results? Will the proposed reforms following the Royal Commission deliver a better outcome?

Introduction

In this paper, I will seek to identify some wider implications of Australia's recent Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry ("Royal Commission") (often referred to as the "Hayne Royal Commission", since the commissioner was Kenneth Hayne, a former High Court judge). I will first point to conduct issues that had previously been identified in the Australian financial services industry, which provide the background to the Royal Commission. I will then outline the Royal Commission's recommendations and findings, in the context of wider international trends in financial regulation. While the Royal Commission raised issues as to the conduct of credit providers and insurance companies as well as financial advisers, my primary focus will be on the issues arising in relation to financial advice. The ultimate question that I address, but only partly answer, is what the Royal Commission can tell us about the situation where a sophisticated financial regulatory regime does not, in practice, fully deliver its objectives.

Structure and regulation of the Australian financial services industry

The financial services industry is of particular significance in Australia, where substantial funds are committed to compulsory superannuation contributions. Obviously, poor financial advice has a significant capacity adversely to impact investors, particularly in relation to their position in retirement. Many financial advisers are either employed by large financial services providers such as the major Australian banks or operate under contractual arrangements with such providers and

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other advisers operate in independent firms. In practice, retail investors can acquire financial products directly from a product issuer, or can take advice from an in–house adviser associated with the product issuer; or from a separate firm which may or may not be owned by the product issuer and may trade under a different name but sell the product issuer's products, or from an adviser who holds an individual license is an employee of an independent corporate licensee.[2] As we will see, this industry structure potentially gives rise to conflicts of interest of a structural character, where product manufacturing, product sales and advisory roles are often concentrated in the same vertically integrated entity.

Australia had (and has) a comprehensive regime for the regulation of financial services found in a self-contained chapter of national corporations legislation, Chapter 7 of the *Corporations Act* 2001 (Cth).[3] That regime adopts a "twin peaks" regulatory structure, with the Australian Prudential Regulation Authority ("APRA") having responsibility for prudential regulation and the Australian Securities & Investments Commission ("ASIC") having responsibility for conduct regulation. The Australian regime has, since at least 1998, adopted a single form of regulation for dealing in and advice about "financial products", defined to include securities, futures contracts and derivative products and other investment and superannuation products. This regime is reasonably complex, and its application to products of different kinds requires layers of regulations and administrative instruments which alter its operation in respect to particular products. That regime also includes disclosure requirements as to the new issue of securities and other financial products.

Financial services providers such as dealers and financial advisers are required to hold an Australian financial services licence at the firm level, but authorised representatives of licensees, including many individual financial advisers, and employees of holders of Australian financial services licences were not separately licensed. The legislation imposes conduct of business rules including suitability requirements; a widely drawn "efficiently, honestly and fairly" standard, which applies to conduct of Australian financial services licensees; and provisions for exclusion from the industry, by way of revocation of the licence held by a firm or a banning order made by ASIC or by a court against an individual adviser. This regime did not (and does not) require that financial advisers be independent of product issuers or specifically address the fact that product issuers and particularly banks have acquired or established advisory firms, sometimes trading under different brand names; and did not (and largely does not) restrict retail client access to complex products.[4] A Background Paper for the Royal Commission noted that this structure:

> "reflects an underlying policy view that clients who are fully informed will be able to make rational product choices and to price products correctly".[5]

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[2] P Hanrahan, Background Paper 7 to the Royal Commission, *Legal Framework for the Provision of Financial Advice and Sale of Financial Products to Australian Households*, pp 8–10.

[3] As to the scope of regulation under Chapter 7, see R Baxt, A Black and P Hanrahan, *Securities and Financial Services Law*, 9th ed, 2016; H Bird and G Gilligan, "Deterring Corporate Misconduct: Penalties, Financial Services Misconduct and the Corporations Act 2001" (Cth) (2016) 34 *C&SLJ* 332.

[4] P Hanrahan, Background Paper 7 to the Royal Commission, *Legal Framework for the provision of financial advice and sale of financial products to Australian households*, pp 9-11.

[5] Id, p 11.

At least in comparative terms, this structure (likely combined with features of the wider Australian economy) had functioned reasonably well in limiting impacts of the global financial crises on the stability of the Australian financial sector[6], although retail investors had then suffered losses associated with conduct issues to which I will shortly turn. At least prior to the Royal Commission, the Australian regulatory regime was generally well-regarded internationally, although ASIC's regulatory performance had from time to time received vigorously, but not necessarily accurate, criticism within Australia. Only four years ago, Professor Moloney observed that

> "[t]he twin peaks model ... allows for specialisation and the concentrated pursuit of retail market interests. The Australian conduct supervisor, the Australian Securities and Investments Commission ... is notable among world regulators for its long focus on mis–selling and the quality of advice ...".[7]

Recurrent conduct issues

Australia has seen recurrent misconduct in financial services and recurrent inquiries into the effectiveness of the regime. Those who are familiar with the history of financial regulation in the United Kingdom, which has also seen recurrent mis-selling issues[8], will find that a familiar story.

On one view, the matters identified by the Royal Commission are a continuation of these earlier issues, and matters that been identified by ASIC and in several earlier inquiries. Retail investors had suffered significant losses on the failure of several entities providing products and services to the retail sector including Westpoint (property development), Opes Prime (securities lending) and Storm Financial (financial advice)[9]. A report of the Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into Financial Products and Services in Australia* (November 2009) identified matters that contributed to those losses including a lack of independence of advisers, where advice was funded by product issuers, the perverse incentives created by commission payment arrangements and the inadequacy of disclosure to address those issues. That Committee recommended the implementation of a "quasi–fiduciary" duty on financial advisers, which was later partly implemented by the Future of Financial Advice ("FOFA") reforms (to which I return below). The Royal Commission's findings highlight limits to the practical impact of those reforms.

Significant issues as to the quality of financial advice were again identified by reviews

[6] J Hill, "Why did Australia fare so well in the global financial crisis?" in E Ferran, N Moloney, J Hill, J Coffee, *The Regulatory Aftermath of the Global Financial Crisis*, 2012, pp 203-300.
[7] N Moloney, "Regulating the retail market" in N Moloney et al, *The Oxford Handbook of Financial Regulation*, 2015 at 752.
[8] J Black and R Nobles, "Personal Pensions Misselling: The Causes and Lessons of Regulatory Failure" (1998) 61 *Mod L Rev* 789; N Moloney "Regulating the Retail Market: Law, Policy and the Financial Crisis" (2010) 63 *Current Legal Problems* 375; E Ferran, "Regulatory Lessons from the Payment Protection Insurance Mis-selling Scandal in the UK" (2012) 13 *European Business Organization Law Review*, 247-270; N Moloney, "The investor model underlying the EU's investor protection regime: consumers or investors?" (2012) 13 *European Business Organization Law Review* 169, especially at 176ff; N Moloney, "EU Financial Market Governance and the Retail Investor, Reflections at an inflection point" (2015) 37 *Yearbook of European Law* 251, especially at 254ff; D Bugeja, *Reforming Corporate Retail Investor Protection: Regulating to Avert Mis-Selling*, 2019.
[9] For review of the issues arising from Storm Financial, see D Kingsford Smith, "Regulating investment risk: Individuals and the global financial crisis" (2009) 22 *UNSWLJ* 514.

undertaken by ASIC in 2011 and 2012, and again in 2013, suggesting that a proportion (and possibly a substantial proportion) of advice to retail investors did not comply with the then statutory suitability standards.[10] As one commentator has observed, those reviews did not indicate any inadequacy in the then statutory standards, but instead that they were not complied with in practice, so that the problem was not with the content of the legislation, but rather with non-compliance with it and, by extension, enforcement of it.[11]

A Senate Economics Committee also undertook an inquiry into ASIC's performance in 2014 and highlighted perceived weaknesses in enforcement in several high profile matters, and the Committee's report noted (at p xvii) that "some financial advisers, brokers and lenders systematically targeted more vulnerable members of the community, especially older Australians with assets but without high levels of financial literacy." A case study undertaken by that Committee in relation to ASIC's response to issues concerning Commonwealth Financial Planning Limited, a subsidiary of one of the four largest Australian banks, also highlighted breaches of duty by advisers, preference of advisers' own interests over client interests, unauthorised dealing with client accounts, all undertaken to generate bonuses for the advisers, failures in the firm's compliance system, and delays and inadequacies in the remediation undertaken after those issues were identified.[12]

The Commonwealth Government then initiated a broader review of the financial system by the Financial Services Inquiry ("FSI") which published its Final Report in December 2014, addressing wider issues as to the stability of the financial system and the structure of retirement savings, and also as to protection of consumers of financial products and regulatory structure. The FSI again recognised difficulties with advice provided to financial consumers and noted that the global financial crisis:

> "brought to light significant numbers of Australian consumers holding financial products that did not suit their needs and circumstances – in some cases resulting in severe financial loss. The most significant problems related to shortcomings in disclosure and financial advice, and over-reliance on financial literacy".[13]

That report also noted a lack of professionalism among financial advisors, observing that "minimum competency standards have been a feature of the industry for a substantial length of time, and changes are needed across the board." The FSI pointed to the need to address educational standards, prompting amendments to those standards that were subsequently made by the *Corporations Amendment (Professional Standards of Financial Advisers) Act* 2017, to which I return below. That Report also recommended the introduction of product design and distribution obligations, similar to those that apply in the United Kingdom, which have now been introduced by the *Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Act* 2019 (Cth) and will take effect from 2021.

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[10] ASIC Report 279, *Shadow shopping of retirement advice*, March 2012; ASIC Report 337, *SMSFs: Improving the quality of advice given to investors*, April 2013.

[11] P Hanrahan, "Regulating financial advice for retirement – the recent Australian reforms", (10 March 2017), p 16.

[12] For commentary, see G Pearson, "Failure in corporate governance: financial planning and greed" in C Mallin (ed), *Handbook on Corporate Governance*, 2016, pp 189-190.

[13] FSI Report Ch 4, quoted P Hanrahan, Background Paper 7 to the Royal Commission, *Legal Framework for the provision of financial advice and sale of financial products to Australian households*, p 14.

Issues had also arisen in respect of failed investments in collective investment schemes relating to agricultural and forestry products.[14] Issues as to financial intermediaries charging advisory fees that were authorised by contract, but related to services that were not in fact provided, were also identified by ASIC before they achieved notoriety in the Royal Commission.[15] A review undertaken by ASIC (January 2018) of advice provided by integrated financial intermediaries that both issued and distributed products had found that up to 75% of the advice given to customers did not meet the statutory "best interests" standard (to which I will return below) and 10% of that advice was likely to leave the customer in a significantly worse financial position.[16]

Concerns had also arisen as to aspects of banks' compliance in other areas, including a significant failure in anti-money laundering systems maintained by the Commonwealth Bank of Australia, which resulted in it paying a substantial (agreed) penalty in court proceedings brought against it and a critical review of its culture commissioned by APRA. Since the Royal Commission, a similar issue has arisen in respect of another major Australian bank.

Focus and recommendations of the Royal Commission

The Royal Commission, to which I will now turn, is the latest but likely not the last of these inquiries. It was established in late 2017, its Interim Report was published on 28 September 2018 and its Final Report was published on 4 February 2019. The Royal Commission was tasked to:

> "inquire into, and report on, whether any conduct of financial services entities might have amounted to misconduct and whether any conduct, practices, behaviour or business activities by those entities fell below community standards and expectations."[17]

The Royal Commission was therefore not limited to determining whether conduct was unlawful, although it ultimately concluded that a range of conduct had in fact been unlawful. The Royal Commission focused on conduct in the retail sector, directed to consumers and small and medium enterprises, rather than in the wholesale market. It applied a case study approach to several areas, starting with consumer lending practices; then financial advice; then loans to small and medium enterprises; dealings with Australians living in rural and regional areas, including farmers and indigenous communities; superannuation; and lastly insurance.

The Interim Report of the Royal Commission observed that the source of many of the issues it identified was "greed" or "the pursuit of short term profit at the expense of basic standards of honesty". The Royal Commission's Final Report similarly observed that:

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[14] Senate Economics Reference Committee, *Agribusiness Managed Investment Schemes: Bitter Harvest*, 2016.

[15] ASIC Report 499, *Financial Advice: Fees for no service*, October 2016

[16] ASIC Report 562, *Financial Advice: Vertically Integrated Institutions and Conflicts of Interest*, January 2018; D Wishart & A Wardrop, "What can the Banking Royal Commission achieve: Regulation for good corporate culture" (2018) 43 *Alternative LJ* 81 at 82.

[17] Royal Commission, Final Report, p 1.

> "in almost every case, the conduct in issue was driven not only by the relevant entity's pursuit of profit but also by individuals' pursuit of gain, whether in the form of remuneration for the individual or profit for the individual's business. Providing a service to customers was relegated to second place. Sales became all important. Those who dealt with customers became sellers. And the confusion of roles extended well beyond frontline staff. Advisers became sellers and sellers became advisers".[18]

The Royal Commission summarised its conclusions in strong terms, observing that conduct of financial services firms over "many years", had caused substantial loss to consumers and yielded substantial profit to those firms, had often broken the law and, where it had not been unlawful, had "fallen short of the kind of behaviour the community not only expects of financial services entities but is also entitled to expect of them."[19]

In the opening summary of its Final Report, the Royal Commission recognised issues with incentive structures which measured sales rather than compliance; observed that entities acted as they did "because they could", by reason of asymmetries of power and knowledge between firms and consumers; pointed to conflicts of interest affecting intermediaries; observed that "too often, entities that broke the law were not held to account", and emphasised that the primary responsibility for misconduct was that of the relevant financial intermediaries and those who managed and controlled them, their boards and senior management.[20] In particular, the Royal Commission identified issues (many of which had previously been identified by ASIC, as I noted above) including financial intermediaries' charging ongoing advice fees where no service was provided to the client; a lack of alignment between advisers' incentives and customer interests; the issue of insurance products that were overpriced or unlikely to respond to claims, particularly in the consumer credit area; conflicts of interest, including in superannuation funds; failures in compliance systems; and failures to comply with statutory breach reporting requirements.

The Royal Commission made some 76 recommendations, many of which require legislative reform or government action. The Commonwealth Government has largely accepted those recommendations and has foreshadowed implementing most of the changes by mid-2020 and completing implementation by the end of 2020. The Government also identified several additional steps that it proposed to address the issues raised by the Royal Commission.[21] In mid-February 2020, the Government

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[18] Royal Commission, Final Report, p 2.

[19] Royal Commission, Final Report, p 1.

[20] Royal Commission, Final Report, p 2.

[21] For commentary on the Royal Commission's findings and recommendations, see G Gilligan, "The Hayne Royal Commission and trust issues in the regulation of the Australian financial sector" (2018) 12 *Law & Fin Mkts Rev* 175; D Millhouse, "From Campbell to Hayne: W[h]ither Australia: Australian Financial Regulation and Supervision at a Cross-Roads" (2019) 13 *Law & Fin Mkts Rev* 81; G Gilligan, "The Hayne Royal Commission – Just Another Piece of Official Discourse" (2019) 13 *Law & Fin Mkts Rev* 114 (which is not as critical of the Commission as its title suggests); J O'Brien, "Because They Could: Trust, Integrity and Purpose in the Regulation of Corporate Governance in the Aftermath of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry" (2019) 13 *Law & Fin Mkts Rev* 141; T Marsh, "The Hayne Report – One Giant Leap Forward for Australia" (2019) 13 *Law & Fin Mkts Rev* 157; D Millhouse, "Empirical Analysis Supports the Hayne Long Run Reform Thesis" (2019) 13 *Law & Fin Mkts Rev* 162; S Humphrey, *Post-Hayne to the Wallis 2.0 Era Fairness Unfettered*, Andromeda Partners, 2019, which focusses on the emphasis on fairness in the Commission's Report,

released exposure drafts of proposed legislation to give effect to several of the Royal Commission's recommendations, including as to in reference checking and information sharing between financial firms, reporting obligations to ASIC and remediation of misconduct that has caused loss to investors, under the catchy title *Royal Commission Response – Protecting Consumers (2020 Measures) Bill* 2020. I will not address the detail of that proposed legislation here.

These changes will be made in parallel to other recent changes to the Australian regulatory regime, including increases in penalties; the introduction of product design and distribution requirements and product intervention powers; the introduction of more demanding requirements as to financial adviser training; and the introduction of a single statutory non-court based dispute resolution regime, operating for many retail claims.

The Royal Commission's focus on norms of conduct, fairness and conflicts of interest

Both the Interim and Final Reports of the Royal Commission emphasise several norms of conduct, expressed in general terms, requiring participants in the financial services industry (1) to obey the law; (2) not to mislead or deceive; (3) to act fairly; (4) to provide services that are fit for purpose; (5) to deliver services with reasonable care and skill; and (6) when acting for another, to act in the best interests of that other.

These norms of conduct are not novel, although they are framed as general standards, by comparison with several wider standards and many specific obligations already contained in the existing Australian regulatory regime directed to fairness, conflicts of interest and acting in a client's "best interests" which were then overlaid in some cases by fiduciary obligations under the general law. The Australian statutory regime also contains prohibitions on misleading or deceptive conduct, which are wider than the international norm since they do not require intent or negligence to establish liability. This emphasises that the existence of statutory obligations, or norms of conduct, is a step in identifying what is required of the financial services industry (and other industries) but far from sufficient to secure compliance.

Fairness and conflicts management duties

A first layer of regulation arose by statute (*Corporations Act* 2001 (Cth) s 912A(1)(a)) imposing an "efficiently honestly and fairly" duty on Australian financial services licensees. This a broad and open standard, which can be breached by a range of improper conduct. [22] The focus on fairness in this standard is consistent with

[22] For case law, see *Story v NCSC* (1988) 13 NSWLR 661; 13 ACLR 225; 6 ACLC 560 (holding that this standard sets a compendious requirement that a financial services licensee go about its duties efficiently having regard to the dictates of honesty and fairness, honestly having regard to the dictates of efficiency and fairness and fairly having regard to the dictates of efficiency and honesty); *R J Elrington Nominees Pty Ltd v Corporate Affairs Commission* (1989) 1 ACSR 93 (holding that this standard can be breached by conduct which is not criminal but which is morally wrong in a commercial sense, viewed "through the lens of commercial morality rather than through the lens of the criminal law", and the test of whether conduct fails the relevant standard requires that the conduct be viewed objectively); *Re Hres & Australian Securities and Investments Commission* (2008) 105 ALD 124; [2008] AATA 707 at [237] (holding that this standard requires competence in providing advice, compliance with statutory obligations, sound ethical values and judgment in matters relating to a client's affairs);

international standards, including the recommendation of the Task Force on Financial Consumer Protection of the OECD Committee on Financial Markets that "all financial consumers should be treated equitably, honestly and fairly at all stages of their relationship with financial services providers".[23] That concept overlaps with, although it is put in shorter form than, the principles incorporated in PRIN 2.1 of the FCA Handbook, which require that a firm, inter alia, "conduct its business with integrity"; conduct its business with "due skill, care and diligence"; "pay due regard to the interests of its customers and treat them fairly"; and "manage conflicts of interest fairly, both between itself and its customers and between a customer and another client."[24] The Fit and Proper Guidelines of the Securities and Futures Commission ("SFC") (Hong Kong) similarly impose a "competently, honestly and fairly" standard and the SFC's Code of Conduct Principles set a similar standard by requiring the adviser to "act honestly, fairly and in the best interest of the client and the integrity of the market."[25]

A second provision (*Corporations Act*, s 912A(1)(aa)) requires a financial services licensee to have in place adequate arrangements for managing conflicts of interest

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Australian Securities and Investments Commission v Camelot Derivatives Pty Ltd (in liq) (2012) 88 ACSR 206; [2012] FCA 414 at [69]–[70] (standard breached by an advisor promoting trading that was excessive in the light of the client's trading objectives); *Australian Securities and Investments Commission v Cassimatis (No 8)* (2016) 338 ALR 209; [2016] FCA 1023 (holding that contraventions of the suitability requirements under former s 945 of the *Corporations Act* that involved "serious departures from reasonable standards of performance of advice" also contravened this standard); *Australian Securities and Investments Commission v Avestra Asset Management Ltd* (2017) 348 ALR 525; 120 ACSR 247; [2017] FCA 497 at [191] (contravention of this standard by the responsible entity of a managed investment scheme); *Australian Securities and Investments Commission v Financial Circle Pty Ltd* (2018) 131 ACSR 484; [2018] FCA 1644 at [137]; *Australian Securities and Investments Commission v Westpac Banking Corporation (No 2)* [2018] FCA 781 at [2347]; *Australian Securities and Investments Commission v Westpac Securities Administration Ltd* [2019] FCAFC 187 (marketing campaign in respect of the consolidation of superannuation accounts contravened this standard). For discussion of this standard, see R Baxt, A Black and P Hanrahan, *Securities and Financial Services Law*, 9th ed, [13.17]–ff; G Pearson, *Financial Services Law and Compliance in Australia*, 2009, [4.3.34], [4.4], [4.4.5]–[4.4.6]; J Moutsopoulos, "Finance Industry has Duty to Manage Conflicts" (2005) *IFLR* 41; P Latimer, "Providing Financial Services 'Efficiently, Honestly and Fairly'" (2006) 24 *C&SLJ* 362; V Battaglia, "Dealing with conflicts: The equitable and statutory obligations of financial services licensees" (2008) 26 *C&SLJ* 483.

[23] Task Force on Financial Consumer Protection of the OECD Committee on Financial Markets, *G20 High Level Principles on Financial Consumer Protection*, 2011; T Williams, "Who wants to watch: a comment on the new international paradigm of financial consumers regulation" (2013) 36 *Seattle UL Rev* 417; J Sarra, "Fairness in Financial markets, Reconceiving Market Norms" (2014) *Forum on Public Policy: A Journal of the Oxford Round Table*, p 9; As to the G20 recommendations, see VHSE Robertson, "Consumer Welfare in Financial Services: A View from EU Competition Law" (2018) 17 *YARS* 29..

[24] As to the related "treating customers fairly" initiative in the United Kingdom, see J Patient "Treating customers fairly: the challenges of principle based regulation" (2007) 22 *JIBLR* 420; P Cartwright, "Conceptualising and understanding fairness: Lessons from and for financial services" in M Kenny (ed) *Unconscionability in European Financial Transactions: Protecting the Vulnerable*, 2010, 205, especially at 218ff; T Williams, "Open the box: An exploration of the Financial Services Authority's model for fairness in consumer financial transactions" in M Kenny (ed), *Unconscionability in European Financial Transactions, Protecting the Vulnerable*, 2010, 227; A Georgosouli, "The FCA's Treating Customers Fairly (TCF) Initiative: What is so good about it and why it may not work" (2011) J *Law & Society 405*; S Gilad, "Institutionalizing fairness in financial markets: Mission impossible?" (2011) 5 *Reg & Governance* 309; N Moloney, "Regulating the retail market" in N Moloney et al, *The Oxford Handbook of Financial Regulation*, 2015, at 759ff.

[25] SFC, Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission, GP1.

that arise wholly, or partly, in their financial services business.[26] There are significant differences between this duty and the general law duties, including that that duty contemplates that a conflict will be "manage[d]" rather than avoided, and that duty cannot be excluded by contract. The Royal Commission did not recommend a change to this requirement, despite finding that licensees and advisers faced with conflicts have generally preferred their own interests to client interests.

Until recent legislative change, a breach of the "efficiently, honestly and fairly" and conflict management requirements only allowed the revocation or suspension of a financial services licence, which would rarely if ever be practical in the case of a large financial institution because of its adverse impacts on customers and the wider economy. That has now changed with the commencement of the *Treasury Laws Amendment (Strengthening Corporate and Financial Sector Penalties) Act 2019* (Cth), which allows the imposition of civil penalties for contraventions of the section, and also introduces a disgorgement remedy, directed to the benefit derived or detriment avoided because of a contravention. These amendments should increase the effectiveness of these provisions.

A "best interests" requirement

A second layer of Australian conflicts regulation involved statutory "best interests" obligations, which are broadly similar to the suitability and appropriateness rules applicable in the EU and the United Kingdom and recently applied to broker-dealers by Regulation Best Interests in the United States.[27] These provisions (particularly *Corporations Act* s 961B) establish a (limited) duty of a provider of financial advice to act in the "best interests" of its retail client and to place the client's interests ahead of its own when providing advice to that retail client.[28] However, the section specifies

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[26] For case law, see *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 160 FCR 35; 62 ACSR 427; [2007] FCA 963 at [311], [444]–[449]; *Australian Securities and Investments Commission v Avestra Asset Management Ltd (in liq)* (2017) 348 ALR 525; 120 ACSR 247; [2017] FCA 497; ASIC RG 181, *Licensing: Managing conflicts of interest* sets out ASIC's policy in respect of licensees' obligation to manage conflicts of interest; see also J Moutsopoulos, "Finance Industry has Duty to Manage Conflicts" (2005) *IFLR* 41.

[27] L Enriques & M Gargantini, "The Expanding Boundaries of MIFID's Duty to Act in the Client's Best Interest: The Italian Case" (2017) 3 *Italian LJ 485;* L Enriques & M Gargantini, "The Overarching Duty to act in the Best Interest of the client in MiFID II" in D Busch & G Ferrarini (eds), *Regulation of the EU financial markets: MiFID II and MiFIR*, 2017; W Zheng & Y Ding, "An Examination of Retail Clients' Investor Suitability Rules in the COBS and the Lessons for China" (2018) 13 *Frontiers L China* 260 at 272; D Bruce Johnsen, "A Transaction Cost Assessment of SEC Regulation Best Interests" (2018) *Colum Bus L Rev* 695; I Ayres & E Fox, "Alpha duties: The Search for Excess Returns and Appropriate Fiduciary Duties" (2019) 97 *Tex L Rev* 445 at 507-508.

[28] For case law, see *Australian Securities and Investments Commission (ASIC) v NSG Services Pty Ltd* [2017] FCA 345 (granting declaratory and other relief by consent in respect of contraventions of the section); *Australian Securities and Investments Commission v Financial Circle Pty Ltd* (2018) 123 ACSR 624; [2018] FCA 2; *Australian Securities and Investments Commission v Westpac Securities Administration Ltd* [2019] FCAFC 187. For commentary, see R Baxt, A Black and P Hanrahan, *Securities and Financial Services Law*, 9th ed, [14.54]–[14.57]; K Lindgren, "Fiduciary Duty and the Ripoll Report" (2010) 28 *C&SLJ* 435; G Craddock, "The Ripoll Committee Recommendation for a Fiduciary Duty in the Broader Regulatory Context" (2012) 30 *C&SLJ* 216; AJ Serpell, "The Future of Financial Advice Reforms" (2012) 30 *C&SLJ* 240; S Corones and T Galloway, "The Effectiveness of the Best Interests Duty - Enhancing Consumer Protection?" (2013) 41 *ABLR* 5; P Hanrahan, "The Relationship between Equitable and Statutory 'Best Interests' Obligations in Financial Services Law" (2013) 7 *J Eq* 46 (who also makes the observation noted above); M Scott Donald, "Regulating for Fiduciary Qualities of Conduct" (2013) 7 *J Eq* 142; R Batten and G Pearson, "Financial Advice in

several steps that an adviser may take in order to satisfy the best interests duty, and creates a "safe harbour" by treating taking the specified steps as compliance with the "best interests" duty. That approach significantly limits the scope of the duty so that it operates primarily as a narrower "suitability" requirement rather than a wider "best interests" requirement.[29] There is some scope for a wider operation of the section in a residual requirement that, in order to comply with the "best interests" duty, an adviser must have "taken any other step that, at the time the advice is provided, would reasonably be regarded as being in the best interests of the client, given the client's relevant circumstances." Compliance with the statutory "best interests" duty would not, in itself, necessarily comply with the general law duty to avoid either an actual conflict of interest or a real and sensible possibility of conflict of interest, to which I referred above. The Final Report of the Royal Commission raised the good question whether it is necessary to retain that "safe harbour" and recommended that it should be removed, unless there is a clear justification for retaining it.[30]

Another provision (*Corporations Act* s 961J) requires a financial services provider to prioritise client interests, which is an alternative to, and seems to be a less demanding standard than, avoidance of conflicts of interest. That duty appears to assume the coexistence of two interests, that of the client and another interest, and to be satisfied by preferencing the client's interest while still having regard to the other interest. The Royal Commission also did not recommend a change to this requirement, despite finding that licensees and advisers faced with conflicts have generally preferred their own interests to client interests. There is also a prohibition on dishonest conduct in relation to a financial product or financial service, as widely defined (*Corporations Act* s 1041G).

Fiduciary duties

A third layer of conflicts regulation arises at general law. Under Australian law, some participants in the financial services industry owe fiduciary duties because they fall within recognised traditional fiduciary categories, such as between trustee and beneficiary and between principal and agent.[31] Other participants in the financial services industry which are not in the traditional fiduciary categories may owe a fiduciary duty on the facts of the particular relationship.[32] Several Australian cases had recognised the possibility that the relationship between financial adviser and

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Australia: Principles to Proscription; Managing to Banning" (2013) 87 *St John's L Rev* 511; S Corones and K Irving, "Raising Levels of Awareness of Rights and Obligations in the Provision of Financial Product Advice to Retail Clients" (2014) 32 *C&SLJ* 192; P Latimer "Protecting the Best Interests of the Client" (2014) 29 *AJCL* 8; T Rajaretnam and A Young, "In the best interest of clients? A reappraisal of the recent reforms in the regulation of financial advisors in Australia" (2015) 26(2) *ICCLR* 39; and see ASIC RG 175 *Licensing: Financial product advisers — conduct and disclosure;* ASIC also provides guidance as to complying with the best interest duties in giving scaled advice in ASIC RG 244, *Giving information, general advice and scaled advice*..

[29] Hanrahan, "The Relationship between Equitable and Statutory 'Best Interests' Obligations in Financial Services Law", above.

[30] Royal Commission, Final Report, Recommendation 2.3.

[31] *Hospital Products Ltd v United States Surgical Corp* (1984) 156 CLR 41 at 68; [1984] HCA 64.

[32] *Hospital Products Ltd v United States Surgical Corp* above per Gibbs CJ at 68, per Mason J at 96–97, per Deane J at 141-142; *Breen v Williams* (1996) 186 CLR 71; *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 160 FCR 35; 62 ACSR 427; [2007] FCA 963 at [272]; *John Alexander's Clubs Pty Limited v White City Tennis Club Limited* (2010) 241 CLR 1; [2010] HCA 19 at [87]; compare *Bristol & West Building Society v Mothew* [1998] Ch 1; *FHR European Ventures LLP v Cedar Capital Partners LLC* [2014] UKSC 45 at [5].

client may give rise to fiduciary duties.[33] Under Australian law, such fiduciary duties are generally proscriptive or prohibitive, imposing the obligation on the fiduciary not to obtain an unauthorised profit or to be in a position of conflict (without the fully informed consent of the principal), and which requires it to *avoid* and not merely "manage" a conflict of interest or prioritise one interest over another. The existence of a fiduciary relationship generally does not impose a positive legal duty on the fiduciary to act in the beneficiary's interests.[34] While these duties can be narrowed or excluded by contract[35], there does not seem to be any general practice in the retail financial services sector of doing so.

Royal Commission's findings of non-compliance

Despite these layers of statutory and general law regulation, the Royal Commission identified many examples of conduct that was not "fair" by any standard, or did not advance the client's interests, or involved significant conflicts of interest in dealings with retail clients and observed, in language echoing the case law as to fiduciary duties, that "experience shows that conflicts between duty and interest can seldom be managed; self-interest will almost always trump duty".[36] That observation is potentially inconsistent with the wide reliance on statutory obligations to manage conflicts of interest in Australian financial services law, to which I have referred

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[33] *Commonwealth Bank of Australia v Smith* (1991) 42 FCR 390; *Aequitas Ltd v Sparad No 100 Ltd (formerly Australian European Finance Corp Ltd)* (2001) 19 ACLC 1006; [2001] NSWSC 14; *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 160 FCR 35; 62 ACSR 427 at [282]–[286], [325]–[330]; *Wingecarribee Shire Council v Lehman Bros Australia Ltd (in liq)* (2012) 301 ALR 1; [2012] FCA 1028 at [732]; *Bathurst Regional Council v Local Government Financial Services Pty Ltd (No 5)* [2012] FCA 1200, on appeal in *ABN Amro Bank NV v Bathurst Regional Council* (2014) 309 ALR 445; [2014] FCAFC 65. For a sample of the academic literature, see A Tuch, "Investment Banks as Fiduciaries: Implications for Conflicts of Interest" (2005) 29 *Melb U L Rev* 478; A Tuch, "Obligations of financial advisors in change-of-control transactions: Fiduciary and other questions" (2006) 24 *C&SLJ* 488; V Battaglia, "Dealing with Conflicts: The equitable and statutory obligations of financial services licensees" (2008) 26 *C&SLJ* 483; K Lindgren, "Fiduciary duty and the Ripoll Report" (2010) 28 *C&SLJ* 435; P Hanrahan, "The relationship between equitable and statutory 'best interests' obligations in financial services law" (2013) 7 *J Eq* 46; M Scott Donald, "Regulating for fiduciary qualities of conduct" (2013) 7 *J Eq* 142; P Latimer, "Protecting the best interests of the client" (2014) 29 *AJCL* 8; S Degeling and J Hudson, "Fiduciary obligations, financial advisers and FOFA" (2014) 32 *C&SLJ* 527.

[34] *Breen v Williams* (1996) 186 CLR 71; *Pilmer v Duke Group Ltd (in liq)* (2001) 207 CLR 165 at 197–8. There is significant controversy as to the limits of this proposition: see G Dempsey & A Greinke, "Prescriptive fiduciary duties in Australia" (2004) 25 *Australian Bar Review* 1; F Gleeson, "Proscriptive and prescriptive duties: is the distinction helpful and sustainable, and if so, what are the practical consequences?", Paper presented at 2017 Corporate and Commercial Law Conference, Supreme Court of New South Wales.

[35] J Getzler. '*ASIC v Citigroup*: Bankers' Conflict of Interest and the Contractual Exclusion of Fiduciary Duties', (2007) 2 J of Eq, 62-70; M Leeming, "The scope of fiduciary obligations: How contract informs, but does not determine, the scope of fiduciary obligations" (2009) 3 *J of Eq* 181-203; J Getzler, "Ascribing and Limiting Fiduciary Obligations Understanding the Operation of Consent" in A Gold and P Miller, *Philosophical Foundations of Law* (2014); P Finn, "Fiduciary Reflections" (2014) 88 ALJ 127; see also A Eastwood & L Hastings "A response to Professor Finn's 'Fiduciary Reflections'" (2014) 98 *ALJ* 314. Note that English law has substantially the same concept of a fiduciary duty as Australian law, but has taken a turn which Australian law had not taken (although the position may still be open in Australia) by treating the statutory regime as narrowing or excluding general law fiduciary principles, rather than leaving the general law and the statutory regime to operate in parallel. As a matter of impression, the Australian courts have also been more ready to find that fiduciary duties are owed to sophisticated parties than English courts, by focussing on whether the relevant undertaking exists rather than on the sophistication of the beneficiary.

[36] Royal Commission, Final Report, p 3.

above.

These matters emphasise that, obviously enough, a sophisticated legal regime is not sufficient in itself to deliver compliance, although exceptions to and failures in a statutory regime may well be sufficient in themselves to deliver non-compliance. These matters also emphasise the significance of limitations on how the relevant statutory requirements are enforced where, for example, the limited sanctions previously applicable to a breach of the "efficiently, honestly and fairly" requirement could not practically be implemented against the larger Australian banks. The introduction of civil penalties for breach of the "efficiently, honestly and fairly" standard may address that issue, subject to wider issues as to enforcement to which I will return below.

Culture and ethics

There had been a significant focus, prior to the Royal Commission, on the culture and ethics of banks and financial intermediaries, in Australia and internationally. The significance of culture and lack of accountability as matters contributing to the global financial crisis had been identified both by the British Parliamentary Committee on Banking Standards and by the US Financial Crisis Inquiry Commission's Final Report in 2011.[37] The Australian FSI had also recognised the significance of culture in its 2014 report, although it resisted specific legislative regulation, arguing that:

> "The Inquiry considers that industry should raise awareness of the consequences of its culture and professional standards, recognising that responsibility for culture in the financial system ultimately rests with individual firms and the industry as a whole. Culture is a set of beliefs and values that should not be prescribed in legislation. To expect regulators to create the single 'right' culture within firms by using prescriptive rules is likely to lead to over–regulation, unnecessary compliance and a lessening of competition. The responsibility for setting organisational culture rightly risks with its leadership."[38]

ASIC had emphasised the significance of organisational culture in a series of speeches and publications.[39] The Royal Commission in turn referred to the *G30 Report into Banking Conduct and Culture* (2018) and these issues were also considered in the FCA's Discussion Paper, *Transforming Culture in Financial Services* (2018). Recent academic literature has also focussed on culture and remuneration issues.[40]

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[37] J O'Brien, "Because They Could: Trust, Integrity and Purpose in the Regulation of Corporate Governance in the Aftermath of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry", (2019) 13 *Law & Fin Mkts Rev* 141 at 156.
[38] pp 7-8, quoted J O'Brien, above n 37, p 148.
[39] For example, G Tanzer, "The importance of culture in improving conduct within the financial industry", speech at Thomson Reuters' Third Australian Regulatory Summit, 27 May 2015; G Medcraft, "Tone from the top: influencing conduct and culture" (2016) 10 *Law & Fin Mkts Rev* 156 – 158.
[40] D Awrey, W Blair & D Kershaw, "Between Law and Markets: Is There a Role for Culture and Ethics" (2013) 38 *Del J Corp L* 191 (considering whether the FCA's and FSA's Treating Customers Fairly initiative could be extended, by analogy, to wholesale markets to require ethical conduct in bilateral counterparty arrangements and discourage socially excessive risk-taking; and also noting the widely held view that remuneration arrangements of executives and lower-level bank staff promoted excessive risk-taking prior to the global financial crisis and pointing to the potential for clawback arrangements to alter the incentives of such managers and staff); CP Skinner, "Misconduct Risk"

The Royal Commission also focussed on the culture of financial providers, which it defined as “the structural values and norms that shape behaviour and mindsets" within an organisation, and also noted the relationship between culture, governance and remuneration. The Royal Commission observed that:

> “the primary responsibility for misconduct in the financial services industry lies with the entities concerned and those who managed and controlled those entities: their boards and senior management".[41]

The Royal Commission also noted that the corporate culture or the “tone" of an organisation was set at the top[42] and noted that relevant matters may include remuneration structures, accountability frameworks, the entity’s response to identified issues and governance policies. The Royal Commission observed that several Australian financial institutions had previously given insufficient attention to non-financial risks and particularly compliance risks and observed that financial services entities must give sufficient attention and devote sufficient resources to the effective management of non-financial risk.[43]

The Royal Commission recommended that all financial services entities should review the design and implementation of their remuneration systems for frontline staff each year to ensure a focus “on not only what staff do, but how they do it" and also supported earlier recommendations of a review of banking culture commissioned by the major banks, the Sedgewick Review, which recommended that long-term incentives be subject to non-financial as well as financial hurdles.[44] The Royal Commission recommended that financial services entities introduce self-assessment of their governance and culture, including determining whether changes previously made to address governance and cultural issues were effective, and repeat those reviews “as often as reasonably practicable".[45] These

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(2016) 84 *Fordham L Rev* 1559 (reviewing misconduct in the mortgage markets prior to the global financial crisis and in respect of LIBOR and arguing that misconduct should be treated as a systemic risk to the financial system and that “compliance stress testing" should be incorporated into the international framework for regulating global banks); G Gordon and D Zaring, “Ethical Bankers" (2017) 42 *J Corp L* 559 (identifying differences between banks and professions which make it more difficult to impose professional standards of the banking industry and create “ethical bankers"); S Omarova, “Ethical Finance as a Systemic Challenge: Risk, Culture and Structure" (2018) 27 *Cornell J L and Public Policy* 797 (identifying the importance of systemic structural factors in shaping a firm's cultural norms and attitudes); and as to Australian academic literature, see A Wardrop, D Wishart and M McMahon, “Regulating financial institution culture: reframing the regulatory toolkit" (2016) 27 *JBFLP* 171 (arguing for supervision of financial firms by reference to social and organisational psychology, following an approach adopted in the Netherlands); FD Kingsford Smith, T Clarke and J Rogers, “Banking and the Limits of Professionalism” (2017) 40 *UNSWLJ* 411. As to the use of the concept of an inadequate ”corporate culture” to impose liability on corporations under Australian criminal law, see O Dixon, “Corporate Criminal Liability: The Influence of Corporate Culture”, Sydney Law School, Legal Studies Research Paper 17/14, February 2017; and for criticism, see JHC Colvin & J Argent, “Corporate and personal liability for culture in corporations" (2016) 34 *C&SLJ* 30.

[41] Royal Commission, Final Report, p 333.
[42] Royal Commission, Final Report, p 335.
[43] Royal Commission, Final Report, pp 405-406.
[44] Sedgwick, Retail Banking Remuneration Review, 5.4-5.5.
[45] Recommendation 5.6. For completeness, the Royal Commission also recommended (Final Report, Recommendation 5.7) that APRA should focus its supervisory program on building cultures that will mitigate the risk of misconduct; use a risk-based approach to reviews; and assess and encourage organisations to give proper attention to the management of the conduct risk and improving

recommendations are put in relatively general terms and do not seek to prescribe, for example, the detailed content of remuneration structures, although APRA has addressed that question in respect of prudentially-regulated entities. However, they have reinforced financial intermediaries' and regulators' focus on this issue.

Financial advice, commission arrangements and professionalisation of financial advisers

The Royal Commission also focussed on the commission and remuneration arrangements in respect of financial advisers, which have caused ongoing difficulties in the Australian financial services regime. The Australian statutory regime previously sought to address the perverse incentives created by commission and volume-based fee arrangements for financial advisers[46], by the FOFA reforms. Specifically, Part 7.7A Division 3 of the *Corporations Act*, introduced by the FOFA reforms, regulates ongoing fees payable by clients. The Royal Commission highlighted difficulties with the operation of these provisions, and particularly focussed on fees charged by product manufacturers and advisers which did not provide corresponding services. The Royal Commission recommended amendment of these provisions to require that ongoing service arrangements be subject to an opt in requirement every year, rather than every two years, and to require the adviser to record in writing each year the services that the client will be entitled to receive and the total of the fees to be charged.[47] These requirements should go at least some way to meeting the issue as to fees for no service identified by the Royal Commission.

Part 7.7A Division 4 of the *Corporations Act* in turn regulates conflicted remuneration. Broadly, this Division applies where personal advice is provided to a retail client and prohibits initial or upfront commissions, trail commissions and payments based on volume or sales targets.[48] These provisions were arguably undermined by a range of exceptions, and particularly by grandfathering of existing

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governance. APRA may well consider that it already addressed each of those issues in its existing review process.

[46] For commentary, see G Pearson, "Commission Culture: A Critical Analysis of Commission Regulation in Financial Services" (2017) 36 *U Qld LJ* 155.

[47] Royal Commission, Final Report, Recommendation 2.1.

[48] A ban on inducements, including commissions paid by product issuers, was similarly introduced in the United Kingdom following the Financial Service Authority's Retail Distribution Review in 2012, and applies to all investment advisers who provide advice to retail clients, with minor exceptions, and to a wide range of retail investment products. There are also limitations on the way in which advisers may charge for personal recommendations to a retail client in relation to a retail investment product, which largely prohibit commissions, remuneration or other benefits from product issuers. Restrictions are also imposed in the United Kingdom on ongoing payment of adviser charges, unless they are in respect of an ongoing service for the provision of personal recommendations; the firm has disclosed the service and the charge; and the retail client has a right to cancel that service. The ban on commissions was, on the face of it, more effectively implemented in the United Kingdom than in Australia, although there are ongoing debates as to the extent to which that has reduced access to financial services in the United Kingdom: Cass Consulting, "The impact of the RDR on the UK's market for financial advice: Challenge and opportunity", June 2013; G McMeel, "International issues in the regulation of financial advice: A United Kingdom perspective – the Retail Distribution Review and a ban on commission payments to financial intermediaries" (2013) 87 *St John's L Rev* 595; N Moloney, "Regulating the retail market" in N Moloney et al, *The Oxford Handbook of Financial Regulation*, 2015, at 759ff; P Ring, "The Retail Distribution Review" (2016) 24 *J of Financial Regulation and Compliance* 140; and see also P Hanrahan, Background Paper 30 to the Royal Commission, Information about Selected Aspects of Foreign Financial Services Regulation, p 23.

arrangements. At the same time, that prohibition may have, perversely, encouraged financial firms to rely on ongoing fees, some of which were not warranted by ongoing services to clients, reflected in the Royal Commission's findings about "fees for no service". The Royal Commission recommended that these grandfathering provisions be repealed as soon as practicable.[49] The Government accepted that recommendation, with the significant qualification that the repeal is only to take effect from 1 January 2021. This amendment may (eventually) realise the initial promise of the FOFA reforms, since a reduction in the financial incentives for inappropriate advice should reduce the extent of that inappropriate advice. The Government also indicated that it would review remaining exceptions to the ban on conflicted remuneration in the course of a review in three years' time.

The Royal Commission also recommended additional disclosure in respect of financial adviser independence and further review if that failed to improve the quality of advice in three years.[50] The real doubts as to the efficacy of disclosure, including of conflicts of interest, in dealing with retail clients[51] raise a corresponding question whether further disclosure will significantly improve the quality of advice.

The Royal Commission also noted several other issues affecting the quality of financial advice, including a fragmented and ineffective disciplinary system for financial advisers. The Royal Commission recognised that individuals guilty of misconduct often moved from one firm to another and recommended the introduction of licence conditions that will require holders of Australian financial services licences and Australian credit licences to undertake reference checking; to report "serious compliance concerns" about individual advisers to ASIC; and to make reasonable efforts to determine the nature and extent of adviser misconduct and advise affected clients and remediate promptly if misconduct is established.[52] The Royal Commission also recommended the reintroduction of a registration regime for individual financial providers and that a central disciplinary body be established for financial advisers.[53] These changes are now under way.

The Royal Commission also identified an incomplete transition from a "sales" culture in respect of financial products towards a "profession" of providing financial advice and doubted that financial advisers had achieved the status of a "profession".[54] In that context, the Royal Commission considered the possibility of distinguishing between sales and true advisory functions in financial services. It took the view that that course should not be adopted, and noted the steps previously taken to seek to professionalise financial advisory services. These steps include the recent introduction of new training standards for financial advisers under the *Corporations Amendment (Professional Standards of Financial Advisers) Act* 2017 (Cth), which

[49] Royal Commission, Final Report, Recommendation 2.4.
[50] Royal Commission, Final Report, Recommendations 2.2 – 2.3.
[51] As to these issues, see D Kingsford Smith, "Financial services regulation and the investor as consumer" in G Howells, *Handbook of Research in International Consumer Law*, 2010, at 446; O Ben–Shahar and C Schneider, "The failure of mandated disclosure" (2011) 159 *U Penn L Rev* 647; M Andenas & IHW Chiu, *The Foundations and Future of Financial Regulation: Governance for Responsibility*, 2014, p 242; D Kingsford Smith and O Dixon, "What next for the financial consumers: more disclosure? Caveat vendor? Fintech online?" in G Howells, *Handbook of Research in International Consumer Law*, 2nd ed, 2018, 381.
[52] Recommendations 2.7 – 2.9.
[53] Recommendation 2.10.
[54] Royal Commission, Final Report, p 119.

took effect from 1 January 2019, and apply to individuals employed or authorised by an Australian financial services licensee to provide personal advice to retail clients in relation to financial products (with limited exclusions for basic banking products, general insurance products, consumer credit insurance or a combination of those products).[55] There is plainly an open question whether the additional requirements of the *Corporations Amendment (Professional Standards of Financial Advisers) Act* 2017, even combined with more effective limitation on commission payments by issuers, can shift the advisory industry from a sales based to a "professional" culture.

Issues arising from industry structure

The Royal Commission also recognised the issue of conflicts of interest arising from vertical integration of product manufacturers and financial advisory firms, where, for example, product manufacturers both provide advisory services and own advisory firms that provide such services.

These issues are not new. ASIC Report 562, *Financial Advice: Vertically Integrated Institutions and Conflicts of Interest* (January 2018), had identified failings in financial advice provided by the five largest banking and financial services providers in Australia, and noted a weighting in products recommended by advisers in vertically integrated businesses to in-house products, and a failure to comply with best interests duties in switching clients from external to in-house products in many instances. ASIC also noted, in its submissions to the Royal Commission, that conflicts arose from structural aspects of the financial services industry, including in a "vertically integrated" business, where there was a conflict between a licensee's interest in selling its in-house products and the client's interest in receiving advice that was in its best interests. On the other hand, ASIC Report 562, and ASIC's submissions to the Royal Commission, also fairly acknowledged possible benefits of vertical integration, including economies of scale that potentially improved cost efficiencies and produced savings that could be passed onto the customer and improved access to advice; some benefit to customers from dealing with a single financial institution; and that some customers valued a perceived safety of dealing with a large institution. However, ASIC questioned whether those cost efficiencies were passed onto customers; whether such arrangements were sufficiently transparent to permit clients to make an informed choice to prefer convenience over countervailing considerations; and whether large institutions were acting consistently with the trust placed in them. In a submission prior to the Interim Report of the Royal Commission, Treasury did not then support structural separation of product manufacturers and advisory functions, noting that it would be complex and disruptive and could have "unintended consequences".

The Royal Commission did not recommend a statutory prohibition on vertical integration of financial services businesses, but noted that more effective regulation of conflicts of interest would place pressure on those structures. Other jurisdictions have also not sought to prevent a product issuer or associated entities providing personalised recommendations to customers about investment products, or required

[55] For comment, see R Bowley, "Regulating the Financial Advice Profession: An Examination of Recent Developments in Australia, New Zealand and the United Kingdom and Recommendations for Further Reform" (2017) 36 *University of Queensland LJ* 177.

financial advisers to be structurally independent of product issuers.[56]

Individual accountability

Australia had introduced a Banking Executive Accountability Regime ("BEAR") applicable to banking executives, which is modelled on the Senior Managers Regime introduced in the United Kingdom, with both regimes requiring accountability statements and maps and imposing behavioural standards.[57] The legislative purposes of the BEAR included that accountable persons "cannot avoid responsibility for problems which happen under their watch".[58] The phrase "avoid responsibility" obviously makes the assumption, which is contestable but which many would accept, that such executives should be held responsible for such matters, because they should be able to identify and address such matters by adequate supervisory structures.

The BEAR requires an "accountable person" (as defined) to comply with his or her accountability obligations, which include "taking reasonable steps in conducting [their] responsibilities to prevent matters from arising that would adversely affect the prudential standing or prudential reputation of the A[uthorised] D[eposit-taking] I[nstitution]."[59] That obligation attaches in relation to each of the responsibilities that cause a person to be an "accountable person" of the ADI or a subsidiary. APRA may disqualify a person from acting as an "accountable person", if he or she has not complied with his or her accountability obligations.[60] However, civil penalties for breach of the obligations under BEAR apply only to banks and not individuals, by contrast with the Senior Managers Regime (UK) and the Managers in Charge Measures (HK). Constitutional limitations also prevent ASIC, by contrast with the FCA, from imposing financial penalties without recourse to a Court.[61]

The Royal Commission recommended that provisions modelled on BEAR should be extended to all insurers and superannuation trustees regulated by APRA.[62] The

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[56] P Hanrahan, Background Paper 30 to the Royal Commission, Information about Selected Aspects of Foreign Financial Services Regulation, p 30.

[57] Treasury, *Background Paper 24 to the Royal Commission, Submission on Key Policy Issues*, p 18; J Cullen, "A culture beyond repair: The nexus between ethics and sanctions in finance" in L Herzog (ed), *Finance in a Just Society*, 2017, pp 176ff; R Clarke, "Individual Accountability in Irish credit institutions – Lessons to be learned from the United Kingdom's Senior Managers' Regime" (2018) 47 *Common Law World Review* 35 at 41; D Wishart & A Wardrop, "What can the Royal Commission achieve: Regulating for good corporate culture" (2018) 43 *Alternative LJ* 81 at 88.

[58] Revised Explanatory Memorandum to the *Treasury Laws Amendment (Banking Executive Accountability and Related Matters) Bill 2017*, [1.22].

[59] *Banking Act* 1959 (Cth), s 37B. The content of "reasonable steps" is defined inclusively in BEAR s 37CB.

[60] *Banking Act* 1959 (Cth), s 37J.

[61] A Eastwood and J Emmerig, "The BEAR necessities: What jurisdictional considerations will Australia's version of the UK's 'Senior Managers and Certification Regime' need to accommodate" (2017) 28 *JBFLP* 321.

[62] Royal Commission, Final Report, Recommendations 3.9, 4.12, 6.8. For completeness, the Royal Commission also recommended that APRA should determine a point of responsibility within each Authorised Deposit Taking Institution for steps in the design, delivery and maintenance of all products and for any necessary remediation of the customer in respect of such products: Royal Commission, Final Report, Recommendation 1.17. The Government accepted that recommendation, which has been controversial, with questions as to the feasibility of having a single point of responsibility for that range of matters. The Royal Commission also recommended that the BEAR be jointly administered by

Government went further to indicate that it would introduce a similar regime for executives in non-prudentially regulated financial firms; to apply to holders of Australian financial services licences and Australian credit licences, market operators and clearing and settlement facilities. Treasury issued a consultation paper in late January 2020 dealing with how the proposed changes should be implemented (under the name "Financial Accountability Regime" ("FAR")), as distinct from whether they should be implemented, which includes a proposal to extend civil penalties for breach of the regime to officers of financial firms.

This is likely to be a positive development, if it survives industry opposition, be subject to legitimate debate as to the form of the provisions and the size of the proposed penalties. Regimes such as the Senior Manager Regime, BEAR and the proposed FAR have real significance in improving executive accountability for misconduct, given the difficulties in otherwise attributing responsibility to executives who may have, or claim that they have, no knowledge of conduct of employees within their reporting line, and also answers the criticism that prosecutions of individuals will otherwise tend to make scapegoats of junior or middle ranking employees.[63] The imposition of such responsibilities on senior management arguably also incentivises their involvement in initiatives to improve conduct, which can increase the prospects of their success.[64]

Enforcement

The Royal Commission identified a lack of enforcement in respect of breaches of the statutory requirements and observed that:

> "financial services entities that broke the law were not properly held to account … misconduct, especially misconduct that yields profit, is not deterred by requiring those who have are found to have done wrong to do no more than pay compensation. And wrongdoing is not denounced by issuing a media release."

That observation may oversimplify the complexities of enforcement in financial services, to which I now turn.

The enforcement alternatives that have been available under Australian law include criminal enforcement; civil penalty proceedings, which can lead to the imposition of a

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ASIC and APRA, with ASIC addressing consumer protection and market conduct obligations and APRA addressing prudential aspects.

[63] DC Rickman, "Corporate Headhunting" (2014) 8 *Harv L & Policy Rev* 265; T Hough, "The Most Senior Wall Street Official: Evaluating the State of Financial Crisis Prosecutions" (2015) 9 *Va L & Bus Rev* 153; SL Schwarz "Excessive Corporate Risk–Taking and the Decline of Personal Blame" (2015) 65 *Emory LJ* 533 (noting public discontent with the regulatory focus on proceedings against banks rather than individuals, and the basis for imposition of personal liability for excessive corporate risk-taking); MR Reiff, "Punishment in the executive suite: Moral responsibility, causal responsibility and financial crime" in L Herzog (ed), *Finance in a Just Society*, 2017, pp 126 – 127 (arguing for a different causal approach which would avoid the suggested difficulty in proving that senior officials had the requisite knowledge and criminal intent in a prosecution); GM Gilchrist, "Individual Accountability for Corporate Crime" (2018) 34 *Ga St U L Rev* 335; GM Gilchrist, "Accountability Lost and the Problem(s) of Asymmetry" (2019) 50 *Loy U LJ* 599 (identifying difficulties arising from information gaps in bringing criminal prosecutions against high level corporate executives).

[64] S Gilad, "Institutionalizing Fairness in Financial Markets: Mission Impossible?" (2012) 5 *Regulation & Governance* 309; D Awrey, W Blair & D Kershaw, "Between Law and Markets: Is There a Role for Culture and Ethics?" (2013) 38 *Del J Corp L* 191 at 222 – 223.

substantial money penalty and exposure to compensation orders and, following recent amendments, also profit disgorgement orders; administrative actions including suspending or cancelling licences or banning individuals from the financial services industry; and the entry into enforceable undertakings.[65] Australian law permitted (and still permits) ASIC to accept an "enforceable undertaking" as an alternative to bringing court proceedings.[66] A breach of an enforceable undertaking exposes the party who gave it to liability to pay the amount of any financial benefit attributable to that breach to the Commonwealth, and to compensate any other person who suffered loss or damage as a result of the breach, and to any other order which the court considered appropriate. That regime functioned similarly to the deferred prosecution regime in the United States and the United Kingdom, which is also under consideration in Australia. The Royal Commission was strongly critical of ASIC's use of that regime to resolve regulatory matters, particularly with larger financial institutions.

An "infringement notice" regime was also available in some areas, which allows ASIC to offer the regulated entity a relatively modest fixed penalty which it may elect to pay, thereby avoiding proceedings, or not pay, leaving itself open to such proceedings. That regime originally applied to breaches of the continuous disclosure obligation on listed companies and has since been extended to other fields, and had been subject to criticism in some circles. For example, the late Professor Robert Baxt put the view, also expressed by the Australian Law Reform Commission, that:

> "An infringement notice regime was appropriate only for minor breaches of law such as parking, speeding and related matters. It had no place in dealing with breaches of complex and significant areas of commercial law."[67]

The Royal Commission largely agreed with those criticisms and observed that infringement notices should principally be used in respect of administrative failings and would rarely be appropriate for provisions that required an evaluative judgment or as an enforcement tool where the infringing party is a large corporation. That preference for limited use of infringement notices plainly reflects a different

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[65] P Hanrahan, "Regulating financial advice for retirement – the recent Australian reforms", 10 March 2017, pp 4-6.

[66] Section 93AA of the ASIC Act provides for ASIC to accept a written undertaken given by a person in connection with a matter in relation to which ASIC has a function or power under the Act. Section 93A of the ASIC Act allows ASIC to accept an enforceable undertaking from the responsible entity of a registered scheme in connection with the specified matters. An enforceable undertaking would not generally be accepted in relation to serious and recurrent breaches of the *Corporations Act*: *Re Jungstedt and Australian Securities and Investments Commission* (2003) 73 ALD 105; [2003] AATA 159. The provision for enforceable undertakings corresponds to Australian Consumer Law s 218, which provided for enforceable undertakings in favour of the Australian Competition and Consumer Commission. For commentary, see M Nehme, "Enforceable undertakings in Australia and beyond" (2005) 18 *AJCL* 68; M Nehme, "Expansion of the powers of the Administrative Appeals Tribunal in relation to enforceable undertakings" (2007) 25 *C&SLJ 116*; M Nehme, "Enforceable undertakings and the court system" (2008) 26 *C&SLJ* 147; V Comino, "The GFC and Beyond – How do we deal with corporate misconduct" (2018) *JBL* 15. ASIC RG 69 sets out ASIC's policy in relation to accepting enforceable undertakings.

[67] R Baxt, 'A fundamental principle of English and Australian common law — Why the presumption of innocence must be retained at all costs' in R Baxt, *Bob's Best: A Collection of Essays by Bob Baxt*, 2015, p 35. For a review of the application of the infringement notice regime, see I Ramsay and A Desai, 'The use of infringement notices by ASIC for alleged continuous disclosure contraventions: Trends and analysis" (2011) 39 *Australian Business Law Review* 260.

philosophy than that reflected in the wider use of penalty notices under the recent *Treasury Laws Amendment (Strengthening Corporate and Financial Sector Penalties) Act* 2019 (Cth).

The Royal Commission instead recommends that ASIC should adopt an approach to enforcement that takes, as its starting point, the question of whether a Court should determine the consequences of a contravention. The Government accepted that recommendation; ASIC has since indicated that it has adopted a "why not litigate?" enforcement stance[68]; and APRA has also indicated that it will adopt a "constructively tough" approach to dealings with prudentially regulated entities. There are, of course, some possibly good answers to the question that ASIC will now ask itself, "why not litigate?", by reference to issues of delay, cost, uncertainty of outcome and the risk that that approach will encourage an equally litigious approach by regulated entities. The enforcement stance to which ASIC has now returned also has echoes of an approach adopted by its predecessor, the Australian Securities Commission, in the early 1990s which was modified in later years with the lessons of experience. Time will tell whether the "why not litigate?" stance may also require variation with time and experience.

There is also a question as to the consequences of successful litigation brought against a bank or major financial institution, which has received substantial international attention.[69] The Royal Commission emphasises that such an action may vindicate a legal principle and that it will have deterrent effect. The extent of that deterrence may be qualified, at least in Australia, by the practical reality that it likely would not be possible to impose a sanction that would substantially prejudice the operation of one of the four major banks, as is emphasised by the fact that they have traditionally been referred to as the "four pillars" of the Australian banking system. Obviously, there is a risk (not unique to Australia) that fines imposed on financial intermediaries following successful proceedings, however large, will ultimately be treated as a cost of business that is ultimately borne by consumers of the financial institution's services or by its shareholders.[70] It is less likely in Australia than in the United States that such fines would be covered by insurance.

Wider legislative structure

The Royal Commission fairly recognised that much of the conduct that it had identified was already contrary to existing legislation, and noted the difficulty of layering additional prohibitions on existing prohibitions, increasing complexity, where the issue may be one of compliance and enforcement. The Royal Commission recommended that, as far as possible, exceptions and qualifications to generally

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[68] ASIC Media Release – 19-035MR, ASIC update on implementation of Royal Commission recommendations, 19 February 2019. For subsequent comments by ASIC as to its enforcement strategy, see S Hughes, "ASIC's approach to enforcement after the Royal Commission" (August 2019) (seeking to distinguish a "why not litigate" strategy from a "litigate first" or "litigate everything" strategy; D Crennan, "The future of the corporation: the regulator's perspective", paper delivered at Supreme Court of New South Wales Annual Corporate and Commercial Law Conference, 2019.
[69] For example, GM Gilchrist, "The Special Problem of Banks and Crime" (2014) 85 *U Colo L Rev* (observing that the non-prosecution of banks is often justified by externalities arising from their fragility and systemic importance; that it is less clear why bank employees have not been prosecuted individually; and that the criminal law may not be the most effective tool to address bank misconduct).
[70] MR Reiff, "Punishment in the executive suite: Moral responsibility, causal responsibility and financial crime" in L Herzog (ed), *Finance in a Just Society*, 2017, p136.

applicable norms of conduct should be removed and that the legislation quote should identify “what fundamental norms of behaviour are being pursued when particular and detailed rules are made about a particular subject matter.”[71]

The Royal Commission also observed that the fact that the Australian regulatory regime for financial services “is now spread over so many different levels and is as complex as it is" indicated the need for simplification; noted that lobbying by the financial services industry was a significant contributor to the present position; and also observed that law reform would:

> “require examination of how the existing laws fit together and identification of the various policies given effect by the law's various provisions. Only once this detailed work is done can decisions be made about how these policies can be given better and simpler legislative effect",

The Royal Commission recognised the undesirability of adding further regulation to an already complex regime and suggested that simplification would avoid “distract[ing] attention from the very simple ideas that must inform the conduct of financial service entities."

It seems unlikely that a larger simplification project will proceed, whatever its attractiveness in principle, which would need to be weighed against the substantial direct and indirect costs of any major law reform project. As Professor Hanrahan had noted prior to the Royal Commission, there is a real possibility that there will be “little appetite for rethinking the fundamentals" in Australian financial services regulation, because of past investments by regulated entities, the regulator, the government and advisers in the current regulatory framework and, inevitably, the fact that regulatory frameworks are “highly path dependent and interconnected, which magnifies the difficulties in reform".[72] The Government's proposed legislative response to the Royal Commission appears to address specific issues identified by the Royal Commission, without extending to any wider simplification project.

Conclusion

I will now seek to identify several themes, perhaps falling short of conclusions, from these matters. First, the most pessimistic view of the Australian developments, combined with the history of mis-selling in the United Kingdom, is that sophisticated regulatory regimes simply cannot prevent recurrent episodes of mis-selling of financial products and misconduct in financial services. That, of course, does not mean that the regulatory regime has no benefit, in seeking to reduce the level of mis-selling activity and misconduct.

Second, regulatory standards of conduct (for example, in Australia, the efficiently, honestly and fairly standard) will only be as strong as the mechanisms available to enforce them. The Australian experience has shown that a power to revoke a financial services licence or impose licence conditions for breach of that standard was of limited value in respect of larger financial institutions, where at least the former could not realistically be done. The introduction of substantial monetary fines

[71] Royal Commission, Recommendations 7.3-7.4.
[72] P Hanrahan, “Fairness and Financial Services: Revisiting the Enforcement Framework" (2017) 35 *C&SLJ* 424.

for a breach of that standard may be a partial solution, but that raises another difficulty, namely the utility of such fines against larger financial institutions, where they are ultimately borne by consumers in the cost of services or by shareholders.

Third, the “too big to fail” problem, and its close analogue the “too big to gaol” problem, can apply not only to institutions that are large in absolute terms, at the international level, but also to institutions that are large in, or critical to the economic functions of, a particular jurisdiction. In jurisdictions like Australia, the domestic banks and large insurers are arguably as important to the domestic economy as the international banks are to the international economy.

Fourth, as international regulators, ASIC and now the Royal Commission have recognised, cultural failings, including failings as to remuneration structures and the way in which conduct is measured and assessed, enable misconduct. The Royal Commission rightly recognised the importance of internal and regulatory review of remuneration structures, accountability structures and the management of misconduct risk on this regard.

Fifth, the Royal Commission has emphasised, as had already long been recognised internationally and in Australia, that the structure of integrated firms and conflicts of interest in remuneration arrangements for financial advisers, and particularly commission arrangements, tend to promote inappropriate recommendations. The Australian experience emphasises, not surprisingly, that exceptions to a ban on commission arrangements, including transitional provisions, may undermine that ban. Even after the conflicts arising from commission arrangements are widely recognised, governments will be faced with arguments to retain them, including suggested competition issues arising from prohibiting them (for example, concerns as to entrenching the banks in the home mortgage market in Australia by removing commissions paid to mortgage brokers).

Sixth, individual accountability is significant and the Senior Managers Regime in the United Kingdom and the Banking Executive Accountability Regime in Australia are important developments, both in promoting the accountability of senior management and in shifting incentives of senior management. The extension of those regimes beyond the banking sector, to financial services generally, is perhaps the most promising of the strategies identified by the Royal Commission. It is also likely to be contentious, so far as industry is concerned, and whether the extension to financial services generally can ultimately be achieved in Australia remains to be seen.

Seventh, effective enforcement is plainly necessary to an effective financial services regime. I have commented on the Royal Commission's preference for court action over other forms of enforcement, including enforceable undertakings, above.

Finally, the Royal Commission rightly recognised the desirability of simplification of complex regulatory structures for financial services, a description which could certainly be applied to the regimes applicable in both the United Kingdom and Australia. That task is difficult, where there are issues of path dependency, significant costs attached to the law reform process and significant costs have been incurred in developing compliance regimes based on existing regulatory structures. It is perhaps not surprising that the recommendation for simplification has so far achieved little traction in Australia.