Conflict of interest regulation after the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

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Introduction

I should start with several observations about the nature of the financial advisory industry and financial services regulation, as the position stood prior to the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry. First, that industry is of particular significance in Australia, given the extent of investment committed to superannuation. Second, poor financial advice has a significant capacity to adversely impact investors, particularly in relation to their position in retirement. Third, prior to the Royal Commission, financial services providers were required to hold an Australian financial services licence, which imposes conduct and disclosure obligations. Authorised representatives, including many individual financial advisers, and employees of holders of Australian financial services licences were not separately licensed. Fourth, many advisers were either employed by large institutions such as the major banks or operated under contractual arrangements with licensees, and a smaller number of advisers operated in independent firms. Fifth, a significant difficulty with the regulation of conflicts of interest in the financial services industry, recognised by the Royal Commission, is the extent to which those conflicts have a structural character, in a vertically integrated financial sector, where product manufacturing, product sales and advisory roles are often concentrated in the same entity.

The present structure for the regulation of financial products and services under Chapter 7 of the *Corporations Act* 2001 (Cth) reflects several significant policy choices made in the late 1990s, primarily by *CLERP Paper No. 6: Proposals for Reform - Financial Markets and Investment Products* (1997), and implemented by the *Financial Services Reform Act* 2001 (Cth). These policy choices include decisions to regulate financial products and services on a functional basis, rather than by reference to legal categories such as securities, futures contracts and insurance; the primary focus on licensing and regulation at the institutional level rather than on individual advisers; the lack of any requirement for separation of issuers (or "manufacturers") of financial products and financial advisers; and reliance on disclosure rather than restricting the range of financial products that can be made available to retail clients.

The present regulatory structure directed to conflicts of interest

As matters stood prior to the Royal Commission, and presently still stand, conflicts of interest affecting financial advisers are regulated in several ways, as follows:

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Nature of duty	Source and application
Advisers are subject to a duty to avoid a real and sensible conflict of interest	General law - will often apply to financial advisers as fact-based fiduciaries, unless excluded
Advisers are subject to duties to act efficiently, honestly and fairly and to manage conflicts of interest	*Corporations Act* ss 912A(1)(a), 912A(1)(aa) - applies to Australian financial services licence holders (but not directly to representatives or advice providers)
Advisers are subject to a (limited) "best interests" duties	*Corporations Act* s 961B - applies to providers of financial advice to retail clients
Advisers are subject to a duty to prioritise client interests	*Corporations Act* s 961J - applies to providers of financial advice to retail clients

The result of this overlapping general law and regulatory regime is that there can be situations where only a statutory duty applies, for example, where a relationship between an adviser and a client is not fiduciary, or a fiduciary duty is excluded, or the relevant conduct is not within the scope of any fiduciary duty. There can also be cases where both fiduciary and statutory duties apply, for example, where a fiduciary duty is not excluded or not effectively excluded and the relationship is an advisory relationship with a retail client. There is a risk that participants in the Australian financial services industry may underestimate the extent of their obligations by structuring compliance activities by reference to the less demanding requirements of the statutory provisions, rather than the more demanding obligation to avoid conflicts of interest, without fully informed consent, under general law.[2]

Focus on conflicts of interest in the Royal Commission

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 wider norms provide the context for a particular focus on conflicts of interest and their consequences in the Royal Commission. In a submission after early hearings and prior to the Interim Report of the Royal Commission, Treasury summarised the conflicts of interest identified by the Royal Commission and ASIC's work as arising from remuneration structures of financial advisers and remaining conflicted remuneration; financial advice business models and incentives to create ongoing advice relationships with customers; and integrated business models that combine financial advice with

[2] AJ Black, "Trusts, Financial Services and Conflicts", Paper delivered at Law Council of Australia Conference - 2015: Superannuation. Super Forever, 19 February 2015; M Scott Donald, "A Servant of Two Masters? 'Managing' conflicts of duties in the Australian Funds Management Industry" (2018) 12 *J of Eq* 1 at 13.

other financial products and services.[3] Treasury also recognised that the Royal Commission's hearings had:

> "highlighted the inherent misalignment of incentives within firms that integrate personal financial advice along with product manufacture, and the challenges firms have had in adequately managing those conflicts. These conflicts arise for both vertically and horizontally integrated firms."[4]

The Interim Report of the Royal Commission in turn 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 Interim Report also fairly recognised that much of the conduct that it identified was 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.

Numerous submissions in response to the Interim Report also focused on conflicts of interest. ASIC's response to the Interim Report referred to the "corrosive effect of widespread conflicts of interest"; observed that such conflicts "have been embedded in the financial system in ways that have manifestly harmed consumers and contributed to systemic market problems"; and noted conflicts of interest in remuneration, product design and business structures. In its response to the Interim Report, Treasury also recognised (at [11]) that:

> "The stark conclusion to be drawn from the Interim Report is that where self-interest clashes with duties and consumer outcomes, self-interest, particularly where motivated by financial incentives, will likely win - and that the current systems in place to manage or mitigate such outcomes too often fail."

The Final Report of the Royal Commission again noted that the conduct addressed by the Royal Commission had been driven by entities' pursuit of profit and individuals' pursuit of gain, whether by way of individual remuneration or profit for an individual's business; noted the confusion of sales and advisory functions within the financial services industries; criticised bonus and commission structures which prioritised sales and profit rather than compliance with law and proper standards; and noted the imbalance of power and knowledge between providers of financial services and consumers; and that the interests of intermediaries were often opposed to the interests of clients.[5]

The Final Report of the Royal Commission also noted several specific issues affecting the quality of financial advice, including charging ongoing advice fees where no service was provided to the client; the giving of poor advice that left clients worse off than if proper advice had been given; and a fragmented and ineffective disciplinary system for financial advisers.[6] The Final Report also noted an incomplete transition from a culture of selling financial products towards a "profession" of providing financial advice and doubted that the financial advisory business had achieved the status of a "profession".[7]

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[3] Treasury, Background Paper 24 to the Royal Commission, *Submission on Key Policy Issues*, p 41.
[4] Treasury, Background Paper 24 to the Royal Commission, *Submission on Key Policy Issues*, p 48.
[5] Royal Commission, Final Report, pp 1-2.
[6] Royal Commission, Final Report, p 119.
[7] Royal Commission, Final Report, p 119.

Conflict of interest regulation under the general law

The Royal Commission placed its primary focus on the adequacy of statutory rather than general law regulation of conflicts of interest and its recommendations will not directly affect the scope of general law duties. It is still important to recognise the scope of those duties.

Some participants in the financial services industry owe fiduciary duties because they fall within recognised traditional fiduciary categories. Traditional examples of such relationships include, relevantly, that between trustee and beneficiary and agent and principal.[8]

Other participants in the financial services industry which are not in the traditional fiduciary categories, including financial advisers, may owe a fiduciary duty on the facts of the particular relationship.[9] In *John Alexander's Clubs Pty Limited v White City Tennis Club Limited* (2010) 241 CLR 1; [2010] HCA 19 at [87], a unanimous High Court identified the "critical feature" of fiduciary relationships as being that:

> "'the fiduciary undertakes or agrees to act *for or on behalf of* or *in the interests of* another person in the exercise of a *power* or *discretion* which will affect the interests of that other person in a legal or practical sense. From this power or discretion comes the duty to exercise it in the interests of the person to whom it is owed."

Several cases have recognised the possibility that the relationship between financial adviser and client may give rise to fiduciary duties.[10] Professor Hanrahan has similarly expressed the view that:

> "it seems that the provision of personalised financial advice to a client in Australia will usually give rise to a fiduciary relationship between the adviser and the client. If a client seeks personal financial advice from a professional financial services firm in circumstances where the financial services firm has held itself out as having expertise in such matters and undertaken to advise the client on them, and it is apparent that the

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

[9] *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; *Bristol & West Building Society v Mothew* [1998] Ch 1; *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 160 FCR 35; 62 ACSR 427; [2007] FCA 963 at [272]; *FHR European Ventures LLP v Cedar Capital Partners LLC* [2014] UKSC 45 at [5].

[10] *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; JE Fisch, "Fiduciary duties and the analyst scandals" (2007) 58 *Ala L Rev* 1083; 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.

> client wants and intends to rely upon the expert recommendations of the adviser (and not just information or opinions that adviser provides) in taking action that will affect the financial position of the client, it is unsurprising that a client would expect the firm's recommendations to be directed at what is in the client's interests, not those of the firm or some third party. Where that expectation exists, it is likely the relationship between the client and the firm will be treated as fiduciary."[11]

The content of and limitations on fiduciary duties

Under Australian law, 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, and the existence of a fiduciary relationship generally does not impose a positive legal duty on the fiduciary to act in the beneficiary's interests.[12] A fiduciary is at least subject to the "no conflict" rule which requires it to avoid and not merely "manage" a conflict of interest or prioritise one interest over another. In *Wingecarribee Shire Council v Lehman Bros Australia Ltd (in liq)* (2012) 301 ALR 1; [2012] FCA 1028, Rares J summarised the no conflict rule as applying in a financial advisory context as follows:

> "A fiduciary such as a financial adviser will be under two proscriptive obligations imposed by equity. Those obligations are, unless the fiduciary has the informed consent of the person to whom they are owed, *first*, not to obtain any unauthorised benefit from the relationship and, *secondly*, not to be in a position where the interests or duties of the fiduciary conflict, or there is a real or substantial possibility they may conflict, with the interest of the person to whom the duty is owed …"

The test for when a conflict arises has been expressed in various ways in the cases, but the shorthand "real [and] sensible possibility" is often applied.[13] The conflict rule has a strict application at least in the sense that, if a transaction has occurred in conflict of interest, a fiduciary cannot displace the breach by asserting the fairness of the transaction or that it was in the beneficiary's best interests or that the fiduciary was not acting with subjective dishonesty.[14]

However, a fiduciary obligation will arise only in relation to that part of the relationship which is fiduciary in character and the duty owed by a fiduciary will be limited to the scope of the service which it undertakes to provide.[15] A contract governing the relationship between the fiduciary and the beneficiary may also define the nature of the relationship and obligations between the parties in a way which limits the scope of any

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[11] PF Hanrahan, "The Fiduciary Idea in Financial Services Law" in J O'Brien and G Gilligan (eds), Integrity, Risk and Accountability in Capital Markets: Regulating Culture, 2013, pp 203 – 228 (at p 212).

[12] *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.

[13] *Boardman v Phipps* [1967] 2 AC 46 at 124; *Chan v Zacharia* (1984) 154 CLR 178 at 198 (referring to "a conflict … or significant possibility of such conflict"); *Hospital Products Ltd v United States Surgical Corp* above at 103; *Pilmer v Duke Group Ltd (in liq)* above at 199.

[14] M Scott Donald, "Managing the Possibility of Conflict" (2015) *Australian Superannuation Law Bulletin* 89.

[15] *Birtchnell v Equity Trustees Executors and Agency Co Ltd* (1929) 42 CLR 384 at 408 per Dixon J; *New Zealand Netherlands Society 'Oranje' Inc v Kuys* [1973] 1 WLR 1126 at 1130 per Lord Wilberforce; *Aequitas v Sparad No 100 Ltd* above [307]; *Howard v Commissioner of Taxation* (2014) 309 ALR 1; [2014] HCA 21.

fiduciary duty.[16] Alternatively, the contract may authorise an act that would otherwise be a breach of fiduciary duty, so as to narrow the scope of that duty, or amount to informed consent or ratification.[17] The parties to a relationship may also seek expressly to provide that their relationship is not fiduciary in character, although the effectiveness of such a term has been controversial in the cases and the academic literature.[18] Attempts to exclude such duties will not always succeed, particularly in dealings with retail investors.[19] However, the possibility of effective exclusion of such duties is a significant limitation on their utility in financial services regulation.

As I noted above, the Royal Commission did not give extended attention to these duties and they are likely to be largely unchanged by its recommendations.

Statutory duties to act efficiently, honestly and fairly and to manage conflicts (ss 912A(1)(a)–(aa))

I now turn to the relevant statutory duties. Many participants in the financial services industry are required to hold Australian financial services licences and are subject to the conduct of business requirements applicable to such licensees. Section 912A(1)(a) of the *Corporations Act* requires a financial services licensee to do all things necessary to ensure that the financial services covered by the licence are provided efficiently, honestly and fairly. This a broad and open standard, which can be breached by a range of improper conduct.[20] ASIC's submissions to the Royal Commission supported the generality of the obligations imposed by s 912A(1)(a), noting that the "efficiently, honestly and fairly" obligation was similar to other provisions that set general normative standards of conduct, such as the prohibition on misleading and deceptive conduct. ASIC noted that:

> "Such standards require broad evaluative judgments, by reference to all of the circumstances and have the considerable advantages of the flexibility to deal with market developments such as the emergence of new financial products and the ability to evolve over time, so as to adequately reflect changing industry and community standards."

A second provision, s 912A(1)(aa) in turn requires a financial services licensee to have in place adequate arrangements for managing conflicts of interest that arise wholly, or partly, in their financial services business.[21] There are significant differences between

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[16] *Hospital Products Ltd v United States Surgical Corporation* above at 97; *News Ltd v Australian Rugby Football League Ltd* (1996) 64 FCR 410 at 539; *Breen v Williams* above per Gummow J at 132–133; *Eric Preston Pty Ltd v Euroz Securities Ltd* (2010) 77 ACSR 135; [2010] FCA 97, aff'd (2011) 274 ALR 705; [2011] FCAFC 11.

[17] For example, in *National Nominees Ltd v Agora Asset Management Pty Ltd (No 2)* [2011] VSC 425.

[18] *South Sydney District Rugby League Football Club Ltd v News Ltd* (2000) 177 ALR 611 at [134]–[135]; *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* above at [296], [337]; P Finn, "Fiduciary Reflections" (2014) 88 *ALJ* 127; M Leeming, "The scope of fiduciary obligations: How contract informs, but does not determine, the scope of fiduciary obligations" (2009) 3 *J Eq* 181.

[19] S Degeling and J Hudson, "Fiduciary obligations, financial advisers and FOFA" (2014) 32 *C&SLJ* 527.

[20] *Story v NCSC* (1988) 13 NSWLR 661; 13 ACLR 225; 6 ACLC 560; *R J Elrington Nominees Pty Ltd v Corporate Affairs Commission (SA)* (1989) 1 ACSR 93; *Re Saxby Bridge Financial Planning Pty Ltd and ASIC* (2003) 46 ACSR 286; [2003] AATA 480, aff'd (2003) 47 ACSR 649; [2003] FCAFC 244.

[21] For discussion of this requirement, see 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.

this duty and the general law duties, including that that duty contemplates that a conflict will be "manage[d]" rather than necessarily avoided[22], and that duty cannot be excluded by contract. The Final Report of the Royal Commission criticised the concept of "managing" conflicts of interest, observing that conflicts were seldom adequately managed and that self-interest trumped duty.[23] However, the Final Report ultimately did not recommend an amendment to s 912A(1)(aa) which adopts that concept.

In submissions to the Royal Commission, ASIC expressed the view that the only defect with s 912A was that it was not a civil penalty provision[24] That has now changed with the commencement of the *Treasury Laws Amendment (Strengthening Corporate and Financial Sector Penalties) Act* 2019 (Cth), which introduced civil penalties for contraventions of the section. That legislation also increases the level of civil (and criminal) penalties for contraventions of the *Corporations Act* and associated legislation and introduces a disgorgement remedy, directed to the benefit derived or detriment avoided because of a contravention.

The "best interests" duty

I now turn to the provisions introduced by the Future of Financial Advice ("FOFA") reforms, following the global financial crisis and associated losses suffered by Australian retail investors. The Royal Commission highlighted issues as to the effectiveness of these provisions.

The first of these provisions, in Part 7.7A Div 2 of the *Corporations Act*, are directed to establishing 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. Section 961B(1) requires a provider of personal advice to a retail client to act in the "best interests" of the client when giving the advice. On its face, and if it stood alone, that section would resemble other statutory provisions that require a person to have regard to the "best interests" of another.[25]

However, s 961B(2) specifies several steps that an adviser may take in order to satisfy the best interests duty, and creates a "safe harbour" by treating taking the steps specified in s 961B(2) as compliance with the "best interests" duty specified in s 961B(1). That subsection significantly limits the scope of the duty under s 961B(1) so that it operates primarily as a narrower "suitability" requirement rather than a wider "best interests" requirement. There is residual scope for a wider operation in s 961B(2)(g) which requires 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."

The Final Report of the Royal Commission raised the good question whether it is necessary to retain that "safe harbour" in s 961B(2) and recommended that it should be

[22] *ASIC v Citigroup Global Markets Australia Pty Limited (No 4)* above.
[23] Royal Commission, Final Report, p 3.
[24] ASIC, submission to the Royal Commission, Round 2: Financial Advice, pp 14-15.
[25] For example, s 601FC(1)(c) of the *Corporations Act* 2001 (Cth) requires a responsible entity, in exercising its powers and carrying out its duties, to "act in the best interests of the members and, if there is a conflict between the members' interests and its own interests, give priority to the members' interests".

removed, unless there is a clear justification for retaining it.[26] That amendment, if made, would return this duty to the wider form initially contemplated by the FOFA reforms, so that the duty would operate as a wider "best interests" duty, equivalent to the existing duties applicable to responsible entities and superannuation entities, rather than a narrower suitability obligation.

I should add that compliance with the statutory "best interests" duty will not, in itself, comply with the general law duty to avoid either an actual conflict of interest or a real and sensible possibility of conflict of interest. The fact that the steps specified in s 961B(2) of the *Corporations Act* were taken would not avoid any breach of the no conflict rule arising from the fact that advice is given in a conflicted setting.

Duty to prioritise client interests

Other provisions in the *Corporations Act* adopt the concept of "prioritising" client interests, which is an alternative to, and seems to be a less demanding standard than, avoidance of conflicts of interest. Section 961J of the *Corporations Act*, also introduced by the FOFA reforms, requires a person who provides financial advice to a retail client to "give priority" to the interests of the retail client when giving advice where it knows, or reasonably ought to know, there is a conflict between the interests of the client and those of the provider, licensee, authorised representative or their associates. A duty to give priority to a client's interests 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 did not specifically recommend changes to these provisions, despite its comment that licensees and advisers faced with conflicts have generally preferred their own interests to client interests.

Ongoing fee arrangements, commission arrangements and fees for no service

Part 7.7A Division 3 of the *Corporations Act*, also introduced by the FOFA reforms, regulates ongoing fees to clients. Part 7.7A Division 4 of the *Corporations Act* deals with conflicted remuneration.[27] 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. Fees calculated as a percentage of investments or by reference to assets under management are permitted for ungeared (but not geared) products with a retail client's agreement. The focus on gearing reflects a concern that clients can be inappropriately advised to adopt highly geared financial strategies in order to increase commissions paid to advisers. These provisions were

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

[27] In the United Kingdom, a ban on inducements, including commissions paid by product issuers, was similarly introduced 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. See P Hanrahan, Background Paper 30 to the Royal Commission, *Information about Selected Aspects of Foreign Financial Services Regulation*, p 23.

arguably undermined by a range of exceptions, and particularly by grandfathering of existing arrangements.[28]

The Royal Commission also highlighted issues as to the effectiveness of these provisions, and particularly focused on fees charged by product manufacturers and advisers which did not provide corresponding services. That issue had previously been identified by ASIC in its Report 499 and in its submissions to the Royal Commission, where ASIC noted that ongoing service fees, particularly in the context of fees for no service, had similarities to the commissions that were prohibited by the FOFA reforms, in that they were recurring, practically invisible to the customer and not linked to work actually done.[29] ASIC also noted that:

> "it is plausible that a continuing culture among licensees and advisers of receiving ongoing commissions which bear no direct relationship to the provision by them of service to the customer … may have contributed to those licensees and advisers paying insufficient regard to the need to charge ongoing service fees only where the service was provided."

The Royal Commission also noted that the ban on conflicted remuneration introduced by the FOFA reforms had prompted a shift from commissions to a fee for service model, but contributed to the development of advice fees charged where no service was provided.[30]

The Royal Commission recommended amendment of the provisions relating to ongoing fees to require that they be subject to annual renewal by the client; 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; and that such arrangements may neither permit nor require payment of fees from an account held on behalf of the client, except on the client's express written authority to the entity that conducts the account given at, or immediately after, the latest renewal of the ongoing fee arrangement.[31] The second requirement of recording the services the client would be entitled to receive will go some way to meeting the issue as to fees for no service. The third requirement would address the risk that an authority is given at the commencement of an arrangement and continues indefinitely thereafter. The Government has accepted this recommendation, which is to apply to all clients, by contrast with the present position where financial advisers are only required to seek clients' agreement for ongoing fee arrangements for new clients after 1 July 2013.

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[28] ASIC's submissions to the Royal Commission noted its concern that "grandfathered" commissions continued to form a significant part of licensees' and advisers' remunerations, almost five years after the implementation of the FOFA reforms, and encouraged advisers to keep clients in legacy products with a continuing commission structure, even when better products were available to meet the client's needs (ASIC, submission to the Royal Commission, Round 2: Financial Advice, p 3). Treasury's submission to the Royal Commission also, albeit somewhat obliquely ([25]), recognised that the FOFA reforms had been scaled back from a principles-based approach to narrower obligations. Treasury's submission to the Royal Commission did not accept ([92]) that conflict of remuneration prohibitions should automatically apply to all intermediaries, and suggest their application should be considered on a case-by-case basis and notes ([101]) that prohibitions on conflicted remuneration may reduce consumers' access to financial services. This arguably begs the question whether consumers are advantaged by access to conflicted financial services. Treasury also pointed to amendments to the conflicted remuneration prohibitions in respect of life insurance from 1 January 2018, which do not ban conflicted remuneration but reduce the percentage of the premium that may be paid as commission ([119]).

[29] ASIC, submission to the Royal Commission, Round 2: Financial Advice, p 3.

[30] Royal Commission, Final Report, p 132.

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

Importantly, the Royal Commission also recommended that the grandfathering provisions for conflicted remuneration be repealed as soon as practicable.[32] The Government accepted the recommendation to repeal conflicted remuneration, with the significant qualification that the amendment is only to take effect from 1 January 2021. From that date, payments under existing contracts which were previously the subject of grandfathering arrangements will be rebateable to the affected clients where they can reasonably be identified. Where it is not practicable to rebate the benefit to an individual client, for example because it is a volume-based rebate which is not attributable to any individual client, the Government has indicated that it "expects" industry to pass the benefit to clients indirectly, for example, by lowering product fees. The Government has also indicated that it will commission ASIC to monitor the extent to which product issuers are acting to end grandfathering through to 1 January 2021 and are passing such benefits to clients, without indicating what will occur if its expectation in that respect is disappointed.

This amendment would largely return the legislation to the form that had originally been proposed in the FOFA reforms. It may well have a significant impact, since a reduction in the financial incentives for inappropriate advice should reduce the extent of that 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 as to measures to improve the quality of advice.

The Royal Commission also recommends the reduction of the cap for commissions for life insurance products, ultimately to zero.[33] The Royal Commission also recommended further consideration of the exceptions from the ban on conflicted remuneration that are currently available for general insurance and consumer credit insurance and for non-monetary benefits under s 963C of the *Corporations Act.*[34] The Government indicated its support for ASIC's review of conflicted remuneration relating to life risk insurance products.

The Royal Commission also observed that the charging of fees for no service may have contravened the prohibition on dishonest conduct under s 1041G of the *Corporations Act*, and further regulatory action may be expected in that territory.

Vertical integration of product manufacturers and advisory firms

The Royal Commission also considered the larger issue of vertical integration of product manufacturers and advisory firms, where, for example, product manufacturers both provide advisory services and own advisory firms that provide such services.

The issues as to vertically integrated institutions and conflicts of interest are not new. In its Report 562, *Financial Advice: Vertically Integrated Institutions and Conflicts of Interest* (January 2018), ASIC reviewed financial advice provided by the five largest banking and financial services providers in Australia. That report identified 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. That report, and ASIC's submissions to the Royal Commission, fairly acknowledged benefits of vertical integration, including

[32] Royal Commission, Final Report, Recommendation 2.4.
[33] Royal Commission, Final Report, Recommendation 2.5.
[34] Royal Commission, Final Report, Recommendation 2.6.

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 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. ASIC also noted, in Report 562 and its submissions to the Royal Commission, that vertically integrated business models gave rise to an inherent conflict of interest, which would need to be carefully managed by a licensee to ensure that advice given to the client complied with the "best interests" duty and was not tainted by that conflict.[35]

ASIC 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; and in a "one stop shop" business model, where an enterprise provided both financial advice and ancillary services.[36] 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".[37]

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 financial advisers to be structurally independent of product issuers.[38]

Accountability of managers and advisers

New training standards for financial advisers were introduced by the *Corporations Amendment (Professional Standards of Financial Advisers) Act* 2017 (Cth), which 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).[39]

The Final Report of the Royal Commission also recommended that a financial adviser who would contravene s 923A of the *Act* by claiming to be independent, impartial or unbiased must, before providing personal advice, give a written statement to the client in a prescribed form explaining simply and concisely why he or she is not independent,

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[35] ASIC, submission to the Royal Commission, Round 2: Financial Advice, p 4.
[36] ASIC, submission to the Royal Commission, Round 2: Financial Advice, p 11.
[37] Treasury, Background Paper 24 to the Royal Commission, *Submission on Key Policy Issues*, p 50.
[38] P Hanrahan, Background Paper 30 to the Royal Commission, *Information about Selected Aspects of Foreign Financial Services Regulation*, p 30.
[39] 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.

impartial, and unbiased.[40] The Government accepted that recommendation, and the disclosure of such information cannot hurt. However, the academic literature, the submissions to the Royal Commission and the Royal Commission itself have recognised the limited utility of disclosure in addressing conflicts, and there is a real question whether disclosure in this form will have any substantial impact on investor decision-making.

The Royal Commission also recommended closer regulation of individual advisers, by requiring reference checking and information sharing in respect of advisers; requiring that licensees report serious compliance concerns about individual advisers to ASIC; and requiring licensees to investigate adviser misconduct that has come to their attention.[41] The Government also accepted these recommendations. The Royal Commission also recommended amendments to require for registration of all financial advisers who provide personal financial advice to retail clients and the introduction of a single disciplinary framework.[42] The Government has also accepted these recommendations.

The Royal Commission also recommended the expansion of the Banking Executive Accountability Regime ("BEAR") to require that accredited persons be responsible for end-to-end management of products, and that that regime extend to all financial institutions regulated by the Australian Prudential Regulation Authority, including insurers and superannuation trustees.[43] BEAR is broadly similar to the senior manager and certification regime introduced in the United Kingdom, with both regimes requiring accountability statements and maps and imposing behavioural standards.[44] The Government agreed to that recommendation, and indicated 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.

ASIC's approach to enforcement

The Government also accepted the Royal Commission's recommendation 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; recognises that infringement notices should principally be used in respect of administrative failings which will rarely be appropriate for provisions that require an evaluative judgment or as an enforcement tool where the infringing party is a large corporation; recognises the relevance and the importance of general and specific deterrence in deciding whether to accept an enforceable undertaking and the utility in obtaining admissions in such undertakings; and separates, as much as possible, enforcement staff from non-enforcement related contact with regulated entities.[45] The Government accepted that recommendation, and ASIC has since indicated that it has adopted a "why not litigate?" enforcement stance.[46]

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[40] Royal Commission, Final Report, Recommendation 2.2.
[41] Royal Commission, Final Report, Recommendations 2.7-2.9.
[42] Royal Commission, Final Report, Recommendation 2.10.
[43] Royal Commission, Final Report, Recommendation 6.8.
[44] Treasury, Background Paper 24 to the Royal Commission, *Submission on Key Policy Issues*, p 18.
[45] Royal Commission, Final Report, Recommendation 6.2.
[46] ASIC Media Release – 19-035MR, ASIC update on implementation of Royal Commission recommendations, 19 February 2019.

At least three observations might be made about these developments in enforcement strategy. First, there are some possibly good answers to a question “why not litigate?”, with reference to issues of delay, cost, uncertainty of outcome and the risk that a regulator’s approach will encourage an equally litigious approach by regulated entities. Second, the enforcement stance to which ASIC has now returned has echoes of an approach adopted by 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. Third, the Royal Commission’s preference for limited use of infringement notices may reflect a different philosophy to that reflected in the wider use of penalty notices under the *Treasury Laws Amendment (Strengthening Corporate and Financial Sector Penalties) Act* 2019 (Cth).