



# Final Report

Royal Commission into  
Misconduct in the Banking,  
Superannuation and  
Financial Services Industry

VOLUME 1

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# Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

1 February 2019

His Excellency General the Honourable Sir Peter Cosgrove AK MC (Retd)  
Governor-General of the Commonwealth of Australia  
Government House  
CANBERRA ACT 2600

Your Excellency

In accordance with the Letters Patent issued to me on 14 December 2017,  
I have made inquiries and now provide the Final Report of the  
Royal Commission into Misconduct in the Banking, Superannuation  
and Financial Services Industry.

Yours sincerely

[Signed]

Kenneth M Hayne  
Commissioner



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# Glossary

Term	Definition
<b>accrued default amount (ADA)</b>	An amount of superannuation accumulated in a situation where (a), the member has not given the fund's trustee any direction about how the amount is to be invested, or (b), the amount is invested in the fund's 'default' investment option.
<b>anti-hawking provisions</b>	Provisions set out in Sections 736, 992AA and 992A of the <i>Corporations Act 2001</i> (Cth) that prohibit offering financial products for issue or sale during, or because of, an unsolicited meeting or telephone call with a retail client.
<b>Australian Credit Licence (ACL)</b>	A licence issued under the <i>National Consumer Credit Protection Act 2009</i> (Cth) that authorises a licensee to engage in particular credit activities.
<b>Australian financial services licence (AFSL), Australian financial services licensee</b>	A licence under the <i>Corporations Act 2001</i> (Cth) that authorises a person who carries on a financial services business to provide financial services. A licensee is the person who provides the services.
<b>authorised deposit-taking institution (ADI)</b>	A body corporate authorised under the <i>Banking Act 1959</i> (Cth) to carry on a banking business in Australia.
<b>Bank Bill Swap Rate (BBSY)</b>	An interest rate used as a benchmark when pricing financial products.
<b>Banking Executive Accountability Regime (BEAR)</b>	A piece of legislation set out in Part IIAA of the <i>Banking Act 1959</i> (Cth) and enacted in February 2018, the BEAR establishes accountability obligations for <b>authorised deposit-taking institutions</b> (ADIs) and their senior executives and directors. It is administered by APRA.
<b>buyer of last resort (BOLR)</b>	Arrangements whereby a licensee or an authorised representative acquires the business of another representative. The purchase price is determined using a specific formula.

Term	Definition
<b>conflicted remuneration</b>	Any benefit, whether monetary or non-monetary, given to a <b>financial services licensee</b> , or their representatives, who provides financial product advice to retail clients that, because of the nature of the benefit or the circumstances in which it is given could reasonably be expected to influence the choice of financial product recommended by the licensee or representative or could reasonably be expected to influence the financial product advice given to retail clients by the licensee or representative: see Section 963A of the <i>Corporations Act 2001</i> (Cth).
<b>enforceable undertaking (EU)</b>	An undertaking enforceable in a court. Issued under the <i>Australian Securities and Investments Commission Act 2001</i> (Cth) and the <i>National Consumer Credit Protection Act 2009</i> .
<b>external dispute resolution (EDR)</b>	An independent service for resolving disputes between consumers and providers of financial products and services, as an alternative to the court system.
<b>financial product</b>	Under the <i>Corporations Act 2001</i> (Cth), a facility through which, or through the acquisition of which, a person makes a financial investment, manages financial risk and/or makes non-cash payments.
<b>financial services entity</b>	Defined by the Letters Patent as (among other things) ‘an ADI ( <b>authorised deposit-taking institution</b> ) within the meaning of the <i>Banking Act 1959</i> ’, ‘a person or entity required by section 911A of the <i>Corporations Act 2001</i> to hold an <b>Australian financial services licence</b> , or who is exempt from the requirement to hold such a licence by virtue of being an authorised representative’, and ‘a person or entity that acts or holds itself out as acting as an intermediary between borrowers and lenders’.

Term	Definition
<b>Financial Services Guide (FSG)</b>	A guide that contains information about the entity providing financial advice, and explains the services offered, the fees charged and how the person or company providing the service will deal with complaints.
<b>financial services licensee</b>	An individual or business that has been granted an <b>Australian financial services licence (AFSL)</b> by ASIC.
<b>Future of Financial Advice (FoFA)</b>	A 2012 package of legislation intended to improve the trust and confidence of Australian retail investors in the financial services sector and ensure the availability, accessibility and affordability of high quality financial advice.
<b>grandfathering arrangements, grandfathered commission</b>	Grandfathering arrangements allow for commissions to continue to be paid to intermediaries who sold financial products prior to the <b>Future of Financial Advice (FoFA)</b> reforms that would otherwise be classified as <b>conflicted remuneration</b> . This source of revenue is known as a grandfathered commission.
<b>group life insurance</b>	Life insurance where a group of people (for example, members of a superannuation fund) are covered by the one contract.
<b>Household Expenditure Measure (HEM)</b>	A measure of what families spend on different types of household items, calculated quarterly by the Melbourne Institute of Applied Economic and Social Research.
<b>mortgage aggregator</b>	An intermediary between mortgage brokers and lenders. Mortgage aggregators have contractual arrangements with lenders that allow brokers operating under the aggregator to arrange loans from those lenders.
<b>mortgage broker</b>	An intermediary between borrowers and lenders of home loans.

Term	Definition
<b>MySuper products</b>	Low-cost, simple superannuation products for members who make no active choice about their superannuation.
<b>registrable superannuation entity (RSE)</b>	A category of superannuation entity, regulated by APRA, that includes regulated superannuation funds, approved deposit funds and pooled superannuation trusts, but does not include self-managed superannuation funds (SMSFs).
<b>successor fund transfer (SFT)</b>	Where a member's benefits are transferred to a successor fund. This is one of the few situations where benefits can be transferred without the member's consent and is subject to strict regulation.
<b>third party guarantor</b>	A person or business other than the borrower who guarantees to pay back a loan if the borrower does not.
<b>Tier 1 Capital</b>	Capital against which losses can be written off while an <b>authorised deposit-taking institution</b> (ADI) continues to operate and can absorb losses should the ADI ultimately fail.
<b>trail commission</b>	A regularly recurring commission to an intermediary, such as a broker, based on a proportion of the current or average loan balance and payable periodically after the loan is made/drawn. Distinct from a commission that is paid up front.
<b>vertical integration</b>	A description of the relationship between entities where financial advice, platforms and funds management are controlled by a single entity.

# Abbreviations

<b>ABA</b>	Australian Bankers' Association (now Australian Banking Association)
<b>ABARES</b>	Australian Bureau of Agricultural and Resource Economics and Sciences
<b>ACBF</b>	Aboriginal Community Benefit Fund
<b>ACCC</b>	Australian Competition and Consumer Commission
<b>ACL</b>	Australian Credit Licence
<b>ADA</b>	accrued default amount
<b>ADI</b>	authorised deposit-taking institution
<b>AFA</b>	Association of Financial Advisers
<b>AFCA</b>	Australian Financial Complaints Authority
<b>AFSL</b>	Australian financial services licence
<b>APRA</b>	Australian Prudential Regulation Authority
<b>ASBFO</b>	Australian Small Business and Family Enterprise Ombudsman
<b>ASIC</b>	Australian Securities and Investments Commission
<b>AUSTRAC</b>	Australian Transaction Reports and Analysis Centre
<b>BEAR</b>	Banking Executive Accountability Regime
<b>BOLR</b>	buyer of last resort
<b>DRE</b>	dual-regulated entity
<b>EDR</b>	external dispute resolution

<b>EU</b>	enforceable undertaking
<b>FASEA</b>	Financial Adviser Standards and Ethics Authority
<b>FoFA</b>	Future of Financial Advice (legislation reforms)
<b>FOS</b>	Financial Ombudsman Service
<b>FPA</b>	Financial Planning Association of Australia
<b>FSC</b>	Financial Services Council
<b>FSG</b>	Financial Services Guide
<b>HEM</b>	Household Expenditure Measure
<b>IDR</b>	internal dispute resolution
<b>KPI</b>	Key Performance Indicator
<b>LVR</b>	loan-to-value ratio
<b>PDS</b>	product disclosure statement
<b>RE</b>	responsible entity
<b>RSE</b>	registrable superannuation entity
<b>SFT</b>	successor fund transfer
<b>SME</b>	small and medium enterprises
<b>SMSF</b>	self-managed superannuation fund

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**Key references**


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<b>Cooper Review, Final Report</b>	Super System Review: Final Report (30 June 2010)
<b>Murray Inquiry, Final Report</b>	Financial System Inquiry Final Report (November 2014)
<b>Ramsay Review, Final Report</b>	Final Report: Review of the Financial System External Dispute Resolution and Complaints Framework (April 2017)
<b>Ramsay Review, Supplementary Final Report</b>	Supplementary Final Report: Review of the Financial System External Dispute Resolution and Complaints Framework (September 2017)
<b>Sedgwick Review, Report</b>	Retail Banking Remuneration Review: Report (19 April 2017)
<b>Wallis Inquiry, Final Report</b>	Financial System Inquiry Final Report (March 1997)

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# Legislation

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ASIC Regulations 2001 (Cth)

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Australian Crime Commission Act 2002 (Cth) (the ACC Act)

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Australian Prudential Regulation Authority Act 1998 (Cth) (the APRA Act)

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Australian Securities and Investments Commission Act 2001 (Cth) (the ASIC Act)

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Australian Small Business and Family Enterprise Ombudsman Act 2015 (Cth)

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Banking Act 1959 (Cth) (the Banking Act)

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Competition and Consumer Act 2010 (Cth)

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Consumer Insurance (Disclosure and Representations) Act 2012 (UK)

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Corporate Law Reform Act 1992 (Cth)

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Corporations Act 1989 (Cth)

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Corporations Act 2001 (Cth) (the Corporations Act)

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Corporations Amendment (Financial Advice Measures) Act 2016 (Cth)

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Corporations Amendment (Revising Future of Financial Advice)  
Regulation 2014 (Cth)

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Corporations Regulations 2001 (Cth)

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Fair Work Act 2009 (Cth)

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Financial Services and Markets Act 2000 (UK)

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Financial Services Reform Act 2001 (Cth)

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Income Tax Assessment Act 1997 (Cth)

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Insurance Contracts Amendment Act 2013 (Cth)

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Insurance Contracts Regulations 2017 (Cth)

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Life Insurance Act 1995 (Cth) (the Life Insurance Act)

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National Consumer Credit Protection Act 2009 (Cth) (the NCCP Act)

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National Consumer Credit Protection Regulations 2010 (Cth)  
(the NCCP Regulations)

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Occupational Superannuation Standards Act 1987 (Cth) (the OSSA Act)

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Privacy Act 1988 (Cth)

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Public Governance, Performance and Accountability Act 2013 (Cth)

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Retirement Savings Accounts Act 1997 (Cth)

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Superannuation Legislation Amendment (Choice of Superannuation Funds) Act 2005 (Cth)

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Superannuation Legislation Amendment (Further MySuper and Transparency Measures) Act 2012 (Cth).

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Superannuation Legislation Amendment (MySuper Core Provisions) Act 2012 (Cth)

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Superannuation Legislation (Trustee Obligations and Prudential Standards) Act 2012 (Cth)

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Superannuation Safety Amendment Act 2004 (Cth)

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Superannuation Legislation (Trustee Obligations and Prudential Standards) Act 2012 (Cth)

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Superannuation Safety Amendment Act 2004 (Cth)

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# Preface

This is the *Final Report* of the results of my inquiry, and the recommendations arising out of my inquiry, into the matters described in the Letters Patent dated 14 December 2017. It is to be read with the *Interim Report* I submitted to His Excellency the Governor General on 28 September 2018.

In Chapter 1 of my *Interim Report*, I refer to the establishment of the Commission and set out the Commission's Terms of Reference. For ease of reference I have included the Letters Patent in Volume 3 of this Report.

I describe in Chapter 1 of the *Interim Report*, and need not repeat in this Report, the first steps taken in appointing staff, counsel and solicitors; the initial inquiries I made of financial services entities, industry associations, consumer advocacy groups and regulatory authorities about the matters that were to be the subject of inquiry; and the steps taken to gather submissions and information from the public. As is recorded elsewhere in this Report, members of the public submitted more than 10,000 complaints about financial services entities by using the Commission's web form. In addition, there were many thousands of telephone calls and emails to the Office of the Royal Commission, some asking for help in making a complaint, some asking about the work of the Commission and some offering comments on the work that was being, or had been, done.

As also explained in Chapter 1 of the *Interim Report*, it was evident at the outset of the Commission's work that not every case could be investigated or examined in the course of public hearings. To investigate, let alone hear evidence about, every case would have taken many years. Choices had to be made. The cases that were chosen were selected as reasonably illustrative of the kinds of conduct about which members of the public had complained. Inevitably, those not chosen are disappointed.

Much of the work of the Commission has been done outside the hearing room. Choosing case studies required solicitors and counsel assisting to examine in detail many more cases of alleged relevant conduct than those taken as case studies in hearings. Many hours were spent, hundreds of complaints and thousands of documents were examined, before choosing what cases would be the subject of public hearings.

Other work done outside the hearing room included the preparation of background and research papers. Some of those papers were published in Volume 3 of the *Interim Report*; the balance of them appear in Volume 3 of this Report.

The *Interim Report* sets out the findings I made in respect of case studies considered during the first four rounds of the Commission's public hearings.

I conducted three other rounds of public hearings:

- between 6 August 2018 and 17 August 2018 – concerning superannuation;
- between 10 September 2018 and 21 September 2018 – concerning insurance; and
- between 19 November 2018 and 30 November 2018 – taking evidence from some CEOs, board chairs and the heads of ASIC and APRA concerning policy and other questions that I had raised in my *Interim Report*.

This Report sets out, in Volume 2, the findings I make in respect of case studies considered during the rounds of hearings concerning superannuation and insurance.

Behind the whole of the Commission's work, and this *Final Report*, lies the work of very many people: as advisers or consultants, as members of the staff of the Office of the Royal Commission, as Solicitors Assisting the Commission, and as Counsel Assisting the Commission. Their names are set out in Volume 3. I am deeply grateful to every one of them for all that they have done so willingly, diligently and skilfully.

# 1. Introduction

## 1 This report

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The central task of the Commission has been 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. The conduct identified and described in the Commission's *Interim Report* and the further conduct identified and described in this Report includes conduct by many entities that has taken place over many years causing substantial loss to many customers but yielding substantial profit to the entities concerned. Very often, the conduct has broken the law. And if it has not broken the law, the conduct has fallen short of the kind of behaviour the community not only expects of financial services entities but is also entitled to expect of them.

This *Final Report* seeks to take what has been learned in respect of each part of the financial services industry that has been examined and identify:

- issues;
- causes; and
- responses and recommendations.

### 1.1 Four observations

Those analyses, taken together, will reveal the importance of four observations about what has been shown by the Commission's work: the connection between conduct and reward; the asymmetry of power and information between financial services entities and their customers; the effect of conflicts between duty and interest; and holding entities to account.

Each of those observations should be explained.

First, 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 front line service staff. Advisers became sellers and sellers became advisers.

The conduct identified and condemned in this *Final Report* and in the *Interim Report* can and should be examined by reference to how the person doing the relevant acts, or failing to do what should have been done, was rewarded for the conduct.

Rewarding misconduct is wrong. Yet incentive, bonus and commission schemes throughout the financial services industry have measured sales and profit, but not compliance with the law and proper standards. Incentives have been offered, and rewards have been paid, regardless of whether the sale was made, or profit derived, in accordance with law. Rewards have been paid regardless of whether the person rewarded *should* have done what they did.

Second, entities and individuals acted in the ways they did because they could. Entities set the terms on which they would deal, consumers often had little detailed knowledge or understanding of the transaction and consumers had next to no power to negotiate the terms. At most, a consumer could choose from an array of products offered by an entity, or by that entity and others, and the consumer was often not able to make a well-informed choice between them. There was a marked imbalance of power and knowledge between those providing the product or service and those acquiring it.

Third, consumers often dealt with a financial services entity through an intermediary. The client might assume that the person standing between the client and the entity that would provide a financial service or product acted for the client and in the client's interests. But, in many cases, the intermediary is paid by, and may act in the interests of, the provider of the service or product. Or, if the intermediary does not act for the provider, the intermediary may act only in the interests of the intermediary.

The interests of client, intermediary and provider of a product or service are not only different, they are opposed. An intermediary who seeks to 'stand in

more than one canoe' cannot.<sup>1</sup> Duty (to client) and (self) interest pull in opposite directions.

Chapter 7 of the *Corporations Act 2001* (Cth) (the Corporations Act), and the *National Consumer Credit Protection Act 2009* (Cth) (the NCCP Act) (but not the *Superannuation Industry (Supervision) Act 1993* (Cth) – the SIS Act), speak of 'managing' conflicts of interest.<sup>2</sup> But experience shows that conflicts between duty and interest can seldom be managed; self-interest will almost always trump duty. The evidence given to the Commission showed how those who were acting for a client too often resolved conflicts between duty to the client, and the interests of the entity, adviser or intermediary, in favour of the interests of the entity, adviser or intermediary and against the interests of the client. Those persons and entities obliged to pursue the best interests of clients or members too often sought to strike some compromise between the interests of clients or members and their own interests or the interests of a related third party (such as the person's employer, or the entity's owner). A 'good enough' outcome was pursued instead of the *best* interests of the relevant clients or members. (Notions of best interests and conflicts between duty and interest are further examined below in connection with **mortgage brokers**, financial advice and superannuation.)

Fourth, too often, financial services entities that broke the law were not properly held to account. Misconduct will be deterred only if entities believe that misconduct will be detected, denounced and justly punished. Misconduct, especially misconduct that yields profit, is not deterred by requiring those who are found to have done wrong to do no more than pay compensation. And wrongdoing is not denounced by issuing a media release.

The Australian community expects, and is entitled to expect, that if an entity breaks the law and causes damage to customers, it will compensate those affected customers. But the community also expects that financial services entities that break the law will be held to account. The community

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<sup>1</sup> *Re Minister for Immigration and Multicultural and Indigenous Affairs; Ex parte Ame* (2005) 222 CLR 439, 448.

<sup>2</sup> The SIS Act requires trustees to give priority to the duties to and interests of the beneficiaries over the duties to, or the interests of, others. See s 52(2)(d).

recognises, and the community expects its regulators to recognise, that these are two different steps: having a wrongdoer compensate those harmed is one thing; holding wrongdoers to account is another.

Some may see what has emerged from the work of the Commission only through the lens of public accountability for what has happened. And public accountability is critically important. But it cannot be the only focus. It is necessary to look to the future as well as to the past.

The responses and recommendations made in this Report will attract varied responses. Those who oppose change will appeal to real or supposed difficulty in altering present arrangements. Reference will be made to change bringing ‘unintended consequences’. That argument is easily made because it has no content; the ‘consequences’ feared are not identified.

But choices must now be made. The arrangements of the past have allowed conduct of the kinds and extent described here and in the *Interim Report* of the Commission. The damage done by that conduct to individuals and to the overall health and reputation of the financial services industry has been large. Saying sorry and promising not to do it again has not prevented recurrence. The time has come to decide what is to be done in response to what has happened. The financial services industry is too important to the economy of the nation to allow what has happened in the past to continue or to happen again.

## **1.2 Primary responsibility**

There can be no doubt 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. Nothing that is said in this Report should be understood as diminishing that responsibility. Everything that is said in this Report is to be understood in the light of that one undeniable fact: it is those who engaged in misconduct who are responsible for what they did and for the consequences that followed.

Because it is the entities, their boards and senior executives who bear primary responsibility for what has happened, close attention must be given to their culture, their governance and their remuneration practices.

## 1.3 Key questions

In its written submission in response to the *Interim Report*, Treasury identified the key questions emerging from the *Interim Report* as:<sup>3</sup>

- To what extent can the law be simplified so that its intent is met, rather than merely its terms being complied with, and how can this be done?
- Should the approach to addressing conflicts of interest change from managing conflicts to removing them, either by banning all or some forms of **conflicted remuneration** and sales or profit-based remuneration and/or changing industry structures?
- What can be done to improve compliance with the law (and industry codes), and the effectiveness of the regulators, to deter misconduct and ensure that grave misconduct meets with proportionate consequences?

Treasury submitted that a fourth key question should be added:<sup>4</sup>

- What more can be done to achieve effective leadership, good governance and appropriate culture within financial services firms so that firms ‘obey the law, do not mislead or deceive, are fair, provide fit for purpose service with care and skill, and act in the best interests of their clients’?

Treasury submitted that answers to these four questions ‘would form the pillars of any comprehensive policy response to what the Commission has publicly exposed’.<sup>5</sup>

I agree. These are the pillars of the policy responses to be made. And, as is explained in the body of the Report, some particular changes to the law are necessary to improve protections for consumers against misconduct, to provide adequate redress and to address asymmetries of power and information between entities and consumers.

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<sup>3</sup> Treasury, Interim Report Submission, 1 [2].

<sup>4</sup> Treasury, Interim Report Submission, 1 [3]. See also, FSRC, *Interim Report*, vol 1, 290.

<sup>5</sup> Treasury, Interim Report Submission, 1 [4].

## 1.4 Extending the Commission

Why deal with these issues now? Why make my *Final Report* now? Why not extend the work of the Commission? Many suggested that I seek an extension of the time by which my *Final Report* was due to allow for further public hearings.

I did not seek any extension of time for this *Final Report* for the reasons I gave in the Introduction to the *Interim Report*. As I said there:<sup>6</sup>

The Letters Patent require me to inquire into, and report on, whether any conduct by financial services entities, including banks and their associated entities, might have amounted to misconduct and whether any conduct, practices, behaviour or business activities by those entities fall below community standards and expectations. I must execute those tasks conscious of the fact that the banking system is a central artery in the body of the economy. Defects and obstructions in the artery can have very large effects. Likewise, prolonged injections of doubt and uncertainty can affect performance.

I concluded then, and remain of the view, that these reasons oblige me to execute my tasks promptly and do so in ways that would achieve two related purposes: to identify properly the underlying causes of conduct of the kinds referred to in the Terms of Reference; and to prompt proper consideration of how best to avoid recurrence of similar conduct.

One reason often given for proposing to extend the work of the Commission was to give more persons who had been affected by relevant misconduct the chance to give evidence of those events. Throughout the work of the Commission I have paid close regard, and given great significance, to the Commission conducting a public inquiry so that there might be public exposure of misconduct and the vindication those affected by misconduct derive from its being exposed. All of the many public submissions made to the Commission were read and considered, and many were considered repeatedly.

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<sup>6</sup> FSRC, *Interim Report*, vol 1, 1.

Not every complaint that was made could be publicly examined. There were too many to do that. Hence, choices had to be made and, inevitably, the choices that were made will have disappointed those not chosen.

But the cases that were the subject of case studies were chosen as being reasonably illustrative of kinds of conduct and general issues that could be seen as emerging from the very active public engagement with the Commission's work and from the Commission's own investigations. The case studies provided a sufficiently broad and firm platform for drawing the conclusions that are expressed in this Report. Multiplying examples would not have altered the breadth or depth of that platform to any useful extent. And, as I point out more than once in this Report, every financial services entity, whether examined in a case study or not, must look at its own conduct and the way in which it governs itself.

The decision not to seek an extension was taken recognising that the Commission could provide no remedy to those who complained that they had been affected by misconduct. The most that could be done was to provide them with a public platform to voice their complaint. I recognise the importance of a Royal Commission in giving public voice to the issues and concerns that prompted its establishment. But the decision not to seek extension was also taken recognising the central importance that the health of the financial system has for the nation's economy and thus for every member of this society. For me, these wider considerations were determinative.

It is time to grapple with the key questions identified. And it is necessary, therefore, to state plainly the principles and general rules that underpin the answers that are to be given.

## **1.5 Underlying principles and general rules**

In my *Interim Report* I asked many questions. As I said at that time, I sought to provoke informed and useful debate about the issues that have emerged in the course of the Commission's inquiries.

Many of those questions were explored in the course of the final round of the Commission's public hearings and in the many submissions made to the Commission. Submissions were received from financial services entities; the Australian Prudential Regulation Authority (APRA); the

Australian Securities and Investments Commission (ASIC); Treasury; those who have been affected by the conduct that has been the subject of the Commission's inquiries; other interested parties given leave to appear at some of the Commission's hearings (including the Finance Sector Union and consumer bodies such as CHOICE and the Consumer Action Law Centre); industry associations (including the Australian Banking Association (ABA) bodies representing financial advisers, mortgage brokers and others); academics; and members of the public more generally.

The focus of this Report must be on issues, causes and responses. I will deal separately with the various sectors of the financial services industry. More particularly I will deal separately with:

- banking;
- financial advice;
- superannuation; and
- insurance.

Some more general issues extend across all sectors of the financial services industry. They are issues about

- culture, governance and remuneration; and
- regulators.

The responses to the issues that are identified in each of those separate areas are informed by some underlying principles. It is useful, therefore, to begin by stating those principles.

### **1.5.1 Underlying principles**

At their most basic, the underlying principles reflect the six norms of conduct I identified in the *Interim Report*:

- obey the law;
- do not mislead or deceive;
- act fairly;

- provide services that are fit for purpose;
- deliver services with reasonable care and skill; and
- when acting for another, act in the best interests of that other.

These norms of conduct are fundamental precepts. Each is well-established, widely accepted, and easily understood.

Of course, when these norms are stated in the terms I have, it will be said that borderline cases can be identified. And applying the norms to some of those borderline cases may not be easy. But real or imagined cases testing the boundaries of a rule do not show that the rule has no content. Debate about whether the wire runs one side or the other of one or more fence posts must not obscure the size of the field the fence encloses.

The six norms of conduct I have identified are all reflected in existing law. But the reflection is piecemeal.

The general obligations of **Australian financial services licence** (AFSL) holders, stated in section 912A of the Corporations Act, and the general obligations of **Australian Credit Licence** (ACL) holders, stated in section 47 of the NCCP Act, stand out.

First, both provisions impose an overarching obligation to ‘do all things necessary to ensure’ that the financial services or credit activities authorised by the licence are provided ‘efficiently, honestly and fairly’.<sup>7</sup> Understood properly, this requirement would embrace all six norms.

Second, both provisions oblige licence holders to comply with, in the case of AFSL holders, the financial services laws and, in the case of ACL holders, the credit legislation.<sup>8</sup> That is, licence holders must obey the law.

Third, both provisions oblige licence holders to maintain their own competence to provide the licenced services and to ensure that their representatives are both adequately trained and competent to provide

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<sup>7</sup> Corporations Act s 912A(1)(a); NCCP Act s 47(1)(a).

<sup>8</sup> Corporations Act s 912A(1)(c); NCCP Act s 47(1)(d).

those services.<sup>9</sup> That is, they are required to have the *capacity* to deliver services with reasonable care and skill.

As the law now stands, breach of these general obligations carries no penalty. They are licence conditions enforceable only indirectly, by threatening withdrawal of the licence.

That said, the requirement that an AFSL holder acts honestly is expressed further in section 1041G of the Corporations Act, which makes it an offence to engage in dishonest conduct in relation to a **financial product** or financial service. But the offence relates only to conduct in relation to a financial product or financial service, and Divisions 3 and 4 of Part 7.1 of the Corporations Act are given over to defining what is, and is not, a financial product, and when a person provides a financial service.

The more particular norms I state about not misleading or deceiving and acting fairly are reflected in the provisions of the *Australian Securities and Investment Commission Act 2001* (Cth) (the ASIC Act) about misleading or deceptive conduct,<sup>10</sup> false or misleading representations,<sup>11</sup> unconscionable conduct<sup>12</sup> and unfair contract terms.<sup>13</sup> And the requirement to provide services that are fit for purpose and deliver services with reasonable care and skill are also reflected in the ASIC Act.<sup>14</sup> But some of those provisions apply generally and some apply only to dealings with consumers. And the unconscionable conduct and consumer protection provisions use definitions of ‘financial product’ and ‘financial service’ that differ from those provided by Chapter 7 of the Corporations Act.<sup>15</sup>

The sixth norm – when acting for another, act in the best interests of that other – is reflected in the financial advice sector by the best interests duty imposed by section 961B of the Corporations Act, together with the

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<sup>9</sup> Corporations Act s 912A(1)(e) and (f); NCCP Act s 47(1)(e) and (f).

<sup>10</sup> ASIC Act s 12DA.

<sup>11</sup> ASIC Act s 12DB.

<sup>12</sup> ASIC Act ss 12CA–12CC.

<sup>13</sup> ASIC Act ss 12BF–12BM.

<sup>14</sup> ASIC Act ss 12EA–12ED.

<sup>15</sup> ASIC Act ss 12BAA, 12BAB.

associated obligation provided by section 961J to give priority to the client's interests over other interests.

The norms are dealt with differently in respect of superannuation and insurance. In superannuation, they find their most prominent reflection in the SIS Act, in the best interests covenant and associated covenants by **registrable superannuation entity** (RSE) licensees and directors of trustees.<sup>16</sup> And those covenants also provide direct reflection of the norm that a person or entity acting for another, must act in the best interests of that other.

In insurance, all of the norms may be seen as embodied in the duty of utmost good faith imposed on each party to an insurance contract by section 13 of the *Insurance Contracts Act 1984* (Cth) (the Insurance Contracts Act).

As I say, the six norms of conduct I have set out are reflected in existing law, but the reflection is piecemeal.

## 1.5.2 General rules

The six norms of conduct I have identified support, and in some cases entail, some general rules:

- the law must be applied and its application enforced;
- industry codes should be approved under statute and breach of key promises made to customers in the codes should be a breach of the statute;
- no financial product should be 'hawked' to retail clients;
- intermediaries should act only on behalf of, and in the interests of, the party who pays the intermediary;
- exceptions to the ban on conflicted remuneration should be eliminated;

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<sup>16</sup> SIS Act ss 52, 52A.

- culture and governance practices (including remuneration arrangements) both in the industry generally and in individual entities, must focus on non-financial risk, as well as financial risk.

Why these general rules?

### *Apply and enforce the law*

The first general rule, that the law must be applied and its application enforced, requires no development or explanation. It is a defining feature of a society governed by the rule of law.

The conduct identified and criticised in the Commission's *Interim Report* and in this Report has been of a nature and extent that shows that the law has not been obeyed, and has not been enforced effectively. It also points to deficiencies of culture, governance and risk management within entities. Too often, entities have paid too little attention to issues of regulatory, compliance and conduct risks. And the risks of regulatory or other non-compliance and of misconduct are the risks of departure from the first general rule of 'obey the law'. What consequences follow, and whether this amounts to effective enforcement of the law, bears directly upon the nature and extent of the regulatory, compliance and conduct risks that entities must manage.

### *Industry codes*

Industry codes are expressed as promises made by industry participants. If industry codes are to be more than public relations puffs, the promises made must be made seriously. If they are made seriously (and those bound by the codes say that they are), the promises that are set out in the code, and are intended to govern the particular relations between the provider and the acquirer of a financial product or financial service, must be kept. This must entail that the promises can be enforced by those to whom the promises are made: the customer who acquires the product or service, and the guarantors of loans to individuals and small businesses.

## *Hawking*

‘Hawking’ company securities, by making unsolicited approaches to potential buyers, has long been unlawful.<sup>17</sup> The practice has long been unlawful because it too readily allows the fraudulent or unscrupulous to prey upon the unsuspecting.<sup>18</sup> There is no real check on what is said to the target and often the target is not able to check the truth of what is said. The asymmetry of power and information between the provider of the product and service and the acquirer is very large. Even if the ‘hawker’ is not fraudulent or unscrupulous (and, too often, cases examined in evidence showed that the hawker was at least unscrupulous) the acquirer is nevertheless ‘unsuspecting’. The potential acquirer who has not sought out the product or service comes to the encounter unprepared to look critically at whatever is said. The potential acquirer often does not know what questions to ask.

Hawking financial products and managed investment products is now generally prohibited.<sup>19</sup> But there are some exceptions. Other than the provisions relating to offers *not* made to retail clients and offers made under an eligible employee share scheme,<sup>20</sup> however, there is no immediately apparent basis for thinking that the exceptions are areas where the fraudulent or unscrupulous may not yet prey upon the unsuspecting. And the evidence given to the Commission points firmly against maintaining exceptions to the general prohibition, at least in respect of superannuation and insurance products, other than the two exceptions mentioned: offers *not* made to retail clients and offers made under an eligible employee share scheme.

For the avoidance of doubt, it should also be made plain that a solicited meeting, or telephone call, to discuss one type of financial product must not

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<sup>17</sup> The 1926 Report of the UK Company Law Amendment Committee chaired by Mr Wilfrid Greene KC (Cmnd 2657) recommended that the offering from house to house of shares, stock, bonds, debentures or debenture stock or similar securities either for subscription or sale should be made an offence. Hawking company securities has long been an offence under Australian company law. See now Corporations Act s 736.

<sup>18</sup> United Kingdom, Report of the UK Company Law Amendment Committee (Cmnd 2657), 48 [92].

<sup>19</sup> Corporations Act ss 992A and 992AA.

<sup>20</sup> Corporations Act ss 992A(3A) and (3B).

be used for the unsolicited offering of some other type of product. (In that regard, common forms of banking products, like transaction accounts and credit card accounts should be treated as together forming the one kind of product. But each superannuation product and each insurance product is, and should be treated as, a distinct product type.)

### *Intermediaries*

In the *Interim Report*, I pointed out how difficult it may be to decide for whom intermediaries act and to whom a particular intermediary may owe duties and responsibilities.<sup>21</sup> As I indicated then, the difficulties may be acute in the case of mortgage brokers. But the difficulties are not confined to home lending. Point-of-sale negotiation of credit arrangements (by car dealers, white goods retailers and the like) presents similar difficulties.

The point is much more important than a dry point of legal analysis. For whom the intermediary acts determines what duties the intermediary owes and to whom they owe them.

The general rule that should apply throughout the financial services industry is that an intermediary who is paid to act as intermediary:

- acts for the person who *pays* the intermediary;
- owes the person who pays a duty to act *only in the interests* of that person; and
- ordinarily owes the person who pays a duty to act in the *best* interests of that person.

The particular working out of these principles, especially with respect to mortgage brokers and the home lending market, is dealt with in the chapter about banking.

### *Conflicted remuneration*

The definition of ‘conflicted remuneration’ in the Corporations Act shows why the practice should be prohibited.

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<sup>21</sup> FSRC, *Interim Report*, vol 1, 56–9.

Section 963A of the Corporations Act defines ‘conflicted remuneration’ as any benefit (whether monetary or non-monetary) given to a **financial services licensee** or a representative of the licensee, who provides financial product advice to persons as retail clients, that, because of the nature of the benefit or the circumstances in which it is given, could have either or both of two effects:

- it could reasonably be expected to influence the choice of financial product recommended by the licensee or representative to retail clients; or
- it could reasonably be expected to influence the financial product advice given to retail clients by the licensee or representative.

That is, as I said in the *Interim Report*, ‘the very hinge about which the conflicted remuneration provisions turn is that the payment is one that “could reasonably be expected to influence the choice of financial product recommended to retail clients”’.<sup>22</sup>

For **grandfathered commissions**, the time when the initial advice was given and the initial conflict arose has passed. The influence of the commission has already done its work once. But the problem remains. The influence continues. Advisers have an incentive to keep their clients in products with grandfathered commissions rather than advise them to move to better products. There can be, and is, no justification for maintaining the grandfathering provisions.

### *Culture and governance*

After the Global Financial Crisis (GFC), financial services entities and regulators, in Australia and elsewhere, gave close attention to financial risk. Until recently, however, too little attention has been given in Australia to regulatory, compliance and conduct risks. Too little attention has been given to the evident connections between compensation, incentive and remuneration practices and regulatory, compliance and conduct risks. The very large reputational consequences that are now seen in the Australian financial services industry, especially in the banking industry, stand as the clearest demonstration of the pressing urgency for dealing with these

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<sup>22</sup> FSRC, *Interim Report*, vol 1, 92.

issues. As the Group of Thirty (G30) said in November 2018, ‘getting culture and conduct right is not a supervisory requirement. It is necessary for banks’ and banking’s economic and social sustainability’.<sup>23</sup>

### 1.5.3 Making change carefully and simply

Treasury,<sup>24</sup> and many of the entities that made submissions,<sup>25</sup> urged the need for caution before recommending change. This is undeniably right.

As I said in the *Interim Report*, adding a new layer of regulation will not assist. It will add to what is already a complex regulatory regime. No doubt the financial services industry is itself complicated. That may be said to explain why the regulatory regime is as complicated as it is. But closer attention will show that much of the complication comes from piling exception upon exception, from carving out special rules for special interests. And, in almost every case, these special rules qualify the application of a more general principle to entities or transactions that are not different in any material way from those to which the general rule is applied.

History shows, as Treasury submitted, that legislative simplification can be a long and difficult task. Programs to simplify the law relating to income taxation and to reform corporate law have extended over many years – well beyond the life of a single Parliament. And I do not doubt that simplifying the law that relates to the financial services industry would be a large task. But there are two parts of that task that can inform, and I consider should inform, what is done in response to this Report.

First, it is time to start reducing the number and the area of operation of special rules, exceptions and carve outs. Reducing their number and their area of operation is itself a large step towards simplification. Not only that,

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<sup>23</sup> G30, *Banking Conduct and Culture: A Permanent Mindset Change*, November 2018, Foreword, v.

<sup>24</sup> Treasury, Interim Report Submission, 1 [4]–[5].

<sup>25</sup> See, eg, AMP, Interim Report Submission, 7 [34]; ANZ, Interim Report Submission, 2 [11]; CBA, Interim Report Submission, 41 [223]; Westpac, Interim Report Submission, 2 [6]; NAB, Interim Report Submission, 17 [50]; Mortgage Choice, Interim Report Submission, 3 [3].

it leaves less room for ‘gaming’ the system by forcing events or transactions into exceptional boxes not intended to contain them.<sup>26</sup>

Second, it is time to draw explicit connections in the legislation between the particular rules that are made and the fundamental norms to which those rules give effect. Drawing that connection will have three consequences. It will explain to the regulated community (and the regulator) *why* the rule is there and, at the same time, reinforce the importance of the relevant fundamental norm of conduct. Not only that, drawing this explicit connection will put beyond doubt the purpose that the relevant rule is intended to achieve. And, the further consequence will be to highlight the fact that exceptions and carve outs like grandfathered commissions constitute a departure from applying the relevant fundamental norm. Emphasising the fact of departure may assist in reducing both the number and the extent of these qualifications.

In their submissions, some entities used the undoubted need for care in recommending change as a basis for saying that there should be *no* change. The ‘Caution’ sign was read as if it said ‘Do Not Enter’.

An assertion was necessarily implicit in the submissions that sought to maintain some aspect of the present regime unchanged: that doing nothing about those matters would carry less cost than making *any* change to the rules under consideration. But rarely, if ever, was the submission developed beyond the point of bare assertion. Rarely, if ever, was there explicit examination of, or comparison between, the costs of doing nothing and the costs and consequences of changing the rules. The rules that govern grandfathered commissions provide a useful example.

Two grounds have often been given for maintaining the present rules about grandfathered commissions without modification: orderly transition and constitutional infirmity.

If the provisions were made to allow orderly transition within the industry, that time has now passed. How much longer is the transition to take? For all the suggestions that it will ‘wither on the vine’, the charging and receipt of

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<sup>26</sup> For example, the preservation of grandfathered commissions during a successor fund transfer by potentially treating the succeeding RSE licensee as a ‘platform operator’: see the NULIS Nominees (Australia) Ltd case study discussed in vol 2 of this Report.

grandfathered commissions remained alive and well until some of the larger participants in the industry (especially the banks) sensed the wind of change may be blowing and found it best to bend now by phasing it out rather than have the wind grow to such intensity that it snap off this branch of their activities.

Whenever change is mooted, someone will suggest that changing the permitted forms of remuneration would lead to constitutional difficulties because it would amount to an acquisition of property otherwise than on just terms. As I said in the *Interim Report*, two points must be made.<sup>27</sup> First, where would be the acquisition? Who would acquire anything? What proprietary benefit or interest would accrue to any person?<sup>28</sup> Second, if the point is good, it was good at the time when most forms of conflicted remuneration were prohibited. Yet no-one sought then to challenge the validity of the relevant provisions and the **Future of Financial Advice** (FoFA) ban on conflicted remuneration has now operated for more than five years without challenge.

It is time to ignore the ghostly apparition of constitutional challenge conjured forth by those who, for their own financial advantage, oppose change that will free advice about, or recommendation of, financial products from the influence of the adviser's personal financial advantage.

A third point is sometimes made in attempting to justify preserving grandfathered commissions. It is said that prohibiting this form of remuneration once and for all will carry with it unintended consequences and the advice industry will be disrupted.

Generalised fears of this kind should not be heeded.

'Disruption' and similar terms can be used, and in some submissions to the Commission were used, as little more than pejorative synonyms for 'change'. As the Treasury submissions show, however, it is always necessary to identify the nature and the extent of the consequences that will or may follow from the change under consideration before speaking of the change as 'disruptive'. Without identifying those consequences, 'disruption' has no useful content.

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<sup>27</sup> FSRC, *Interim Report*, vol 1, 95.

<sup>28</sup> Cf *JT International SA v The Commonwealth* (2012) 250 CLR 1.

If an exception to the rules prohibiting grandfathered commissions is to be preserved, the exception must be closely and cogently justified. Saying only that there may be ‘disruption’ or ‘unintended consequences’ is nothing but a naked appeal to fear of the future. And it seeks to graft some exception onto the body of law intended to give effect to a coherent set of policy objectives without any attempt to identify the competing policy objectives.

Creating exceptions that depart from underlying principles has consequences. Those consequences are amply demonstrated by the grandfathering arrangements made in respect of FoFA. ‘Temporary’ or ‘transitional’ carve outs departing from principle too often become (and in this case did become) entrenched. Carve outs and exceptions are too often exploited (and in this case have been exploited) for purposes having nothing to do with the stated purpose of their creation. Creating carve outs and exceptions impedes, and may even prevent (and in this case did prevent) achieving fully the intended policy objectives that inform the body of the law. Instead, the law is (and here it was) made more complex; it is (and here it was) made harder not only for regulators to administer but also for the regulated community, and the public more generally, to understand.

## 2 Recommendations

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In the succeeding chapters of this Report, I make a number of recommendations. It is desirable to set them out here and to do that:

- first, by reference to subject matter, recording the recommendations in the order in which they are considered in the body of the Report; and
- second, restating the recommendations but reordering them by reference to the key questions identified above, and then by reference to the more particular changes that must be made to protect consumers against misconduct, to provide adequate redress and to address asymmetries of power and information.

## 2.1 Reading the recommendations

All of the recommendations set out below are to be read and understood in the light of what is said in the body of the Report. In particular, each recommendation is to be read in light of the reasons given for making it and what is said about other steps regulators, entities and the industry more generally can, and should, take in response to the conduct and events referred to in the *Interim Report* and this Report.

# 3 Recommendations by subject matter

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## 3.1 Banking

### Consumer lending: Direct lending

#### **Recommendation 1.1 – The NCCP Act**

The NCCP Act should not be amended to alter the obligation to assess unsuitability.

### Consumer lending: Intermediated home lending

#### **Recommendation 1.2 – Best interests duty**

The law should be amended to provide that, when acting in connection with home lending, mortgage brokers must act in the best interests of the intending borrower. The obligation should be a civil penalty provision.

#### **Recommendation 1.3 – Mortgage broker remuneration**

The borrower, not the lender, should pay the mortgage broker a fee for acting in connection with home lending.

Changes in brokers' remuneration should be made over a period of two or three years, by first prohibiting lenders from paying trail commission to mortgage brokers in respect of new loans, then prohibiting lenders from paying other commissions to mortgage brokers.

**Recommendation 1.4 – Establishment of working group**

A Treasury-led working group should be established to monitor and, if necessary, adjust the remuneration model referred to in Recommendation 1.3, and any fee that lenders should be required to charge to achieve a level playing field, in response to market changes.

**Recommendation 1.5 – Mortgage brokers as financial advisers**

After a sufficient period of transition, mortgage brokers should be subject to and regulated by the law that applies to entities providing financial product advice to retail clients.

**Recommendation 1.6 – Misconduct by mortgage brokers**

ACL holders should:

- be bound by information-sharing and reporting obligations in respect of mortgage brokers similar to those referred to in Recommendations 2.7 and 2.8 for financial advisers; and
- take the same steps in response to detecting misconduct of a mortgage broker as those referred to in Recommendation 2.9 for financial advisers.

## **Consumer lending: Intermediated lending for vehicles and other consumer goods**

**Recommendation 1.7 – Removal of point-of-sale exemption**

The exemption of retail dealers from the operation of the NCCP Act should be abolished.

## Access to banking services

### Recommendation 1.8 – Amending the Banking Code

The ABA should amend the Banking Code to provide that:

- banks will work with customers:
  - who live in remote areas; or
  - who are not adept in using English,to identify a suitable way for those customers to access and undertake their banking;
- if a customer is having difficulty proving his or her identity, and tells the bank that he or she identifies as an Aboriginal or Torres Strait Islander person, the bank will follow AUSTRAC's guidance about the identification and verification of persons of Aboriginal or Torres Strait Islander heritage;
- without prior express agreement with the customer, banks will not allow informal overdrafts on basic accounts; and
- banks will not charge dishonour fees on basic accounts.

## Lending to small and medium enterprises

### Recommendation 1.9 – No extension of the NCCP Act

The NCCP Act should not be amended to extend its operation to lending to small businesses.

### Recommendation 1.10 – Definition of 'small business'

The ABA should amend the definition of 'small business' in the Banking Code so that the Code applies to any business or group employing fewer than 100 full-time equivalent employees, where the loan applied for is less than \$5 million.

### Recommendation 1.11 – Farm debt mediation

A national scheme of farm debt mediation should be enacted.

### **Recommendation 1.12 – Valuations of land**

APRA should amend Prudential Standard APS 220 to:

- require that internal appraisals of the value of land taken or to be taken as security should be independent of loan origination, loan processing and loan decision processes; and
- provide for valuation of agricultural land in a manner that will recognise, to the extent possible:
  - the likelihood of external events affecting its realisable value; and
  - the time that may be taken to realise the land at a reasonable price affecting its realisable value.

### **Recommendation 1.13 – Charging default interest**

The ABA should amend the Banking Code to provide that, while a declaration remains in force, banks will not charge default interest on loans secured by agricultural land in an area declared to be affected by drought or other natural disaster.

### **Recommendation 1.14 – Distressed agricultural loans**

When dealing with distressed agricultural loans, banks should:

- ensure that those loans are managed by experienced agricultural bankers;
- offer farm debt mediation as soon as a loan is classified as distressed;
- manage every distressed loan on the footing that working out will be the best outcome for bank and borrower, and enforcement the worst;
- recognise that appointment of receivers or any other form of external administrator is a remedy of last resort; and
- cease charging default interest when there is no realistic prospect of recovering the amount charged.

## Enforceability of industry codes

### Recommendation 1.15 – Enforceable code provisions

The law should be amended to provide:

- that ASIC’s power to approve codes of conduct extends to codes relating to all APRA-regulated institutions and ACL holders;
- that industry codes of conduct approved by ASIC may include ‘enforceable code provisions’, which are provisions in respect of which a contravention will constitute a breach of the law;
- that ASIC may take into consideration whether particular provisions of an industry code of conduct have been designated as ‘enforceable code provisions’ in determining whether to approve a code;
- for remedies, modelled on those now set out in Part VI of the Competition and Consumer Act, for breach of an ‘enforceable code provision’; and
- for the establishment and imposition of mandatory financial services industry codes.

### Recommendation 1.16 – 2019 Banking Code

In respect of the Banking Code that ASIC approved in 2018, the ABA and ASIC should take all necessary steps to have the provisions that govern the terms of the contract made or to be made between the bank and the customer or guarantor designated as ‘enforceable code provisions’.

## Processing and administrative errors

### Recommendation 1.17 – BEAR product responsibility

After appropriate consultation, APRA should determine for the purposes of section 37BA(2)(b) of the Banking Act, a responsibility, within each ADI subject to the BEAR, for all steps in the design, delivery and maintenance of all products offered to customers by the ADI and any necessary remediation of customers in respect of any of those products.

## 3.2 Financial advice

### Ongoing fee arrangements

#### **Recommendation 2.1 – Annual renewal and payment**

The law should be amended to provide that ongoing fee arrangements (whenever made):

- must be renewed annually by the client;
- must record in writing each year the services that the client will be entitled to receive and the total of the fees that are to be charged; and
- may neither permit nor require payment of fees from any account held for or on behalf of the client except on the client's express written authority to the entity that conducts that account given at, or immediately after, the latest renewal of the ongoing fee arrangement.

### Lack of independence

#### **Recommendation 2.2 – Disclosure of lack of independence**

The law should be amended to require that a financial adviser who would contravene section 923A of the Corporations Act by assuming or using any of the restricted words or expressions identified in section 923A(5) (including 'independent', 'impartial' and 'unbiased') must, before providing personal advice to a retail client, give to the client a written statement (in or to the effect of a form to be prescribed) explaining simply and concisely why the adviser is not independent, impartial and unbiased.

## Quality of advice

### **Recommendation 2.3 – Review of measures to improve the quality of advice**

In three years' time, there should be a review by Government in consultation with ASIC of the effectiveness of measures that have been implemented by the Government, regulators and financial services entities to improve the quality of financial advice. The review should preferably be completed by 30 June 2022, but no later than 31 December 2022.

Among other things, that review should consider whether it is necessary to retain the 'safe harbour' provision in section 961B(2) of the Corporations Act. Unless there is a clear justification for retaining that provision, it should be repealed.

## Conflicted remuneration

### **Recommendation 2.4 – Grandfathered commissions**

Grandfathering provisions for conflicted remuneration should be repealed as soon as is reasonably practicable.

### **Recommendation 2.5 – Life risk insurance commissions**

When ASIC conducts its review of conflicted remuneration relating to life risk insurance products and the operation of the ASIC Corporations (Life Insurance Commissions) Instrument 2017/510, ASIC should consider further reducing the cap on commissions in respect of life risk insurance products. Unless there is a clear justification for retaining those commissions, the cap should ultimately be reduced to zero.

### **Recommendation 2.6 – General insurance and consumer credit insurance commissions**

The review referred to in Recommendation 2.3 should also consider whether each remaining exemption to the ban on conflicted remuneration remains justified, including:

- the exemptions for general insurance products and consumer credit insurance products; and
- the exemptions for non-monetary benefits set out in section 963C of the Corporations Act.

## **Professional discipline of financial advisers**

### **Recommendation 2.7 – Reference checking and information sharing**

All AFSL holders should be required, as a condition of their licence, to give effect to reference checking and information-sharing protocols for financial advisers, to the same effect as now provided by the ABA in its 'Financial Advice – Recruitment and Termination Reference Checking and Information Sharing Protocol'.

### **Recommendation 2.8 – Reporting compliance concerns**

All AFSL holders should be required, as a condition of their licence, to report 'serious compliance concerns' about individual financial advisers to ASIC on a quarterly basis.

### **Recommendation 2.9 – Misconduct by financial advisers**

All AFSL holders should be required, as a condition of their licence, to take the following steps when they detect that a financial adviser has engaged in misconduct in respect of financial advice given to a retail client (whether by giving inappropriate advice or otherwise):

- make whatever inquiries are reasonably necessary to determine the nature and full extent of the adviser's misconduct; and
- where there is sufficient information to suggest that an adviser has engaged in misconduct, tell affected clients and remediate those clients promptly.

### **Recommendation 2.10 – A new disciplinary system**

The law should be amended to establish a new disciplinary system for financial advisers that:

- requires all financial advisers who provide personal financial advice to retail clients to be registered;
- provides for a single, central, disciplinary body;
- requires AFSL holders to report 'serious compliance concerns' to the disciplinary body; and
- allows clients and other stakeholders to report information about the conduct of financial advisers to the disciplinary body.

## **3.3 Superannuation**

### **Trustees' obligations**

#### **Recommendation 3.1 – No other role or office**

The trustee of an RSE should be prohibited from assuming any obligations other than those arising from or in the course of its performance of the duties of a trustee of a superannuation fund.

### **Recommendation 3.2 – No deducting advice fees from MySuper accounts**

Deduction of any advice fee (other than for intra-fund advice) from a MySuper account should be prohibited.

### **Recommendation 3.3 – Limitations on deducting advice fees from choice accounts**

Deduction of any advice fee (other than for intra-fund advice) from superannuation accounts other than MySuper accounts should be prohibited unless the requirements about annual renewal, prior written identification of service and provision of the client's express written authority set out in Recommendation 2.1 in connection with ongoing fee arrangements are met.

## **‘Selling’ superannuation**

### **Recommendation 3.4 – No hawking**

Hawking of superannuation products should be prohibited. That is, the unsolicited offer or sale of superannuation should be prohibited except to those who are not retail clients and except for offers made under an eligible employee share scheme.

The law should be amended to make clear that contact with a person during which one kind of product is offered is unsolicited unless the person attended the meeting, made or received the telephone call, or initiated the contact for the express purpose of inquiring about, discussing or entering into negotiations in relation to the offer of that kind of product.

## Nominating default funds

### **Recommendation 3.5 – One default account**

A person should have only one default account. To that end, machinery should be developed for ‘stapling’ a person to a single default account.

### **Recommendation 3.6 – No treating of employers**

Section 68A of the SIS Act should be amended to prohibit trustees of a regulated superannuation fund, and associates of a trustee, doing any of the acts specified in section 68A(1)(a), (b) or (c) where the act may reasonably be understood by the recipient to have a substantial purpose of having the recipient nominate the fund as a default fund or having one or more employees of the recipient apply or agree to become members of the fund.

The provision should be a civil penalty provision enforceable by ASIC.

## Regulation

### **Recommendation 3.7 – Civil penalties for breach of covenants and like obligations**

Breach of the trustee’s covenants set out in section 52 or obligations set out in section 29VN, or the director’s covenants set out in section 52A or obligations set out in section 29VO of the SIS Act should be enforceable by action for civil penalty.

### **Recommendation 3.8 – Adjustment of APRA and ASIC’s roles**

The roles of APRA and ASIC with respect to superannuation should be adjusted, as referred to in Recommendation 6.3.

### **Recommendation 3.9 – Accountability regime**

Over time, provisions modelled on the BEAR should be extended to all RSE licensees, as referred to in Recommendation 6.8.

## 3.4 Insurance

### Manner of sale and types of products sold: Hawking

#### **Recommendation 4.1 – No hawking of insurance**

Consistently with Recommendation 3.4, which prohibits the hawking of superannuation products, hawking of insurance products should be prohibited.

#### **Recommendation 4.2 – Removing the exemptions for funeral expenses policies**

The law should be amended to:

- remove the exclusion of funeral expenses policies from the definition of ‘financial product’; and
- put beyond doubt that the consumer protection provisions of the ASIC Act apply to funeral expenses policies.

### Specific steps in respect of particular products: Add-on insurance

#### **Recommendation 4.3 – Deferred sales model for add-on insurance**

A Treasury-led working group should develop an industry-wide deferred sales model for the sale of any add-on insurance products (except policies of comprehensive motor insurance). The model should be implemented as soon as is reasonably practicable.

#### **Recommendation 4.4 – Cap on commissions**

ASIC should impose a cap on the amount of commission that may be paid to vehicle dealers in relation to the sale of add-on insurance products.

## **Pre-contractual disclosure and representations**

### **Recommendation 4.5 – Duty to take reasonable care not to make a misrepresentation to an insurer**

Part IV of the Insurance Contracts Act should be amended, for consumer insurance contracts, to replace the duty of disclosure with a duty to take reasonable care not to make a misrepresentation to an insurer (and to make any necessary consequential amendments to the remedial provisions contained in Division 3).

### **Recommendation 4.6 – Avoidance of life insurance contracts**

Section 29(3) of the Insurance Contracts Act should be amended so that an insurer may only avoid a contract of life insurance on the basis of non-disclosure or misrepresentation if it can show that it would not have entered into a contract on any terms.

## **Unfair contract terms**

### **Recommendation 4.7 – Application of unfair contract terms provisions to insurance contracts**

The unfair contract terms provisions now set out in the ASIC Act should apply to insurance contracts regulated by the Insurance Contracts Act. The provisions should be amended to provide a definition of the 'main subject matter' of an insurance contract as the terms of the contract that describe what is being insured.

The duty of utmost good faith contained in section 13 of the Insurance Contracts Act should operate independently of the unfair contract terms provisions.

## Claims handling

### **Recommendation 4.8 – Removal of claims handling exemption**

The handling and settlement of insurance claims, or potential insurance claims, should no longer be excluded from the definition of ‘financial service’.

## Status of industry codes

### **Recommendation 4.9 – Enforceable code provisions**

As referred to in Recommendation 1.15, the law should be amended to provide for enforceable provisions of industry codes and for the establishment and imposition of mandatory industry codes.

In respect of the Life Insurance Code of Practice, the Insurance in Superannuation Voluntary Code and the General Insurance Code of Practice, the Financial Services Council, the Insurance Council of Australia and ASIC should take all necessary steps, by 30 June 2021, to have the provisions of those codes that govern the terms of the contract made or to be made between the insurer and the policyholder designated as ‘enforceable code provisions’.

### **Recommendation 4.10 – Extension of the sanctions power**

The Financial Services Council and the Insurance Council of Australia should amend section 13.10 of the Life Insurance Code of Practice and section 13.11 of the General Insurance Code of Practice to empower (as the case requires) the Life Code Compliance Committee or the Code Governance Committee to impose sanctions on a subscriber that has breached the applicable Code.

## External dispute resolution

### **Recommendation 4.11 – Co-operation with AFCA**

Section 912A of the Corporations Act should be amended to require that AFSL holders take reasonable steps to co-operate with AFCA in its resolution of particular disputes, including, in particular, by making available to AFCA all relevant documents and records relating to issues in dispute.

### **Recommendation 4.12 – Accountability regime**

Over time, provisions modelled on the BEAR should be extended to all APRA-regulated insurers, as referred to in Recommendation 6.8.

## Group life policies

### **Recommendation 4.13 – Universal terms review**

Treasury, in consultation with industry, should determine the practicability, and likely pricing effects, of legislating universal key definitions, terms and exclusions for default MySuper group life policies.

### **Recommendation 4.14 – Additional scrutiny for related party engagements**

APRA should amend Prudential Standard SPS 250 to require RSE licensees that engage a related party to provide group life insurance, or who enter into a contract, arrangement or understanding with a life insurer by which the insurer is given a priority or privilege in connection with the provision of life insurance, to obtain and provide to APRA within a fixed time, independent certification that the arrangements and policies entered into are in the best interests of members and otherwise satisfy legal and regulatory requirements.

### **Recommendation 4.15 – Status attribution to be fair and reasonable**

APRA should amend Prudential Standard SPS 250 to require RSE licensees to be satisfied that the rules by which a particular status is attributed to a member in connection with insurance are fair and reasonable.

## 3.5 Culture, governance and remuneration

### Remuneration

#### **Recommendation 5.1 – Supervision of remuneration – principles, standards and guidance**

In conducting prudential supervision of remuneration systems, and revising its prudential standards and guidance about remuneration, APRA should give effect to the principles, standards and guidance set out in the Financial Stability Board's publications concerning sound compensation principles and practices.

Recommendations 5.2 and 5.3 explain and amplify aspects of this Recommendation.

#### **Recommendation 5.2 – Supervision of remuneration – aims**

In conducting prudential supervision of the design and implementation of remuneration systems, and revising its prudential standards and guidance about remuneration, APRA should have, as one of its aims, the sound management by APRA-regulated institutions of not only financial risk but also misconduct, compliance and other non-financial risks.

#### **Recommendation 5.3 – Revised prudential standards and guidance**

In revising its prudential standards and guidance about the design and implementation of remuneration systems, APRA should:

- require APRA-regulated institutions to design their remuneration systems to encourage sound management of non-financial risks, and to reduce the risk of misconduct;
- require the board of an APRA-regulated institution (whether through its remuneration committee or otherwise) to make regular assessments of the effectiveness of the remuneration system in encouraging sound management of non-financial risks, and reducing the risk of misconduct;
- set limits on the use of financial metrics in connection with long-term variable remuneration;

- require APRA-regulated institutions to provide for the entity, in appropriate circumstances, to claw back remuneration that has vested; and
- encourage APRA-regulated institutions to improve the quality of information being provided to boards and their committees about risk management performance and remuneration decisions.

#### **Recommendation 5.4 – Remuneration of front line staff**

All financial services entities should review at least once each year the design and implementation of their remuneration systems for front line staff to ensure that the design and implementation of those systems focus on not only what staff do, but also how they do it.

#### **Recommendation 5.5 – The Sedgwick Review**

Banks should implement fully the recommendations of the Sedgwick Review.

### **Culture and governance**

#### **Recommendation 5.6 – Changing culture and governance**

All financial services entities should, as often as reasonably possible, take proper steps to:

- assess the entity's culture and its governance;
- identify any problems with that culture and governance;
- deal with those problems; and
- determine whether the changes it has made have been effective.

### **Recommendation 5.7 – Supervision of culture and governance**

In conducting its prudential supervision of APRA-regulated institutions and in revising its prudential standards and guidance, APRA should:

- build a supervisory program focused on building culture that will mitigate the risk of misconduct;
- use a risk-based approach to its reviews;
- assess the cultural drivers of misconduct in entities; and
- encourage entities to give proper attention to sound management of conduct risk and improving entity governance.

## **3.6 Regulators**

### **Twin peaks**

#### **Recommendation 6.1 – Retain twin peaks**

The ‘twin peaks’ model of financial regulation should be retained.

### **ASIC’s enforcement practices**

#### **Recommendation 6.2 – ASIC’s approach to enforcement**

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 by entities, will rarely be appropriate for provisions that require an evaluative judgment and, beyond purely administrative failings, will rarely be an appropriate enforcement tool where the infringing party is a large corporation;

- recognises the relevance and importance of general and specific deterrence in deciding whether to accept an enforceable undertaking, and the utility in obtaining admissions in enforceable undertakings; and
- separates, as much as possible, enforcement staff from non-enforcement related contact with regulated entities.

## **Superannuation: Conduct regulation**

### **Recommendation 6.3 – General principles for co-regulation**

The roles of APRA and ASIC in relation to superannuation should be adjusted to accord with the general principles that:

- APRA, as the prudential regulator for superannuation, is responsible for establishing and enforcing Prudential Standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by superannuation entities APRA supervises are met within a stable, efficient and competitive financial system; and
- as the conduct and disclosure regulator, ASIC's role in superannuation primarily concerns the relationship between RSE licensees and individual consumers.

Effect should be given to these principles by taking the steps described in Recommendations 6.4 and 6.5.

### **Recommendation 6.4 – ASIC as conduct regulator**

Without limiting any powers APRA currently has under the SIS Act, ASIC should be given the power to enforce all provisions in the SIS Act that are, or will become, civil penalty provisions or otherwise give rise to a cause of action against an RSE licensee or director for conduct that may harm a consumer. There should be co-regulation by APRA and ASIC of these provisions.

### **Recommendation 6.5 – APRA to retain functions**

APRA should retain its current functions, including responsibility for the licensing and supervision of RSE licensees and the powers and functions that come with it, including any power to issue directions that APRA presently has or is to be given.

## **The BEAR: Co-regulation**

### **Recommendation 6.6 – Joint administration of the BEAR**

ASIC and APRA should jointly administer the BEAR. ASIC should be charged with overseeing those parts of Divisions 1, 2 and 3 of Part IIAA of the Banking Act that concern consumer protection and market conduct matters. APRA should be charged with overseeing the prudential aspects of Part IIAA.

### **Recommendation 6.7 – Statutory amendments**

The obligations in sections 37C and 37CA of the Banking Act should be amended to make clear that an ADI and accountable person must deal with APRA and ASIC (as the case may be) in an open, constructive and co-operative way. Practical amendments should be made to provisions such as section 37K and section 37G(1) so as to facilitate joint administration.

### **Recommendation 6.8 – Extending the BEAR**

Over time, provisions modelled on the BEAR should be extended to all APRA-regulated financial services institutions. APRA and ASIC should jointly administer those new provisions.

## Co-ordination and information sharing

### **Recommendation 6.9 – Statutory obligation to co-operate**

The law should be amended to oblige each of APRA and ASIC to:

- co-operate with the other;
- share information to the maximum extent practicable; and
- notify the other whenever it forms the belief that a breach in respect of which the other has enforcement responsibility may have occurred.

### **Recommendation 6.10 – Co-operation memorandum**

ASIC and APRA should prepare and maintain a joint memorandum setting out how they intend to comply with their statutory obligation to co-operate.

The memorandum should be reviewed biennially and each of ASIC and APRA should report each year on the operation of and steps taken under it in its annual report.

## Governance

### **Recommendation 6.11 – Formalising meeting procedure**

The ASIC Act should be amended to include provisions substantially similar to those set out in sections 27–32 of the APRA Act – dealing with the times and places of Commissioner meetings, the quorum required, who is to preside, how voting is to occur and the passing of resolutions without meetings.

### **Recommendation 6.12 – Application of the BEAR to regulators**

In a manner agreed with the external oversight body (the establishment of which is the subject of Recommendation 6.14 below) each of APRA and ASIC should internally formulate and apply to its own management accountability principles of the kind established by the BEAR.

**Recommendation 6.13 – Regular capability reviews**

APRA and ASIC should each be subject to at least quadrennial capability reviews. A capability review should be undertaken for APRA as soon as is reasonably practicable.

**Oversight****Recommendation 6.14 – A new oversight authority**

A new oversight authority for APRA and ASIC, independent of Government, should be established by legislation to assess the effectiveness of each regulator in discharging its functions and meeting its statutory objects.

The authority should be comprised of three part-time members and staffed by a permanent secretariat.

It should be required to report to the Minister in respect of each regulator at least biennially.

**3.7 Other important steps****External dispute resolution****Recommendation 7.1 – Compensation scheme of last resort**

The three principal recommendations to establish a compensation scheme of last resort made by the panel appointed by government to review external dispute and complaints arrangements made in its supplementary final report should be carried into effect.

## **ASIC Enforcement Review Taskforce Government Response**

### **Recommendation 7.2 – Implementation of recommendations**

The recommendations of the ASIC Enforcement Review Taskforce made in December 2017 that relate to self-reporting of contraventions by financial services and credit licensees should be carried into effect.

## **Simplification so that the law's intent is met**

### **Recommendation 7.3 – Exceptions and qualifications**

As far as possible, exceptions and qualifications to generally applicable norms of conduct in legislation governing financial services entities should be eliminated.

### **Recommendation 7.4 – Fundamental norms**

As far as possible, legislation governing financial services entities should identify expressly what fundamental norms of behaviour are being pursued when particular and detailed rules are made about a particular subject matter.

## 4 Recommendations: Answering the key questions

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As I have already said, I think it useful to restate and reorder what I have set out above so that the reader can see the way in which particular recommendations fit together.

Restated and reordered below, the recommendations seek to answer, in these ways, the key questions:

- How can the law be simplified so that its intent is met?
- How should the approach to conflicts of interest and conflicts between duty and interest change?
- What can be done to improve compliance and the effectiveness of the regulators? and
- What more can be done to achieve effective leadership, good governance and appropriate culture so that financial services entities obey the basic norms of behaviour that underpin the proper regulation of the financial services industry?

Some recommendations respond to more than one question. Then there are some (not listed below) that make more particular recommendations, including some directed to preserving the existing law or to monitoring and responding to market changes resulting from the recommendation.<sup>29</sup>

With that in mind, the restatement and reordering is as follows.

### 4.1 Simplifying the law so that its intent is met

A general recommendation is that, as far as possible, exceptions and qualifications to generally applicable norms of conduct in legislation governing financial services entities should be eliminated (Recommendation 7.3).

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<sup>29</sup> See Recommendations 1.1, 1.4 and 1.9.

In this way, the first, and essential, step to take is to reduce exceptions and carve outs.

The more complicated the law, the harder it is to see unifying and informing principles and purposes. Exceptions and limitations encourage literal application and focusing on boundary-marking and categorisation. Boundary-marking and categorisation may promote uncertainty. Removing exceptions and limitations encourages understanding and application of the law in accordance with its purposes. That is, 'its intent is met, rather than merely its terms complied with'.<sup>30</sup> Like cases are more evidently treated alike. Uncertainty may be reduced.

Several recommendations propose the removal of exceptions and limitations in the existing law and industry codes. They relate to:

- the point-of-sale exemption for retail dealers under the NCCP Act (Recommendation 1.7);
- grandfathered commissions (Recommendation 2.4);
- life risk and general insurance commissions (Recommendations 2.5, 2.6 and 4.4);
- funeral expenses policies (Recommendation 4.2);
- insurance claims handling and settlement (Recommendation 4.8); and
- the definition of 'small business' in the 2019 Banking Code of Practice (Recommendation 1.10).

Next, as far as possible, legislation governing financial services entities should identify expressly what fundamental norms of behaviour are being pursued when particular and detailed rules are made about a particular subject matter (Recommendation 7.4). By drawing explicit connections in the legislation between the particular rules that are made and the fundamental norms to which those rules give effect, the regulated community and the public more generally will better understand what the rules are directed to achieving.

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<sup>30</sup> Treasury, Interim Report Submission, 1 [2].

The recommendation that mortgage brokers owe borrowers a best interests duty (Recommendation 1.2) gives mortgage brokers the same duty to their clients as financial advisers owe their clients.

The further recommendation that mortgage brokers be subject to and regulated by the same laws as financial advisers (Recommendation 1.5) will ensure consistent treatment of advisers.

## 4.2 Conflicts

Where possible, conflicts of interest and conflicts between duty and interest should be removed. There must be recognition that conflicts of interest and conflicts between duty and interest should be eliminated rather than 'managed'.

Several recommendations deal with conflicts of interest or conflicts between duty and interest. They include the recommendations:

- that mortgage brokers owe borrowers a best interests duty (Recommendation 1.2);
- about financial advisers disclosing any lack of independence (Recommendation 2.2);
- about conflicted remuneration with respect to:
  - grandfathered commissions (Recommendation 2.4);
  - mortgage brokers (Recommendation 1.3);
  - life risk insurance products (Recommendation 2.5);
  - general insurance and consumer credit insurance products (Recommendation 2.6); and
  - add-on insurance products (Recommendation 4.4);
- about superannuation trustees (Recommendation 3.1); and
- about related party engagements for group life insurance through superannuation (Recommendation 4.14).

## 4.3 Regulators and compliance

The recommendations seek to improve the effectiveness of the regulators in deterring misconduct and ensuring that there are just and appropriate consequences for misconduct.

Some recommendations seek to increase the ways in which the regulators can enforce the law by recommending that:

- the BEAR be extended to other APRA-regulated institutions (Recommendations 3.9, 4.12 and 6.8);
- APRA determine a new responsibility under the BEAR for bank products (Recommendation 1.17);
- the breach of trustee and director covenants and obligations under the SIS Act should be subject to civil penalties (Recommendation 3.7); and
- the ASIC Enforcement Review Taskforce recommendations be carried into effect (Recommendation 7.2).

Some recommendations relate to the governance and performance of APRA and ASIC. These include the recommendations about:

- a new oversight authority (Recommendation 6.14);
- both APRA and ASIC formulating and applying to their own management and accountability principles of the kind set out in the BEAR (Recommendation 6.12);
- formalising ASIC's meeting procedures (Recommendation 6.11); and
- regular capability reviews of each of APRA and ASIC, including an immediate capability review of APRA (Recommendation 6.13).

Other recommendations re-adjust the roles of APRA and ASIC to reflect better the twin peaks model (Recommendation 6.1). They include recommendations about:

- co-regulation of superannuation (Recommendations 3.8, 6.3, 6.4 and 6.5);

- joint administration of the BEAR in both its present form (Recommendations 6.6 and 6.7) and its extension to other APRA-regulated institutions (Recommendations 3.9, 4.12 and 6.8); and
- co-operation and information sharing between APRA and ASIC (Recommendations 6.9 and 6.10).

Some recommendations relate to ASIC's operations, including:

- ASIC's approach to enforcement (Recommendation 6.2); and
- the need for ASIC to undertake, or play a part in, reviews relating to the quality of advice by, and commissions paid to, financial advisers (Recommendations 2.3, 2.5 and 2.6).

Other recommendations seek to increase compliance with the law by:

- establishing a new disciplinary system for financial advisers (Recommendation 2.10);
- extending the sanctions power under the Life Insurance Code of Practice and the General Insurance Code of Practice (Recommendation 4.10); and
- requiring co-operation with external dispute resolution processes (Recommendation 4.11).

## **4.4 Culture, governance and remuneration**

Because primary responsibility for misconduct in the financial services industry lies with the entities concerned and those who manage and control them, effective leadership, good governance and appropriate culture within the entities are fundamentally important. And culture, governance and remuneration are closely connected. But it now must be accepted that regulators have an important role to play in supervision of these matters. Supervision must extend beyond financial risk to non-financial risk and that requires attention to culture, governance and remuneration.

Some recommendations relate to APRA's prudential supervision of APRA-regulated institutions and the content of its prudential standards and guidelines and recommend:

- APRA's giving effect to the Financial Stability Board's publications concerning sound compensation principles and practices (Recommendation 5.1); and
- APRA using supervision, prudential standards and guidance to:
  - promote and encourage sound management by APRA-regulated institutions of not only financial risk but also misconduct, compliance and other non-financial risks (Recommendations 5.2 and 5.3); and
  - take steps (identified in Recommendation 5.7) to encourage entities to give proper attention to sound management of conduct risk and improving entity governance.

Other recommendations urge:

- all financial services entities to review the design and implementation of remuneration systems for front line staff at least once each year (Recommendation 5.4);
- banks to implement fully the recommendations of the Sedgwick Review (Recommendation 5.5); and
- all financial services entities to assess, as often as reasonably possible, the entity's culture and governance, identify any problems, deal with them and determine whether the changes have been effective (Recommendation 5.6).

There are also other ways in which the recommendations seek to address culture. These are by requiring AFSL holders to:

- take steps (identified in Recommendation 2.9) in cases where they detect a financial adviser has engaged in misconduct;
- reference check and share information relating to termination of financial advisers (Recommendation 2.7); and
- report 'serious compliance concerns' (Recommendation 2.8).

Equivalent recommendations are made in respect of ACL holders when dealing with mortgage brokers (Recommendation 1.6).

Then there are the more particular recommendations to increase protections.

## 4.5 Increasing protections

There are recommendations that seek to change, or add to, the law, or industry codes of conduct, in ways that will increase protections to consumers from misconduct or conduct that falls below community standards and expectations. Those recommendations are:

- about making some provisions of industry codes enforceable (Recommendations 1.15, 1.16 and 4.9) to give certainty and enforceability to the terms of the contract between a financial services entity and its client or a guarantor;
- that the ABA amend the Banking Code (in the ways identified in Recommendation 1.8) to improve access to banking;
- about the enactment of a national scheme of farm debt mediation (Recommendation 1.11);
- about the valuation of land (Recommendation 1.12), the charging of default interest (Recommendation 1.13) and how banks should deal with distressed agricultural loans (Recommendation 1.14);
- that ongoing fee arrangements (whenever made) must be expressly renewed by the client each year (Recommendation 2.1);
- prohibiting advice fees from being deducted from MySuper accounts (Recommendation 3.2) and limiting deduction of advice fees from choice accounts (Recommendation 3.3);
- prohibiting hawking of superannuation products (Recommendation 3.4) and insurance products (Recommendation 4.1);
- that a person should have only one default superannuation account (Recommendation 3.5);
- about the trustee's conduct in influencing the way employers choose default superannuation funds (Recommendation 3.6);

- that a deferred sales model be established for the sale of add-on insurance (Recommendation 4.3);
- that ASIC impose a cap on add-on insurance commissions (Recommendation 4.4);
- about the duties relating to, and remedies flowing from, misrepresentations and non-disclosures in insurance (Recommendations 4.5 and 4.6);
- to apply unfair contract terms to insurance contracts (Recommendation 4.7);
- increasing scrutiny of related party engagements for insurers of superannuation members through group life policies (Recommendation 4.14), attributing statuses to members of group life policies that are fair and reasonable (Recommendation 4.15) and recommending that a review be undertaken to determine the practicability of legislating universal terms in MySuper group life policies (Recommendation 4.13); and
- establishing a compensation scheme of last resort (Recommendation 7.1).

These recommendations seek to improve the law to protect consumers from the misconduct and conduct that fell below community standards and expectations identified by the Commission. They are recommendations for changes that will reduce the chance that conduct of the kinds identified will happen again, or happen again with the same effect for consumers.

## 2. Banking

### Introduction

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In this part of the Report I will deal with conduct and issues relating to what may loosely be described as ‘traditional’ banking services. In the *Interim Report*, I pointed out<sup>1</sup> that the traditional business of banking comprised lending, deposit taking and the provision of transaction services.<sup>2</sup>

Bank-owned entities have played a prominent role in matters that are the subject of this Report in connection with financial advice, superannuation and insurance. Chief among these issues has been the charging of fees for no service. I will deal separately with those sectors of the industry and then, at the end of the Report, draw together what I consider to be overarching issues, causes and recommendations about culture, governance, and the management and control of regulatory, compliance and conduct risks in the various sectors of the industry.

In dealing with the conduct and issues that have emerged in connection with ‘traditional’ banking services it is important to deal separately with direct lending under the *National Consumer Credit Protection Act 2009* (Cth) (the NCCP Act), with intermediated home and automotive lending (and associated issues), with access to banking services, with lending to small and medium enterprises, with the enforceability of the 2019 Banking Code and with what the banks referred to as ‘processing’ or ‘administrative’ errors.

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<sup>1</sup> FSRC, *Interim Report*, vol 1, 74.

<sup>2</sup> Malcolm Edey and Brian Gray, ‘The Evolving Structure of the Australian Financial System’ (Paper presented at The Future of the Financial System Conference, H C Coombs Centre for Financial Studies, Kirribilli, 8–9 July 1996) 8–9 <[www.rba.gov.au/publications/confs/1996/pdf/conf-vol-1996.pdf](http://www.rba.gov.au/publications/confs/1996/pdf/conf-vol-1996.pdf)>.

# 1 Direct lending under the NCCP Act

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Direct lending is a core business of banks. The issues that emerged during the Commission in relation to direct lending were of two kinds: issues about compliance with existing norms of conduct (both statutory and voluntarily assumed under the Banking Code), and issues about whether those norms (the law or the Banking Code) should be changed.

The most convenient starting point is the provisions that now govern direct lending by banks.

## 1.1 The existing provisions

Four sets of provisions are relevant:

- the responsible lending provisions of the NCCP Act;
- the responsible lending provisions of the Banking Code;
- the consumer protection provisions of the *Australian Securities and Investments Commission Act 2001* (Cth) (the ASIC Act); and
- the unfair contract terms provisions of the ASIC Act.

Little needs to be said about the last two sets of provisions beyond emphasising the need for their application and enforcement. Together, the consumer protection provisions and the unfair contract terms provisions give detailed content to three of the six basic norms of conduct I have identified in the Introduction. Those three norms are: act fairly; provide services that are fit for purpose; and deliver services with reasonable care and skill.

The ASIC Act prohibits misleading conduct in relation to financial services.<sup>3</sup> It prohibits unconscionable conduct in connection with the supply or possible supply of financial services to a person other than a listed public company.<sup>4</sup> It implies terms of due care and skill, and fitness for purpose into contracts

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<sup>3</sup> ASIC Act ss 12DA, 12DB, 12DC, 12DF.

<sup>4</sup> ASIC Act ss 12CA, 12CB.

for the supply of financial services where the services under the contract were acquired for use or consumption in connection with a small business.<sup>5</sup>

Since 2015, the ASIC Act has provided that unfair terms in standard form small business contracts for financial services and financial products are void.<sup>6</sup>

As will be seen, however, the responsible lending provisions of both the NCCP Act and the Banking Code give important further content to these norms. It is necessary to say more about the responsible lending provisions.

Lending to consumers,<sup>7</sup> as distinct from lending for a business purpose, is governed by the NCCP Act. The NCCP Act obliges credit licensees to assess whether the proposed credit contract or increase in credit limit will be unsuitable for the consumer.<sup>8</sup> The Act also obliges the licensee to make the inquiries and verification prescribed in section 130. The inquiries required by section 130(1)(a) and (b) are reasonable inquiries about the consumer's 'requirements and objectives in relation to the credit contract' and 'about the consumer's financial situation'. The verification required is 'reasonable steps to verify the consumer's financial situation'.<sup>9</sup> Section 133 then prohibits a licensee entering, or increasing the credit limit of, an unsuitable credit contract.

At all relevant times, the industry code of practice (known, until its latest iteration, as the Code of Banking Practice) has provided that a bank that has subscribed to, or is bound by, the Banking Code and is considering the provision to a person covered by the Banking Code of a new loan or an increase to a loan limit will exercise the care and skill of a diligent and prudent banker. The diligent and prudent banker provision has applied to

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<sup>5</sup> ASIC Act s 12ED, read with the definition of 'small business' in s 12BC(2).

<sup>6</sup> ASIC Act s 12BF.

<sup>7</sup> Section 5 of Sched 1 of the NCCP Act (the National Credit Code) provides that the National Credit Code applies to the provision of credit to a natural person or a strata corporation, wholly or predominantly for personal, domestic or household purposes, or to purchase, renovate or improve residential property for investment purposes. (Other applications of the National Credit Code need not be noticed here.) The definition provisions of the NCCP Act then engage and apply the provisions made by s 5 of the National Credit Code.

<sup>8</sup> NCCP Act ss 128–129.

<sup>9</sup> NCCP Act s 130(1)(c).

lending to small businesses (as ‘small business’ has been defined by successive iterations of the Banking Code). A new code, the 2019 Banking Code of Practice (the 2019 Banking Code), has been approved by ASIC and will come into operation on 1 July 2019.

## 1.2 Compliance with existing provisions

### 1.2.1 The NCCP Act

When dealing with particular case studies in the *Interim Report*, I concluded that there had been conduct that might amount to a contravention of the NCCP Act. Those conclusions recognise that the relevant provisions of the NCCP Act hinge on two distinct prohibitions:

- first, the requirement, by section 128, not to enter a credit contract unless the prescribed inquiries and verification have been made; and
- second, the requirement, by section 133, not to enter a credit contract or increase a credit limit if the contract is unsuitable.

The first requirement looks to what a credit licensee must do *before* entering a contract; the second looks to whether, according to the prescribed criteria, the contract that is made *is* unsuitable.

The conduct identified in the Commission’s hearings pointed towards banks tending to conflate the two requirements into a single inquiry about serviceability of the loan. This conflation was most apparent in connection with unsolicited offers made by banks of overdraft limits or credit card limit increases. Offers of these kinds were made according to the bank’s assessment, from the customer’s past history, of whether the customer was likely to be able to service the amount of credit being offered. But, as I pointed out in the *Interim Report*, and note further below, the NCCP Act obliges a licensee to make reasonable inquiries about a consumer’s objectives and requirements, to make reasonable inquiries about a consumer’s financial situation and to take reasonable steps to verify the consumer’s financial situation.<sup>10</sup>

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<sup>10</sup> FSRC, *Interim Report*, vol 1, 23–30.

Both income and expenditure must be considered in first inquiring about, and then verifying, the customer's financial situation. I said in the *Interim Report* that I consider that verification means doing more than taking the customer at his or her word. I do not consider this to be a novel proposition.<sup>11</sup>

Since the first round of the Commission's hearings, a number of banks have altered their lending processes and procedures by introducing additional inquiries about a borrower's financial situation and by taking some further steps to verify that situation. These changes may in part be responses to concerns expressed by the Australian Prudential Regulation Authority (APRA) as a result of the targeted reviews undertaken in 2016 and 2017.<sup>12</sup> Those reviews identified a number of deficiencies in the processes that banks used to verify borrower expenses, including insufficient controls to verify information and a significant rate of default to the **Household Expenditure Measure** (HEM), which I discuss further below.

By way of just three examples of such changes, CBA has now introduced mandatory expense breakdowns, it has updated standardised serviceability calculators and systems to identify customer commitments with other financial institutions, and it has increased the number of expense fields in its application forms.<sup>13</sup> ANZ has introduced a more detailed breakdown of living expenses for home loan applications,<sup>14</sup> and is moving towards using digital tools to capture and categorise data about a customer's current expenditure.<sup>15</sup> As I said in the *Interim Report*, since March 2018, Westpac has expanded the number of expense categories included in its home loan application process from six to 13, and made some categories mandatory.<sup>16</sup>

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<sup>11</sup> See, eg, *ASIC v Cash Store Pty Ltd (in liquidation)* [2014] FCA 926.

<sup>12</sup> See, eg, Exhibit 1.87, 28 April 2017, KPMG Targeted Review; Exhibit 1.190, May 2017, Westpac Targeted Review; Exhibit 1.197, May 2017, PWC Report for CBA as Part of the APRA Targeted Review.

<sup>13</sup> Exhibit 7.2, Witness statement of Matthew Comyn, 14 November 2018, 59–60 [216]–[217] and 61–3 [221].

<sup>14</sup> Exhibit 7.121, Witness statement of Shayne Elliott, 16 November 2018, 8 [41]–[47].

<sup>15</sup> Exhibit 7.121, Witness statement of Shayne Elliott, 16 November 2018, 8 [45].

<sup>16</sup> FSRC, *Interim Report*, vol 1, 26.

## Benchmarks

In the *Interim Report*, I said that using a statistical measure of ‘the median spend on absolute basics’ plus the 25th percentile spend on discretionary basics<sup>17</sup> as a default measure of household expenditure does not constitute verification of a borrower’s expenditure. I remain of that view.

It is necessary for me to say something about two developments relating to benchmarks that followed the *Interim Report*.

First, in November 2018, Perram J of the Federal Court refused to accept a proposal made jointly by ASIC and Westpac to resolve proceedings brought by ASIC alleging that Westpac had contravened section 128 of the NCCP Act.<sup>18</sup> The parties proposed that the Court impose a civil penalty of \$35 million on Westpac for contravening the NCCP Act in assessing the suitability of home loans for customers in the period between 12 December 2011 and March 2015.<sup>19</sup> Westpac had used the HEM in its assessment of the loan applications.<sup>20</sup>

In his reasons for refusing to make the orders the parties had proposed, Perram J said that the conduct expressed in a declaration proposed by the parties was not conduct that ‘could possibly be a contravention’ of section 128.<sup>21</sup>

I observe that the Statement of Agreed Facts filed by the parties for the purposes of the application determined by Perram J said nothing at all about ‘verification in accordance with section 130’ (as mentioned in section 128(d)) and nothing about the operation of section 130(1)(c) requiring a licensee, for the purposes of section 128(d), to take ‘reasonable steps to verify the consumer’s financial situation’.

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<sup>17</sup> As measured by the HEM. See, FSRC, *Interim Report*, vol 1, 27–8.

<sup>18</sup> *ASIC v Westpac Banking Corporation* [2018] FCA 1733.

<sup>19</sup> *ASIC v Westpac Banking Corporation* [2018] FCA 1733, [1], [3].

<sup>20</sup> *ASIC v Westpac Banking Corporation* [2018] FCA 1733, [5].

<sup>21</sup> *ASIC v Westpac Banking Corporation* [2018] FCA 1733, [29]. The declaration sought was to the effect that Westpac contravened the requirements of s 128 of the NCCP Act ‘by reason of ... the use within its Serviceability Calculation Rule of the HEM Benchmark rather than Declared Living Expenses of customers’.

The proceedings remain undetermined and, absent some different agreement being reached and resulting in final orders disposing of the proceeding, await trial and judgment. That being so, it would not be right for me to offer any view about the conclusions reached by Perram J or to say anything at all about the reasons that have been published. At the time of writing, the proceedings between ASIC and Westpac remain on foot and may well go to trial.<sup>22</sup> The court processes must play out without commentary from me. **If the court processes were to reveal some deficiency in the law's requirements to make reasonable inquiries about, and verify, the consumer's financial situation, amending legislation to fill in that gap should be enacted as soon as reasonably practicable.**

The second development to notice is that banks are reducing their reliance on the HEM.<sup>23</sup> During the seventh round of hearings, Mr Matthew Comyn, the CEO of CBA, told the Commission:<sup>24</sup>

[W]e're doing a better job of discovering what a customer's declared living expenses figure actually is, and, therefore, HEM as the prudent floor is being relied on less and less. I would certainly like to see it in the 50s very soon. I'm very confident it's going to be at that level very soon. As it gets towards 50 per cent, given the nature of the way the HEM benchmark is designed ... just mathematically, somewhere around 40 or 50 per cent should be largely reflective of the underlying expenditure.

In this comment, Mr Comyn rightly acknowledged that, by improving processes for inquiries and verification, banks' reliance upon the HEM or other benchmarks is likely to reduce. This is unsurprising, but important. It is important because it underscores the point that while the HEM can have some utility when assessing serviceability – that is to say, in assessing whether a particular consumer is likely to experience substantial hardship as a result of meeting their obligation to repay a line of credit<sup>25</sup> – the measure should not, and cannot, be used as a substitute for inquiries

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<sup>22</sup> See *ASIC v Westpac Banking Corporation (No 2)* [2018] FCA 1984, [1], [9].

<sup>23</sup> See, eg, Exhibit 7.121, Witness statement of Shayne Elliott, 16 November 2018, 8 [43]; Transcript, Shayne Elliott, 29 November 2018, 7333–4.

<sup>24</sup> Transcript, Matthew Comyn, 19 November 2018, 6593–4.

<sup>25</sup> See, eg, Westpac, Interim Report Submission, 21.

or verification. As ASIC rightly indicates in its Regulatory Guide relating to responsible lending conduct:<sup>26</sup>

[u]se of benchmarks is not a replacement for making inquiries about a particular consumer's current income and expenses, nor a replacement for an assessment based on that consumer's verified income and expenses.

I consider that the steps that I have referred to above – steps taken by banks to strengthen their home lending practices and to reduce their reliance on the HEM – are being taken with a view to improving compliance with the responsible lending provisions of the NCCP Act. If this results in a 'tightening' of credit, it is the consequence of complying with the law as it has stood since the NCCP Act came into operation.

In saying this, I think it important to refer to a number of aspects of Treasury's submissions in response to the Commission's *Interim Report*. Treasury indicated that '[t]here is little evidence to suggest that the recent tightening in credit standards, including through APRA's prudential measures or the actions taken by ASIC in respect of [responsible lending obligations], has materially affected the overall availability of credit'.<sup>27</sup> Rather, Treasury considered that 'to the extent that firms are correcting lax credit assessment practices, there has likely been an improvement in the credit quality of marginal borrowers'.<sup>28</sup> As Treasury also said, finding that 'some lenders have not consistently undertaken reasonable inquiries to verify the financial position of potential borrowers, suggests that not all possible information (including quality of information) relevant for differentiating between the quality of borrowers has been fully utilised across the industry'.<sup>29</sup> But, taken together, Treasury said that the considerations it took into account (including the Reserve Bank's analysis indicating that most borrowers in the home mortgage market comfortably meet existing serviceability criteria) 'suggest that the housing market has the capacity to absorb some adjustment in the application of lending standards necessary to meet the requirements of existing [responsible lending obligations]

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<sup>26</sup> ASIC, Regulatory Guide 209, November 2014, 37 [209.104]–[209.105].

<sup>27</sup> Treasury, Interim Report Submission, 34 [174] (footnote omitted).

<sup>28</sup> Treasury, Interim Report Submission, 34 [174].

<sup>29</sup> Treasury, Interim Report Submission, 34 [176].

without imposing unwarranted risks to macroeconomic outcomes'.<sup>30</sup> Put another way, **if 'appropriately managed, ensuring the industry consistently meets the requirements of existing laws will likely enhance rather than detract from macroeconomic performance'**.<sup>31</sup> To my mind, these are important observations.

### *'Not unsuitable'*

Consumer advocacy groups urged me to recommend that the NCCP Act be amended to require lenders to determine whether a loan contract (or credit limit increase) was 'suitable' for the consumer (as distinct from 'not unsuitable').<sup>32</sup> I do not favour that proposal.

The double negative 'not unsuitable' does seem clumsy and, at first sight, may be thought no different in substance from the lender being required to determine that the loan is 'suitable' for the borrower. But there is an important practical difference between the two tests. The 'not unsuitable' test may be described as directed to avoiding harm. By contrast, asking about suitability invites attention to whether there is benefit to the borrower. The inquiries and verification required by the NCCP Act put the lender in a position where it can assess whether making the loan is unsuitable because it is likely that the consumer will be unable to comply with the consumer's financial obligations under the loan or could only comply with them by enduring what section 133(2) refers to as 'substantial hardship'. Those inquiries and verification are not suited to assessing what, if any, benefit the consumer will gain by borrowing.

I am not persuaded that the test should be changed.

I also consider that the NCCP Act, in its current form, sufficiently regulates the making of unsolicited offers of credit to consumers. Unsolicited offers of credit card limit increases are regulated by Division 4 of Part 3-2B of the NCCP Act. As already noted, the Act requires credit licensees to make reasonable inquiries about a consumer's requirements and objectives and

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<sup>30</sup> Treasury, Interim Report Submission, 35 [177].

<sup>31</sup> Treasury, Interim Report Submission, 35 [177].

<sup>32</sup> FRLC, Interim Report Submission, 11–12; CALC, Interim Report Submission, 20–1 [84]–[89]; Consumer Credit Legal Service WA, Interim Report Submission, 18–19 [3.42]–[3.48].

about the consumer's financial situation *before* making a credit contract. As I explained in connection with some of the case studies discussed in the *Interim Report*, most unsolicited offers of credit to consumers will occur in circumstances in which the credit licensee would find it hard, if not impossible, to show compliance with those requirements, if only because it is not for the lender to impose its judgment of what the consumer requires or 'needs' and it is not for the lender to impose its judgment of what objectives the consumer could have (even should have) in taking up a proffered line of credit.<sup>33</sup>

Subject to these matters, there was little or no debate about the terms of the NCCP Act. And, as will be apparent from what I have said, I am not persuaded that the terms of the NCCP Act should be amended to alter the obligation to assess unsuitability. My conclusions about issues relating to the NCCP Act can be summed up as 'apply the law as it stands'.

### Recommendation 1.1 – The NCCP Act

The NCCP Act should not be amended to alter the obligation to assess unsuitability.

## 1.2.2 The responsible lending provisions of the Banking Code

Again, there was little or no debate about the way in which the Banking Code framed the lender's responsible lending obligation – to 'exercise the care and skill of a diligent and prudent banker'.<sup>34</sup> I see no reason to alter this formulation of the obligation. I discuss the enforceability of this and other provisions of the Code below.

# 2 Intermediated home lending

Two distinct forms of intermediated lending were examined: home lending through **mortgage brokers** and lending for motor vehicles, whitegoods and

<sup>33</sup> FSRC, *Interim Report*, vol 2, 72–3; see also 106–7 and 113–14 concerning unsolicited offers of credit card limit increases.

<sup>34</sup> 2019 Banking Code cl 49.

furniture through point-of-sale exceptions to the NCCP Act. They must be dealt with separately.

## 2.1 Home lending through mortgage brokers

As I said in the *Interim Report*, almost every person buying a house in Australia will borrow a large part of the cost. Many Australians have home loans with one of the major lenders.<sup>35</sup> At the time of the *Interim Report*, home loans were, and they remain, the largest asset on the books of **authorised deposit-taking institutions** (ADIs).<sup>36</sup>

The mortgage broking industry is a key distribution channel for home loans, accounting for more than half of all residential home loans settled.<sup>37</sup> Reliance on the broker channel among the larger banks is varied. Approximately 40% of all CBA loans come through the broking channel,<sup>38</sup> while for ANZ the amount is around 55%.<sup>39</sup> Because of their smaller physical branch presence, smaller lenders are more dependent upon brokers to compete in the home loan market.<sup>40</sup> But brokers are not the only means by which smaller banks deal in that market. Most home loans made by Bendigo and Adelaide Bank are made through the bank's network of community owned branches.<sup>41</sup> The branch receives a share of the revenue produced by the loan.<sup>42</sup> In addition to this, Bendigo and Adelaide Bank lends to 'mortgage managers' who make home loans to customers at a rate higher than the rate charged to the manager by the bank.<sup>43</sup>

Consideration of lending arranged through mortgage brokers must begin by recognising two facts. First, borrowers look to mortgage brokers for advice about how to finance what is, for many borrowers, the most valuable asset

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<sup>35</sup> FSRC, *Interim Report*, vol 1, 30.

<sup>36</sup> FSRC, *Interim Report*, vol 1, 30.

<sup>37</sup> FSRC, *Interim Report*, vol 1, 32.

<sup>38</sup> Transcript, Matthew Comyn, 19 November 2018, 6558.

<sup>39</sup> Transcript, Shayne Elliott, 28 November 2018, 7281.

<sup>40</sup> ACCC, *Residential Mortgage Price Inquiry Final Report*, November 2018, 10, 58.

<sup>41</sup> Transcript, Robert Johanson, 29 November 2018, 7381.

<sup>42</sup> Transcript, Robert Johanson, 29 November 2018, 7381.

<sup>43</sup> Transcript, Robert Johanson, 29 November 2018, 7381.

they will buy in a single transaction.<sup>44</sup> And brokers not only give advice about what they think is best for the borrower, they submit the loan application on the borrower's behalf and, to the extent the terms are negotiable, negotiate the terms of the loan for the borrower.

Second, as already noted, it is not easy to determine for whom a mortgage broker acts. The lender pays the broker, not the borrower. Typically, the lender pays a commission, both an upfront commission and a **trail commission**.<sup>45</sup> For the lender, the broker is a channel for distributing the lender's products including, but not always limited to, the lender's home loan products. The lender seeks to foster relationships with brokers that will encourage the broker to recommend that lender's products. The lender seeks to treat the broker as *its* broker, and have the broker treat it as the broker's preferred lender. Yet, at the same time, the lender provides in its contracts with brokers and **mortgage aggregators** that they act for the borrower, not the lender.<sup>46</sup>

Not only do borrowers look to mortgage brokers for advice about mortgages, the brokers themselves and the Mortgage and Finance Association of Australia (MFAA, an industry association) publicly emphasise both the skills and help that brokers can offer to clients in securing the best outcome for the client.<sup>47</sup> As ASIC reported in March 2017, the three main reasons consumers then gave for using a mortgage broker were to 'Access a wider range of loans', to 'Get a better interest rate/deal', and because the 'Broker is knowledgeable/an expert'.<sup>48</sup>

Yet, despite brokers playing this advisory role, the *Corporations Act 2001* (Cth) (the Corporations Act) provisions about providing financial product advice to retail clients do not apply to giving advice about a residential home loan. Those provisions do not apply because a mortgage that secures

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<sup>44</sup> See Transcript, Matthew Comyn, 19 November 2018, 6561; Transcript, Shayne Elliott, 29 November 2018, 7338.

<sup>45</sup> FSRC, *Interim Report*, vol 1, 32.

<sup>46</sup> FSRC, *Interim Report*, vol 1, 57.

<sup>47</sup> See, eg, MFAA, *Your Broker Behind You* (20 December 2018) MFAA <[www.mfaa.com.au/yourbrokerbehindyou](http://www.mfaa.com.au/yourbrokerbehindyou)>.

<sup>48</sup> ASIC, Report 516, 16 March 2017, 176.

obligations under a credit contract (not otherwise expressly included by operation of some particular sections of Chapter 7 of the Corporations Act) is not a ‘financial product’ for the purposes of Chapter 7 of the Act.<sup>49</sup> Hence, making a recommendation or stating an opinion about a mortgage is not giving ‘financial product advice’.<sup>50</sup> And it is not considered to be personal advice, even though the broker would be expected to consider the borrower’s objectives, financial situation and needs.<sup>51</sup> It follows that the best interests duty that the Corporations Act imposes on those who provide personal advice to a retail client<sup>52</sup> does not apply to a mortgage broker.

Internal papers prepared by CBA when the Sedgwick Review<sup>53</sup> was considering broker and other remuneration compared the fees received by a mortgage broker with the fees charged by a financial adviser for personal financial advice to a retail client. The fees charged by a broker were said to be higher than the fees charged for financial advice (the figures quoted were about \$6,600 compared with \$2,300).<sup>54</sup> No doubt the two tasks differ. The financial adviser must reduce the advice to writing, as a Statement of Advice; the broker need not. The broker will take the information provided by the client and turn that into a loan application that the broker will submit. But the difference between the fees is striking. And it is all the more striking when it is recalled, as it must be, that home loans are not complicated financial products.

For the purposes of the NCCP Act, a mortgage broker who suggests a particular home loan, or helps a borrower obtain the loan, will be a ‘credit assistance’ provider, a ‘credit representative’, or a ‘representative’ of the credit licensee that will be the lender.<sup>55</sup> A mortgage broker thus engages

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<sup>49</sup> Corporations Regulations 2001 (Cth) reg 7.1.06(1)(f).

<sup>50</sup> Corporations Act s 766B(1).

<sup>51</sup> Corporations Act s 766B(3).

<sup>52</sup> Corporations Act Pt 7.7A Div 2.

<sup>53</sup> An independent review into remuneration practices in retail banking commissioned by the ABA in 2016. The Sedgwick Review is considered further in the chapter on culture, governance and remuneration.

<sup>54</sup> Exhibit 7.15, 12 April 2017, Email Comyn to Narev, 3 [4.3.1]; Transcript, Matthew Comyn, 19 November 2018, 6579–85.

<sup>55</sup> NCCP Act ss 8, 64 and Pt 2-3.

in a credit activity and must hold an **Australian Credit Licence** (ACL) or be an employee or credit representative of a mortgage aggregator (or other entity) that holds an ACL.<sup>56</sup> The holder of an ACL must do all things necessary to ensure that the credit activities authorised by the licence are engaged in efficiently, honestly and fairly, and they must have in place ‘adequate arrangements to ensure that clients ... are not disadvantaged by any conflict of interest that may arise wholly or partly in relation to credit activities engaged in by the licensee or its representatives’.<sup>57</sup> But if a broker does suggest a particular home loan to a borrower, the broker is not bound by a statutory best interests duty.<sup>58</sup> Is there then a gap between what a borrower *expects* a broker to do and what a borrower can *require* the broker to do? If there is a gap, does it matter? That must be determined in light of the ways in which the broker channel of home loan origination has been shown to be operating. Two particular matters should be noted: first, the nature and extent of misconduct identified in the course of the Commission’s work and second, what is known about outcomes for customers whose home loans have been arranged through an intermediary.

### 2.1.1 Misconduct

Use of any intermediary, be it an introducer, a mortgage broker or a mortgage aggregator, means that there is an additional level at which the intended relationship between lender and borrower can be distorted in some way. The lender is isolated, even insulated, from what the intermediary does with the borrower.<sup>59</sup> The intermediary may pass on information to the lender that is wrong; the intermediary may join forces with either the would-be borrower or with one or more employees of the lender to deceive the lender. Examples of these kinds of conduct were examined in the Commission’s work and are the subject of case studies discussed in the *Interim Report*.<sup>60</sup>

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<sup>56</sup> NCCP Act s 29.

<sup>57</sup> NCCP Act s 47(1)(a) and (b).

<sup>58</sup> I say ‘statutory’ best interests duty because there may be cases where the general law would impose a duty on a broker to act in the interests of, and only in the interests of, the intending borrower. But that would depend entirely on the facts of the particular case.

<sup>59</sup> FSRC, *Interim Report*, vol 2, 24.

<sup>60</sup> FSRC, *Interim Report*, vol 2, 1–14, 16–32, 32–41, 43–51.

Cases where the use of a broker (or other intermediary) results in the lender receiving incomplete or false information on which to assess the proposed loan are of most immediate relevance.

When the Commission first took evidence about these issues in March 2018, it was evident that in many cases brokers assembling information about a loan applicant's financial situation either did not make sufficient inquiries, or did not seek sufficient verification of what they were told, about these matters.<sup>61</sup> The fact that so many home loan applications then proceeded with the lender assuming that the borrower's living expenses were equal to the HEM, not as the borrower declared them to be, could lead only to the conclusion that the broker had not taken effective steps to inquire about the borrower's expenses or to verify the expense information the borrower had given.

The fact that the broker is paid only if a loan application succeeds stands as an obvious motive for that kind of conduct. It is in the broker's financial interests to have the lender approve the loan. And, as both the NAB Introducer home loans and the Aussie Home Loans broker misconduct case studies showed, payments by banks to intermediaries have induced some to engage in other forms of dishonest conduct.

Since the Commission took evidence on these matters, lenders have changed their processes and procedures to capture the financial situation of loan applicants more accurately. I am not able to say how effective those changes have been. NAB has reduced the numbers of 'introducers' it uses.<sup>62</sup> CBA is selling the Aussie Home Loans business.<sup>63</sup> But the financial incentive (being paid commission by the lender) for brokers to secure approval of home loan applications remains. And because the amount paid varies with the amount of the loan, it is an incentive to brokers to have the borrower take as large a loan as the borrower can afford, regardless of whether the borrower needs to borrow, or is wise to borrow, that sum.

Even when the amount of commission paid, and to be paid, to the broker is disclosed, the immediate sting of the payment is not felt by the borrower

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<sup>61</sup> See, eg, FSRC, *Interim Report*, vol 2, 24–6.

<sup>62</sup> Exhibit 7.80, Witness statement of Andrew Thorburn, 19 November 2018, 10 [32(a)].

<sup>63</sup> Transcript, Matthew Comyn, 19 November 2018, 6560.

because it is the lender that pays the commission. On reflection, the borrower may recognise that the cost of commission, like all other costs of the lender, will affect the price that is charged for the loan. But there is not that immediate and direct connection that would be observed if the fees charged by the broker for the work done were charged to the borrower, either directly or by paying the fees out of the amount borrowed.

### 2.1.2 Customer outcomes

In the *Interim Report*, I noted what CBA, Australia's largest home lender, had said to the Sedgwick Review, and what had been found by ASIC, about broker remuneration driving undesirable customer outcomes.<sup>64</sup>

In its submission to the Sedgwick Review in February 2017, CBA said that 'the use of loan size linked with upfront and trail commissions for third-parties, can potentially lead to poor customer outcomes'.<sup>65</sup>

In its March 2017 report, ASIC found that:

- broker loans were reliably associated with higher leverage, even for customers with an identical estimate of risk;
- loans written through brokers have a higher incidence of interest-only repayments, have higher debt-to-income levels, higher loan-to-value ratios and higher incurred interest costs compared with loans negotiated directly with the bank; and
- over time, higher leverage means broker customers have an increased likelihood of falling into arrears, pay down their loans more slowly and on average pay more interest than customers who dealt directly with the bank.<sup>66</sup>

ASIC's findings were consistent with, indeed appear to have been based on, work CBA had done in October and November 2016 looking into consumer outcomes for borrowers who used brokers. CBA made a five-year longitudinal study of those outcomes and presented the results of that work

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<sup>64</sup> FSRC, *Interim Report*, vol 1, 59–60.

<sup>65</sup> FSRC, *Interim Report*, vol 1, 60.

<sup>66</sup> ASIC, Report 516, 16 March 2017, 14 [51]–[52].

to ASIC.<sup>67</sup> These consequences are consistent not only with value-based commissions driving the results observed, but also with the payments being made by *lenders* rather than borrowers driving the results. If there are other causes of the results, they are, at least, less obvious.

Value-based commissions paid by lenders to mortgage brokers are a form of **conflicted remuneration**. That is, value-based commissions are a form of remuneration that can reasonably be expected to influence the choice of mortgage, the amount to be borrowed, and the terms on which the amount is borrowed. The evidence from CBA showed that the size of commissions has an effect on which lender the broker recommends to the borrower.<sup>68</sup> The size of commissions also affects the size and terms of the loan. On their face, the outcomes demonstrated by CBA's work and described in their submission to the Sedgwick Review, and confirmed by ASIC, constitute the realisation, in fact, of the expected effect.

It is evident that, after CBA had made its study of customer outcomes, it gave very close consideration to changing the terms on which it would offer to deal with brokers. In his then capacity as head of Retail Banking Services within CBA, Mr Comyn was on the edge of announcing a change to a fixed fee model, paid by the lender, but did not proceed.<sup>69</sup> He decided that other lenders would not follow CBA's lead without regulatory compulsion, and that, if CBA changed, it would suffer commercial detriment (by losing custom from brokers) for no real benefit for consumers.<sup>70</sup>

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<sup>67</sup> Exhibit 7.10, November 2016, CBA Slide Pack of November 2016 Concerning Customer Outcomes; Exhibit 7.11, November 2016, CBA Slide Pack Customer Outcomes Update of November 2016; Exhibit 7.12, 31 October 2016, Memorandum of Commonwealth Executive Committee and Slide Pack of October 2016; Transcript, Matthew Comyn, 19 November 2018, 6563–5.

<sup>68</sup> Exhibit 7.10, November 2016, CBA Slide Pack of November 2016 Concerning Customer Outcomes; Exhibit 7.11, November 2016, CBA Slide Pack Customer Outcomes Update of November 2016; Exhibit 7.12, 31 October 2016, Memorandum of Commonwealth Executive Committee and Slide Pack of October 2016; Transcript, Matthew Comyn, 19 November 2018, 6563–5.

<sup>69</sup> Transcript, Matthew Comyn, 19 November 2018, 6585.

<sup>70</sup> Transcript, Matthew Comyn, 19 November 2018, 6585.

### 2.1.3 More recent changes

After CBA made its submission to the Sedgwick Review and the report of that review was published, and after ASIC published its report about broker remuneration, the Combined Industry Forum (CIF), composed of industry bodies and financial services entities, considered, and published reports about, changing broker remuneration. And the submissions made to the Commission in response to the *Interim Report* have also considered these issues.

In December 2017, the CIF released a report setting out reforms to broker remuneration agreed upon by its members.<sup>71</sup> The changes included paying commissions based on the amount of funds actually drawn down by a customer (rather than the size of the loan approved), ceasing volume and campaign-based commissions, limiting the value and availability of rewards such as entertainment and overseas trips, and developing a mortgage broking industry code.<sup>72</sup>

In July 2018, the CIF reported that its members had eliminated volume-based commissions and mooted the adoption of a ‘customer first’ duty.<sup>73</sup> These proposals reflected some, but not all, of the recommendations the Productivity Commission had made about broker remuneration in its report on competition in the Australian financial system.<sup>74</sup>

As I said in the *Interim Report*, the CIF reforms announced are limited. While the perverse incentives created by volume-based commissions, which reward brokers for the number of customers placed with a lender, are to be removed, upfront and trail commissions based on loan value will remain. While basing those commissions on funds *drawn down* will remove an incentive for brokers procuring a loan larger than the borrower will *use*,

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<sup>71</sup> CIF, *Response to ASIC Report 516*, December 2017.

<sup>72</sup> CIF, *Response to ASIC Report 516*, December 2017, 4–5.

<sup>73</sup> CIF, *Working Towards a Better Mortgage Broking Industry for Customers*, July 2018, 12, 18.

<sup>74</sup> Productivity Commission, Report 89, 29 June 2018, 331. The Commission recommended: banning trail commissions; requiring upfront commissions to be based on funds drawn; banning volume-based commissions and payments and campaign-based commissions; and limiting the clawback period to two years.

the change will not deal with the more basic problem of borrowers being encouraged to borrow more than they *need*.<sup>75</sup>

Nor has it been made clear what would be the content of a ‘customer first’ duty. On its face, it appears to differ from the duty to act in the best interests of the client that the Corporations Act imposes on financial advisers. Rather, it appears to be a duty to give preference to the client’s interests in cases where the client’s interests and the broker’s interests do not coincide. That is an obligation, however, that is markedly narrower than a best interests duty. And it has not been explained why the duty a mortgage broker owes to a borrower should differ from the duty a financial adviser owes to a retail client.<sup>76</sup>

Further, the reforms proposed by the CIF would not alter the basic structure of brokers’ remuneration – lenders paying value-based upfront and trail commissions in respect of loans made. It is those elements of the structure that drive poor customer outcomes.

It is important to recognise, as the Productivity Commission has in its report on competition in the Australian financial system, that ‘a credible rationale based on consumer interests for the structure of broker remuneration’ has not been identified.<sup>77</sup> Rather, and as the Productivity Commission also said, ‘a particular set of remuneration arrangements [has] become entrenched in the mortgage broking industry as a matter of convention’.<sup>78</sup> Entrenched convention may provide a sufficient explanation for current practice. But, however deeply entrenched may be the convention, it provides no answer to the more fundamental and telling observations: first, that the remuneration arrangements have *no credible rationale* based on consumer interests; and second, that they actually *work against* consumer interests.

Yet ASIC, and others, submitted that ‘it is too early to determine whether these changes to remuneration [suggested by the CIF] go far enough, and

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<sup>75</sup> FSRC, *Interim Report*, vol 1, 62–3.

<sup>76</sup> FSRC, *Interim Report*, vol 1, 63.

<sup>77</sup> Productivity Commission, Report 89, 29 June 2018, 329.

<sup>78</sup> Productivity Commission, Report 89, 29 June 2018, 330.

whether a complete prohibition on conflicted remuneration is necessary'.<sup>79</sup> And both banks and brokers have resisted change<sup>80</sup> even though documents produced to the Commission showed that in recent years, senior and experienced bankers had favoured moving to a system where brokers charged borrowers a fee for the services the broker provided.<sup>81</sup>

Brokers will undoubtedly say that the views of the bankers should be discounted. It will be said that bankers are doing no more than trying to advance the interests of banks; however, the same proposition can be applied with no less force to the views of brokers. Arguments for or against change should all be approached with a proper degree of scepticism. And, when viewed in that light, I consider that the arguments for change are compelling.

In discussing those arguments for change it is useful to begin by considering trail commissions.

## 2.2 Trail commissions

Trail commissions are valuable to brokers and brokerage businesses. Because they are valuable, brokers and brokerage businesses resist any change to trail commissions. But it is necessary to look not only at how trail commissions are valuable to those that receive them, but *why* they are valuable to both the party receiving the payments and the party making them.

The chief value of trail commissions to the recipient, to put it bluntly, is that they are money for nothing.

Why should a broker, whose work is complete when the loan is arranged, continue to benefit from the loan for years to come? It cannot be that they are deferred payment of fees earned earlier when the amount paid as trail depends upon the length of the life of the loan. And it cannot be that they

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<sup>79</sup> ASIC, Interim Report Submission, 29 [129].

<sup>80</sup> See, eg, Finance Brokers Association of Australia, Interim Report Submission, 1–2, 11–12; Mortgage Choice, Interim Report Submission, 9–10; Aussie Home Loans, Module 1 Policy Submission, 6–7; Westpac, Interim Report Submission, 8–9; Regional Banks, Interim Report Submission, 15–17; NAB, Interim Report Submission, 49 [205].

<sup>81</sup> Exhibit 7.9, October 2016, Emails between Comyn and Narev, 4.

are a fee for providing continuing services given there is no obligation for the broker to do so and no evidence of it being done.<sup>82</sup>

It is said that trail commissions stand as an incentive for brokers not to 'switch' borrowers in and out of different mortgage arrangements. It is said that the payment of trail commissions somehow keeps the broker 'in touch' with the borrower. But how and why the payment of trail commission is *necessary* to achieving either of these results has not been satisfactorily explained. Problems arising from unnecessary 'switching' or 'churning' of home loans are more effectively addressed by providing for 'clawback' of commissions or fees (repayment of commissions or fees if the borrower defaults, or the loan is paid out within a short period). In this connection, **I note, and if commission payments were to remain, I would support, the recommendation made by the Productivity Commission to prohibit commission clawbacks from being passed on to borrowers.**<sup>83</sup>

As the Aussie Home Loans broker misconduct case study showed, brokers are astute to do nothing that will interfere with the continued flow of trail commissions.<sup>84</sup> Why would they? In the examples considered in that case study, possible adverse effects on borrowers were not seen as reason enough to risk disturbing the overall flow of trail commissions by asking whether the misconduct identified in relation to particular loans might have occurred in connection with other loans the broker had negotiated.<sup>85</sup>

On the other side of the ledger, the chief value of trail commissions to the lenders that pay them is that they represent another force binding the broker to the lender. Their payment contributes to the lenders being able to treat brokers as the lenders' sales channel. As the Productivity Commission found, 'trail commissions have the effect of aligning the broker's interests with those of the lender, rather than those of the borrower'.<sup>86</sup> I agree. It is unsurprising, then, that lenders would not want to be seen as standing apart from industry practice by advocating some change to existing arrangements.

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<sup>82</sup> Productivity Commission, Report 89, 29 June 2018, 42, 328.

<sup>83</sup> Productivity Commission, Report 89, 29 June 2018, 331.

<sup>84</sup> FSRC, *Interim Report*, vol 2, 40–2.

<sup>85</sup> FSRC, *Interim Report*, vol 2, 40–1.

<sup>86</sup> Productivity Commission, Report 89, 29 June 2018, 329.

## 2.3 Best interests duty

If, *in practice*, brokers were to act in the best interests of borrowers, poor customer outcomes of the kinds identified by CBA in its submissions to the Sedgwick Review, and by ASIC in its March 2017 report, would be reduced. If, *in practice*, brokers were to act in the best interests of borrowers, there would be fewer cases where brokers act in ways that see lenders given wrong or incomplete information about the financial situation of loan applicants. (I emphasise the words ‘in practice’ because it will later be necessary to look at what can reasonably be expected to occur.) But the first, and in my view essential, step to take is to bring the law into line with what consumers expect. They expect brokers to act in their best interests. Brokers should be obliged to do so.

I consider that the law should be amended to provide that, when acting in connection with home lending, mortgage brokers must act in the best interests of the intending borrower.

As ASIC submitted, the content of the duty is best expressed ‘as a broad statement of principle’.<sup>87</sup> ASIC’s proposed drafting of the obligation as ‘to act in the best interests of the consumer [I might prefer ‘loan applicant’] in the selection and arranging of loans’ goes a long way to capturing the heart of the relevant ideas.<sup>88</sup>

Imposing this obligation would give statutory recognition to what borrowers currently expect of brokers. It is not an obligation that should affect the practices of lenders and, accordingly, it is not a change that should affect the price or the availability of credit, whether to consumers, small business borrowers or others. Nor should the obligation apply to aggregators, who have no direct relationship with the borrower and play no role in the selection or recommendation of the loan.<sup>89</sup>

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<sup>87</sup> ASIC, Interim Report Submission, 29 [130].

<sup>88</sup> ASIC, Interim Report Submission, 29 [130].

<sup>89</sup> See, eg, NAB, Interim Report Submission, 49 [208].

The best interests obligation must be enforceable. Because it is a provision of the same kind and quality as the obligations on holders of an **Australian financial services licence (AFSL)** and holders of an ACL – to do all things necessary to ensure that the licensed activities are engaged in ‘efficiently, honestly and fairly’<sup>90</sup> – the best interests obligation should be enforceable by civil penalty. The maximum penalty prescribed should be at the level proposed by the ASIC Taskforce Review.<sup>91</sup>

### Recommendation 1.2 – Best interests duty

The law should be amended to provide that, when acting in connection with home lending, mortgage brokers must act in the best interests of the intending borrower. The obligation should be a civil penalty provision.

## 2.4 Do more?

Many will say that enacting the obligation and then seeing how it operates in practice is all that should now be done in connection with intermediated home lending. It will be argued that to do more than this would be needlessly disruptive. In particular, it will be said that it will diminish the competitive benefits that broker intermediation has introduced into the home loan market by allowing more effective competition from the small to medium lenders whose branch networks are not as extensive as those of the four biggest banks. A further point, made by Mr Shayne Elliott, the CEO of ANZ, was that moving to *borrowers* paying brokers a fee for service may penalise smaller borrowers because, for them, it would be uneconomic to go to a broker.<sup>92</sup>

Three points must be considered.

First, the present system of remunerating mortgage brokers is conflicted remuneration. It can reasonably be expected to influence the broker’s recommendations about choice of lender, amount to be borrowed, and

<sup>90</sup> NCCP Act s 47(1)(a); Corporations Act s 912A(1)(a).

<sup>91</sup> ASIC Taskforce Review, Final Report, December 2017, 58.

<sup>92</sup> Transcript, Shayne Elliott, 29 November 2018, 7339–41.

terms on which the amount is borrowed. And the influence is in favour of the party paying the commission – that is, the lender.<sup>93</sup>

Second, as already noted, a borrower who engages a mortgage broker looks to the broker for advice. The advice the borrower wants is what the broker thinks will be best for the borrower. And, if there is scope for negotiation with the lender, the borrower wants the broker to strike the deal that is best for the borrower. In all these activities, the borrower rightly wants and expects the broker's undivided loyalty. Yet, as has been noted in the introduction to this Report and will be developed in the chapter about financial advice, all too often advisers have preferred their own interests against the interests over clients, despite having an obligation to pursue the best interests of their clients. The evidence given to the Commission showed how often those retained to give financial advice to a client resolved conflicts between their duty to the client and their interests (or the interests of some related entity) in favour of their own financial interests or those of the entity they represent, and against the interests of the client. Advisers facing a conflict between self-interest and duty have too often sought to strike some compromise between the two competing forces rather than, as the law has required, to give priority to the interests of the client or member. That is, a 'good enough' outcome has been pursued instead of the *best* interests of the relevant clients or members. The short answer is: duties do not always overcome human biases, particularly when those biases are subconscious.<sup>94</sup>

All this being so, why would mortgage brokers behave differently? Furthermore, in the face of experience of how the **Future of Financial Advice** (FoFA) reforms have operated, how can it be said that prescribing a best interests duty by itself will have the desired effect?

Third, it is said that changing to a system where the borrower, not the lender, pays the broker would reduce the number of borrowers using brokers. It is said that abolishing trail commissions would adversely affect the profitability, and thus the viability, of brokerage businesses. In either event, it is said that brokers will go out of business and the competitive

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<sup>93</sup> Productivity Commission, Report 89, 29 June 2018, 323.

<sup>94</sup> See Sunita Sah, *FSRC Research Paper: Conflicts of Interest and Disclosure*, 7 November 2018, 6.

pressures that the broker channel introduces into the home lending market will be diminished. In particular, it is said that this will happen because smaller lenders rely on brokers to compete.

There are at least three unspoken premises for these arguments. First, the arguments assume that borrowers do not see, and will not see, enough advantage in using a broker if the remuneration arrangements change in a way that makes the cost of the service apparent, and charge that cost to the borrower. That is, the borrower will not be able to see that the benefit of using a broker outweighs the cost. The Commission was repeatedly told that borrowers like using the services of brokers.<sup>95</sup> At present, in addition to purporting to act for borrowers, brokers are providing a distribution service to lenders and being paid commission by lenders. It would seem to follow that the price paid to brokers reflects the value to the lender of the distribution service provided to the lender rather than the value of the service provided by a broker to the borrower. If borrowers pay a transparent price for the service provided to them then the market will determine that price based on the value of the service to borrowers.

Second, each argument appears to assume that the cost of using the brokerage service cannot be capitalised in the loan and repaid over the life of the loan. The cost that would be capitalised (even if calculated as the amount now paid as upfront commission plus a net present value of the likely income stream from trail commission) would be but a fraction of the amount most borrowers would borrow and would not be an amount likely to affect serviceability requirements or calculations.

Third, the argument assumes that mortgage brokers are contributing significantly to competition in the home loan market. Recent reports raise doubts about this assumption. The Productivity Commission found that while the pro-competitive effects of brokers in the market were significant and obvious in the 1990s, they have since declined.<sup>96</sup> ASIC's report concluded that brokers have the *potential* to play a valuable role as a distribution

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<sup>95</sup> Transcript, Matthew Comyn, 19 November 2018, 6560–1; Exhibit 7.121, Witness statement of Shayne Elliott, 16 November 2018, 24 [147]; MFAA, Interim Report Submission, 5; Loan Market Group, Interim Report Submission, 6–7.

<sup>96</sup> Productivity Commission, Report 89, 29 June 2018, 301.

channel for lenders without a branch network and thus exert downward pressure on home loan pricing by forcing lenders to compete more strongly with each other for business.<sup>97</sup> But ASIC found that remuneration and ownership structures can inhibit the consumer and competition benefits that can be achieved by brokers.<sup>98</sup> ASIC also observed that smaller lenders were less able to access or remunerate brokers than larger lenders.<sup>99</sup> Rather than competing on the basis of who is offering the best product at the best price, lenders are competing on the basis of who can offer higher commissions to aggregators and brokers. And the Australian Competition and Consumer Commission (the ACCC)'s inquiry into Residential Mortgage Pricing found that, while *some* of the seven non-major banks that were considered have a heavy reliance on brokers and aggregators to gain market share,<sup>100</sup> the big four banks focus largely on each other in setting variable interest rates for their main brands and do not appear to have meaningful regard to the pricing decisions of smaller lenders.<sup>101</sup> What is clear from the review is that there are challenges to competition in the home loan market that go beyond distribution.

So long as brokers are seen by borrowers to be acting on their behalf, the problem that present remuneration arrangements are conflicted remains unsolved by the remuneration changes proposed by the CIF.

I therefore recommend steady but deliberate movement towards changing the existing remuneration arrangements for brokers, so that the borrower, not the lender, should pay the mortgage broker a fee for acting in connection with home lending.

Changes in brokers' remuneration should be made over a period of two or three years. I would begin with trail commissions. There should come a time within about 12 or 18 months (no greater precision is possible) when

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<sup>97</sup> ASIC, Report 516, 16 March 2017, 9 [22].

<sup>98</sup> ASIC, Report 516, 16 March 2017, 9 [23].

<sup>99</sup> ASIC, Report 516, 16 March 2017, 17 [72].

<sup>100</sup> ACCC, *Residential Mortgage Price Inquiry Final Report*, November 2018, 10.

<sup>101</sup> ACCC, *Residential Mortgage Price Inquiry Interim Report*, March 2018, 28.  
That finding appears undisturbed by the findings in the ACCC's Final Report:  
ACCC, *Residential Mortgage Price Inquiry Final Report*, November 2018, 50.

lenders are prohibited from paying trail commission to mortgage brokers in respect of new loans. Existing trail commissions would stand unaffected. No doubt, as Mr Robert Johanson, the Chair of Bendigo and Adelaide Bank, emphasised, it would be necessary to distinguish between trail commissions and the revenue-sharing arrangements that Bendigo makes with its community-owned outlets.<sup>102</sup> It is and should remain a matter for the lender to determine whether it shares the revenue it receives from the borrower with another party. But trail commissions are not a share of revenue earned by the lender.

Within a *further* 12 to 18 month period, lenders should be prohibited from paying any other commissions to mortgage brokers. Lest there be any doubt about it, my intention would be that the fee payable to a broker in respect of advising about, procuring or negotiating loans after that date would be payable by the borrower, and, if the lender agrees, could be paid out of the principal sum advanced to the borrower under the loan agreement. How the fee is fixed is best left to the market to determine. It could be a fixed amount, a stepped fee, a value-based fee or some combination.

When mortgage brokers are no longer paid by lenders, it may well be that lenders dealing directly with borrowers should be required to charge a fee to recover the costs that would be avoided if the loan were to be originated through a broker, but which are incurred if originated directly. This would be in order to prevent lenders competing unfairly with brokers. I explain this fee further below.

As noted above, CBA assumed in its internal deliberations that the fee charged by a broker on an average loan was about \$6,600 and would reduce to around \$2,310, in line with the market guidance on the price for complex financial advice.<sup>103</sup> (The assumed rate of commission was 0.6 to 0.7% of loan value.) It should not be assumed, however, that the upfront fee will necessarily be regressive and work to the disadvantage of borrowers of smaller amounts. ANZ's modelling concluded this would happen because if the upfront commission presently paid was paid by the borrower as a flat fee, the cost to the borrower would be higher for any loan less than

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<sup>102</sup> Transcript, Robert Johanson, 29 November 2018, 7381.

<sup>103</sup> Exhibit 7.15, 12 April 2017, Emails Comyn to Narev, 3 [4.3.1].

\$419,000 (approximately).<sup>104</sup> This was based on ANZ's current commission rate of around 0.55% and a hypothetical flat fee of \$2,302. But this ignores the fact that brokers currently provide their services in respect of smaller loans for an upfront payment that is, on average, significantly less than \$2,302. Based on ANZ's figures, brokers earned around \$550 upfront for a loan of \$100,000. In any case, this figure reflects the value of the broker to the lender as distributor. It does not reflect the value of the service to the borrower.

Changes of the kind that I have described above were introduced in the Netherlands in 2013. The mortgage broking industry continued without significant adverse consequences to its own operations, the market generally or individual participants. Mortgage brokers offered different remuneration arrangements including charging an hourly rate for advice and flat fees.<sup>105</sup> Furthermore, to 'create a level playing field' between direct and intermediated lending, lenders were required to identify their costs of providing advice and other services to borrowers who did not use a broker and expressly charge a fee to recover those costs from those borrowers.<sup>106</sup>

There is, therefore, readily available experience to be drawn on to move to a mortgage broking system where borrowers who choose to use a broker pay the broker a fee for the service. The result would be that within a period of two to three years brokers would no longer receive conflicted remuneration. No longer would the remuneration arrangements within the industry be such as can reasonably be expected to influence the choice of lender, the amount to be borrowed, or the terms on which the amount is borrowed.

Changes of the kind I propose will give brokers the incentive to give borrowers value for money. In particular, the changes will induce brokers to search out the best deals available. To do that, they will have to look beyond the entities with which they may have become accustomed to dealing. And brokers will also have the incentive to offer, or continue to offer, services that borrowers cannot derive from the direct lending channel and for which borrowers are willing to pay.

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<sup>104</sup> Exhibit 7.158, 7 December 2018, Letter from Shayne Elliott to Commissioner Hayne, 1.

<sup>105</sup> ASIC, Report 516, 16 March 2017, 45 [222].

<sup>106</sup> See Background Paper No 30, 25.

I acknowledge that the changes I propose are significant. They are responsive to the current state of the residential mortgage market. But the residential mortgage market is constantly changing and will change further as a result of what I have proposed. It is important that adjustments can be made as the market continues to evolve.

A Treasury-led working group should be established to monitor the changes and make adjustments as necessary. That group should include representatives of the ACCC and APRA. The working group should pay particular attention to:

- the effect of the changes on interest rates;
- the effect of the changes on competition between lenders;
- the effect of the changes on competition between lenders and brokers; and
- developments in the residential mortgage market that mean that the changes that I have proposed should be re-evaluated.

As I have indicated, it may be that to create a level playing field between banks and brokers, banks should be required to charge a fee to direct customers based on the costs that are incurred by the bank when there is no broker. I recognise that suggesting that banks charge an additional fee will be difficult for some to understand. But, if brokers are to charge a fee for their services, then it may be necessary for the purposes of maintaining competition, for banks also to be required to do so when directly originating a loan. The fee should reflect no more than the costs incurred by the bank when originating a loan without the assistance of a broker. If only brokers end up charging a fee, customers may cease to use their services, which would eliminate any potential benefit that brokers can have on competition in the residential mortgage market. Both the fee charged by the broker and the fee charged by the bank should be able to be capitalised into the loan.

Although I have explained what I think may well be necessary in order to create a level playing field, this is a matter that ought to be considered by the Treasury-led working group and should form part of their consideration of the effect of the changes on competition between lenders and brokers.

Assuming that such a fee is required, the Treasury-led working group or the ACCC should be responsible for monitoring the fees set by banks and ensuring that they charge no more than the additional cost to the bank of making a loan to the borrower through its proprietary lending channel rather than through a broker.

I expect that new forms of intermediation will emerge in the home lending market. For example, I expect that comparison and transaction sites of the kind now so familiar in connection with travel and accommodation may become more common. The ACCC's survey of residential mortgage borrowers found an increase in borrower preferences for online residential mortgage applications, suggesting that online originations may become more important in future.<sup>107</sup> As I have said above, as these changes occur in the market, it will be for the working group to assess whether the new model requires adjustment.

### **Recommendation 1.3 – Mortgage broker remuneration**

The borrower, not the lender, should pay the mortgage broker a fee for acting in connection with home lending.

Changes in brokers' remuneration should be made over a period of two or three years, by first prohibiting lenders from paying trail commission to mortgage brokers in respect of new loans, then prohibiting lenders from paying other commissions to mortgage brokers.

### **Recommendation 1.4 – Establishment of working group**

A Treasury-led working group should be established to monitor and, if necessary, adjust the remuneration model referred to in Recommendation 1.3, and any fee that lenders should be required to charge to achieve a level playing field, in response to market changes.

## **2.5 Brokers as advisers**

There is a further issue to consider. But none of the recommendations made so far depends upon how this final issue is considered or resolved.

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<sup>107</sup> ACCC, *Residential Mortgage Price Inquiry Final Report*, November 2018, 58.

That is, implementation of the other changes that have been proposed does not depend on, and should not be delayed by, debate about this further issue.

The further issue to be considered is presented by the very point at which the debate about mortgage brokers begins. Consumers go to mortgage brokers for advice. The advice the consumer seeks is about what ordinary parlance would see as a financial product – a secured home loan. And the transaction about which the consumer seeks advice is very important to the consumer. For many it will be the most important and the most expensive capital acquisition they make.

Why not regulate mortgage brokers in precisely the same way as any other person who is to provide personal advice to a retail client? Why not treat mortgage brokers as financial advisers?

I know that doing this would bring with it the requirement to provide written statements of advice. I know that it would bring with it the educational requirements expected of other financial advisers.

But what reasonable answer can be given to the observation that the special and distinct treatment of mortgage brokers is no more than yet another carve out from, or exception to, generally applicable rules stated in the law because they are seen as necessary to the proper conduct of provision of financial services in Australia? None is evident to me. I consider that **after a sufficient period of transition, mortgage brokers should be subject to and regulated by the law that applies to entities providing financial product advice to retail clients.**

Before leaving this topic, I make two further observations about bringing the framework for mortgage brokers into line with that for financial advisers.

The first observation relates to the steps that a lender or aggregator should take after identifying that a mortgage broker has engaged in misconduct. Consistently with what I say in the chapter concerning financial advice, when a lender or aggregator detects that a broker has engaged in misconduct in respect of a particular loan, it should always take steps to assess whether the broker may have acted poorly in respect of other loans. The evidence before the Commission showed that entities have not always done this. The result is that the damage done by a broker may not come to light until long after the event. That works to the detriment of both the

affected clients and the entity itself. It is necessary in principle, and better in practice, for lenders and aggregators discovering misconduct by a broker to make whatever inquiries are reasonably necessary to determine the nature and full extent of the broker's conduct. Where there is sufficient information to suggest that a broker has acted poorly, any customer affected by that misconduct should be told and remediated promptly.

The second observation relates to what is sometimes termed the 'rolling bad apples' phenomenon. In the chapter of this Report dealing with financial advice, I make two recommendations about financial advisers. In short, they are that:

- compliance with the Australian Banking Association (ABA)'s reference checking and information-sharing protocol for financial advisers (or, at least, substantially similar requirements) should be mandatory for all AFSL holders whose licence authorises the provision of financial advice; and
- the reporting of 'serious compliance concerns' by AFSL holders to ASIC should be formalised, and licensees should be required to report such concerns to ASIC on a quarterly basis.

In my view, similar requirements should apply to mortgage brokers.

### **Recommendation 1.5 – Mortgage brokers as financial advisers**

After a sufficient period of transition, mortgage brokers should be subject to and regulated by the law that applies to entities providing financial product advice to retail clients.

### **Recommendation 1.6 – Misconduct by mortgage brokers**

ACL holders should:

- be bound by information-sharing and reporting obligations in respect of mortgage brokers similar to those referred to in Recommendations 2.7 and 2.8 for financial advisers; and
- take the same steps in response to detecting misconduct of a mortgage broker as those referred to in Recommendation 2.9 for financial advisers.

## 2.6 Aggregators

It is important to recognise that many mortgage brokers interact with lenders through aggregators. Aggregators provide services to brokers, such as access to administrative support and information technology systems. They also operate as a single point of contact between large numbers of brokers and particular lenders. In this way, they also provide a service to lenders. Aggregators are currently remunerated by commissions paid by lenders, part of which is typically passed on to brokers.

Under the proposed model, this form of remuneration should not continue.

**If brokers value the service provided to them by an aggregator, they should pay the aggregator a fee for that service. If lenders value the service provided to them by an aggregator, they too should pay the aggregator a fee for that service. The market should determine those fees. The Treasury-led working group should monitor the activities of aggregators under the new model.**

## 2.7 Introducers

Before leaving the topic of intermediated home lending, I should say something about introducers.

As I noted in the *Interim Report*, at a practical level, introducers are more clearly the face of the lender than the borrower.<sup>108</sup> Under the law, introducers must comply with certain requirements, including that they do no more than refer the potential borrower to the lender and facilitate the borrower making contact with the lender.<sup>109</sup> Introducers have an obligation to disclose to a potential borrower any benefits, including commissions, that the introducer may receive for the referral.<sup>110</sup> The effect of the current regime is that introducers are not permitted to be involved in the credit application or assessment process.

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<sup>108</sup> FSRC, *Interim Report*, vol 1, 57.

<sup>109</sup> National Consumer Credit Protection Regulations 2010 (Cth) (the NCCP Regulations) regs 25(2)(a), 25(2A)(a).

<sup>110</sup> NCCP Regulations reg 25(2)(b).

**Introducers must only act within the confines of their prescribed role. Entities must have systems in place to ensure that introducers do not exceed this role. And entities should not regard the role of the introducer as modifying their own responsible lending obligations.**

If introducers and entities behave in this way, introducer programs are not incompatible with responsible lending obligations.

### 3 Intermediated auto lending and associated issues

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Consumers making large purchases, such as motor vehicles, whitegoods, or furniture, may borrow money in order to pay the price. Often the application for credit is made at the point of sale, not at the lender's premises. The person with whom the consumer deals at the point of sale is not subject to the NCCP Act.<sup>111</sup> Retail dealers, like car dealers, are entitled to, and do, act as agents for lenders without holding an ACL.<sup>112</sup> Under the point-of-sale exceptions to the NCCP Act, many car dealers (and some retailers), without holding an ACL, have offered loans to consumers to be provided by a lender.<sup>113</sup> Retail dealers acting in this way are sometimes referred to as 'vendor introducers'.

The case studies examined by the Commission showed three kinds of relevant conduct leading to adverse outcomes for the borrower, or at least, a lender making a loan that was not properly shown to be 'not unsuitable' for the borrower:

- the use of so-called 'flex commissions';
- lenders relying on the retail dealer to provide accurate information about the borrower's financial situation; and
- lenders capitalising the cost of 'add-on insurances' in the amount lent.

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<sup>111</sup> NCCP Regulations reg 23.

<sup>112</sup> Background Paper No 4, 23

<sup>113</sup> Exhibit 1.158, Witness statement of Michael Saadat, 5 March 2018, 2 [11], 23 [128]; Background Paper No 4, 23.

### 3.1 Flex commissions

I discussed the use of flex commissions in the *Interim Report*.<sup>114</sup> As I recorded there, under that kind of arrangement, the lender fixed a base rate of interest that would be charged under the loan agreement. If the dealer could persuade the borrower to agree to pay a higher rate, the dealer received a large part of the interest payable over and above the base rate. In more recent times, lenders provided that the agreed rate must not exceed a rate fixed by the lender but, below that cap, the dealer was free to offer a loan on behalf of the lender at a rate greater than the base rate fixed by the lender.

Many borrowers knew nothing of these arrangements. Lenders did not publicise them; dealers did not reveal them. The dealer's interest in securing the highest rate possible is obvious. It was the consumer who bore the cost. To the borrower, the dealer might have appeared to be acting for the borrower by submitting a loan proposal on behalf of the borrower. The borrower was given no indication that in fact the dealer was looking after its own interests rather than acting as a mere conduit between lender and borrower. For all the borrower knew, the interest rate the dealer quoted had been fixed by the lender. But, whenever the dealer quoted a rate larger than the base rate, the dealer was acting in its own interests.

Since 1 November 2018, flex commissions have been banned.<sup>115</sup> But, because at least one large lender, Westpac, was continuing to offer flex commission arrangements to car dealers when the Commission looked at these matters in March 2018, there will be many car loan contracts on foot where the interest rate being charged will be above whatever rate the lender fixed at the time as its base rate.

Until 1 November 2018, the conduct was not unlawful. It was conduct that Westpac accepted could create unfairness in individual transactions.<sup>116</sup> But despite recognising this to be so, Westpac considered that it could

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<sup>114</sup> FSRC, *Interim Report*, vol 1, 63–4.

<sup>115</sup> ASIC Credit (Flexible Credit Cost Arrangements) Instrument 2017/780 (Cth).

<sup>116</sup> FSRC, *Interim Report*, vol 2, 89; Westpac, Module 1 Case Study Submission, 9 [41].

not stop the practice because doing that ‘would simply leave the market to others who did not’.<sup>117</sup>

Flex commissions stand as one of the starker examples of changes to practices in the financial services industry – even changes seen by important industry participants as desired and desirable – foundering on the rock of first-mover disadvantage. There are times, and this was one, where regulatory intervention was necessary to achieve change.

### 3.2 Relying on the retail dealer

Lenders relied, and continue to rely, on retail dealers submitting completed loan applications that give accurate information about the applicant’s financial situation and sufficient means for the lender to verify the applicant’s financial situation. Often, the retail dealer will not make the underlying sale unless the loan is approved. The dealer thus has a strong reason to portray the loan applicant’s financial situation in a way that will warrant loan approval. On this matter the case studies showed that dealers did not, and it can safely be assumed, do not now, always record the true position.

Yet the lender must meet its obligations under the NCCP Act, regardless of whether it has sub-contracted some or all of the steps to a retail dealer and regardless of whether its contract with the dealer obliges the dealer to do these things on pain of termination of the dealership.

As the Productivity Commission has noted, when the NCCP Act was introduced in 2009, the Government said that it would review the exemption of retailers within 12 months.<sup>118</sup> In 2013, Treasury announced a review of the exemptions for retail dealers (in its terms, vendor introducers), released a discussion paper and sought submissions.<sup>119</sup> The discussion paper proposed three options for consideration:<sup>120</sup>

- maintaining the status quo;

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<sup>117</sup> Westpac, Module 1 Case Study Submission, 10 [45]; FSRC, *Interim Report*, vol 2, 90.

<sup>118</sup> Productivity Commission, Report 89, 29 June 2018, 432.

<sup>119</sup> Treasury, *The Exemption of Retailers from the National Consumer Credit Protection Act 2009*, January 2013.

<sup>120</sup> Treasury, *The Exemption of Retailers from the National Consumer Credit Protection Act 2009*, January 2013, 2.

- requiring retail dealers to comply with the NCCP Act; or
- modifying the application of the obligations in the NCCP Act, according to the functions they are performing, so that retail dealers who are more actively involved in product selection and delivery would be subject to a higher level of regulation:
  - retail dealers acting as a broker would be required to hold an ACL or be appointed as a credit representative by an ACL holder;
  - retail dealers who act only on behalf of a single financier or under first or second choice arrangements would be subject to modified and limited regulation under the NCCP Act; and
  - retail dealers who have a role in product selection but have a limited role in arranging finance would be subject to different modified regulation under the NCCP Act.

As the 2013 Treasury discussion paper said, the exemption of retail dealers under the NCCP Act has several consequences:<sup>121</sup>

- they are not subject to entry or conduct standards and ASIC has no power to exclude from the market any who engage in conduct that is dishonest or incompetent;
- they have no responsible lending obligations; and
- consumers may be unable to obtain remedies for their conduct.

Treasury did not complete the review. The Productivity Commission has recommended that Treasury do that 'with a view to removing or reforming the exemption'.<sup>122</sup>

On the material I have seen, I would strongly favour the second option identified by Treasury in its 2013 discussion paper. That is, I strongly favour removing the exemption of retail dealers from the operation of the NCCP Act, with the consequence that retail dealers would be subject to the requirements of that Act.

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<sup>121</sup> Treasury, *The Exemption of Retailers from the National Consumer Credit Protection Act 2009*, January 2013, 7.

<sup>122</sup> Productivity Commission, Report 89, 29 June 2018, 433.

### **Recommendation 1.7 – Removal of point-of-sale exemption**

The exemption of retail dealers from the operation of the NCCP Act should be abolished.

## **3.3 Capitalising add-on insurance**

As will be explained when dealing with other aspects of insurance and how it is sold, I consider that add-on insurance, including add-on insurance offered in connection with the sale of motor vehicles, should generally be sold under a deferred sales model. The detail of that model is discussed further in the course of dealing with other forms of insurance that may be said to be of low value to consumers.

One likely consequence of this change is that the premiums payable for policies subject to the deferred sales model could not be financed by the loan made to purchase the vehicle without specific adjustment of the loan arrangement. However, in my view, the potential inconvenience caused by this outcome is justified in light of the benefits to the consumer of moving to a deferred sales model.

# **4 Access to banking services**

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Before moving away from consumers' interactions with banks, I think it necessary to say something about access to banking services.

It is unsurprising that large entities, carrying on their businesses in all parts of Australia, apply the same policies and procedures whenever they can. But, as the Commission's inquiries showed, not all Australians can always resort to those standard policies and procedures. Not all Australians have the same access to telephone or internet banking.<sup>123</sup> Not all Australians can 'step into the nearest branch' to sort out some issue that has emerged. Not all Australians have English as a first language or are as adept in using the English language as others. Not all Australians can easily produce

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<sup>123</sup> See generally Transcript, Shayne Elliott, 28 November 2018, 7285.

standard identification records. Not all Australians need, or benefit from, 'standard offerings' like informal overdrafts.

For some Australians, these characteristics arise from living in a regional or remote location. As I said in the *Interim Report*, at 30 June 2017, about 28% of the Australian population lived in regional or remote areas. This is nearly 7 million people. At the same time, only 4% of all branches of ADIs and 2% of ATMs were located in areas classified as remote or very remote. The banks' branch networks have been shrinking for some years. The banks have fewer face-to-face points of presence.<sup>124</sup> But, as will be apparent from what I have said, it is not only people who live regionally or remotely who will experience the types of issues that I have described.

Four steps should be taken to improve access to banking services. None was seriously opposed in the submissions provided to the Commission.

The first relates to the way in which the 2019 Banking Code deals with customers requiring particular assistance.

Chapter 14 of the 2019 Banking Code is entitled 'Taking extra care with customers who may be vulnerable'. One clause in that chapter (clause 40) provides that: 'If you tell us about your personal or financial circumstance, we will work with you to identify a suitable way for you to access and undertake your banking'. But the general tenor of this and other provisions of the chapter is that they are directed only to those who are vulnerable and they will apply *only* upon the customer telling the bank of the circumstances that make the customer vulnerable.

It is not only the vulnerable who need consideration. Those identified above (including those who live in remote or isolated areas, who are not adept in using English, who cannot readily produce standard identification documents, and who neither need nor benefit from products such as informal overdrafts) also require consideration.

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<sup>124</sup> FSRC, *Interim Report*, vol 1, 257.

I consider that provision should be made in the 2019 Banking Code to require banks to work with customers who live in remote areas, or who are not adept in using English, to identify a suitable way for those customers to access and undertake their banking. Some of those to whom these provisions would apply will identify as Aboriginal or Torres Strait Islander peoples, but the relevant criteria are remoteness and language, not identification.

Second, as explained during the fourth and fifth rounds of the Commission's hearings, the Australian Transaction Reports and Analysis Centre (AUSTRAC) has published guidance intended to overcome the difficulties that are sometimes faced by Aboriginal and Torres Strait Islander people in assembling documentary proof of identity (AUSTRAC Guidance).<sup>125</sup> The AUSTRAC Guidance recognises that some Aboriginal and Torres Strait Islander customers may not have identification documents that reporting entities most commonly use to establish and verify the identity of their customers, or that the information contained in the documents may no longer be accurate or up to date. As a result, these people may face barriers in accessing financial services.<sup>126</sup>

During the fourth round of hearings, Ms Lynda Edwards from Financial Counselling Australia and Mr Nathan Boyle from ASIC gave evidence about the implementation of the AUSTRAC Guidance. Ms Edwards said that the processes outlined in the AUSTRAC Guidance are 'not always ... used' by financial services entities.<sup>127</sup> Mr Boyle said that the AUSTRAC Guidance has been 'taken up by financial services institutions at the ... head office level', but that application of the Guidance 'hasn't filtered down to the customer-facing staff or to the telephone staff'.<sup>128</sup> As a result, Mr Boyle said that he was 'still not seeing a real reduction in the difficulties that people are having identifying themselves on the ground'.<sup>129</sup>

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<sup>125</sup> See AUSTRAC, *Aboriginal and/or Torres Strait Islander People* (13 December 2018) AUSTRAC <[www.austrac.gov.au/aboriginal-and-or-torres-strait-islander-people](http://www.austrac.gov.au/aboriginal-and-or-torres-strait-islander-people)>.

<sup>126</sup> AUSTRAC, *Part B of an AML/CTF Program (Customer Due Diligence Procedures)* (13 December 2018) AUSTRAC <[www.austrac.gov.au/part-b-amlctf-program-customer-due-diligence-procedures](http://www.austrac.gov.au/part-b-amlctf-program-customer-due-diligence-procedures)>.

<sup>127</sup> Transcript, Lynda Edwards, 3 July 2018, 3726.

<sup>128</sup> Transcript, Nathan Boyle, 3 July 2018, 3727.

<sup>129</sup> Transcript, Nathan Boyle, 3 July 2018, 3727.

In my view, these problems may be addressed at least in part by amending the 2019 Banking Code to provide that, if a customer is having difficulty proving his or her identity, and tells the bank that he or she identifies as an Aboriginal or Torres Strait Islander person, the bank will follow the AUSTRAC Guidance.

Third, the 2019 Banking Code should be amended to record that banks will not allow informal overdrafts on basic accounts without prior express agreement with the customer. The 2019 Banking Code refers to ‘basic, low or no fee accounts’.<sup>130</sup> I use the expression ‘basic account’ to embrace all three types of accounts.

I explained in the *Interim Report* that a ‘basic account’ is a bank account that provides the account holder with essential banking services at a lower cost than other forms of account.<sup>131</sup> Those who are on a low income, especially those in receipt of certain government benefits or holding government concession cards, may find that a ‘basic account’ suits their needs better than other forms of account.<sup>132</sup>

As I also explained in the *Interim Report*, an informal overdraft will arise when a bank allows a customer to withdraw more than the amount standing to the credit of the customer’s account.<sup>133</sup> The bank may allow overdrawing without any prior agreement with the customer.<sup>134</sup> If the bank does meet the customer’s request to withdraw an amount larger than the balance standing to the credit of the account, the bank will charge the customer a fee for lending the customer the amount of the informal overdraft.<sup>135</sup>

I have two principal concerns with informal overdrafts, particularly on basic accounts. The first is that, as I said in the *Interim Report*, the fee charged when an informal overdraft is granted may be small but, with repeated

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<sup>130</sup> See, eg, 2019 Banking Code, Ch 16.

<sup>131</sup> FSRC, *Interim Report*, vol 1, 260.

<sup>132</sup> FSRC, *Interim Report*, vol 1, 260; see also 2019 Banking Code, Ch 16.

<sup>133</sup> FSRC, *Interim Report*, vol 1, 260.

<sup>134</sup> FSRC, *Interim Report*, vol 1, 260.

<sup>135</sup> FSRC, *Interim Report*, vol 1, 260.

overdrawing, these fees can soon mount up.<sup>136</sup> The second is that the evidence received during the fourth round of hearings indicated that some customers did not know that they had been offered, and had made use of, an informal overdraft.<sup>137</sup> Some customers knew nothing more than that their request to withdraw money had been met.

In my view, these characteristics suggest that the ABA should amend the Banking Code to provide that informal overdrafts should not be offered on basic accounts unless the customer has expressly sought, and been granted, that facility. In those circumstances, a customer will have actively turned their mind to whether they wish to have the facility, and they will be aware of the potential consequences of using the facility.

Fourth, the ABA should amend the Banking Code to provide that banks will not charge dishonour fees on basic accounts. In their submissions in response to the *Interim Report*, each of the major banks advised that they had adopted this position.<sup>138</sup> Other banks, to the extent that they have not followed the lead of the major banks, should do so, and also discontinue charging dishonour fees on basic accounts.

Before leaving this topic, I make two further observations.

The first is that clause 181 of the 2019 Banking Code will oblige banks to comply with the *Code of Operation: Recovery of Debts from Department of Human Services Income Support Payments or Department of Veterans' Affairs Payments*. The Code of Operation provides for what has come to be known as the 90% arrangement, which limits the amount that a bank may take from government benefits in reduction of a debt owed to the bank. Restricting informal overdraft arrangements to customers who actively seek out such an arrangement would very likely go some way to reducing the numbers of customers on benefits who owe significant debts to banks, and would very likely go some way to reducing the amounts owed by individual customers.

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<sup>136</sup> FSRC, *Interim Report*, vol 1, 260.

<sup>137</sup> Transcript, Nathan Boyle, 3 July 2018, 3721.

<sup>138</sup> ANZ, Interim Report Submission, 5 [24]–[26]; CBA, Interim Report Submission, 25 [125], 26 [137]; NAB, Interim Report Submission, 37 [144]; Westpac, Interim Report Submission, 50 [242].

The second observation is about the importance of continuing to develop innovative solutions to address barriers to access.

One example of this, which I discussed in the *Interim Report*, is CBA's Indigenous Customer Assistance Line (ICAL).<sup>139</sup> ICAL provides support for geographically isolated Aboriginal and Torres Strait Islander customers in 90 remote communities by providing free balance inquiries, replacement cards, access to funds, and other, more general, support.<sup>140</sup> ICAL uses a special identification process tailored to the customers who use the service.<sup>141</sup> Financial Counselling Australia (FCA) told the Commission that the ICAL service is 'very helpful' for both Aboriginal and Torres Strait Islander people, and for financial capability workers working with that population, because the dedicated staff 'are trained to understand the specific issues facing them and respond appropriately to issues such as remoteness and identification'.<sup>142</sup>

Westpac is now in the process of establishing such a service,<sup>143</sup> and ANZ has indicated that it is willing to do so.<sup>144</sup>

**A telephone service, no matter its efficacy, is not capable of solving all of the issues impeding access to banking services, whether by Aboriginal and Torres Strait Islander people or by others living in remote areas. It could only ever form part of a range of initiatives directed towards improving access. But the provision of this service has been identified as helpful by those working with Aboriginal and Torres Strait Islander communities,<sup>145</sup> and I strongly encourage the development of such services.**

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<sup>139</sup> FSRC, *Interim Report*, vol 1, 258.

<sup>140</sup> FSRC, *Interim Report*, vol 1, 258.

<sup>141</sup> FSRC, *Interim Report*, vol 1, 258.

<sup>142</sup> FCA, Interim Report Submission, 18 [77].

<sup>143</sup> Westpac, Interim Report Submission, 47–8 [225].

<sup>144</sup> ANZ, Interim Report Submission, 4 [20]; cf ANZ, Module 4 Policy Submission, 18 [85]; Transcript, Shayne Elliott, 28 November 2018, 7290.

<sup>145</sup> Legal Aid NSW, Module 4 Policy Submission, 16; CALC, Module 4 Policy Submission, 21 [77]–[79].

### **Recommendation 1.8 – Amending the Banking Code**

The ABA should amend the Banking Code to provide that:

- banks will work with customers:
  - who live in remote areas; or
  - who are not adept in using English,to identify a suitable way for those customers to access and undertake their banking;
- if a customer is having difficulty proving his or her identity, and tells the bank that he or she identifies as an Aboriginal or Torres Strait Islander person, the bank will follow AUSTRAC's guidance about the identification and verification of persons of Aboriginal or Torres Strait Islander heritage;
- without prior express agreement with the customer, banks will not allow informal overdrafts on basic accounts; and
- banks will not charge dishonour fees on basic accounts.

## **5 Lending to small and medium enterprises**

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With some exceptions, I generally do not favour altering the rules that govern lending to small and medium enterprises (SMEs).

### **5.1 The lending framework**

I will begin by explaining why I do not favour extending the provisions of the NCCP Act to small businesses.

As I said in the *Interim Report*, the responsible lending provisions of the NCCP Act do not apply to lending for business purposes.<sup>146</sup> In particular, the provisions of section 128 of the NCCP Act prohibiting an ACL holder from entering a credit contract with a consumer without making an assessment that the credit contract will not be unsuitable for the consumer do not apply. Nor do the hardship, pre-contractual disclosure, price regulation, and enforcement provisions of the National Credit Code. I explained in the *Interim Report* that the policy choices that have been made to limit the application of this regime reflect recognition of the need to ensure that small businesses have access to reasonably affordable and available credit.<sup>147</sup>

That said, there are some important provisions that do apply to small business lending. A number of protections within the ASIC Act that apply to consumers also apply to lending to small businesses. These include the prohibition on misleading or deceptive conduct in relation to financial services<sup>148</sup> and on unconscionable conduct in connection with the supply or possible supply of financial services,<sup>149</sup> as well as the implication of particular warranties into contracts for the supply of financial services<sup>150</sup> and the unfair contract terms regime,<sup>151</sup> which I discuss in some detail in the chapter of this Report concerning insurance. In addition, there are a number of general law principles that supplement this framework.<sup>152</sup> And the chief protection for small business borrowers has for some time been, and remains, the Banking Code, to which I will return.<sup>153</sup> Among other things, the Banking Code provides that, if a lender is considering providing a borrower 'with a new loan, or an increase in a loan limit', the lender will 'exercise the care and skill of a diligent and prudent banker'.<sup>154</sup>

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<sup>146</sup> FSRC, *Interim Report*, vol 1, 162.

<sup>147</sup> FSRC, *Interim Report*, vol 1, 163.

<sup>148</sup> ASIC Act ss 12DA, 12DB, 12DC, 12DF.

<sup>149</sup> ASIC Act ss 12CA, 12CB.

<sup>150</sup> ASIC Act s 12ED, read with the definition of 'small business' in s 12BC(2).

<sup>151</sup> ASIC Act Pt 2 Div 2 Sub-div BA.

<sup>152</sup> FSRC, *Interim Report*, vol 1, 164.

<sup>153</sup> FSRC, *Interim Report*, vol 1, 164.

<sup>154</sup> 2019 Banking Code cl 49.

As I said in the *Interim Report*, the evidence and submissions provided to the Commission did not reveal any great appetite to change this lending framework.<sup>155</sup> The submissions received by the Commission following the *Interim Report* were consistent with this trend.<sup>156</sup> I do not consider this surprising: extending the responsible lending obligations in the NCCP Act would likely increase the cost of credit for small business and reduce the availability of credit. I am not persuaded that the benefits to be gained in individual cases from applying the NCCP Act to small business outweigh the overall costs of taking that step. I therefore do not consider that the NCCP Act should be amended to extend its operation to lending to small businesses.

**In the *Interim Report*, I also raised a number of questions about how banks practically discharge their obligations under the Banking Code when lending to small businesses. One question related to the inquiries that a diligent and prudent banker should make when deciding whether to offer or extend a line of credit.<sup>157</sup> Other questions related to how banks discharge their obligations to assess whether small businesses will be able to repay a loan.<sup>158</sup> The Commission received a number of submissions from banks about the steps that they take to discharge these obligations. Having reviewed those submissions, I do not consider that it would be useful to prescribe any particular approach to be applied by all banks in respect of the discharge of these obligations.**

### **Recommendation 1.9 – No extension of the NCCP Act**

The NCCP Act should not be amended to extend its operation to lending to small businesses.

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<sup>155</sup> FSRC, *Interim Report*, vol 1, 164. These submissions were generally consistent with the submissions made to Mr Khoury: see Philip Khoury, *Independent Review Code of Banking Practice*, 31 January 2017, 49 [8.4.2].

<sup>156</sup> See, eg, ABA, Module 3 Policy Submission, 8; ANZ, Module 3 Policy Submission, 3–4 [16]–[22]; ASBFEO, Interim Report Submission, 4; ASIC, Module 3 Policy Submission, 2–3 [4]–[7]; CBA, Module 3 Policy Submission, 4–6 [17]–[19]; NAB, Module 3 Policy Submission, 5–6 [16]–[17]; Westpac, Module 3 Policy Submission, 1 [2(c)], 2 [5], 4–6 [16]–[20].

<sup>157</sup> FSRC, *Interim Report*, vol 1, 334.

<sup>158</sup> FSRC, *Interim Report*, vol 1, 334.

## 5.2 The 2019 Banking Code and the definition of ‘small business’

I consider that the definition of ‘small business’ in the 2019 Banking Code is too complicated and too confined in its reach. The definition advanced in the Khoury Review, which would have had the Banking Code govern loans to any business (or group) employing fewer than 100 full time equivalent employees, where the loan applied for was less than \$5 million, is preferable to the three-part test now set out in the 2019 Banking Code. As it stands, satisfying the three-part test requires: annual turnover of less than \$10 million, fewer than 100 full-time employees, and less than \$3 million total debt to all credit providers (including amounts undrawn under existing loans, any loan being applied for and the debt of all of its related entities that are businesses).<sup>159</sup> I see no reason to doubt Mr Khoury’s evidence that adopting the test he proposed would have a relatively small effect, extending coverage of the provisions to another 10,000 or 20,000 businesses.<sup>160</sup> I recommend that the ABA amend the definition of ‘small business’ in the 2019 Banking Code of Practice to adopt the definition proposed in the Khoury Review.

### **Recommendation 1.10 – Definition of ‘small business’**

The ABA should amend the definition of ‘small business’ in the Banking Code so that the Code applies to any business or group employing fewer than 100 full-time equivalent employees, where the loan applied for is less than \$5 million.

<sup>159</sup> 2019 Banking Code cl 1.

<sup>160</sup> Transcript, Philip Khoury, 21 May 2018, 2024–9.

## 5.3 Guarantors

I do not favour altering or adding to the existing law in relation to guarantees, whether given in support of lending to SMEs or more generally.

As I explained in the *Interim Report*, because third party guarantees are commonly taken in support of loans to SMEs, the general law principles that affect whether a guarantee is enforceable are important.<sup>161</sup>

The law, as it now stands, will sometimes prevent a creditor from enforcing a guarantee given by a volunteer.<sup>162</sup> In the *Interim Report*, I made reference to the cases of *Commercial Bank of Australia Ltd v Amadio*<sup>163</sup> and *Garcia v National Australia Bank Ltd*.<sup>164</sup> I explained that, in *Amadio*, the High Court held that it would be unconscionable to allow the bank to enforce a guarantee given by the parents of a borrower because the bank's employee had shut his eyes to the misconduct by which the son had procured his parents to give the guarantee. I also explained that, in *Garcia*, the High Court held that it would be unconscionable to allow the bank to enforce a guarantee of a company's obligations given by the wife of the principal of the company when the bank had not taken steps to explain the content and effect of the guarantee or have a third party do so. Though the wife was both a shareholder and director of the company, her participation was nominal rather than substantial and she was, therefore, treated as a volunteer.

These principles are important, and they form the backdrop against which many individuals and businesses have structured their dealings. I therefore approach any amendment to these principles with caution.

The 2019 Banking Code has introduced some additional protections for guarantors, particularly those contained in Part 7 of the Code. I consider that those developments are desirable. But the evidence received by the Commission has not persuaded me that any steps need to be taken beyond those developments.

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<sup>161</sup> FSRC, *Interim Report*, vol 1, 178.

<sup>162</sup> FSRC, *Interim Report*, vol 1, 178–9.

<sup>163</sup> *Commercial Bank of Australia v Amadio* (1983) 151 CLR 447.

<sup>164</sup> *Garcia v National Australia Bank Ltd* (1998) 194 CLR 395.

**If the principles of general law do not prevent enforcement, if the bank has assessed the principal debtor's ability to repay according to the standard set in the 2019 Banking Code, and if no other provisions of the 2019 Banking Code stand against enforcement, then a guarantee should be enforceable according to its terms.**

The issues referred to so far have all been issues about loan origination. What about loan renewal and enforcement?

## 5.4 Loan renewal and enforcement

Matters relating to extending the term of a loan or continuing the terms on which a loan was first made have been a potent source of disagreement between small business borrowers and banks, and a frequent cause of dissatisfaction. This is understandable. If the bank will not extend the term of a loan beyond the term originally agreed or if the bank will do that only on terms the borrower considers unfair, the borrower will often feel let down by 'his' or 'her' bank. If the borrower cannot refinance elsewhere, the loan agreement will probably be enforced and the borrower's business will fail.

Clause 86 of the 2019 Banking Code will provide, in general terms, that lenders must give three months' notice of their intention not to renew a loan to a small business borrower who is not in default. I consider that this requirement is appropriate, and that it will go some way to ameliorating the hardship demonstrated in some of the case studies that related to loan renewal and enforcement.

But I do not favour any reform beyond this. In particular, **I do not favour imposing any obligation on a lender to renew a loan or to renew it on particular terms.** There is, in my view, no sound basis for seeking to interfere in what must be the free choice of both parties to decide whether to make an agreement and, if so, on what lawful terms that agreement will be made. The risk that a term loan will not be extended, and the risk that new and different terms may be sought by the lender as the price for making a new loan agreement, must both rest with the borrower. These are risks that are inherent in any and every business venture that borrows.

## 5.5 Agricultural enterprises

Four states – New South Wales, Victoria, Queensland and South Australia – have legislated for farm debt mediation.<sup>165</sup> There are differences between the schemes but, essentially, each requires banks and other creditors to offer mediation to farmers before taking enforcement action against farm property, including the farm itself and farm machinery. The object is to have a neutral and independent mediator assist the farmer and the lender to reach an agreement about current and future debt arrangements. As was revealed in case studies dealt with in the *Interim Report*, farm debt mediation has too often been treated as a step that is taken only because the lender considers enforcement very probable, even inevitable, and the applicable statute requires a process of mediation before enforcement can proceed. The mediation may then be treated as no more than a step that must be taken before the lender demands and obtains an order requiring repayment of all that is owing.

Properly used, however, mediation may allow the lender and the borrower to agree upon practical measures that will, or may, lead to the borrower working out of the financial difficulties that have caused the lender to treat the loan as distressed. Ordinarily, then, **I consider that lenders should offer farm debt mediation as soon as the loan is classified as distressed. If used in conjunction with rural financial counselling services,<sup>166</sup> early farm debt mediation should allow wider and better choices for the lender and borrower about servicing, and ultimately repaying, the loan.** As indicated below, I consider that the 2019 Banking Code should be amended accordingly.

In addition to this question about the timing of farm debt mediation, however, there is a wider issue about its regulation. As mentioned, only four states have legislated for farm debt mediation (South Australia's compulsory farm debt mediation scheme having entered into force since the publication

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<sup>165</sup> *Farm Debt Mediation Act 1994* (NSW); *Farm Debt Mediation Act 2011* (Vic); *Farm Business Debt Mediation Act 2017* (Qld); *Farm Debt Mediation Act 2018* (SA).

<sup>166</sup> See generally Department of Agriculture and Water Resources, *Rural Financial Counselling Service (RFCS)* (6 August 2018) Department of Agriculture and Water Resources <[www.agriculture.gov.au/ag-farm-food/drought/assistance/rural-financial-counselling-service](http://www.agriculture.gov.au/ag-farm-food/drought/assistance/rural-financial-counselling-service)>.

of the *Interim Report*). In addition to this, Western Australia operates a voluntary scheme.

One solution to the issue of inconsistent adoption of farm debt mediation by states would be the instigation of a single national legislated scheme. There was little or no disagreement expressed in submissions to the Commission that there would be advantage to this solution.<sup>167</sup> The evident advantage of a single scheme would be that banks and other lenders would be expected to formulate nationally applicable policies and training about how best to use the scheme. And using the scheme to best advantage should result in better and more orderly resolution of the difficulties that are presented for both lender and borrower when a loan is distressed.

What about the application of Banking Code provisions to agricultural enterprises?

Many agricultural enterprises employ fewer than 100 full-time equivalent employees. If the amount of the particular facility is less than \$5 million, Mr Khoury's draft of the Banking Code would have applied the Code's small business provisions to the transaction. As I have already said, I favour the definition of small business and small business facility proposed by Mr Khoury after his detailed review of the Code and its operation.

There are, however, several respects in which I consider that applicable norms of conduct should be amended to deal with agricultural enterprises. They concern valuation of security, farm debt mediation and charging default interest.

First, I consider that Prudential Standard APS 220 should be amended to require that internal appraisals of the value of land (including, but not limited to agricultural land) be independent of loan origination, loan processing and loan decision processes. APRA has already said that it intends to revise its credit risk capital framework to effect this position.<sup>168</sup>

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<sup>167</sup> See, eg, ANZ, Interim Report Submission, 25 [122]; CBA, Interim Report Submission, 24 [125]; Westpac, Interim Report Submission, 46 [220]; Suncorp, Interim Report Submission, 4; ABA, Interim Report Submission, 29–30 [3.3.7]; NAB, Interim Report Submission, 33–4 [124]–[125]; ASBFEO, Interim Report Submission, 8.

<sup>168</sup> APRA, Module 4 Policy Submission, 5 [19]–[20].

Second, I consider that APRA should amend APS 220 to provide for valuation of agricultural land in a manner that will recognise, to the extent possible:

- the likelihood of external events (including, but not limited to, fire, drought and flood) affecting the land's realisable value; and
- the time that may be taken to realise the land by sale at a reasonable price affecting the land's realisable value.

Third, as further explained below, I would not stop banks providing in their loan agreements for charging of default interest (whether by fixing a rate and providing that a lower rate is 'acceptable' so long as there is no default, or by adopting some other form of provision). But I do consider that there are powerful reasons for the ABA to amend the 2019 Banking Code to provide that, while a declaration remains in force, banks will not charge default interest on loans secured by agricultural land in an area declared to be affected by drought or other natural disaster.

Natural disasters are not the only reason an agricultural loan may become distressed.

Although I would stop short of proposing any change in the law or in the Code, **I would urge banks dealing with any distressed loan to recognise and apply their own hardship policies.**

Evidence to the Commission suggested that banks may not always have done so in connection with distressed agricultural loans.<sup>169</sup>

Fourth, when dealing with distressed agricultural loans, I urge banks to:

- ensure that those loans are managed by experienced agricultural bankers;
- offer farm debt mediation as soon as a loan is classified as distressed. The purpose of mediation should be to seek agreement about how to work out of existing and reasonably anticipated financial distress;

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<sup>169</sup> Transcript, Ross McNaughton, 29 June 2018, 3581–3.

- manage every distressed loan on the footing that working out will be the best outcome for bank and borrower, and enforcement the worst;
- recognise that appointment of receivers or any other form of external administrator is a remedy of last resort; and
- cease charging default interest when there is no realistic prospect of recovering the amount charged.

I will say something further about the final point. Providing for the payment of default interest is, and should remain, a matter for any lender to proffer (within the limits of the law) as a term of the loan contract it offers to make. But there comes a time, especially in connection with distressed agricultural loans, when charging default interest serves no larger commercial purpose than providing a bargaining chip to be thrown onto the table by the bank even though, when played, it is a chip with no realisable value.

#### **Recommendation 1.11 – Farm debt mediation**

A national scheme of farm debt mediation should be enacted.

#### **Recommendation 1.12 – Valuations of land**

APRA should amend Prudential Standard APS 220 to:

- require that internal appraisals of the value of land taken or to be taken as security should be independent of loan origination, loan processing and loan decision processes; and
- provide for valuation of agricultural land in a manner that will recognise, to the extent possible:
  - the likelihood of external events affecting its realisable value; and
  - the time that may be taken to realise the land at a reasonable price affecting its realisable value.

#### **Recommendation 1.13 – Charging default interest**

The ABA should amend the Banking Code to provide that, while a declaration remains in force, banks will not charge default interest on loans secured by agricultural land in an area declared to be affected by drought or other natural disaster.

### **Recommendation 1.14 – Distressed agricultural loans**

When dealing with distressed agricultural loans, banks should:

- ensure that those loans are managed by experienced agricultural bankers;
- offer farm debt mediation as soon as a loan is classified as distressed;
- manage every distressed loan on the footing that working out will be the best outcome for bank and borrower, and enforcement the worst;
- recognise that appointment of receivers or any other form of external administrator is a remedy of last resort; and
- cease charging default interest when there is no realistic prospect of recovering the amount charged.

## **6 Enforceability of industry codes**

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I deal next with the enforceability of industry codes, and I do so by reference principally to the 2019 Banking Code.

### **6.1 Enforcing the code**

As I explained in the introduction to this Report, I consider it important that some provisions of industry codes be picked up and applied as law, so that breaches of those provisions will constitute a breach of the law. The provisions to be picked up and applied are those that govern the terms of the contract made or to be made between the financial services entity and the customer or a guarantor. In the 2019 Banking Code, the provisions to be applied are the promises that are made to customers (and guarantors) in the Code.

In order to explain why I have reached this view, I need to say something about the purpose of industry codes and about the model that I propose to achieve this outcome. In the following paragraphs, I focus on the 2019

Banking Code. In the chapter of this Report dealing with insurance, I will say something further about some issues that arise in connection with the three insurance codes.

## 6.2 The purpose of industry codes

Industry codes of practice occupy an unusual place in the prescription of generally applicable norms of behaviour. They are offered as a form of ‘self-regulation’ by which industry participants ‘set standards on how to comply with, and exceed, various aspects of the law’.<sup>170</sup> They are offered, therefore, as setting generally applicable and enforceable norms of conduct. Industry codes pose some challenge to the understanding that the fixing of generally applicable and enforceable norms of conduct is a public function to be exercised, directly or indirectly, by the legislature.

As Treasury pointed out, self-regulation through an industry code carries with it a number of limitations and difficulties:<sup>171</sup>

- the standards set may not be adequate;
- not all industry participants may subscribe to, and be bound by, the code;
- monitoring and enforcement of compliance with the code may be inadequate; and
- the limited consequences for breach of the code may not be enough to make industry participants correct and prevent systemic failures in its application.

I would add one point. There may now be some doubt about the extent to which obligations contained in industry codes can be relied on and enforced by individuals. The doubt arises, in part, because of the broad range of provisions contained in industry codes. Some are expressed as promises, capable of direct application to the relationship between an individual and a financial services entity. Others are not.

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<sup>170</sup> Treasury, Interim Report Submission, 9 [56].

<sup>171</sup> Treasury, Interim Report Submission, 9–10 [58].

Another matter to be considered is the necessarily incremental development of this area of the law through judicial decisions. Intermediate courts of appeal have held that terms contained in earlier versions of the Code are incorporated into, and form part of, the contract between bank and customer or guarantor.<sup>172</sup> Of necessity, these decisions related to specific provisions of the Code, and were informed by the specific circumstances of the cases.

In the circumstances, there may be some uncertainty about which provisions of industry codes can be relied on, and enforced, by individuals. Uncertainty of this kind is highly undesirable. All participants in the financial services industry – including consumers – must know what rules govern their dealings. This is especially so given that rights under contracts with financial services entities are capable of being traded, assigned and subrogated. Parties to contracts, not only the immediate but also any successor parties, must know what terms govern their relationship.

Some attention has already been given to how these limitations and difficulties can be met. In its December 2017 report, the ASIC Enforcement Review Taskforce made five recommendations about industry codes in the financial sector. It recommended that:

- ASIC approval should be required for the content of and governance arrangements for relevant codes;<sup>173</sup>
- entities should be required to subscribe to the approved codes relevant to the activities in which they are engaged;<sup>174</sup>
- approved codes should be binding on and enforceable against subscribers by contractual arrangements with a code monitoring body;<sup>175</sup>
- an individual customer should be able to seek appropriate redress through the subscriber's internal and **external dispute resolution**

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<sup>172</sup> *Brighton v Australia and New Zealand Banking Group Ltd* [2011] NSWCA 152; *Doggett v Commonwealth Bank of Australia* (2015) 47 VR 302; *National Australia Bank Ltd v Rose* [2016] VSCA 169.

<sup>173</sup> ASIC Taskforce Review, Final Report, December 2017, 33.

<sup>174</sup> ASIC Taskforce Review, Final Report, December 2017, 34.

<sup>175</sup> ASIC Taskforce Review, Final Report, December 2017, 35.

arrangements for non-compliance with an applicable approved code;<sup>176</sup> and

- the code monitoring body, comprising a mix of industry, consumer and expert members, should be required to monitor the adequacy of the code and industry compliance with it over time, and periodically report to ASIC on these matters.<sup>177</sup>

Each of these recommendations is directed towards meeting difficulties of the kind identified by Treasury, and I see their force. But, as I explain below, I consider it necessary to go one step beyond what was proposed by the ASIC Enforcement Review Taskforce. As Treasury rightly said in its submissions, '[f]or codes to be meaningful rather than tokenistic, there needs to be reasonably effective mechanisms in place to ensure adherence'.<sup>178</sup> In particular, there must be adequate means to identify, correct and prevent systemic failures in applying the code. As I have said, in order to do that, some provisions of the codes should be picked up and applied as law.

Before saying more about that, I note that Treasury invited consideration of whether similar aims could be achieved by providing ASIC with rule-making powers generally similar to those given by the *Competition and Consumer Act 2010* (Cth) (the Competition and Consumer Act).<sup>179</sup> Treasury observed that adopting a model of that kind would require consideration of how wide the power would be and what accountability mechanisms or constraints would accompany it.<sup>180</sup>

I do not favour pursuing this course.

As ASIC indicated in Regulatory Guide 183, which related to the approval of codes, harnessing the views and collective will of relevant industry participants is essential to the creation of an industry code.<sup>181</sup> I would not

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<sup>176</sup> ASIC Taskforce Review, Final Report, December 2017, 35.

<sup>177</sup> ASIC Taskforce Review, Final Report, December 2017, 35.

<sup>178</sup> Treasury, Interim Report Submission, 12 [65].

<sup>179</sup> Treasury, Interim Report Submission, 14 [76].

<sup>180</sup> Treasury, Interim Report Submission, 14 [76].

<sup>181</sup> ASIC, Regulatory Guide 183, March 2013, 4 [183.1].

discard those benefits by giving ASIC the entire responsibility for creation of the kinds of norms that are now set out in the 2019 Banking Code and that have been developed and applied within significant parts of the banking sector for many years. As I explain below, ASIC can and should encourage industry to develop the ideas that are to be reflected in the enforceable code provisions, and should more broadly continue to engage with industry about its codes. But it is now time to give certainty and enforceability to key code provisions that govern the terms of the contract made or to be made between the financial services entity and the customer or a guarantor.

### **6.3 Identifying the enforceable code provisions**

In my view, the law<sup>182</sup> should be amended to provide that breach of an enforceable code provision will constitute a breach of the law. The law should also be amended to provide for remedies that may follow from such a breach. Those remedies should be modelled on those now set out in Part VI of the Competition and Consumer Act.

I anticipate that the process of identifying and rendering enforceable the enforceable code provisions will proceed in four steps:

- industry should identify the provisions that it says govern the terms of the contract made or to be made between the financial services entity and the customer or guarantor;
- industry should seek ASIC's approval of those provisions;
- ASIC should review the provisions put forward by industry; and
- once ASIC has approved the enforceable code provisions, they will be enforceable by statute. Customers will be able to elect whether to enforce any breaches of those provisions through existing internal or external dispute resolution mechanisms or through the courts.

I say more about each of these steps below, but before I do, I think it important to emphasise two points.

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<sup>182</sup> The Corporations Act may be the preferable option, given that it already contains ASIC's code approval power: see s 1101A.

First, by creating a system of enforceable code provisions, I do not intend to interfere with ASIC's existing, and more general, power under section 1101A of the Corporations Act to approve industry codes. I consider that industry should continue to be given the option to seek general ASIC approval of its codes, because, as ASIC commented in Regulatory Guide 183, 'where approval by ASIC is sought and obtained, it is a signal to consumers that this is a code they can have confidence in'.<sup>183</sup> To that end, the law should be amended to provide that:

- ASIC's power to approve codes of conduct extends to codes relating to all APRA-regulated institutions and ACL holders; and
- industry codes of conduct approved by ASIC may include 'enforceable code provisions', being provisions in respect of which a contravention will constitute a breach of the law.

Second, the model that I have proposed is intended to supplement, rather than derogate from, existing internal and external dispute resolution mechanisms provided by the relevant codes. In my view, the model is necessary because something beyond the existing mechanisms is required. Experience shows that systemic issues identified by the Financial Ombudsman Service (FOS), or revealed in the course of determining individual disputes, have not always been resolved in ways that have encouraged or secured future compliance with norms.<sup>184</sup> Entities have sometimes disagreed with the conclusions reached by the external dispute resolution body and, where they have, they may have chosen to persist in some practice that has been criticised. Problems of that kind are likely to be reduced, and perhaps even eliminated, if breaches of enforceable code provisions are made contraventions of the relevant statute, and can thereby be enforced through the courts.

Returning to the steps I have identified above, industry should identify the provisions of its codes that govern, or are intended to govern, the terms of the contract made or to be made between the financial services institution and the customer. Taking the example of the 2019 Banking Code, I anticipate that this specification will include obligations such as the obligation to engage with customers in a fair, reasonable and

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<sup>183</sup> ASIC, Regulatory Guide 183, March 2013, 4 [183.3].

<sup>184</sup> See, eg, FSRC, *Interim Report*, vol 2, 298–302.

ethical manner (clause 10), the obligation to exercise the care and skill of a diligent and prudent banker when extending credit (clause 49) and provisions about guarantees (chapters 25–29). I say more about the nature of the task presented by the three insurance codes in the chapter dealing with insurance.

Industry should then seek ASIC's approval of the proposed enforceable code provisions. In the particular case of the 2019 Banking Code, which has already been approved by ASIC, this will require the ABA to identify for ASIC the subset of code provisions that will be 'enforceable code provisions'.

If industry did not put forward its proposed enforceable code provisions in a timely manner, consideration would have to be given to whether it is desirable to establish and impose a mandatory industry code. The process for implementing a mandatory code should be the same as the process used in respect of industry codes prescribed under the Competition and Consumer Act.<sup>185</sup> To that end, the law should be amended to provide for the establishment and imposition of mandatory financial services industry codes, so that the relevant mechanisms are in existence should they need to be exercised. Those provisions should be in a similar form to the provisions that exist in the Competition and Consumer Act, including section 51AE of that Act.

After receiving a proposal from industry, ASIC should review the proposed enforceable code provisions put forward by industry. ASIC's role must go beyond being the passive recipient of industry proposals. Rather, ASIC should assess whether industry has identified, from the provisions contained in the code, those provisions that should be made enforceable code provisions. In undertaking this task, ASIC should have particular regard to the need to ensure that all terms governing the contract made or to be made have been identified. ASIC should also assess whether the proposed enforceable code provisions are expressed clearly and unambiguously, so that they are capable of being enforced through the courts. ASIC should continue to engage with industry until any defects are remedied.

Finally, if financial services entities breach an enforceable code provision, customers and guarantors should be able to elect whether to enforce that

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<sup>185</sup> See generally Treasury, *Industry Codes of Conduct: Policy Framework*, 2017, 14–15.

breach through existing internal or external dispute resolution mechanisms, or through the courts. As I have said above, to effect this outcome, the law should be amended to provide that breach of an enforceable code provision will constitute a breach of the law. The law should also be amended to provide for the remedies for a breach. The remedies should be modelled on those now set out in Part VI of the Competition and Consumer Act.

As noted above, it would be for the customer (or guarantor) to elect which path was to be taken in seeking redress. Resort to internal dispute resolution procedures would not constitute any election about future action. The enforceable code provisions should specify, however, that resort to the Australian Financial Complaints Authority, or another external dispute resolution mechanism, will be treated as an election not to pursue court remedies unless good cause is shown to the contrary. I say ‘unless good cause is shown to the contrary’ because I consider that it should ultimately be left to the court to determine whether steps taken outside that forum should lead to the preclusion of court proceedings in any particular case.

## **6.4 The proposed model: Codes more broadly**

As noted above, in setting out this model for enforceable code provisions, I do not intend to interfere with the broader development of, or operation of, industry codes. Nor do I intend to modify or limit ASIC’s powers to approve the non-enforceable provisions of industry codes. With that said, I consider that the law should be amended to provide that ASIC may take into consideration whether particular provisions of an industry code of conduct have been designated as ‘enforceable code provisions’ in determining whether to approve a code.

I draw attention to this point because I consider it important that the banking industry, and (as I will come to) the insurance industry, continue to develop their industry codes over time. I expect that the non-enforceable provisions of industry codes will continue to play an important role in setting standards of behaviour within those industries over time.

Similarly, as will be apparent from what I have said, subject to the caveat with respect to insurance that I deal with in the appropriate chapter, I do not consider that any amendment should be made to the basic structure of internal and external dispute resolution.

### **Recommendation 1.15 – Enforceable code provisions**

The law should be amended to provide:

- that ASIC's power to approve codes of conduct extends to codes relating to all APRA-regulated institutions and ACL holders;
- that industry codes of conduct approved by ASIC may include 'enforceable code provisions', which are provisions in respect of which a contravention will constitute a breach of the law;
- that ASIC may take into consideration whether particular provisions of an industry code of conduct have been designated as 'enforceable code provisions' in determining whether to approve a code;
- for remedies, modelled on those now set out in Part VI of the Competition and Consumer Act, for breach of an 'enforceable code provision'; and
- for the establishment and imposition of mandatory financial services industry codes.

### **Recommendation 1.16 – 2019 Banking Code**

In respect of the Banking Code that ASIC approved in 2018, the ABA and ASIC should take all necessary steps to have the provisions that govern the terms of the contract made or to be made between the bank and the customer or guarantor designated as 'enforceable code provisions'.

## **7 Processing and administrative errors**

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### **7.1 Identifying processing and administrative errors**

The case studies revealed numerous cases where banks charged fees or interest in amounts larger than agreed because of what were called 'processing' or 'administrative' errors. Often the errors went undetected for some time. Often identification of who had been affected and what

compensation should be paid took many months. Some of the events were examined in detail in the case studies dealt with in the *Interim Report*.<sup>186</sup>

No systems for processing the numbers of transactions or variety of arrangements offered by banks will ever operate perfectly. Mistakes in enterprises as large as a bank are inevitable. In the end it is a human endeavour. Three points made in the *Interim Report* should be repeated. As I said then, and repeat, they are simple but fundamental.<sup>187</sup>

First, entities should not offer to sell what they cannot deliver. And that is what has been done when an entity has offered interest rate or fee discounts but has not charged the proper rate or the proper fee because relevant accounts were not linked, or automated systems were not properly programmed to charge the right rate or fee.

Failing to charge the contractually stipulated rate or fee is evidently conduct that falls below community standards and expectations. Performing a contract according to its terms must be seen as a standard of behaviour that the community expects to be met.

Failing to charge the contractually stipulated rate or fee is also misconduct. It is a breach of duty or it is a breach of a recognised and widely adopted benchmark for conduct, or, most probably, it is both.

Further, failing to charge the correct rate or fee might also constitute a contravention of section 912A of the Corporations Act or section 47 of the NCCP Act. Those sections oblige a financial services licensee and a credit licensee respectively to do *all* things necessary to ensure that the services covered by their licences are provided efficiently, honestly and fairly. And not charging the right rate or the right fee may be, in at least many cases, not providing the relevant service 'efficiently, honestly and fairly'. Regardless of whether failing to charge the right rate and right fee is a breach of section 912A or section 47, it is, on its face, a breach of contract.

Second, the entity that sells a product should have adequate systems in place *before* the first sale is made. Selling without knowing that what

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<sup>186</sup> See, eg, FSRC, *Interim Report*, vol 2, 74–82, 438–42.

<sup>187</sup> FSRC, *Interim Report*, vol 1, 66–7.

is sold can be delivered is, at best, careless of the interests of the customers to whom the product is sold. At worst, it is deceptive.

The third, and equally simple, observation to make is that, if an entity does not deliver what it has sold, the entity must remedy that default and the consequences of the default as soon as is reasonably practicable.

Once this is acknowledged, it is clear that the processing or administrative errors identified by banks called for much quicker responses than were frequently observed. One example is ANZ's prolonged processes for identifying and then compensating customers affected by failures that were first identified in 2003, too many of which were still far from complete when the Commission took evidence on the subject in March 2018.

A fourth point should be made. Often, processing or administrative errors go undetected for as long as they do because communications from the bank to the customer do not alert the customer to the need to check what has been charged, or do not permit the customer to make that check. In all but the most exceptional cases, the bank's communication will take the form it does on the assumed basis that it is accurately recording the consequences of the applicable arrangements with the customer. But if that is what the communication does convey, it may be that the communication is likely to mislead or deceive.

Banks, and other financial services entities, do not always recognise that the law relating to misleading and deceptive conduct does not depend upon intention. The relevant focus is upon the effect of the conduct in issue.

It follows that there may be occasions where so-called processing or administrative errors should be examined through the lens of the law relating to misleading and deceptive conduct. Doing that may cause entities to give better attention, before products are launched into the market, to whether their systems do support the product. Compensating customers who have not been given what was promised is very much a second-best solution.

## **7.2 Preventing processing and administrative errors**

Recognising, as I must, that no systems for processing the numbers of transactions or variety of arrangements offered by banks will ever operate perfectly, does not mean that there is nothing to be done except sweep up the consequences after the event.

Banks *must* do more to prevent these errors. As was noted in the *Interim Report*, even confining attention to home loans, about \$239 million had been repaid to customers in respect of processing and administrative errors before the Commission began its inquiries.<sup>188</sup> And it will be recalled that other forms of processing and administrative errors were explored and are discussed in the *Interim Report*.

Mr Elliott, the CEO of ANZ, told the Commission that processing and administrative errors arose from a combination of factors.<sup>189</sup> Of those, I mention two in particular: number and complexity of products, and absence of ‘end-to-end’ accountability. Both are issues wholly within the control of every financial services entity.

It is for each bank to decide what products it will issue. It is for each bank to determine whether its administration and IT systems are set up in ways that will deliver to customers what the customers have been promised and charge them no more than is agreed. And the more numerous and more complex the bank’s offerings are, the greater the care needed to ensure that the bank can deliver what it has promised and charge only what it is entitled to charge.

The evidence led in the Commission shows that processing or administrative errors have occurred when the ‘left hand does not know what the right hand is doing’. And that has occurred because there has been no clearly identified ‘ownership’ of the overall process beginning with someone within the bank proposing a new product or product feature and culminating in the bank offering that product, or product feature to customers. There has been, in Mr Elliott’s terms, disaggregation of the management of the value chain with no-one ‘accountable from the design of the product through to its implementation and if something goes wrong, remediating it and, importantly, keeping it fit for purpose’.<sup>190</sup>

Each of the tasks mentioned by Mr Elliott is fundamental to the performance of a bank’s business. So important is it that a senior executive within the bank be accountable for the bank meeting the promises it makes to customers in respect of the products it sells or issues to them,

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<sup>188</sup> FSRC, *Interim Report*, vol 1, 37.

<sup>189</sup> Transcript, Shayne Elliott, 28 November 2018, 7277–8.

<sup>190</sup> Transcript, Shayne Elliott, 28 November 2018, 7278.

that I consider that it is a responsibility that should be subject to the provisions of the **Banking Executive Accountability Regime** (BEAR). There should be one person in the bank responsible for those tasks in respect of *all* the bank's products. The person having responsibility for those tasks should be an 'accountable person' under section 37BA of the *Banking Act 1959* (Cth) (the Banking Act); the ADI should have the accountability obligations specified in section 37C with respect to that person (and the accountable person, the obligations set out in section 37CA); and the key personnel of the ADI should have the obligations described in section 37D with respect to the accountable person.

To these ends, APRA should consult with at least the four largest banks about how best to describe or define, for the purposes of section 37BA(2)(b)(ii) and (4) of the Banking Act, a responsibility embracing the matters described by Mr Elliott in respect of product design, delivery, maintenance and, where necessary, remediation. Following that consultation, APRA should determine that responsibility for the purposes of section 37BA(2)(b) of the Banking Act. The consequence would be that each bank subject to the BEAR would be required to give APRA an accountability statement and an accountability map under section 37F identifying (among other things) the responsibilities of the accountable person and details of the reporting lines and lines of responsibility of the accountable person.<sup>191</sup> The further consequence would be that there should no longer be that disaggregation of responsibility that has contributed to so many and such costly processing and administrative errors.

### **Recommendation 1.17 – BEAR product responsibility**

After appropriate consultation, APRA should determine for the purposes of section 37BA(2)(b) of the Banking Act, a responsibility, within each ADI subject to the BEAR, for all steps in the design, delivery and maintenance of all products offered to customers by the ADI and any necessary remediation of customers in respect of any of those products.

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<sup>191</sup> Banking Act ss 37F, 37FA, 37FB.

## Conclusion

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This chapter has dealt with ‘traditional’ banking services. It has not dealt with issues arising in connection with financial advice, superannuation or insurance and has not considered the larger questions of culture, governance and remuneration examined in later parts of this Report.

Some changes should be made in connection with traditional banking services.

I am not persuaded that the NCCP Act’s framework for responsible lending to consumers needs change. The responsible lending issues identified during the Commission’s hearings will be resolved by banks applying the law as it stands. As I have explained, however, reform is required to other aspects of home lending: to the duties of mortgage brokers and to the remuneration structures associated with home lending. Other reforms affecting consumers are also necessary, including removing the exemption of retail dealers from the operation of the NCCP Act and several reforms to improve the accessibility of banking for all Australians.

While I do not consider that the NCCP Act should be extended to apply to lending to small businesses, some reforms are needed in this area. A number of them concern agricultural loans, including introducing a national scheme of farm debt mediation, strengthening standards for valuations and not charging default interest in certain circumstances.

The changes I recommend in relation to consumer lending and lending to small businesses are underpinned by two broader changes: one directed to improving the ways in which banking products work – by introducing a responsibility for product design, delivery and maintenance into the BEAR; and the second directed to making the promises made in the Banking Code more meaningful – by introducing statutory consequences for breaching key provisions of the Code.

## An addendum: Bankwest

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Chapter 5 of the *Interim Report* – Bankwest and CBA – set out my conclusions about complaints that have been made regarding CBA’s conduct in respect of customers who had borrowed from Bankwest before CBA acquired Bankwest in 2008.

I seek neither to add to, nor subtract from, what I said about those matters in the *Interim Report*.

Since the *Interim Report* was published, the Solicitor Assisting the Commission, Counsel Assisting and I have received many communications from those who see themselves as ‘victims’ of Bankwest disputing what is said in the *Interim Report*, and asking me to re-open consideration of some or all of the issues considered in the *Interim Report* and, more recently, saying how necessary it is that there be a further inquiry into their complaints.

I now will make only two points.

First, as I said in the *Interim Report*:<sup>192</sup>

[I]t should not be surprising that the sense of individual grievance [of borrowers who suffered loss], joined with the grievances of others, should spark allegations that the lender did not act according to the lender’s judgments about the risks of continuing the loan to a particular borrower, but acted according to some overall plan that was at least improper if not unlawful. And this is what has happened with respect to CBA’s conduct in relation to the Bankwest business loan book. Borrowers, seeing that others were dealt with and affected in ways that they regard as relevantly similar, have formed the unshakeable view that CBA’s conduct towards them was wrong. They will not accept that CBA may have acted case by case, according to judgments made about each loan. Instead they seek to assign reasons for CBA’s conduct that they say show how and why the conduct was wrong.

Second, as those who now agitate for a new inquiry have said in their correspondence with the Commission, their allegations have been the central focus of many previous inquiries and, I would add, two cases in the Supreme Court of New South Wales that have gone to judgment.<sup>193</sup> Yet they say there should be yet another inquiry. I do not agree. Enough is enough.

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<sup>192</sup> FSRC, *Interim Report*, vol 1, 208.

<sup>193</sup> FSRC, *Interim Report*, vol 1, 190–3.

# 3. Financial advice

## Introduction

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Over the last decade, many Australians have sought financial advice. Over the same period, the financial advice industry has grown significantly. As at 1 April 2018, there were 25,386 financial advisers in Australia, an increase of around 41% compared with the number of financial advisers in August 2009.<sup>1</sup> The Productivity Commission has noted that in 2015/2016 the financial advice sector was estimated to be worth \$4.6 billion in revenue.<sup>2</sup>

Three different issues have emerged in connection with the provision of financial advice. The first is ‘fees for no service’: ongoing advice fees charged when no advice was given to the client. The second is that clients have often been given poor advice that has left them worse off than they would have been if proper advice had been given. The third is the fragmented and ineffective disciplinary system for financial advisers.

## 1 History

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Each issue has its roots in the history of the financial advice industry. It is not possible to understand the current issues without first understanding their history – the context in which the issues arose, the decisions that contributed to them, and the fate of past attempts to resolve them.

Expressed in a single sentence, that history tells the story of an incomplete transformation – from an industry dedicated to the sale of **financial products** to a profession concerned with the provision of financial advice. I say ‘incomplete’ because I do not believe that the practice of giving financial advice is yet a profession. The general weight of the evidence

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<sup>1</sup> Background Paper No 6 (Part A), 7.

<sup>2</sup> Background Paper No 6 (Part A), 8.

given to the Commission by those involved in the industry was to the same effect. Some said it is on the cusp;<sup>3</sup> others were, perhaps, more cautious.<sup>4</sup>

Despite recognition, within the industry, that the provision of financial advice is not yet a profession, those who seek financial advice do not always appreciate this. Mrs Jacqueline McDowall, who gave evidence in the Commission's second round of hearings, had confidence in the advice that she received because she believed her financial adviser was a professional. She said:<sup>5</sup>

[W]e felt with his – with his professional advice, he knew what he was talking about, and we felt that, yes, we're all – we're all going there together, he's looking after us.

As in many other cases, however, that confidence was misplaced. Mrs McDowall received poor advice. By the end of her experience, Mrs McDowall said:<sup>6</sup>

I will never, ever trust anybody again, even if they say they're a professional this or a professional that. It's all just to gain money for their side.

Others paid fees – sometimes large amounts, over many years – for services they were never provided. The consequences for advisers who gave poor advice, or who charged fees for no service, were often inadequate.

This state of affairs shows, and is the result of, the incomplete transformation I described above.

For some time now, a financial adviser has been something between a salesperson and a professional adviser. The industry has moved from scandal to scandal, causing financial harm to clients, and damaging public confidence in the value of financial advice. This cannot continue.

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<sup>3</sup> Transcript, Michael Wright, 20 April 2018, 1444–5.

<sup>4</sup> Transcript, Peter Kell, 16 April 2018, 1031.

<sup>5</sup> Transcript, Jacqueline McDowall, 19 April 2018, 1363.

<sup>6</sup> Transcript, Jacqueline McDowall, 19 April 2018, 1371.

But, before considering what can and should be done about it, it is necessary to look back, to see how it came about.

## 1.1 How did the financial advice industry emerge?

Traditionally, the business of banking comprised lending, deposit-taking and the provision of transaction services.<sup>7</sup> Until the 1970s, the reach of the funds management sector – that is, entities that pool and invest money on behalf of customers – was limited. At that time, the sector was composed largely of superannuation and life insurance companies.<sup>8</sup>

From the 1970s, Australia began to deregulate its financial markets. Restrictions on bank interest rates and liability structures were removed; foreign banking was made easier to access; the Australian dollar was floated.<sup>9</sup> The financial sector expanded. At the same time, growth in the size and liquidity of securities markets allowed more diverse financial products to develop.<sup>10</sup>

From 1983, successive changes to the tax treatment of superannuation increased the complexity of superannuation but also established it as a vehicle for compulsory saving. These developments included the incorporation of superannuation into employment awards in 1986 and legislation in 1991 imposing tax penalties where employer contributions were not made.<sup>11</sup> With greater amounts of savings invested in

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<sup>7</sup> Malcolm Edey and Brian Gray, 'The Evolving Structure of the Australian Financial System' (Paper presented at The Future of the Financial System Conference, H C Coombs Centre for Financial Studies, Kirribilli, 8–9 July 1996) 8–9.

<sup>8</sup> Malcolm Edey and Brian Gray, 'The Evolving Structure of the Australian Financial System' (Paper presented at The Future of the Financial System Conference, H C Coombs Centre for Financial Studies, Kirribilli, 8–9 July 1996) 7.

<sup>9</sup> RBA, *Submission to the Financial System Inquiry*, March 2014, 16 <[http://fsi.gov.au/files/2014/04/Reserve\\_Bank\\_of\\_Australia.pdf](http://fsi.gov.au/files/2014/04/Reserve_Bank_of_Australia.pdf)>.

<sup>10</sup> Malcolm Edey and Brian Gray, 'The Evolving Structure of the Australian Financial System' (Paper presented at The Future of the Financial System Conference, H C Coombs Centre for Financial Studies, Kirribilli, 8–9 July 1996) 17–20.

<sup>11</sup> Malcolm Edey and Brian Gray, 'The Evolving Structure of the Australian Financial System' (Paper presented at The Future of the financial System Conference, H C Coombs Centre for Financial Studies, Kirribilli, 8–9 July 1996) 35.

superannuation funds, Australians had a far higher exposure to capital markets, and increasingly began to seek financial advice.

Before the early 1980s, Australians who required financial advice often went to their bankers, brokers, accountants and insurance advisers.<sup>12</sup> As the market for superannuation and investment products grew, the life insurance companies and other financial institutions that manufactured financial products looked to financial advisers to sell them.<sup>13</sup> At that time, most financial advisers came from a background of life insurance, in which a sales-driven, commission-based culture prevailed and comprehensive advice was not commonly sought or given.<sup>14</sup> These were the roots of today's financial advice industry, and the culture has endured.

The 1990s brought even more of the Australian public into the market for financial products and services, and therefore advice.<sup>15</sup> A series of privatisations (such as CBA, Telstra and Qantas) and demutualisations (such as AMP and NRMA Insurance)<sup>16</sup> increased share ownership. Further deregulation of the financial sector contributed to a surge in credit provision and the design of new and more complex financial products. These developments in combination with the prevailing low interest rates raised household indebtedness and increased the value of market-linked financial assets that households held.<sup>17</sup>

It was in the 1990s that banks began their expansion into wealth management.

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<sup>12</sup> Janet Cowan, William Blair and Sharon Taylor, 'Personal Financial Planning Education in Australian Universities' (2006) 15 *Financial Services Review* 43, 46.

<sup>13</sup> Robert Brown, 'Reinventing Financial Planning' (2008) 3(1) *Australian Journal of Financial Planning* 17, 20.

<sup>14</sup> Robert Brown, 'Reinventing Financial Planning' (2008) 3(1) *Australian Journal of Financial Planning* 17, 20.

<sup>15</sup> Background Paper No 7, 5.

<sup>16</sup> See also ASX, *The Australian Share Ownership Study* (2014) 26–7 <[www.asx.com.au/documents/resources/australian-share-ownership-study-2014.pdf](http://www.asx.com.au/documents/resources/australian-share-ownership-study-2014.pdf)>.

<sup>17</sup> Marianne Gizycki and Philip Lowe, 'The Australian Financial System in the 1990s' (Paper presented at The Australian Economy in the 1990s Conference, H C Coombs Centre for Financial Studies, Kirribilli, 24–5 July 2000) 187.

## 1.2 Development of the regulatory framework

The regulatory framework that governs financial advice and product sales today was designed in response to, and in the midst of, these changes. A number of design decisions should be noted for their part in shaping the financial advice industry as it is today.

The 1997 Financial System Inquiry chaired by Mr Stan Wallis (the Wallis Inquiry) reviewed the then fragmented regulation of the financial system and recommended that there be a 'consistent and comprehensive disclosure regime' administered by a single regulator.<sup>18</sup> The adoption of this model marked the start of the uniform treatment of traditional intermediary services and of financial sales and advice relating to funds management. In 1998, the Australian Securities and Investments Commission (ASIC) was established, combining the responsibilities of the then Australian Securities Commission and the Insurance and Superannuation Commission.<sup>19</sup>

In April 1997, Treasury released its Corporate Law Economic Reform Program Paper No 6 (CLERP 6). Although extensive amendments have been made to the legislation passed to implement CLERP 6, a number of its underlying principles have endured. One of those principles was to fold sales and advice relating to insurance and superannuation into the regulation of securities.<sup>20</sup> That regulatory framework was premised on independent intermediation and the use of mandatory disclosure as a means of investor protection.<sup>21</sup> It did not take into account that insurance and superannuation decisions were usually made with consumption (a payment in case of injury; an income stream at retirement) rather than investment in mind, or that those products were usually sold by sales agents and not independent brokers such as those who traded in securities.<sup>22</sup>

Another key principle in CLERP 6 was to regulate intermediaries (including advisers) at firm level rather than at the individual level, in part to allow

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<sup>18</sup> Wallis Inquiry, Final Report, 17.

<sup>19</sup> Background Paper No 7, 6.

<sup>20</sup> See Treasury, *Corporate Law Economic Reform Program – Proposals for Reform: Paper No 6*, April 1997, 1, Proposal 1.

<sup>21</sup> Background Paper No 7, 8.

<sup>22</sup> Background Paper No 7, 8.

ASIC to target its resources efficiently.<sup>23</sup> Thus, under the *Corporations Act 2001* (Cth) (the Corporations Act), individual advisers do not hold licences. The licensed entity is commonly the relevant **financial services entity** and individual advisers act as authorised representatives of the licensed entity. The firm has a statutory obligation to ensure that its authorised representatives comply with financial services laws.

Importantly, CLERP 6 did not provide that financial advisers were to be independent from product issuers. It is not clear whether the authors considered the possibility that financial advisers may be employed or authorised by issuers of products about which they advise, a situation that is now widespread. Nor did CLERP 6 engage with the fiduciary duties or other general law obligations that may attach to financial advisers but conflict with their employment conditions. The financial advice industry is still caught in this structural link between product issuers and the adviser's legal obligation to act in the best interests of the client.<sup>24</sup>

Finally, CLERP 6 established that household access to wholesale markets and complex products would not be restricted.<sup>25</sup> Rather, it relied on mandatory pre-disclosure as the means to inform consumers about risks on the basis that consumers would then make informed and rational choices about the best investment strategies for them. That meant leveraged and complex investments could be marketed and sold in the retail market.<sup>26</sup>

### 1.3 Vertical integration

The Wallis Inquiry reflected the prevailing conditions of deregulation and globalisation, which produced a sense that financial markets would displace banks from their core functions and cause financial service providers to specialise and disaggregate.<sup>27</sup> It expected that this rise in competition would eliminate mispricing of financial products and services, create efficiencies in the system and ultimately produce lower costs for consumers.<sup>28</sup> The RBA

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<sup>23</sup> Background Paper No 7, 9–10.

<sup>24</sup> Background Paper No 7, 10.

<sup>25</sup> Background Paper No 7, 10–11.

<sup>26</sup> Background Paper No 7, 10–11.

<sup>27</sup> RBA, *Submission to the Financial System Inquiry*, March 2014, 14.

<sup>28</sup> See Wallis Inquiry, Final Report, Ch 4.

has said that the Wallis Inquiry underestimated banks' capacity to expand and acquire businesses along their supply chains.<sup>29</sup>

From the time of the Wallis Inquiry, banks' accumulation of wealth management businesses accelerated. During the late 1990s and early 2000s, each of the major banks acquired or merged with a fund manager.

- In 2000, CBA acquired Colonial Mutual Life Assurance Ltd,<sup>30</sup> which conducted life and other insurance businesses, and a funds management business.
- In 2000, NAB acquired the financial services businesses of Lend Lease, including MLC Holdings Ltd.<sup>31</sup>
- In 2002, ANZ entered joint venture arrangements with ING Group in respect of wealth management and life insurance businesses in Australia and New Zealand,<sup>32</sup> and later acquired the full business.
- In 1999, Westpac founded Magnitude Group Pty Ltd. In 2002, Westpac acquired all of BT Financial Group's asset accumulation businesses.<sup>33</sup> And in 2008, as part of its merger with St George Bank Ltd, Westpac acquired St George's financial advice business, which included employed advisers as well as Securitor Financial Group Ltd.

The **vertical integration** of product manufacture with product sale and financial advice is a 'one stop shop' vision in which retail customers' investment needs can be provided alongside traditional banking facilities such as loan and deposit services. Vertical integration has seen the acquisition by entities of a number, or all, of the steps in supply of financial products to consumers, starting with designing and creating the product,

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<sup>29</sup> RBA, *Submission to the Financial System Inquiry*, March 2014, 14.

<sup>30</sup> CBA, 'Intention to Merge with Colonial' (ASX Announcement, 10 March 2000).

<sup>31</sup> Lend Lease, 'LLC Ann: Sale of MLC Businesses to NAB Uncon Settlement 30/6' (ASX Announcement, 27 June 2000).

<sup>32</sup> ANZ, 'ANZ & ING Complete Funds Management and Life Insurance JV' (ASX Announcement, 30 April 2002).

<sup>33</sup> Westpac, 'Westpac Completes BT Financial Group Transaction' (ASX Announcement, 31 October 2002).

providing asset management services and investment platforms, and engaging in distribution to customers by way of financial advice or sales.<sup>34</sup>

From the perspective of banks, vertical integration always promised the benefit of cross-selling opportunities (the opportunities for cross-selling financial products to existing and new customers).<sup>35</sup> Vertical integration also promises the virtue of efficiency, which is then passed on to consumers in the form of lower costs and greater access to financial advice.<sup>36</sup> Customers may also enjoy the simplicity of dealing with just one institution.<sup>37</sup> However the internal efficiency of the 'one stop shop' does not necessarily produce efficiency in outcomes for customers. The 'one stop shop' model creates a bias towards promoting the owner's products above others, even where they may not be ideal for the consumer.<sup>38</sup>

By the time of the Final Report of the Financial System Inquiry in 2014 (the Murray Inquiry), the 'one stop shop' model was well established in the market. The Murray Inquiry report observed that the high concentration of and steadily increasing vertical integration in some sectors had the potential to limit the benefits of competition in the future.<sup>39</sup> While the report did not express a view as to the merits of vertical integration, the Murray Inquiry recommended ways in which to make ownership and alignment

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<sup>34</sup> See generally Productivity Commission, Report 89, 29 June 2018, ch 9.

<sup>35</sup> See, eg, Theodore Golat, 'Banks' Wealth Management Activities in Australia', *Reserve Bank Bulletin* (2016) September Quarter, 53, 54–6.

<sup>36</sup> See Transcript, Michael Wilkins, 28 November 2018, 7242. Mr Wilkins said that vertical integration provides a number of advantages, particularly in respect of 'affordability of advice', in that 'the administration of advice networks can have its fixed costs spread over a broader cost base'. See also Productivity Commission, Report 89, 29 June 2018, 249–50.

<sup>37</sup> See Transcript, Brian Hartzler, 21 November 2018, 6832. Mr Hartzler considered that Westpac owning advice licensees, and being able to provide financial advice, was part of Westpac providing systems that 'make it convenient for people to manage their banking and their investments all in one place', which would 'help make [Westpac] a more attractive bank for people to be with'.

<sup>38</sup> Productivity Commission, Report 89, 29 June 2018, 85, quoting Choice, *Competition in the Australian Financial System: Submission to the Productivity Commission*, September 2017, 30; ASIC, Report 562, 1 January 2018, 16.

<sup>39</sup> Murray Inquiry, Final Report, 255–6.

more transparent.<sup>40</sup> It did, however, note that the Global Financial Crisis (GFC) had exposed ‘significant numbers of Australian consumers holding financial products that did not suit their needs and circumstances’ and that there were ‘significant problems relat[ing] to shortcomings in disclosure and financial advice’.<sup>41</sup>

## 1.4 Early scandals

Scandals dating back to the GFC began to shed light on the conflicts and culture in the financial advice industry. Regulatory responses, however, focused on the remediation of specific instances of poor advice, rather than seeking to identify root causes within institutions and the industry. Those responses set the tone for future approaches to misconduct by financial advisers, that is, to compensate customers according to arrangements negotiated with ASIC while requiring few changes to the business itself.

### 1.4.1 Storm Financial

Shortly before the second half of 2008, Storm Financial was a profitable company with \$77 million in annual revenue and \$120 million in consolidated gross assets.<sup>42</sup>

The business model of Storm Financial was to provide advice in standard or template form, with minimal tailoring to the investor.<sup>43</sup> Almost 90% of Storm’s clients were encouraged to take out loans against the equity in their own homes, to obtain a margin loan and use the funds from these loans to invest in the share market via index funds.<sup>44</sup> In late 2008 and early 2009, many clients of Storm Financial were in negative equity positions, sustaining significant losses.<sup>45</sup>

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<sup>40</sup> Murray Inquiry, Final Report, 271–2.

<sup>41</sup> Murray Inquiry, Final Report, 27.

<sup>42</sup> *ASIC v Cassimatis (No 8)* (2016) 336 ALR 209, 1023 [1].  
See also *ASIC v Cassimatis (No 9)* [2018] FCA 385, [6].

<sup>43</sup> *ASIC v Cassimatis (No 8)* (2016) 336 ALR 209, 1023 [9].

<sup>44</sup> See *ASIC v Cassimatis (No 8)* (2016) 336 ALR 209, 1023 [9];  
ASIC, Media Release 18-081MR, 22 March 2018.

<sup>45</sup> ASIC, Media Release 18-081MR, 22 March 2018.

Many investors lost their investment, their homes and their life savings and still had significant debts outstanding. ASIC estimated the total loss suffered by investors who borrowed to invest through Storm was about \$830 million.<sup>46</sup>

In December 2008, ASIC commenced an investigation into Storm Financial.<sup>47</sup> In early 2009, Storm Financial was placed into voluntary administration and liquidators were subsequently appointed.

ASIC commenced a number of legal proceedings in relation to the Storm Financial scandal including proceedings alleging that the directors of Storm Financial had breached their duties as directors and that Storm Financial had provided inappropriate advice.<sup>48</sup> In March 2018, the Federal Court imposed a penalty of \$70,000 (from a maximum penalty of \$200,000) on each of the directors of Storm Financial and ordered that each be disqualified from managing corporations for seven years.<sup>49</sup>

ASIC also entered into settlement agreements with various institutions to provide compensation for losses suffered:

- In 2012, ASIC entered into a settlement agreement with CBA to make available up to \$136 million as compensation to CBA customers who had borrowed from the bank to invest through Storm Financial.<sup>50</sup> CBA had already provided approximately \$132 million to Storm Financial investors under its resolution scheme.<sup>51</sup>
- In 2013, ASIC intervened in a class action brought against Macquarie Bank in respect of Storm Financial regarding the fairness of settlement arrangements. The Full Federal Court held that the distribution of the

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<sup>46</sup> ASIC, Media Release 12-227MR, 14 September 2012.

<sup>47</sup> ASIC, *ASIC Investigation Background* (28 October 2016) ASIC <<https://storm.asic.gov.au/proceedings/summary-of-asic-actions/asic-investigation-background/>>.

<sup>48</sup> ASIC, *Summary of ASIC Actions: Civil Penalty Proceedings against the Cassimatises* (28 October 2016) ASIC <<http://storm.asic.gov.au/proceedings/summary-of-asic-actions/>>.

<sup>49</sup> ASIC, Media Release 18-081MR, 22 March 2018. See also *ASIC v Cassimatis (No 9)* [2018] FCA 385, [98], [106].

<sup>50</sup> ASIC, Media Release 12-227MR, 14 September 2012.

<sup>51</sup> ASIC, Media Release 12-227MR, 14 September 2012.

settlement sum was not fair and reasonable to all group members and a revised settlement arrangement was made. Macquarie agreed to pay \$82.5 million by way of compensation and costs.<sup>52</sup>

- In 2014, ASIC made a settlement agreement with the Bank of Queensland. BOQ agreed to pay approximately \$17 million as compensation for losses suffered on investments made through Storm Financial.<sup>53</sup>

## 1.4.2 Commonwealth Financial Planning (CFPL)

In 2010, a whistleblower raised with ASIC allegations of misconduct by financial advisers employed by CFPL, a subsidiary of CBA.<sup>54</sup> The allegations included that certain CBA financial advisers were advising clients to invest in profit-generating but high risk products that were not appropriate for them, switching products without the relevant client's permission and forging clients' signatures on documents.

As a result, when the GFC occurred, thousands of clients of CFPL, many of whom were nearing retirement or had already retired, lost millions of dollars.

CBA paid more than \$20 million in compensation to clients who had received inappropriate financial advice from two CFPL financial advisers (Mr Don Nguyen and Mr Anthony Awkar).<sup>55</sup>

It later became apparent, however, that the misconduct extended beyond these two advisers and CBA subsequently implemented a second compensation program.<sup>56</sup>

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<sup>52</sup> ASIC, Media Release 13-214MR, 12 August 2013.

<sup>53</sup> ASIC, Media Release 14-244MR, 22 September 2014.

<sup>54</sup> Simon Hoyle, 'For CBA He Was the Wrong Guy in the Wrong Place at the Wrong Time', Professional Planner (online), 4 July 2014 <[www.professionalplanner.com.au/featured-posts/2014/07/04/striking-a-blow-29119/](http://www.professionalplanner.com.au/featured-posts/2014/07/04/striking-a-blow-29119/)>; Jeff Morris, 'I Gift Wrapped Commonwealth Bank for ASIC and It Did Nothing', The Sydney Morning Herald (online), 27 April 2018 <[www.smh.com.au/business/banking-and-finance/i-gift-wrapped-commonwealth-bank-for-asic-and-it-did-nothing-20180427-p4zbyk.html](http://www.smh.com.au/business/banking-and-finance/i-gift-wrapped-commonwealth-bank-for-asic-and-it-did-nothing-20180427-p4zbyk.html)>.

<sup>55</sup> Exhibit 2.277, Undated, Updated CFP Board Pack, 182–5; see also ASIC, Report 431, 23 April 2015, 27, 52.

<sup>56</sup> ASIC, Report 431, 23 April 2015, 6.

In October 2011, ASIC accepted an **enforceable undertaking** (EU) from CFPL that required CFPL to review the advice given to clients by an additional 16 advisers, and pay to clients any compensation arising from that review. Three additional CFPL advisers and six advisers from another CBA advice arm, Financial Wisdom Limited, were subsequently identified as also having provided inappropriate advice and CBA paid compensation to those clients who had been affected by it.<sup>57</sup>

In 2013, Australian media reported misconduct by financial planners at CFPL, a systematic cover up by management, and inadequate offers of compensation to complaining customers.<sup>58</sup>

In July 2014, CBA commenced the Open Advice Review Program. The program was open to those who had been customers of CFPL and Financial Wisdom between 1 September 2003 and 1 July 2012. The program has offered a total of \$37.6 million in compensation to customers.<sup>59</sup>

## 1.5 The FoFA reforms

As noted above, several financial product and financial services providers had collapsed during or after the GFC. The losses had been large and many consumers had been affected. Reforms, known as the **Future of Financial Advice** (FoFA) reforms, were proposed. The reforms were properly seen as radical alterations to the regulation of the financial advice industry that had emerged and developed in the decade or so that preceded their enactment.

The 2012 FoFA reforms<sup>60</sup> had three principal elements:

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<sup>57</sup> ASIC, Report 431, 23 April 2015, 6–7.

<sup>58</sup> Adele Ferguson and Chris Vedelago, 'Targets, Bonuses, Trips – Inside the CBA Boiler Room,' *The Sydney Morning Herald* (online), 22 June 2013 <[www.smh.com.au/business/banking-and-finance/targets-bonuses-trips-inside-the-cba-boiler-room-20130621-2oo9w.html#ixzz3ls7bmVx0](http://www.smh.com.au/business/banking-and-finance/targets-bonuses-trips-inside-the-cba-boiler-room-20130621-2oo9w.html#ixzz3ls7bmVx0)>; quoted in Adam Steen, Dianne McGrath and Alfred Wong, 'Market Failure, Regulation and Education of Financial Advisors' (2016) 10(1) *Australasian Accounting, Business and Finance Journal* 4, 9.

<sup>59</sup> CBA, *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry Submission*, 29 January 2018, 10 [33].

<sup>60</sup> Effected by the *Corporations Amendment (Future of Financial Advice) Act 2012* (Cth); *Corporations Amendment (Further Future of Financial Advice Measures) Act 2012* (Cth).

- the imposition of a best interests obligation on financial advisers giving personal advice to retail clients;
- a ban on **conflicted remuneration**; and
- measures intended to promote greater transparency in the charging of fees for advice by requiring consumer agreement to ongoing fees, and enhanced disclosure of fees and the services associated with ongoing fees.

Further changes were made in 2014 and 2015.<sup>61</sup>

The content and extent of changes to be made in 2012, and later in 2014 and 2015, were contested. Before the introduction of the legislation that was enacted in 2012, the Government established a ‘Peak Consultation Group’ drawn from bodies as diverse as the Association of Financial Advisers (AFA), the Australian Bankers’ Association (ABA), CHOICE, Industry Super Australia and the Property Council of Australia. For about 12 months before the legislation was enacted, this group met each month to discuss the proposals. It is, therefore, not surprising that the resulting provisions show signs of compromise and accommodation of widely divergent interests.

In the *Interim Report*, I focused on two of those compromises. The first was that conflicts of interest between adviser and client should be permitted to remain but be ‘managed’. The second was that some forms of conflicted remuneration were, and still are, allowed to continue. Both of those compromises lie at the heart of the issue that I will deal with in the third section of this chapter – the provision of poor advice – and I will return to them there.

It is convenient, however, to say something about another consequence of the FoFA reforms.

In many ways, the FoFA reforms represented an important step towards making financial advice a profession. Putting to one side the ‘safe harbour’ provision in section 961B(2), to which I will return later in this chapter, the FoFA reform introduced statutory requirements for financial advisers

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<sup>61</sup> Corporations Amendment (Revising Future of Financial Advice) Regulation 2014 (Cth); Corporations Amendment (Financial Advice) Regulation 2015 (Cth); *Corporations Amendment (Financial Advice Measures) Act 2016* (Cth).

to act in the best interests of their clients,<sup>62</sup> and to prioritise the interests of their clients over the interests of product issuers and **Australian financial services licence (AFSL)** holders.<sup>63</sup>

Perhaps more significantly, the FoFA reforms required the financial advice industry to make a fundamental change to the way advisers were remunerated. Before the introduction of those reforms, a significant source of revenue for financial advisers was commissions on the products they recommended. As in the case of **mortgage brokers**, financial advisers commonly received a combination of upfront and **trail commissions**: upfront commissions when the product was sold, and trail commissions in subsequent years.

While the compromises made in the FoFA reforms allowed advisers to continue to receive many of those commissions – most notably, trail commissions on products purchased before 1 July 2013, and upfront and trail commissions on many life insurance products – the ban on conflicted remuneration played an important role in shifting the financial advice industry from a commission-based model to a fee-for-service model.

Unlike many other service industries that operate on a fee-for-service model, much of the financial advice industry did not choose to structure its fee arrangements on the basis that a client would pay a fixed fee or an hourly fee for the time spent by an adviser in preparing advice for the client. Rather, in what appears to have been an attempt to replicate the revenue stream that flowed from a combination of upfront and trail commissions, many advisers charged an upfront fee for preparation of a statement of advice, and encouraged clients to enter into an ‘ongoing fee arrangement’, under which the adviser would charge an ongoing fee in exchange for particular services.

Of course, unlike a trail commission, which is paid by the product issuer in recognition of the initial sale of the financial product, an ongoing fee is paid by the client, and is paid in exchange for the provision of a service. This shift – from a model that imposed no ongoing obligations on a financial adviser to a model that did impose such obligations – lies at the heart of the ‘fees for no service’ matter, which I will take up in the next section of this chapter.

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<sup>62</sup> Corporations Act s 961B(1).

<sup>63</sup> Corporations Act s 961J(1).

## 1.6 More recent developments

Before I turn to that matter, it remains to say something briefly about more recent developments.

In February 2017, the Government announced changes designed to lift the professional, education and ethical standards of financial advisers.<sup>64</sup> The changes include compulsory education requirements, supervision for new advisers, a code of ethics for the industry, an industry exam and ongoing annual professional development obligations. Details regarding these changes (as at April 2018) were set out in Part B of the Commission's sixth published Background Paper.<sup>65</sup>

A new Commonwealth standard setting body, the Financial Adviser Standards and Ethics Authority (FASEA), was established in 2017 to develop these requirements and govern the professional standing of the financial advice sector.<sup>66</sup> FASEA will develop the new code of ethics, and professional organisations will be able to apply to ASIC for approval as code monitoring bodies. All advisers will be required to subscribe to the code of ethics of a monitoring body by 1 January 2020.<sup>67</sup>

Other requirements commenced on 1 January 2019.<sup>68</sup> From that date, new advisers are required to hold a relevant degree before they are eligible to sit the exam and commence a year of supervised work and training.<sup>69</sup> Existing advisers have two years to pass the exam (by 1 January 2021) and five years to reach a standard equivalent to a degree (by 1 January 2024).<sup>70</sup>

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<sup>64</sup> The Hon Kelly O'Dwyer MP, Minister for Revenue and Financial Services, 'Higher Standards for Financial Advisers to Commence' (Media Release, 9 February 2017).

<sup>65</sup> Background Paper No 6 (Part B), 8–12.

<sup>66</sup> See generally Treasury, *Financial Adviser Standards and Ethics Authority Limited (FASEA)* <<https://treasury.gov.au/programs-and-initiatives-banking-and-finance/financial-adviser-standards-and-ethics-authority-limited-fasea/>>.

<sup>67</sup> Treasury, Module 2 Policy Submission, 15.

<sup>68</sup> See generally ASIC, *Professional Standards for Financial Advisers – Reforms* (17 June 2018) <<http://asic.gov.au/regulatory-resources/financial-services/professional-standards-for-financial-advisers-reforms/>>.

<sup>69</sup> See, generally, Corporations Act Ch 7 Pt 7.6 Div 8A.

<sup>70</sup> See, generally, Corporations Act Ch 10 Pt 10.23A.

Some entities moved to implement these new standards sooner. For example, on 7 May 2018, ANZ announced it would begin implementing a range of initiatives to ‘help improve the quality of financial planning, and customer remediation when things go wrong’.<sup>71</sup> One of those initiatives was that ANZ will ‘[o]nly employ new planners with a relevant undergraduate degree and industry certification, and require existing planners to be enrolled in further necessary training by January 2019’.<sup>72</sup>

## 1.7 Further Observations

The proposed changes to lift the professional, education and ethical standards of financial advisers represent a further important step towards making financial advice a profession. Once these changes have taken effect, it may be possible to ask again whether the financial advice industry has truly changed from an industry dedicated to the sale of financial products to a profession concerned with the provision of financial advice.

But, in my view, without more being done, the answer will be ‘no’.

In the next three sections of this chapter, I deal with three matters that will need to be addressed before the provision of financial advice can truly be regarded as a profession.

First is the charging of ‘fees for no service’. As I said in the *Interim Report*, charging for what you do not do is dishonest. Although this should have been obvious to everyone, the practice of charging ‘fees for no service’ has been endemic in the financial advice industry. **Until satisfactory steps have been taken to deal with those involved in the charging of ‘fees for no service’, and to ensure that it does not happen again, the financial advice industry will lack the public respect and trust that is a necessary aspect of any profession.**

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<sup>71</sup> ANZ, ‘ANZ Unveils Plan to Improve Financial Planning’ (Media Release, 7 May 2018).

<sup>72</sup> ANZ, ‘ANZ Unveils Plan to Improve Financial Planning’ (Media Release, 7 May 2018).

Second is poor advice – which, too often, is the result of **the conflicts of interest that continue to characterise the financial advice industry**. Other professions are not so pervaded by conflicts of interest and do not have such a high tolerance for the continued existence of conflicts of interest. Other professions do not have such faith in the notion that conflicts of interest and conflicts between duty and interest can be effectively managed. **Until something is done to address these conflicts, the financial advice industry will not be a profession.**

Third is the disciplinary system for financial advisers. **One hallmark of a profession is the existence of a credible and coherent system of professional discipline where the ultimate sanction is expulsion from the profession.** While ASIC now has the power to ban financial advisers from providing financial services, **the existing disciplinary arrangements for financial advisers are fragmented, and hampered by inadequate sharing of information.**

Making financial advice a profession is important not merely for its own sake. It is a necessary step to protect those who seek financial advice. As I said above, clients place their trust in advisers on the basis that they will behave like professionals.

Two different solutions present themselves. The first is to have advisers act as salespeople, and be clearly identified as such. The second is to have advisers act as professionals. Past reforms have favoured this second course, and it is now too late to undo those reforms. Even if it were not too late, it is the course that I favour. Leaving the sale of complex financial products entirely to intermediaries who have no obligation to act in the interests of customers is likely only to lead to further poor outcomes for consumers of financial products. It will also leave Australians without access to financial advice. While finishing the transformation of financial advice to a profession will take time and effort, it is not impossible.

I therefore turn to consider the three matters that I believe will need to be addressed before the provision of financial advice can truly be regarded as a profession.

## 2 Fees for no service

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### Introduction

When a client consulted a financial adviser, the agreement made between them often said that the adviser would provide the client with certain services in exchange for an ongoing fee. The services to be provided under those arrangements were often so loosely defined that they had little or no substantive content beyond a promise to speak to the client (sometimes to *offer* to speak to the client) once each year.<sup>73</sup>

Some superannuation funds charged members fees for providing the member with ‘access’ to advice (described in one case as ‘ongoing general support services’<sup>74</sup>) from a nominated adviser. The member may have played no part in negotiating for provision of the service.<sup>75</sup>

It is now clear that over the last decade many who sought and obtained advice from a financial adviser, and many members of superannuation funds, were charged ongoing fees for services that were not provided. The fees were charged ‘invisibly’, in that they were deducted from consumers’ investment accounts, often enough their superannuation accounts.

The total amounts taken were very large. By August 2018, AFSL holders, including entities wholly owned by AMP and by the major banks, had paid clients about \$260 million in compensation for the money that had been taken, together with interest on the amount of earnings lost.<sup>76</sup> At that time, the total amount paid and to be paid as compensation was estimated to be about \$850 million – but the then Deputy Chair of ASIC said that he

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<sup>73</sup> FSRC, *Interim Report*, vol 1, 128.

<sup>74</sup> The MasterKey Business Super plan of which MLC Nominees Pty Limited was trustee and NULIS Nominees (Australia) Ltd became trustee. See Exhibit 5.43, Witness statement of Nicole Smith, 1 August 2018, 5 [13].

<sup>75</sup> For example, the ‘employer service fee’ charged to members of the MasterKey Business Super (MKBS) plan was deducted from member accounts of MKBS where the *employer* and the adviser had agreed that the fee would be charged. See Exhibit 5.43, Witness statement of Nicole Smith, 1 August 2018, 5 [13].

<sup>76</sup> Transcript, Peter Kell, 17 August 2018, 5254–5.

‘wouldn’t at all be surprised if it ends up being in excess of a billion dollars’.<sup>77</sup> Evidence given during the seventh round of hearings supported that prediction. By the time of those hearings:

- the amount that AMP expected to pay was \$359.7 million,<sup>78</sup> of a total amount of approximately \$1 billion received by AMP in ongoing service fees in the 10 year period between 2008 to 2017;<sup>79</sup>
- CBA had paid a total of approximately \$116 million in remediation for its ‘fees for no service’ conduct;<sup>80</sup> and
- Westpac estimated that, for its salaried advisers, across both 2017 and 2018, \$117 million would be paid.<sup>81</sup> Westpac had not then made a provision in its accounts for remediation of amounts received by its authorised representatives.<sup>82</sup>

The fees were deducted automatically from clients’ accounts. Many licensees did not keep records that would allow them to determine whether the promised services were delivered. Some licensees kept records that showed that the adviser formerly ‘linked’ with the client was no longer linked with that client. The client may have terminated the relationship with the adviser; the adviser may have left the advice licensee; the client may no longer have been an eligible member of the relevant superannuation fund to seek advice from the nominated adviser; the client may have died. There could be, and there were, many reasons why the records of the licensee showed that the client could not (and therefore would not) receive the promised services.

But in all these kinds of case, advice licensees charged clients’ investment accounts with ongoing fees. The fees were charged in many cases without the licensee asking, or knowing, whether services had been provided, and

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<sup>77</sup> Transcript, Peter Kell, 17 August 2018, 5254–5.

<sup>78</sup> Transcript, Michael Wilkins, 27 November 2018, 7192; Exhibit 7.112, Witness statement of Michael Wilkins, 21 November 2018, 22.

<sup>79</sup> Transcript, Michael Wilkins, 27 November 2018, 7199.

<sup>80</sup> Transcript, Matthew Comyn, 20 November 2018, 6677.

<sup>81</sup> Transcript, Brian Hartzer, 21 November 2018, 6836.

<sup>82</sup> Transcript, Brian Hartzer, 21 November 2018, 6838.

even in many cases where the licensee's records showed that the promised services could not possibly be delivered. And, in cases where there was no 'linked adviser', the licensee kept the fees for itself.

Several questions arise from clients having been charged ongoing fees for services that were not provided:

- How and why did these events occur?
- What has been the response to these events?
- Has that response been adequate?
- What changes are necessary to ensure these events do not occur again?

I will consider each of those questions in turn.

## **2.1 How and why did these events occur?**

In the *Interim Report*, I identified several considerations that pointed towards the conclusion that the root cause of the fees for no service conduct was greed: greed by licensees, and greed by advisers.

The evidence that emerged in later rounds of the Commission's hearings only served to reinforce that conclusion.

However, expressed at that level of generality, the identification of the root cause provides little guidance about whether the responses that have been made are adequate, or about what changes should be made to ensure that these events do not occur again.

It is therefore appropriate that I say something further about the causes of the fees for no service conduct.

Before doing so, it is important to notice that, as the proceedings of the Commission continued, and the nature and extent of the fees for no service conduct became more evident, it seemed to me that some sought to deflect attention away from whether the conduct was dishonest. There began to emerge a narrative, reflected even in the evidence of Mr Wayne Byres, Chair of the Australian Prudential Regulation Authority (APRA), that fees for no service was all just a series of careless mistakes capable of being swept aside as 'processing errors'.

This explanation was advanced by Mr Andrew Thorburn, CEO of NAB. He sought to portray the charging of fees for no service as a product of poor systems and carelessness. It was, in his words, 'just professional negligence'.<sup>83</sup> And Mr Byres said, in his statement, that 'in many cases the fees for no service issue was in large part a product of poor IT infrastructure ... [and] legacy system issues'.<sup>84</sup>

I cannot and do not accept this.

As I put to Mr Thorburn, his proposition was that 'this money fell into the pocket of NAB accidentally'.<sup>85</sup> Mr Thorburn's frank, and inevitable response was 'I can't disagree with that ... it wasn't intended to be ours but it became ours'.<sup>86</sup> The amounts of money that just 'fell into the pocket' of so many large and sophisticated financial entities, the number of times it happened, and the many years over which it happened, show that it cannot be swept aside as no more than bumbling incompetence or the product of poor computer systems. I say more about these matters when considering whether the responses to fees for no service have been adequate.

In identifying the causes of the conduct, the observations made by ASIC in its October 2016 report provide a useful starting point. In that report, ASIC observed that during the time fees were being charged for no service:

- the financial advice industry had a culture of reliance on automatic periodic payments such as sales commissions and adviser service fees;
- some advice licensees prioritised advice revenue and fee generation over ensuring that they delivered the required services;
- some licensees and advisers did not keep adequate records to enable monitoring and analysis; and

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<sup>83</sup> Transcript, Andrew Thorburn, 26 November 2018, 7073.

<sup>84</sup> Exhibit 7.145, Witness statement of Wayne Byres, 27 November 2018, 91 [363]; Transcript, Wayne Byres, 30 November 2018, 7475.

<sup>85</sup> Transcript, Andrew Thorburn, 26 November 2018, 7070.

<sup>86</sup> Transcript, Andrew Thorburn, 26 November 2018, 7070.

- some licensees did not develop and enforce effective monitoring and checking procedures to prevent systemic failures.<sup>87</sup>

No doubt these observations were then, and remain, accurate. But, as I said in the *Interim Report*, they are observations that do not go far beyond the proposition that fees were charged for no service. Points made in the *Interim Report* should be repeated.

The first is obvious. Charging for what you do not do is wrong. No doubt, as Mr Anthony Regan – then AMP’s Group Executive, Advice and New Zealand – pointed out, fees were charged for no service during a period that saw great legal and regulatory change.<sup>88</sup> But contrary to Mr Regan’s evidence, neither the pace nor the extent of regulatory change made any contribution to the occurrence of these events. As Mr Regan himself accepted, charging fees for no service is obviously wrong.<sup>89</sup>

Since Mr Regan’s evidence, others have also recognised that this conduct is wrong. In his evidence in the seventh round of hearings, Mr Matthew Comyn, CEO of CBA, accepted that charging fees for no service reflected not only an unacceptable culture and lack of professional conduct among CBA’s advisers, but an unacceptable culture on the part of managers.<sup>90</sup> Mr Thorburn said that retaining fees charged for a service when NAB did not provide that service was ‘absolutely wrong’.<sup>91</sup> Mr Thorburn accepted that where a financial adviser charges and retains fees to a client for services they know they have not provided, that is dishonest conduct.<sup>92</sup> (As explained above, Mr Thorburn sought to assert that no-one *knew* this was happening. The money just kept ‘falling into NAB’s pocket’.)

Second, and equally obviously, making an ongoing fee arrangement gives the adviser a financial advantage. The adviser stands to earn, and to continue to earn, annual amounts from the client. The less the adviser does before the fee is paid, the greater the financial advantage.

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<sup>87</sup> ASIC, Report 499, 27 October 2016, 8.

<sup>88</sup> Exhibit 2.13, Witness statement of Anthony Regan, 11 April 2018, 54 [291].

<sup>89</sup> Transcript, Anthony Regan, 16 April 2018, 1072–3.

<sup>90</sup> Transcript, Matthew Comyn, 20 November 2018, 6679.

<sup>91</sup> Transcript, Andrew Thorburn, 26 November 2018, 7067–8.

<sup>92</sup> Transcript, Andrew Thorburn, 26 November 2018, 7073.

And, as ASIC noted in its 2016 report, licensees did not have systems in place to ensure that *any* services were provided in return for the fees being charged. Licensees did, however, have systems in place that recorded incoming revenue.<sup>93</sup>

Third, licensees did nothing to prevent advisers having more customers on their books than they could monitor or advise annually. Often, the advisers had ‘acquired’ (or ‘inherited’) those clients from some other adviser.<sup>94</sup> And licensees such as AMP and its associated entities, that have provided, and continue to provide, ‘**buyer of last resort**’ arrangements for advisers who wish to leave the business, not only facilitate, but actively encourage, the treatment of client books as a tradeable asset to be valued as a multiple of annual income earned. The annual income in this case consisted of commissions and fees paid by clients.<sup>95</sup>

Fourth, the services to be provided under ongoing fee arrangements often were, and still are, neither well-defined nor onerous. Evidence showed how the services to be provided under ongoing service arrangements may not only be very loosely defined but also defined in a way that has little or no substantive content beyond a promise to speak with the client once each year. Describing the services (as Mr Michael Wright, the national head of BT Financial Advice did) as ‘strategic advice and reassurance’<sup>96</sup> may encourage both adviser and client to view the provision of ongoing services as a matter of form rather than substance and as a matter that is not of any immediate or pressing moment or value. What exactly was, or is, to be provided in an ‘annual review’? What is meant when it is said that the client may ‘have access’ to the adviser? Was (or is) the only promise made to ‘offer’ an annual review? And some advisers have in the past charged fees for services that ASIC said had ‘limited’ (I would say no) value such as maintaining records that the law required the advisers to maintain and retain.<sup>97</sup>

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<sup>93</sup> ASIC, Report 499, 27 October 2016, 39–40 [191(a)].

<sup>94</sup> ASIC, Report 499, 27 October 2016, 40 [191(b)].

<sup>95</sup> Transcript, Anthony Regan, 16 April 2018, 1061–2.

<sup>96</sup> Transcript, Michael Wright, 20 April 2018, 1450.

<sup>97</sup> ASIC, Report 499, 27 October 2016, 40.

As ASIC pointed out in its submissions, the promised services, even if provided, may not give the client a benefit commensurate with their cost. If, as each of Ms Marianne Perkovic (on behalf of CBA), Mr Regan (on behalf of AMP) and Mr Darren Williams (on behalf of ANZ) said may be the case, the future advice fee is fixed as a percentage of the ‘funds under advice’ (rather than as a fixed dollar sum), the question of value for money is all the more evident. Ms Perkovic said that the maximum fee charged by CFPL, under its Legacy package, was 0.94% of funds under advice;<sup>98</sup> Mr Regan produced an example of an agreement between an adviser at Hillcross and a client where the ongoing service fee was fixed at 0.6% of funds under advice;<sup>99</sup> Mr Williams said that some ongoing service fees were calculated as a percentage of the fees under advice but that other such fees were fixed as a flat dollar amount.<sup>100</sup>

When asked to describe what was generally provided under ongoing advice arrangements, Mr Wright said, that ‘before FoFA, the conversation was much more around performance. Post-FoFA, and particularly now in our business, the conversation is much more around *strategic advice and reassurance*’.<sup>101</sup> Mr Wright spoke of how the ‘conversation’ was now used to reflect on statutory changes, and ensure that strategic advice was going to meet the client’s goals and aspirations by, if needs be, ‘rebalanc[ing] or reposition[ing]’ to meet those goals.<sup>102</sup>

Subject to one important qualification, the descriptions that Ms Perkovic, Mr Regan and Mr Williams gave of ongoing services were not substantially different from the description given by Mr Wright. The qualification that must be noted is that Ms Perkovic described the ‘core component’ of ongoing

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<sup>98</sup> Exhibit 2.73, Witness statement of Marianne Perkovic, 3 April 2018, 5 [29].

<sup>99</sup> Exhibit 2.13, Witness statement of Anthony Regan, 11 April 2018, Exhibit AGR-1 [AMP.6000.0020.0234 at .0236].

<sup>100</sup> Exhibit 2.92, Witness statement of Darren Williams, 13 April 2018, 10–11 [49].

<sup>101</sup> Transcript, Michael Wright, 20 April 2018, 1450 (emphasis added).

<sup>102</sup> Transcript, Michael Wright, 20 April 2018, 1450.

services as an annual review<sup>103</sup> but, according to Ms Perkovic, at least in the case of Bankwest Financial Advice (BWFA), the mere offer of an annual review was considered sufficient for the fee to be charged.<sup>104</sup>

If done properly, an annual review might require the application of a deal of time, skill and judgment. Whether it did would depend not only upon the skill and diligence of the adviser but also upon what investments the client had, whether the client's circumstances had changed and whether investment conditions had changed either generally or in relation to one or more of the products in which the client had invested. Absent extraordinary external events or radical change in the client's personal position, it would be very easy to provide the service with little time and little effort. And, as pointed out above, the less work that is done, the greater the financial advantage to the adviser.

The fifth consideration to notice is that the fees charged under ongoing fee arrangements were, and still are, often charged 'invisibly': by being deducted from the client's investment accounts. If there is no recognition of a pressing need for the services and the charge is deducted automatically against funds under investment, neither adviser nor client may think about whether the services promised have been or should be provided. One line in a periodic investment statement recording the payment will draw the matter to attention *only* if the client is attentive enough to look beyond the total given at the foot of the statement. And there are many who will not do that. Whether a fee disclosure statement draws the matter to the client's attention may depend upon what emphasis the adviser gives when presenting the statement, to how beneficial the adviser's past advice has been, and how well the client's investments have proved or are proving to be.

Sixth, before the FoFA reforms required advisers to obtain client agreement every two years for the charging of ongoing fees, and to provide information each year about the services provided in exchange for the ongoing fee, the client may have made the agreement for ongoing fees at the time advice was first provided and neither at that time nor thereafter adverted to, or

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<sup>103</sup> Provided in the past, by one CBA licensee, BWFA, by telephone. See Exhibit 2.73, Witness statement of Marianne Perkovic, 3 April 2018, 4 [24], 9 [62].

<sup>104</sup> Transcript, Marianne Perkovic, 18 April 2018, 1289–92.

been reminded of, the adviser's obligation. This problem was made worse by the transitional arrangements for the FoFA reforms. Although those reforms commenced on 1 July 2012, the Corporations Act provided that compliance with the new provisions (including the provisions requiring the giving of renewal notices and fee disclosure statements) was not compulsory until 1 July 2013.

Because of the way the provisions of the Corporations Act requiring the giving of fee disclosure statements and renewal notices were structured, the first occasion on which an adviser could have been required to give a fee disclosure statement was 1 July 2014, and the first occasion on which an adviser could have been required to give a renewal notice was 1 July 2015. This meant that, even after the FoFA reforms took effect, it was some years before advisers were required to bring to their clients' attention the services provided (or not provided) in exchange for their ongoing fees.

Seventh, income from trail commissions was, and has remained, an important part of the revenue earned from the provision of financial advice. This is consistent with ASIC's observation of an industry culture that relies on automatic periodic payments from customers.<sup>105</sup> The highest source of revenue for financial advisers providing advice on behalf of three out of AMP's four advice licensees for every year between 2008 and 2018 (for which AMP had records)<sup>106</sup> was ongoing or trail commissions.<sup>107</sup> And for the fourth of those advice licensees, where fees for service were the largest source of revenue for advisers, the advisers were employees of the licensee.

Yet Mr Wright gave evidence that despite clients not going to an adviser for ongoing advice,<sup>108</sup> most clients of authorised representatives of the financial advice businesses conducted by Westpac's advice licensees (Magnitude and Securitor) would be on an ongoing fee arrangement.<sup>109</sup>

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<sup>105</sup> ASIC, Report 499, 27 October 2016, 8.

<sup>106</sup> AMP did not have records about revenue sources for two entities (Charter and iPac) for 2008 to 2011 because those entities were not then part of AMP. See Exhibit 2.171, Witness statement of Anthony Regan, 11 April 2018, 21 [78].

<sup>107</sup> Exhibit 2.171, Witness statement of Anthony Regan, 11 April 2018, 19–21 [77]–[78].

<sup>108</sup> Transcript, Michael Wright, 20 April 2018, 1451.

<sup>109</sup> Transcript, Michael Wright, 20 April 2018, 1449–50.

(He said that fewer clients of Westpac's *employed* financial advisers would have ongoing arrangements. Even so, it is to be noted that the case study relating to Mrs McDowall showed that an adviser employed by Westpac signed Mr and Mrs McDowall up for an ongoing fee of \$3,000 per annum.<sup>110</sup> The point not having been explored in evidence, one can only wonder what the purpose of that ongoing fee might have been thought to be.)

## 2.2 What has been the response to these events?

The causes having been identified, the next question is how the entities and regulators have responded to these events.

Those responses must be understood in light of the way in which the issues emerged. That history was set out in the *Interim Report*<sup>111</sup> but should be repeated here.

In 2014, ASIC started its 'Wealth Management Project', a major project focusing upon the financial advice businesses conducted by ANZ, CBA, NAB, Macquarie, Westpac and AMP.<sup>112</sup> In April 2015, ASIC announced that it was 'investigating multiple instances of licensees charging clients for financial advice, including annual advice reviews, where the advice was not provided'.<sup>113</sup> ASIC said that it would 'consider all regulatory options, including enforcement action' where it found evidence of breaches of the law and that it would 'look to ensure that advice licensees follow a proper process of customer remediation and reimbursement of fees where such breaches have occurred'.<sup>114</sup> As events turned out, however, until immediately before the time the Commission began taking evidence about fees for no service, ASIC had undertaken some investigations and had pursued remediation, but had taken no enforcement action.<sup>115</sup> Rather, as Mr Peter Kell, Deputy Chair of ASIC, said, '[m]ost of ASIC's work

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<sup>110</sup> Exhibit 2.98, Witness statement of Jacqueline McDowall, 4 April 2018, Exhibit JM-2 [WIT.0900.0001.0037 at .0059].

<sup>111</sup> FSRC, *Interim Report*, vol 1, 124–5.

<sup>112</sup> Exhibit 2.1, Witness statement of Peter Kell, 12 April 2018, 2 [9].

<sup>113</sup> ASIC, Media Release 15-081MR, 16 April 2015.

<sup>114</sup> ASIC, Media Release 15-081MR, 16 April 2015.

<sup>115</sup> Exhibit 2.1, Witness statement of Peter Kell, 12 April 2018, Exhibit PK-4 [ASIC.0902.0001.3189].

in the [fees for no service] project [had] focused on remediation'.<sup>116</sup> And it was not until a few days before those hearings began that ASIC announced:

- first, that it had agreed with ANZ that ANZ would give an EU in relation to the charging of fees for no service; and
- then, a few days later, that it had agreed with CBA that two of CBA's financial advice licensees (CFPL and BWFA, a CBA licensee that ceased to provide advice in 2016) would give an EU in relation to the charging of fees for no service.

In October 2016, ASIC reported that AMP, ANZ, CBA and NAB had all identified systemic issues in relation to the charging of ongoing fees; Westpac had identified a systemic issue 'in relation to one adviser only'; Macquarie had not identified any systemic failures in respect of fees for no service.<sup>117</sup>

ASIC said that '[m]ost of the systemic failures identified' had occurred before the FoFA reforms, which became mandatory on 1 July 2013.<sup>118</sup> But the report also revealed that, as at 31 August 2016, compensation arising from fees for no service was estimated to be more than \$178 million in respect of about 200,000 customers,<sup>119</sup> and that by 31 August 2016, about \$23.7 million had been paid, or agreed to be paid to over 27,000 customers. Between 31 August 2016 and 31 January 2018, the total compensation paid or agreed to be paid and the number of customers affected increased markedly, to the figures given by Mr Kell in his April 2018 statement: more than \$216 million and more than 305,000 customers.<sup>120</sup> And, contrary to the tenor of ASIC's 2016 report, the evidence to the Commission showed that there had been some significant systemic failures after the FoFA reforms.

As I said in the *Interim Report*, advice licensees may well regard their undertaking remediation programs for clients who had been charged fees

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<sup>116</sup> Exhibit 2.1, Witness statement of Peter Kell, 12 April 2018, 11 [42].

<sup>117</sup> ASIC, Report 499, 27 October 2016, 5 [7].

<sup>118</sup> ASIC, Report 499, 27 October 2016, 6 [16].

<sup>119</sup> ASIC, Report 499, 27 October 2016, 7.

<sup>120</sup> Exhibit 2.1, Witness statement of Peter Kell, 12 April 2018, PK-3 [ASIC.0902.0001.3370].

for no service as their public acknowledgment of wrongdoing.<sup>121</sup> But, until about March 2018, ASIC's chief focus had been upon remediation. And the only formal and public steps that ASIC had taken with respect to the issue, beyond issuing its reports and press releases, was ASIC's acceptance of the ANZ and CBA EUs, just before the Commission began its hearings about fees for no service.<sup>122</sup> Those undertakings went no further than to record ASIC's 'concerns' and the acknowledgment by the relevant entities that those concerns were 'reasonably held'. As I also said in the *Interim Report*, this was well short of a full and frank acknowledgment by the entities that what they had done was wrong; there was also no public denunciation of the conduct as wrong.<sup>123</sup>

ASIC's October 2016 report about fees for no service focused upon advice licensees associated with AMP, ANZ, CBA, NAB or Westpac. The report showed, among other things, that some of the advice licensees had not then completed their review and remediation activities.<sup>124</sup> As the work of the Commission proceeded, it became clear not only that some entities had still not completed their review and remediation activities, but also that the work would have to continue for some time. It is important to record why that is so.

First, some entities appear not to have given the tasks high priority. The work of identifying who should be compensated and how much compensation should be paid is detailed and time consuming. In their evidence to the Commission, some entities recognised that they had given too little attention to these matters and had not done enough work, quickly enough.<sup>125</sup>

Second, some entities began to look for particular kinds of cases where fees were charged for no service only because evidence was led in the Commission about some other entity having charged fees in those

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<sup>121</sup> FSRC, *Interim Report*, vol 1, 125.

<sup>122</sup> Enforceable Undertaking, ASIC and ANZ, 29 March 2018, 5 pt 3; ASIC, Media Release 18-092MR, 6 April 2018; Enforceable Undertaking, Commonwealth Bank Subsidiaries, 9 April 2018, 9 [3.5.5]; ASIC, Media Release 18-102MR, 13 April 2018.

<sup>123</sup> FSRC, *Interim Report*, vol 1, 126.

<sup>124</sup> ASIC, Report 499, 27 October 2016, 21.

<sup>125</sup> See Transcript, Darren Whereat, 20 April 2018, 1519–20, 1546; Transcript, Sarah Britt, 23 April 2018, 1607, 1609–10, 1619.

circumstances. So, when evidence was led, in April 2018, about Count Financial Limited having charged ongoing fees to dead clients,<sup>126</sup> other entities asked, apparently for the first time, whether they had also done this.<sup>127</sup> So, for example:

- In May 2018, NAB made a breach notification to ASIC and APRA concerning fees it had charged to members following notification of their death.<sup>128</sup> NAB identified this breach after undertaking reviews to confirm whether it had charged ongoing advice fees to members where they were deceased, having become 'aware of similar issues affecting another financial services entity'.<sup>129</sup>
- In June 2018, AMP made a breach notification to ASIC and APRA that, in short, it had retained or not properly refunded premiums charged to members after their death.<sup>130</sup> That breach notification identified 3,124 members with a total of \$922,902 in premium refunds owing.<sup>131</sup> At 5 September 2018, AMP had identified that 4,645 customers were affected by this issue, with \$1.3 million in premium refunds owing.<sup>132</sup> In the sixth round of hearings, AMP's Group Executive for Wealth Solutions and Chief Customer Officer, Mr Paul Sainsbury explained that AMP commenced an investigation into whether it had charged deceased members fees after notification of their death following 'Commonwealth Bank's circumstances around premiums [for] deceased members'.<sup>133</sup>

Third, some entities proposed what ASIC described as 'review and remediation processes that were legalistic and not focused on customers'

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<sup>126</sup> Transcript, Marianne Perkovic, 19 April 2018, 1340–1.

<sup>127</sup> Transcript, Linda Elkins, 15 August 2018, 4962–3.

<sup>128</sup> Exhibit 7.80, Witness statement of Andrew Thorburn, 19 November 2018, 55–6 [192], [194(d)].

<sup>129</sup> Exhibit 7.80, Witness statement of Andrew Thorburn, 19 November 2018, 55 [194(a)].

<sup>130</sup> Transcript, Paul Sainsbury, 17 September 2018, 5884; Exhibit 6.234, Witness statement of Paul Sainsbury, 5 September 2018, Exhibit PJS-2 Tab 3 [AMP.6000.0281.0046].

<sup>131</sup> Transcript, Paul Sainsbury, 17 September 2018, 5884; Exhibit 6.234, Witness statement of Paul Sainsbury, Exhibit PJS-2 Tab 3 [AMP.6000.0281.0046 at .0046].

<sup>132</sup> Transcript, Paul Sainsbury, 17 September 2018, 5892.

<sup>133</sup> Transcript, Paul Sainsbury, 17 September 2018, 5891.

interests<sup>134</sup>. Issues of that kind were considered more fully in the case study about NULIS Nominees (Australia) Ltd. As that case study showed, negotiations about these processes could be, and in that case were, protracted.

Fourth, progress appears to have been hampered by deficiencies in record keeping: deficiencies by both the licensee in having access to the authorised representatives' records, and by the authorised representative in recording whether or not the service was provided.<sup>135</sup>

Until the Commission began to examine these matters, however, compensation appears to have been ASIC's sole focus. As the Commission's work proceeded, ASIC's focus widened. First, ASIC moved to secure the EUs given by ANZ and CBA. In September 2018, ASIC instituted civil penalty proceedings against MLC Nominees Pty Ltd and NULIS in the Federal Court of Australia alleging contraventions of various provisions of the Corporations Act, the *Australian Securities and Investments Commission Act 2001* (Cth) (the ASIC Act) and the *Superannuation Industry (Supervision) Act 1993* (Cth) in connection with the charging of certain advice fees.<sup>136</sup> And, still more recently, ASIC has said that it is considering other forms of response.

## 2.3 Were the responses adequate?

Between them, AMP, ANZ, CBA, NAB and Westpac will pay customers of their advice licensees or their superannuation funds compensation totalling \$850 million, or more, for taking money as payment for services that were not provided. Each of those entities will pay its own amount of compensation, and none of them is responsible for what the others did. It is neither right nor useful to seek to impose collective responsibility. But, in judging the adequacy of the responses made by the entities

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<sup>134</sup> ASIC, Report 499, 27 October 2016, 42 [203].

<sup>135</sup> See, eg, Transcript, Brian Hartzer, 21 November 2018, 6838; Transcript, Andrew Thorburn, 26 November 2018, 7096–7; Transcript, Michael Wilkins, 21 November 2018, 7196–7.

<sup>136</sup> *ASIC v MLC Nominees Pty Ltd & Anor* FCA, NSD1654/2018; ASIC, Media Release 18-259MR, 6 September 2018. See also the case study about NAB and NULIS in vol 2 of this Report.

and by the regulators, it is necessary to recognise that the conduct ran through the whole industry.

Until this Commission was established, ASIC and the relevant entities approached the fees for no service conduct as if it called, at most, for the entity to repay what it had taken, together with some compensation for the client not having had the use of the money. That is, the conduct was treated as if it was no more than a series of inadvertent slips brought about by some want of care in record keeping.

It is necessary to keep steadily in mind that entities took money (a lot of money) from their customers for nothing. The conduct was so widespread that seeing it as no more than careless must be challenged.

It is necessary to go behind the global characterisation of the conduct as charging 'fees for no service'. The description is accurate but it is incomplete. In many cases, the advice licensee knew that the client would not receive any services in exchange for the ongoing fee. And there were cases where ongoing fees were charged when there could have been no possibility of providing the services for which the fees were charged.

The first kind of case, where the advice licensee knew that the client would not receive the relevant services includes, but would not be limited to, cases where the advice licensee's records showed no adviser (or advice group) assigned to the client. It may also include cases where the advice licensee knew that the 'linked' adviser had so many clients that he or she could not possibly have provided ongoing advice to all, but it is more convenient to leave this kind of case aside at this point.

If the advice licensee's records showed no 'linked adviser' the fee deducted from the client was taken by the advice licensee for its own use. Hence, the essential facts of the case can be described as:

- money was taken from clients;
- the money was taken as the fee for advice given or to be given to the client by an adviser;
- but no advice was given; and
- the advice licensee took the money for itself; it did not pay it to an adviser or return it to the client. (Or, putting the same point another

way, the licensee retained for itself the difference between fees charged and fees remitted.)

The second kind of case includes, but again may not be limited to, cases where the advice licensee charged the client an ongoing fee for advice given or to be given after it had been told of the client's death. Again, the essential facts are simple:

- money was taken from clients;
- the money was taken as the fee for advice given or to be given to the client by an adviser;
- but the advice licensee knew that the promised advice had not been given and could not be given; and
- the advice licensee took the money anyway and either paid it to the adviser or took it for itself.

### **2.3.1 Possible offences**

In both kinds of cases described, there is a real question whether, contrary to section 1041G of the Corporations Act, the licensee, in the course of carrying on a financial services business in this jurisdiction, engaged in dishonest conduct in relation to a financial product or financial service. Section 1311(1) of the Corporations Act makes that contravention an offence.

Since November 2010, for an individual, the maximum penalty for that offence has been imprisonment for 10 years, or a fine the greater of 4,500 penalty units or three times the total value of the benefits obtained by the person and reasonably attributable to the commission of the offence, or both. Since November 2010, for a body corporate, the maximum penalty for that offence has been a fine the greatest of 45,000 penalty units, or three times the total value of the benefits obtained by a person and reasonably attributable to the commission of the offence, or, if the court cannot determine the total value of those benefits, 10% of the body corporate's turnover during the year ending at the end of the month in which the body corporate committed or began committing the offence.<sup>137</sup>

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<sup>137</sup> Corporations Act s 1311, Sched 3, item 310.

There is also a real question whether, contrary to section 12DI(3) of the ASIC Act, the licensee, in trade or commerce, accepted a payment for financial services and, at the time of acceptance, there were reasonable grounds for believing that the person would not be able to supply the financial services within a reasonable time. Section 12GB(1) of the ASIC Act makes that contravention an offence.

Since 2001, for an individual, the penalty for that offence has been a fine not exceeding 2,000 penalty units. Since 2001, for a body corporate, the maximum penalty for that offence has been a fine not exceeding 10,000 penalty units.

Of these two provisions, I consider that section 1041G – with its emphasis on dishonest conduct – more accurately reflects both the nature and the gravity of the conduct described in the two cases set out above. I also consider that the maximum penalties applicable to a contravention of section 1041G more accurately reflect the gravity of that conduct. Accordingly, it is on that provision that I have focused.

I will say more about the construction and application of section 1041G later in this chapter. For present purposes, the important point is that ASIC appears not to have considered the application of the criminal law in connection with fees for no service until a witness giving evidence to the Commission was asked whether she had thought that taking money to which there was no entitlement raised a question of the criminal law.<sup>138</sup>

The charging of fees for no service has extended over many years. Breach notifications given to ASIC by entities refer to events occurring at various times: in September 2007,<sup>139</sup> ‘throughout 2013–2014’,<sup>140</sup> ‘Financial Year (FY) 2014’.<sup>141</sup>

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<sup>138</sup> Transcript, Nicole Smith, 8 August 2018, 4365.

<sup>139</sup> Exhibit 2.13, Witness statement of Anthony Regan, 11 April 2018, Exhibit AGR-1 Tab 33 [AMP.9000.0001.1460].

<sup>140</sup> Exhibit 2.77, Witness statement of Marianne Perkovic, 3 April 2018, Exhibit MP-13 [CBA.0001.0039.0453].

<sup>141</sup> Exhibit 2.78, Witness statement of Marianne Perkovic, 9 April 2018, Exhibit MP-2 [CBA.0517.0020.0018].

Documents ASIC produced to the Commission showed that, in the second half of August 2018, ASIC began to examine whether a brief of evidence should be prepared and submitted to the Commonwealth Director of Public Prosecutions in connection with one entity's possible contravention of section 1041G. Information made available to the Commission did not show any direct examination of possible criminal proceedings against other entities in connection with a possible contravention of section 1041G.

### 2.3.2 Communication to ASIC

Having considered the documents and other information provided by ASIC, as well as the submissions made in response to the *Interim Report*, I decided that I should, and in November 2018 did, communicate to ASIC information obtained in the course of the Commission's inquiries that relates, or may relate, to the possible contravention by other entities of section 1041G.<sup>142</sup> In particular, I informed ASIC that I was of the opinion that the information and evidence provided to the Commission showed that the conduct of at least two other entities may have contravened section 1041G. I further informed ASIC that I was of the opinion that the information and evidence provided to the Commission showed that:

- entities other than the two to which I specifically referred in my communication, and the entity that was the subject of the work ASIC began in August 2018, may have engaged in conduct of the kinds described above as the first kind of case and the second kind of case; and
- if they did, the conduct may have contravened section 1041G.

I invited ASIC to consider whether criminal or other legal proceedings should be instituted in respect of that conduct.

Examination of these issues by ASIC is still continuing, and it would not be right for me to anticipate the outcome of those deliberations. Nor would it be right for me now to name the entities I identified in my communication to ASIC. But it is important that I explain my opinion that section 1041G may apply to conduct of the kinds described and explain why I think it important to consider its application.

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<sup>142</sup> *Royal Commissions Act 1902* (Cth) s 6P.

### 2.3.3 Section 1041G

As I have said, I think it important to begin by recognising both the essential character and the scale of the conduct in issue. It was, as I have said, entities taking money for nothing. And at least \$850 million will be paid in compensation.

Section 1041G prohibits engaging in dishonest conduct in relation to a financial product or financial service. On its face, taking money for nothing is dishonest conduct. If the conduct in issue was a contravention of section 1041G, it is that section that best captures and conveys the criminality.

Section 1041G was added to the Corporations Act, with effect from 11 March 2002, by the *Financial Services Reform Act 2001* (Cth). It has, therefore, been in force for the times relevant to these matters. Section 1311 of the Corporations Act makes contravention of section 1041G an offence. The penalties specified for failure to comply with section 1041G have been amended from time to time. That detail need not be noticed. There is a proposal to amend the definition of ‘dishonesty’ in section 1041G(2).<sup>143</sup> That amendment, if made, will have only prospective effect and may also be set aside from consideration.

As the provision stood at the relevant times, it provided that:

- (1) A person must not, in the course of carrying on a financial services business in this jurisdiction, engage in dishonest conduct in relation to a financial product or financial service.
- (2) In this section:

***Dishonest*** means:

- (a) dishonest according to the standards of ordinary people; and
- (b) known by the person to be dishonest according to the standards of ordinary people.

The provisions of Part 2.5 of the Commonwealth Criminal Code (about corporate criminal responsibility) do not apply to an offence based on

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<sup>143</sup> See ASIC Taskforce Review, Report, 68–9; ASIC Taskforce Review, Government Response, 10.

section 1041G (or other provisions of Chapter 7).<sup>144</sup> Instead, section 769B provides (in effect) that people (including bodies corporate) are generally responsible for the conduct of their directors, agents or employees.

Thus, subject to some exceptions that are not relevant, conduct engaged in on behalf of a body corporate by a director, employee or agent, within the scope of the person's actual or apparent authority, is taken, for the purposes of a proceeding for an offence based on section 1041G, to have been engaged in also by the body corporate.<sup>145</sup> If it is necessary to establish the state of mind of the body corporate, it is sufficient to show that a director, employee or agent of the body, being a director, employee or agent by whom the conduct was engaged in within the scope of that person's actual or apparent authority, had that state of mind.<sup>146</sup>

To return, then, to the facts set out above. There is no doubt that money was taken from clients. Nor is there any basis for doubting that, when taken, the taker did not intend to return it to the client. If there was no adviser linked to the client, the money taken was applied by the taker to its own use. (I say the money was applied by the taker to its own use on the basis that the total of the amounts deducted exceeded the total amount paid out to advisers. The excess was constituted by the fees charged but not remitted.) If the client had died and the taker had been told and had recorded that the client had died, there could be no ongoing service given and the taker's records showed that there could be none given.

I consider that it is open to a jury to conclude, beyond reasonable doubt, that, in either of the cases described, the taker, in the course of its carrying on a financial services business in this jurisdiction engaged in conduct in relation to a financial service that was dishonest according to the standards of ordinary people and that the conduct was known by the taker to be dishonest according to the standards of ordinary people. It is necessary to explain both conclusions.

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<sup>144</sup> Corporations Act s 769A.

<sup>145</sup> Corporations Act s 769B(1)(a), read with s 769B(10)(a)(i).

<sup>146</sup> Corporations Act s 769B(3).

In the first kind of case, one or more employees of the taker, acting within the scope of their actual authority, will have directed the application of the fee received to the taker's own account. It is the application of what was taken (to the entity's own use) that is the dishonest act. It is dishonest because it is taking something for nothing. And if no more is said or known, I think the only conclusion open to a jury, once it found that the taking was objectively dishonest, would be that the person or persons who directed that the funds be taken to the entity's own use *knew* that its taking was dishonest according to the standards of ordinary people.<sup>147</sup> If it is decided (beyond reasonable doubt) that the taking was objectively dishonest, a doubt could be entertained about *knowledge* of dishonesty *only* by speculating about the existence of some unarticulated and unsupported claim of right. And there is no issue about that 'unless the absence of knowledge or, which is the *same* thing, belief as to legal right is *specifically* raised *and* there is some evidence to that effect'.<sup>148</sup>

In the second kind of case (death of the client) the taker may either retain the amount taken or may have passed it on to an adviser. If the taker retained the money (and some did) the case would be of the first kind considered. If the taker passed some or all of it on to an adviser, the taking itself would be the dishonest act, there being no possibility of supplying the contracted services. But subject to that difference, this second kind of case would be analysed in the same way as the first. The taking is objectively dishonest. Absent some evidence of a belief as to the legal right to take the money, it follows from the objective dishonesty of the taking that the taker knew it to be dishonest.

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<sup>147</sup> As Toohey and Gaudron JJ said in *Peters v The Queen* (1998) 192 CLR 493, 509 [31]: 'As a matter of ordinary experience, it will generally be inferred from an agreement to use dishonest means to deprive another of his or her property or to imperil his or her rights or interests *that the parties to that agreement knew that they had no right* to that property or to prejudice those rights or interests. And as with the defence of honest claim of legal right, *it will be taken there is no issue in that regard unless the absence of knowledge* or, which is the same thing, belief as to legal right *is specifically raised and there is some evidence to that effect*' (emphasis added; footnote omitted).

<sup>148</sup> *Peters v The Queen* (1998) 192 CLR 493, 509 [31] (Toohey and Gaudron JJ). As five members of the High Court pointed out in *Macleod v The Queen* (2003) 214 CLR 230, 241–2 [35]–[37] (Gleeson CJ, Gummow and Hayne JJ), 256 [99] (McHugh J), 264–5 [130] (Callinan J), the ratio of the decision in *Peters* is to be found in the reasons of Toohey and Gaudron JJ.

The two-part test of dishonesty that now appears in section 1041G(2) derives from the English decision in *R v Ghosh*.<sup>149</sup> That it originates from *Ghosh* is made plain by the May 1997 Report of the Model Criminal Code Officers Committee proposing a draft definition of ‘dishonesty’ not materially different from what was later enacted in section 1041G as a legislative embodiment of the *Ghosh* test.<sup>150</sup>

Consistent with what Toohey and Gaudron JJ said in *Peters*, Lord Lane CJ said in *Ghosh* that the first question for a jury will be the objective one of whether the conduct was dishonest according to the standards of ordinary people. If it was:<sup>151</sup>

then the jury must consider whether the defendant himself must have realised that what he was doing was by those standards dishonest. *In most cases, where the actions are obviously dishonest by ordinary standards, there will be no doubt about it. It will be obvious that the defendant himself knew that he was acting dishonestly.* It is dishonest for a defendant to act in a way which he knows ordinary people consider to be dishonest, *even if he asserts or genuinely believes that he is morally justified in acting as he did.*

It would be for prosecuting authorities to determine how charges would be framed. One way may be to fix upon one or more events of ‘taking’ by the entity. But however the charges are framed, it may be expected that the prosecution would seek to lead evidence that the particular takings charged were made as part of an established system and were not matters of accident. If the taking of fees was objectively dishonest, the question becomes as I have indicated: on what basis *on the evidence* would it be argued that a jury should entertain a reasonable doubt that the defendant knew that it was acting dishonestly by taking payment for a service that it did not provide?

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<sup>149</sup> [1982] QB 1053.

<sup>150</sup> Model Criminal Code Officers Committee, Report, *Chapter 3, Conspiracy to Defraud*, May 1997, 32–3.

<sup>151</sup> *R v Ghosh* [1982] QB 1053, 1064 (emphasis added).

## 2.4 Avoiding future fees for no service

So far, I have considered the causes of the fees for no service conduct, and the responses to that conduct. It remains for me to consider what can, and should, be done to prevent similar conduct from occurring in the future.

### 2.4.1 Improvements to systems and processes

Some of the necessary steps are already underway.

In its 2016 report, ASIC recorded the changes that some licensees – AMP, ANZ, CBA and NAB – had made to their systems to prevent a recurrence of charging fees for no service. Those changes varied from changing system controls,<sup>152</sup> to altering record keeping and oversight.<sup>153</sup>

A number of entities provided further detail about those changes in their evidence to the Commission. To take CFPL as an example, since identifying fees for no service issues, CFPL has:<sup>154</sup>

- introduced a system that provides a central electronic record of all customers paying ongoing service fees and when ongoing service is provided;
- introduced a centralised document management system to record customer interactions and retain evidence of delivery of service;
- established an Ongoing Services Admin and Support team to administer ongoing service processes and controls;
- included reviews of ongoing services as part of the file audit process; and
- implemented additional processes and controls for customers paying ongoing fees when an adviser leaves CFPL, including checks designed to identify customers who are paying ongoing fees but are not assigned to an adviser.

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<sup>152</sup> ASIC, Report 499, 27 October 2016, 35–8.

<sup>153</sup> ASIC, Report 499, 27 October 2016, 36–8.

<sup>154</sup> Exhibit 7.2, Witness statement of Matthew Comyn, 14 November 2018, 49 [166].

Further, as I noted in the *Interim Report*, one of the requirements of the ANZ and CBA EUs was to have senior management attest that the relevant licensee's compliance systems and processes were (at the time of the undertaking) reasonably adequate to track the licensee's contractual obligations to its ongoing service clients. ANZ's attestation was to be 'audited';<sup>155</sup> the attestation relating to CFPL (BWFA having ceased to carry on advice business) was to be 'supported by an expert report'.<sup>156</sup>

As noted above, and in the *Interim Report*, inadequate systems and processes of licensees may have contributed to some of the fees for no service conduct. It is to be hoped that the steps taken by entities to improve their systems and processes will go some way to preventing similar conduct from occurring in future.

However, as explained above, it is important not to view the fees for no service conduct as being merely the result of inadequate systems or processes. It had other and equally important causes, not least the enticing call of profit, the uncertain content of what was promised and the capacity to deduct the fees invisibly. Those matters are not solved by changing the systems and processes of AFSL holders.

## 2.4.2 Further changes

As I said in the *Interim Report*, the uncertainty of the content of what is promised is not an issue to be solved by regulation. It is, and must be, a matter for client and adviser to decide what if any services will be provided after the provision of initial advice. It is, and must be, a matter for client and adviser to decide how those services are defined.

Even accepting that it is a matter for client and adviser to decide what services are to be provided, and how those services are to be defined, it is consistent with the policies that underpinned the FoFA reforms to consider:

- first, the information that an adviser must give a client about the services to be provided under such an arrangement;

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<sup>155</sup> Enforceable Undertaking, ASIC and ANZ, 29 March 2018, 5–6 pt 3. See also ASIC, Media Release 18-092MR, 6 April 2018.

<sup>156</sup> Enforceable Undertaking, ASIC and CBA, 9 April 2018, 8–9 [3.3]–[3.5]. See also ASIC, Media Release 18-102MR, 13 April 2018.

- second, the period for which a contract for future services can be made; and
- third, the mechanism by which advisers and licensees should be permitted to charge ongoing fees to clients.

I deal with each in turn.

### *Information about the services to be provided*

Under existing law, where a client has entered into an ongoing fee arrangement with a financial adviser, the adviser must give the client a fee disclosure statement each year.<sup>157</sup> Among other things, the fee disclosure statement must set out:<sup>158</sup>

- the amount of each ongoing fee paid under the arrangement by the client in the previous year;
- information about the services that the client was entitled to receive under the arrangement during the previous year; and
- information about the services that the client received under the arrangement during the previous year.

The fee disclosure statement is plainly a backward-looking document, looking *back* at what services the client *was entitled* to receive, and what services *were provided*. Neither the definition of ongoing fee arrangement in section 962A(2) nor any other provision of the Corporations Act appears to require an adviser to identify prospectively with any degree of specificity what services the client *will be entitled* to receive, and what services *will be provided*.

Obviously, principles of contractual certainty under the law of contract will require that those services be specified with some degree of certainty. But that degree of certainty could be reached by saying that the services to be provided under the ongoing fee arrangement are such services as the adviser chooses to provide. That is not satisfactory.

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<sup>157</sup> Corporations Act ss 962H, 962S.

<sup>158</sup> Corporations Act s 962H(2).

In my view, a financial adviser who enters into an ongoing fee arrangement with a retail client should be required to provide to the client – every time the ongoing fee arrangement is made or renewed – a statement of the services that the client will be entitled to receive under the arrangement during the coming year.

### *The duration of the arrangement*

Under existing law, a client who entered into an ongoing fee arrangement after 1 July 2013 must positively renew the arrangement every two years – otherwise, the arrangement will terminate.<sup>159</sup> This is achieved in practice by requiring the giving of a renewal notice every two years,<sup>160</sup> and providing that the ongoing fee arrangement will automatically terminate unless the client positively opts to renew it within 30 days of receiving the renewal notice.<sup>161</sup>

An important function of a renewal notice is to prompt a client who has entered into an ongoing fee arrangement to consider whether he or she values what he or she is receiving under that arrangement. A client who is asked to give positive consent to the renewal of an ongoing fee is likely to focus his or her mind on what he or she has received in exchange for that fee.

As noted above, ASIC's view is that the services promised under ongoing fee arrangements, even when provided, may not give the client a benefit commensurate with their cost. I have no basis on which to doubt that view. Where the ongoing fee is fixed as a percentage of the 'funds under advice' (rather than as a fixed dollar sum), the question of value for money is all the more evident.

The information that the client needs in order to assess whether the services provided under an ongoing fee arrangement represent value for money is currently set out in the fee disclosure statement as a record of what *was* done. That statement must be provided annually. There is no reason that a client should not continue to receive annually a fee disclosure statement of that kind.

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<sup>159</sup> Corporations Act Pt 7.7A Div 3 ss 962A–962Q; see especially ss 962K, 962L.

<sup>160</sup> Corporations Act s 962K.

<sup>161</sup> Corporations Act s 962N.

But the central changes I would make are to require that ongoing fee arrangements must be renewed annually and that the client be told what *will* be done.

Subject to an exception for certain arrangements entered into between 1 July 2012 and 1 July 2013, no requirement to give a renewal notice currently applies to ongoing fee arrangements made before 1 July 2013.

As noted above, before the FoFA reforms required advisers to obtain client agreement every two years for the charging of ongoing fees, the client may have made the ongoing fee arrangement at the time advice was first provided and neither at that point nor thereafter adverted to, or been reminded of, the adviser's obligations. I have no doubt that this was a key contributing factor in many instances where fees were charged for no service.

While this position has been addressed to some extent by the requirement to provide fee disclosure statements,<sup>162</sup> there are still some ongoing fee arrangements in relation to which financial advisers are not required to provide renewal notices. That is no longer acceptable. I can see no principled reason for it to be maintained.

Regardless of whether a client entered into an ongoing fee arrangement before or after 1 July 2013, that arrangement must be subject to annual renewal.

### *Authorisation for deductions*

Ongoing fees have often been paid, and are still often paid, by deduction from clients' investment accounts, including superannuation accounts. The 'invisible' nature of the payments contributed to the charging of fees for no service.

Deducting advice fees from superannuation accounts presents its own particular issues and I deal with those in the chapter on superannuation. But, subject to that important qualification, I see no reason in principle why licensees should not be permitted to continue to deduct fees from investment accounts (other than superannuation accounts), provided the entity making the deduction has the express authority of the client.

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<sup>162</sup> Corporations Act s 962S.

I noted in the *Interim Report* that platform operators have routinely deducted, and continue to deduct, ongoing service fees from clients' accounts and have remitted, and continue to remit, the fees to advice licensees without having any authority beyond the licensee's claim to be entitled to payment. (If the client's account has insufficient cash to make the payment, assets are liquidated to realise sufficient cash.) As I said there, to pay away money held on behalf of another, on the request of the party who claims payment, is a distinctly unusual arrangement. It is not one that I consider should be permitted to continue.

If a licensee wants a product issuer to deduct an ongoing fee from a client's investment account, then the client must give the issuer express authority for this to occur. That authority should operate only for the period of the ongoing fee arrangement to which it relates, and should be required to be renewed annually, with the ongoing fee arrangement.

## Conclusion

In what I have said above, I have tried, as far as possible, to recommend changes to the *substance* of ongoing fee arrangements, rather than the *form* in which those arrangements are given effect. The heart of the matter is this: if a financial adviser and a client want to enter into an arrangement under which the client agrees to pay fees on an ongoing basis, the arrangement:

- must be renewed annually by the client;
- must tell the client clearly what fees he or she will pay, and what services he or she will receive in exchange for those fees; and
- must not permit or require the deduction of fees from any account held by the client except with the client's express written authority, which must also be renewed annually.

Those requirements should apply to *all* ongoing fee arrangements, whenever made.

If ongoing fee arrangements have those characteristics, those arrangements will be unlikely to give rise to fees for no service conduct of the kind that was the subject of evidence before the Commission.

### **Recommendation 2.1 – Annual renewal and payment**

The law should be amended to provide that ongoing fee arrangements (whenever made):

- must be renewed annually by the client;
- must record in writing each year the services that the client will be entitled to receive and the total of the fees that are to be charged; and
- may neither permit nor require payment of fees from any account held for or on behalf of the client except on the client's express written authority to the entity that conducts that account given at, or immediately after, the latest renewal of the ongoing fee arrangement.

## **3 Inappropriate advice**

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### **Introduction**

The second matter that emerged in connection with the provision of financial advice is that clients have often been given poor advice that has left them worse off than they would have been if proper advice had been given.

I repeat what I said in the *Interim Report*.<sup>163</sup>

Hindsight will always show that some advice an adviser gives a client turns out to have been disadvantageous. Advice that is given about financial products or investment will not always turn out for the best.

Not all advisers (financial or other) are equally skilled or diligent. In some cases, reasonable advisers may form radically different views about what should be done.

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<sup>163</sup> FSRC, *Interim Report*, vol 1, 138–9.

Nothing can be done to change these outcomes. But recognising that there will be unforeseen and unwanted outcomes and recognising that some advisers will not be as skilled or diligent as others cannot be permitted to obscure some large and deep-seated issues.

The cases of ‘inappropriate’ advice considered in the course of the Commission’s work called attention to four recurring points:

- advisers proposing actions that benefited the adviser;
- advisers proposing actions that benefited the licensee either with whom the adviser was aligned or by whom the adviser was employed;
- advisers lacking skill and judgment; and
- licensees being unwilling to find out whether poor advice had been given and, if it had, to take timely steps to put it right.

The first two points, about advisers proposing actions that benefited either the adviser or the licensee with whom the adviser was aligned, direct attention to the conflict between the adviser’s duty to the client and the adviser’s interest.

### 3.1 Conflicts of duty and interest

As I said in the *Interim Report*,<sup>164</sup> consideration of conflicts of interest, or more accurately, conflicts between duty and interest, begins from two simple points:

- So long as advisers stand to benefit financially from clients acting on the advice that is given, the adviser’s interests conflict with the client’s interests.
- So long as licensees stand to benefit financially from clients acting on the advice that is given, the licensee’s interests conflict with the client’s interests.

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<sup>164</sup> FSRC, *Interim Report*, vol 1, 139.

The client's interests always require consideration of whether to take any step, and only then, consideration of what steps to take. Doing nothing is an available choice. Sometimes it is the best choice.

If steps are to be taken, it is in the client's interests to take whatever steps are best for them (best both in the sense of achieving the best outcome for the client, but best also in the sense of achieving that outcome most efficiently at the best available price).

By contrast, the adviser's and licensee's interests are to have the client buy a product or make an investment that will give the adviser, the licensee, or both, a financial benefit. Not only is it in their interests to have the client do something rather than do nothing, it is in their interests to have the client take a step from which the adviser, the licensee, or both will benefit financially.

### 3.1.1 The legislative premise

The premise for the FoFA reforms was that conflicts of the kind described do exist, must be recognised and should be regulated. The FoFA reforms did not seek to eliminate the conflicts. Instead, the reforms have sought to ameliorate the consequences of the conflicts. The legislation sought to do this by imposing on advisers the best interests obligation<sup>165</sup> with the associated requirements that the adviser provide appropriate advice<sup>166</sup> and give priority to the client's interests.<sup>167</sup>

Those provisions were supplemented in two ways. First, by the prohibitions on conflicted remuneration<sup>168</sup>. Second, by adding to the general obligation of all financial licensees (to do all things necessary to ensure that the financial services covered by the licence are provided efficiently, honestly and fairly<sup>169</sup>) the further requirement to have in place adequate arrangements

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<sup>165</sup> Corporations Act s 961B(1).

<sup>166</sup> Corporations Act s 961G.

<sup>167</sup> Corporations Act s 961J.

<sup>168</sup> Corporations Act ss 963E–963L.

<sup>169</sup> Corporations Act s 912A(1)(a).

for the management of conflicts of interest that may arise in relation to activities undertaken by the licensee or a representative.<sup>170</sup>

The legislative provisions emphasise process rather than outcome. Although the fundamental obligation is cast as a ‘best interests duty’ there is no explicit reference in the legislation to making comparisons of a kind that would merit the use of the superlative ‘best’ in the collocation ‘best interests’. Instead, the Corporations Act provides that the best interests obligation will be met if an adviser follows the steps described in section 961B(2).<sup>171</sup>

Section 961B(2) is a ‘safe harbour’ provision. Six steps must be taken, and there is a seventh and general catch-all provision requiring the adviser to take any other step that ‘would reasonably be regarded as being in the best interests of the client’. The six required steps are to:

- identify the subject matter of the advice;
- identify the client’s relevant circumstances (objectives, financial situation and needs);
- make reasonable inquiries to remedy the deficiency if the information about the client’s relevant circumstances appears incomplete or inaccurate;
- assess whether the adviser has the required expertise;
- conduct a reasonable investigation into the financial products that might achieve the client’s objectives and meet the client’s needs; and
- base all judgments on the client’s relevant circumstances.

It is convenient to focus on one of those steps: to conduct ‘a reasonable investigation’ into the products that might achieve the relevant objectives of the client and meet the client’s needs.<sup>172</sup> In practice this requires the adviser

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<sup>170</sup> Corporations Act s 912A(1)(aa).

<sup>171</sup> Section 961B(3) of the Corporations Act deals separately with satisfaction of the best interests duty when advice is given by Australian ADIs.

<sup>172</sup> Corporations Act s 961B(2)(e).

to make little or no independent inquiry into, or assessment of, products. Instead, in most cases, advisers and licensees act on the basis that the obligation to conduct a reasonable investigation is met by choosing a product from the licensee's 'approved products list'.

### 3.1.2 Applying the current law about the client's interests

ASIC's January 2018 report – *Financial Advice: Vertically Integrated Institutions and Conflicts of Interest* – showed that the approved products lists maintained by advice licensees controlled by the five largest banking and financial institutions included products manufactured by third parties and that third party products made up nearly 80% of the lists.<sup>173</sup> But the report also showed that, overall, more than two-thirds (by value) of the investments made by clients were made in in-house products.<sup>174</sup> (At the level of individual licensees the proportion varied from 31% to 88% invested in in-house products.<sup>175</sup> By product type, the proportions invested in in-house products varied: 91% for platforms; 69% for superannuation and pensions; 65% for insurance; and 53% for investments. But taken as a whole, the report shows that advisers favour in-house products.)

The result is not surprising. Advisers may be expected to know more about the products manufactured by the licensee with which the advisers are associated than they know about a rival licensee's products. Advisers will often be readily persuaded that the products 'their' licensee offers are as good as, if not better than, those of a rival. And when those views align with the adviser's personal financial interests, advising the client to use an in-house product will much more often than not follow as night follows day.<sup>176</sup>

It is the very fact that the result is not surprising that shows that the premise of the current law is flawed. It is not surprising that, despite the breadth of approved product lists, more than two-thirds (by value) of the investments made by clients of vertically integrated institutions were made in in-house

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<sup>173</sup> ASIC, Report 562, 1 January 2018, 28.

<sup>174</sup> ASIC, Report 562, 1 January 2018, 28 [113].

<sup>175</sup> ASIC, Report 562, 1 January 2018, 29.

<sup>176</sup> Sunita Sah, *FSRC Research Paper: Conflicts of Interest and Disclosure*, 7 November 2018, 3–11.

products.<sup>177</sup> And that is not surprising because experience shows, and has shown for decades, that, more often than not, interest trumps duty. But, as noted above, the premise for the FoFA reforms was that, although conflicts between the duties owed by an adviser or a licensee and the interests of that adviser or that licensee exist and must be recognised, those conflicts can be ‘managed’ and regulated. As I have said, the FoFA reforms were not designed to eliminate the conflicts, but to try to ameliorate their consequences.

As the January 2018 ASIC report shows, however, the law, as it stands, has not resulted in conflicts being managed successfully. It has not seen the client’s interests being preferred over the interests of the adviser and the entity with which the adviser is aligned. The law, as it now stands, has not prevented the outcomes described in that report.

The report concluded that, in 75% of the advice files reviewed by ASIC, ‘the adviser had not demonstrated compliance with the best interests duty in section 961B of the Corporations Act’<sup>178</sup> and ‘the adviser appeared to have prioritised their own interests – or those of a related party of the adviser – over the customer’s interests, in breach of section 961J’ of the Corporations Act.<sup>179</sup>

Not only that, the report said that a ‘common theme we saw across the non-compliant advice was the unnecessary replacement of financial products, where advisers recommended that a client switch to a new product where their existing product appeared to be suitable to meet the customers’ needs and objectives’.<sup>180</sup>

In *none* of the 75% of files judged by ASIC to be ‘non-compliant’ did the adviser demonstrate that following the advice given to the client would leave the client in a *better* position.<sup>181</sup>

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<sup>177</sup> ASIC, Report 562, 1 January 2018, 28 [113].

<sup>178</sup> ASIC, Report 562, 1 January 2018, 36 [137].

<sup>179</sup> ASIC, Report 562, 1 January 2018, 42 [174].

<sup>180</sup> ASIC, Report 562, 1 January 2018, 36 [139].

<sup>181</sup> ASIC, Report 562, 1 January 2018, 37 [147].

In 10% of all the files ASIC reviewed, ASIC ‘had significant concerns about the potential impact of the advice on the customer’s financial situation’.<sup>182</sup> The impacts included changed insurance arrangements resulting in exclusions or loadings being applied to the new policy, new insurance arrangements requiring payment of significantly higher premiums ‘on a like-for-like basis’, and the move to a new superannuation platform increasing the continuing superannuation product fees without any additional benefit.<sup>183</sup>

The Commission’s case studies pointed in the same direction. First, there were cases, such as those involving Mr and Mrs McDowall<sup>184</sup> and Ms Donna McKenna<sup>185</sup>, where the adviser proposed that the client invest in in-house products that would give an immediate and direct financial benefit to the adviser but which, if followed, would not be in the clients’ best interests. Second, and just as importantly, many of the cases in which entities accepted that clients should be compensated for poor advice were cases where the advice had been to invest in products (in-house or other) that gave the adviser a financial benefit.<sup>186</sup>

## **3.2 Can conflicts be managed better?**

Accepting, for the moment, the premise of the FoFA reforms – that conflicts of duty and interest exist, must be recognised and should be ‘managed’ – the question that presents itself is: is there more that could be done to ‘manage’ those conflicts better?

### **3.2.1 Improved education and standards for financial advisers**

I referred earlier to changes to the education requirements for financial advisers, announced in February 2017.<sup>187</sup> As I have mentioned, the changes

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<sup>182</sup> ASIC, Report 562, 1 January 2018, 37 [145].

<sup>183</sup> ASIC, Report 562, 1 January 2018, 37 [145].

<sup>184</sup> FSRC, *Interim Report*, vol 2, 169–74, 179–80.

<sup>185</sup> FSRC, *Interim Report*, vol 2, 242–9.

<sup>186</sup> See, eg, FSRC, *Interim Report*, vol 2, 218–20.

<sup>187</sup> The Hon Kelly O’Dwyer MP, Minister for Revenue and Financial Services, ‘Higher Standards for Financial Advisers to Commence’ (Media Release, 9 February 2017).

include compulsory education requirements, supervision for new advisers, a code of ethics for the industry, an industry exam and ongoing annual professional development obligations. Details regarding these changes (as at April 2018) were set out in Part B of the Commission's sixth published Background Paper.<sup>188</sup>

I said in the *Interim Report*,<sup>189</sup> and remain of the view, that prevention of poor advice begins with education and training. Those who know *why* steps are prescribed are more likely to follow them than those who know only that the relevant manual says, 'do it'.

I believe that, as they come into effect, the new education requirements will improve the quality of advice that is given, and improve the way that financial advisers manage the conflicts of interest with which they are faced.

However, while I am confident that improved education and standards are part of the solution, I do not believe that they will be sufficient, without more being done to ensure that conflicts in the financial advice industry are managed adequately.

### **3.2.2 Design and distribution obligations and product intervention powers**

In its submissions in response to the Commission's second round of hearings, Treasury suggested that a number of reforms already underway may assist in addressing conflicts of interest in the financial advice industry. These included the Government's proposed design and distribution obligations and product intervention power.

As I noted in the *Interim Report*,<sup>190</sup> the Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2018 (Cth), if enacted, would introduce design and distribution obligations intended to promote the provision of suitable financial products to consumers of those products. The reforms recognise that current disclosure

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<sup>188</sup> Background Paper No 6 (Part B), 8–12.

<sup>189</sup> FSRC, *Interim Report*, vol 1, 143.

<sup>190</sup> FSRC, *Interim Report*, vol 1, 105.

requirements are not, on their own, sufficient to inform consumers fully.<sup>191</sup> The obligations revolve around making an appropriate target-market determination for products and dealing with the product accordingly.

Further, ASIC would be granted a new product intervention power. Under the proposed power, ASIC could make an order that a person must not engage in specified conduct in relation to a product where ASIC perceives a risk of significant consumer detriment.<sup>192</sup> ASIC would also be able to ban aspects of remuneration practices where there is a direct link between remuneration and distribution of the product.

I do not doubt that these changes may assist in addressing conflicts of interest in the financial advice industry. Again, however, I do not consider that these changes will be sufficient, without more being done to ensure that conflicts in the financial advice industry are managed adequately.

### 3.2.3 Better disclosure?

One of the principles that informed many of the recommendations of the Wallis Inquiry was that consumers would make better choices if they were given relevant information. This idea of ‘disclosure’ underpins the now teetering edifice of product disclosure statements (PDSs) and **Financial Services Guides** (FSGs).

The primary means by which a financial adviser’s conflicts of interest are currently disclosed is through an FSG. The provisions explaining when an FSG must be provided are lengthy but, for present purposes, it is enough to say that an FSG must usually be provided when a financial adviser is to give personal advice to a retail client.<sup>193</sup>

The FSG will be prepared and provided by the ‘providing entity’, which will either be:

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<sup>191</sup> Treasury, Module 2 Policy Submission, 4–5.

<sup>192</sup> Treasury, Module 2 Policy Submission, 4–5. See Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2017 (Cth) Sched 2 ss 301C, 1023C.

<sup>193</sup> Background Paper No 7, 55.

- the authorised representative – in cases where the financial service is provided by an authorised representative of an AFSL holder;<sup>194</sup> or
- the AFSL holder – in cases where the AFSL holder is providing the service directly or through a representative who is not an authorised representative.<sup>195</sup>

If an FSG is required, it must be provided to the client as soon as is practicable after it becomes apparent that the financial service will be provided to the client, and in any event before that service is provided.<sup>196</sup>

Among other things, an FSG must include information about:<sup>197</sup>

- who the providing entity acts for when providing the financial service;
- the remuneration (including commission) or other benefits that the providing entity (and certain related parties) are to receive in respect of the provision of the financial service; and
- any associations or relationships between the providing entity, or any related body corporate, and the issuers of any financial products, being associations or relationships that might reasonably be expected to be capable of influencing the providing entity in providing the financial services.

At present, there is no requirement to disclose any information about any approved products list used by the providing entity.

The United Kingdom has gone some way towards requiring disclosure of that kind of information. In the UK, financial advisers who provide personal recommendations to retail clients are divided into two types: those who provide ‘independent advice’ and those who provide ‘restricted advice’.

A financial adviser who provides ‘independent advice’ must assess a sufficient range of relevant products available on the market that must:<sup>198</sup>

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<sup>194</sup> Corporations Act s 941B.

<sup>195</sup> Corporations Act s 941A.

<sup>196</sup> Corporations Act s 941D(1).

<sup>197</sup> Corporations Act s 942B.

<sup>198</sup> Financial Conduct Authority, Conduct of Business Sourcebook, 6.2B.11.

- be sufficiently diverse with regard to their type, and the product issuers, to ensure that the client's investment objectives can be suitably met; and
- not be limited to relevant products issued by:
  - the financial adviser's firm, or entities having close links with the firm; or
  - other entities with which the financial adviser's firm has such close legal or economic relationships, including contractual relationships, as to present a risk of impairing the independent basis of the advice provided.

A financial adviser who provides 'restricted advice' is not required to assess a range of products of that kind. However, they must disclose to the client, in good time before providing the advice:<sup>199</sup>

- the fact that the advice will be 'restricted advice';
- the fact that the advice will be based on a more restricted analysis of different types of relevant products; and
- whether the range will be limited to relevant products issued by entities having close links to the financial adviser's firm or any other legal or economic relationships, such as contractual relationships, so as to present a risk of impairing the independent basis of the advice provided.

A single firm may have advisers who offer independent advice and advisers who offer restricted advice.<sup>200</sup> However, a firm must not allow a single financial adviser to provide both independent advice and restricted advice.<sup>201</sup>

By itself, simple disclosure of conflicts of interest, is insufficient as a means of managing them. The whole regime of disclosure presupposes that what is given to a consumer in writing will be read, and if read, will be understood.

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<sup>199</sup> Financial Conduct Authority, Conduct of Business Sourcebook, 6.2B.33.

<sup>200</sup> Financial Conduct Authority, Conduct of Business Sourcebook, 6.2B.29.

<sup>201</sup> Financial Conduct Authority, Conduct of Business Sourcebook, 6.2B.29.

Often, that presupposition is wrong. And given the length and complexity of FSGs and PDSs that is unsurprising. Further, as Professor Sah explains in her research paper, disclosure of conflicting interests may fail as ‘a discounting cue for biased advice, it may even make matters worse’.<sup>202</sup>

This is not to say, however, that matters that might affect a person’s decision about whether to obtain financial advice from a particular adviser should not be disclosed. If, whether because he or she is required to have regard to an approved products list or for some other reason, an adviser will only consider relevant products issued by:

- the adviser’s firm, or entities having close links with the firm; or
- other entities with which the adviser’s firm has such close legal or economic relationships, including contractual relationships, as to present a risk of impairing the independent basis of the advice provided,

this should be disclosed to the client. I do not think it is necessary to go as far as requiring the disclosure of the approved products list itself. In most circumstances, that list is unlikely to assist a retail client to understand the conflicts of interest that might attend the advice to be provided.

In Australia, quite different requirements govern the use of the word ‘independent’ (and the words ‘impartial’ and ‘unbiased’) by financial advisers from those that are applied in the UK. Relevantly, a financial adviser will contravene section 923A(1) of the Corporations Act if he or she uses any of those words in relation to the financial services he or she provides unless *all* of the following are satisfied:

- the financial adviser does not receive:
  - commissions (other than commissions rebated in full to the client);
  - any form of remuneration calculated on the basis of the volume of business placed by the adviser with a product issuer; or

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<sup>202</sup> Sunita Sah, *FSRC Research Paper: Conflicts of Interest and Disclosure*, 7 November 2018, 15 [3(b)].

- any other gift or benefit from a product issuer that may reasonably be expected to influence the adviser;
- neither the financial adviser’s employer, nor any person on behalf of whom the adviser provides financial services, receives any of those benefits;
- the financial adviser operates free from direct or indirect restrictions relating to the financial products in respect of which he or she provides financial services; and
- the financial adviser operates without any conflicts of interest that might:
  - arise from his or her associations or relationships with issuers of financial products; and
  - be reasonably expected to influence the adviser in carrying on a financial services business or providing financial services.

At present, there is no requirement for a financial adviser who does not satisfy those requirements to explain to a retail client that he or she is *not* independent. A client may be able to infer that fact from some of the matters disclosed in an FSG. In my view, however, this is not sufficient. A financial adviser who does not meet the requirements set out above and who provides personal advice to a retail client should be required to bring that fact to the client’s attention, and to explain, prominently, clearly and concisely, why that is so. I consider that disclosure of that kind is likely to be more readily understood by, and therefore more useful to, a client than the existing requirement merely to disclose, in general terms, certain information about the providing entity.

### **Recommendation 2.2 – Disclosure of lack of independence**

The law should be amended to require that a financial adviser who would contravene section 923A of the Corporations Act by assuming or using any of the restricted words or expressions identified in section 923A(5) (including ‘independent’, ‘impartial’ and ‘unbiased’) must, before providing personal advice to a retail client, give to the client a written statement (in or to the effect of a form to be prescribed) explaining simply and concisely why the adviser is not independent, impartial and unbiased.

### 3.2.4 Amending the best interests duty?

A further possibility would be to amend section 961B of the Corporations Act, which creates the obligation for financial advisers to act in the best interests of the client in relation to the advice. There are several ways in which this could be done.

One option would be to amend the provision to be more prescriptive about how an adviser must pursue the client's best interests. This could be achieved, for example, by requiring advisers to make explicit in the statement of advice the comparisons they have made between products, or to make explicit their reasons for any recommendation to switch products. But I do not favour this approach. It would represent a significant expansion of the safe harbour model and, given that the present safe harbour model does not prevent interest from trumping duty, altering the model is unlikely to work.

Another option would be to remove the safe harbour provision entirely. In my view, such a change would not be without merit. As I have said, the safe harbour provision currently has the effect that, in practice, an adviser is required to make little or no independent inquiry into, or assessment of, products. By prescribing particular steps that must be taken, and allowing advisers to adopt a 'tick a box' approach to compliance, the safe harbour provision has the potential to undermine the broader obligation for advisers to act in the best interests of their clients.

Having said that, I am not convinced that it is necessary or appropriate to remove the safe harbour provision at this stage. There are already many changes affecting financial advisers that will come into effect over the next few years; there will be more if the recommendations in this report are adopted. Whether it is necessary to remove, or otherwise amend, the safe harbour provision will depend in part on how effective those other changes have been in improving the quality of advice given by financial advisers.

In my view, once those changes have come into effect, there will be significant value in conducting a review to determine whether those changes have been effective in improving the quality of advice. The review should consider not only changes in the law, but also changes in the practices of regulators and financial services entities (whether made in response to changes in the law, or otherwise). If those changes have not – or have

not sufficiently – improved the quality of advice given by financial advisers, consideration must be given to what further changes will be necessary.

Among other things, that review should consider whether it is necessary to retain the safe harbour provision. Unless there is a clear justification for retaining that provision at that time, it should be repealed.

### **Recommendation 2.3 – Review of measures to improve the quality of advice**

In three years' time, there should be a review by Government in consultation with ASIC of the effectiveness of measures that have been implemented by the Government, regulators and financial services entities to improve the quality of financial advice. The review should preferably be completed by 30 June 2022, but no later than 31 December 2022.

Among other things, that review should consider whether it is necessary to retain the 'safe harbour' provision in section 961B(2) of the Corporations Act. Unless there is a clear justification for retaining that provision, it should be repealed.

Each measure I have described should improve the way that financial advisers manage the conflicts of interest that pervade their industry.

But, in my view, none of those measures, either alone or in combination, will be sufficient to ensure that conflicts of interest in the financial advice industry are managed adequately.

As I noted in the *Interim Report*,<sup>203</sup> the results recorded in ASIC's report on vertical integration were obtained by examining the files of 10 advice licensees associated with the five largest entities: AMP, ANZ, CBA, NAB, and Westpac. As such, they are results based on the work of advisers associated with the largest entities that may, because of their size, be assumed to be the best-resourced, and the most capable of managing conflicts of interest. They are results that, on their face, deny the fundamental premise for the legislative scheme of the FoFA reforms:

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<sup>203</sup> FSRC, *Interim Report*, vol 1, 91.

that conflicts of interest can be ‘managed’ by saying to advisers, ‘prefer the client’s interests to your own’. Experience (too often, hard and bitter experience) shows that conflicts cannot be ‘managed’ by saying, ‘Be good. Do the right thing’. People rapidly persuade themselves that what suits them is what is right. And people can and will do that even when doing so harms the person for whom they are acting.

Nor, as I have explained above, can conflicts be ‘managed’ by requiring disclosure of their existence. Since FoFA, disclosure has been treated as a central (even complete and sufficient) remedy for conflicts of interest. The evidence shows that the current arrangements have not worked. Too often, interest trumps duty.

It is necessary, therefore, to see what else can and should be done. And to do that, it is necessary to challenge the fundamental premise of the FoFA reforms that conflicts can be ‘managed’. Not all conflicts can be ‘managed’. As far as reasonably possible, conflicts should be eliminated.

### 3.3 Reducing or eliminating the conflict

As I said in the *Interim Report*,<sup>204</sup> and have repeated above, consideration of conflicts between duty and interest begins from two simple observations:

- So long as advisers stand to benefit financially from clients acting on the advice that is given, the adviser’s interests conflict with the client’s interests.
- So long as licensees stand to benefit financially from clients acting on the advice that is given, the licensee’s interests conflict with the client’s interests.

Consideration of how to reduce or eliminate conflicts of interest in the financial advice industry must therefore begin with consideration of the benefits that flow to advisers and licensees.

#### 3.3.1 Conflicted remuneration

As I have mentioned, the FoFA reforms included a ban on conflicted

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<sup>204</sup> FSRC, *Interim Report*, vol 1, 139.

remuneration. That is, they provided that a **financial services licensee** must not accept conflicted remuneration and that it must take reasonable steps to ensure that representatives of the licensee do not accept conflicted remuneration.<sup>205</sup>

Section 963A of the Corporations Act defines conflicted remuneration as ‘any benefit, whether monetary or non-monetary, given to a financial services licensee or a representative of the licensee, who provides financial product advice to persons as retail clients that, because of the nature of the benefit or the circumstances in which it is given:

- could reasonably be expected to influence the choice of financial product recommended by the licensee or representative to retail clients; or
- could reasonably be expected to influence the financial product advice given to retail clients by the licensee or representative.’

That is, the very hinge about which the conflicted remuneration provisions turn, is that the payment is one that ‘could reasonably be expected to influence the choice of financial product recommended to retail clients’.

An authorised representative<sup>206</sup> or other representative<sup>207</sup> must not accept conflicted remuneration. An employer of a financial services licensee or a representative of a licensee must not give employees conflicted remuneration<sup>208</sup> and a product issuer or seller must not do so.<sup>209</sup>

Volume-based benefits are presumed to be conflicted remuneration.<sup>210</sup> A platform operator cannot accept volume-based shelf-space fees.<sup>211</sup> Financial services licensees<sup>212</sup> and authorised representatives<sup>213</sup> are forbidden to charge asset-based fees on borrowed amounts.

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<sup>205</sup> Corporations Act s 963F.

<sup>206</sup> Corporations Act s 963G.

<sup>207</sup> Corporations Act s 963H.

<sup>208</sup> Corporations Act s 963J.

<sup>209</sup> Corporations Act s 963K.

<sup>210</sup> Corporations Act s 963L.

<sup>211</sup> Corporations Act ss 964, 964A.

<sup>212</sup> Corporations Act s 964D.

<sup>213</sup> Corporations Act s 964E.

From 1 January 2018, conflicted remuneration includes volume-based benefits given to a licensee or representative in relation to information given on, or dealing in, a life risk insurance product.<sup>214</sup> A monetary benefit relating to a life risk product will not be conflicted remuneration if it is a level commission within the applicable cap<sup>215</sup> and provides a 'clawback' arrangement if the policy is cancelled, not continued, or the policy cost is reduced in the first two years of the policy.<sup>216</sup>

Section 965 seeks to prevent avoidance of the conflicted remuneration provisions by forbidding entering into, beginning to carry out or carrying out a scheme if it would be concluded that the sole purpose of the scheme was to avoid the application of any part of the relevant Corporations Act division.

On their face the conflicted remuneration prohibitions may appear to be comprehensive. But there are exceptions to their application<sup>217</sup> relating to general insurance,<sup>218</sup> life risk insurance products<sup>219</sup> and basic banking products,<sup>220</sup> and there is also power to prescribe benefits, or circumstances in which a benefit is given, that take the benefit outside the definition of conflicted remuneration.<sup>221</sup>

Any attempt to reduce or eliminate conflicts of interest in the financial advice industry must begin, therefore, with examination of those exceptions, and whether they continue to be justified. That examination must take place against the point of principle made by ASIC in its submissions. This is that

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<sup>214</sup> Corporations Regulations 2001 (Cth) reg 7.7A.11B.

<sup>215</sup> For the calendar year 2018, 80% upfront commission and 20% trail commission, reducing to 70% upfront and 20% trail in 2019 and 60% upfront and 20% trail from 1 January 2020. See ASIC, ASIC Corporations (Life Insurance Commissions) Instrument 2017/510, 31 May 2017 (Cth) Pts 2, 3; Corporations Act s 963B; Corporations Regulations 2001 (Cth) regs 7.7A.11C(1)(d), 7.7A.11D(1)(b).

<sup>216</sup> See ASIC, ASIC Corporations (Life Insurance Commissions) Instrument 2017/510, 31 May 2017 (Cth) s 6.

<sup>217</sup> ASIC, Regulatory Guide 246, 7 December 2017, 72.

<sup>218</sup> Corporations Act s 963B(1)(a).

<sup>219</sup> Corporations Act s 963B(1)(b).

<sup>220</sup> Corporations Act s 963D.

<sup>221</sup> Corporations Act s 963B(1)(e).

‘any exception to the ban on conflicted remuneration, by definition, has the ability to create misaligned incentives, which can lead to inappropriate advice’.<sup>222</sup> As I said in the *Interim Report*,<sup>223</sup> that is not a point that depends on evidence. It is the unchallenged (and unchallengeable) basic premise for the conflicted remuneration provisions.

I will begin with the exception that received the most attention in the Commission’s hearings – the exception for **grandfathered commissions**.

### *The exception for grandfathered commissions*

As I noted in the *Interim Report*,<sup>224</sup> after the commencement of the FoFA reforms, payment and receipt of some forms of conflicted remuneration for financial advice was permitted to continue by ‘grandfathering’ provisions made by Subdivision 5 of Division 4 of Part 7.7A of the Corporations Regulations 2001 (Cth).<sup>225</sup> It is neither necessary nor profitable to trace the detail or history of those grandfathering provisions. At the risk of some minor inaccuracy it is enough to note that certain arrangements made before the FoFA reforms came into force in July 2013 that would otherwise have fallen within the ban on conflicted remuneration were, and remain, excluded from the definition of conflicted remuneration. For present purposes, two points are important.

First, despite it being recognised that the grandfathered forms of remuneration are conflicted remuneration (because they could reasonably be expected to influence the choice of financial product recommended by a licensee or representative to retail clients, or could reasonably be expected to influence the financial product advice given to retail clients by the licensee or representative), charging and receiving these exempted forms of remuneration has been permitted to continue.

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<sup>222</sup> ASIC, Module 2 Policy Submission, 31 [139].

<sup>223</sup> FSRC, *Interim Report*, vol 1, 97.

<sup>224</sup> FSRC, *Interim Report*, vol 1, 93.

<sup>225</sup> Corporations Regulations 2001 (Cth) regs 7.7A.15B–7.7A.16F.

Second, in 2014 when ASIC looked at the value of ‘grandfathered’ benefits, it found that, ‘[o]n average, licensees indicated that grandfathered benefits were worth around one-third of their total income (though substantially more or less than the average in some cases).’<sup>226</sup>

In the *Interim Report*,<sup>227</sup> I posed the following question: If the premise for the conflicted remuneration provisions is accepted (and no-one suggested that it should not be) how can the grandfathering provisions be justified today?

In my view, the answer to that question is now clear: they cannot.

Each of the major banks has already announced steps to reduce or eliminate payments of grandfathered commissions in their financial advice businesses.<sup>228</sup>

Westpac was the first to make changes in this area. In June 2018, Westpac announced that financial advisers employed by BT Financial Advice would no longer receive grandfathered commissions. Westpac estimated that up to 140,000 client accounts were subject to commissions that would be removed,<sup>229</sup> and estimated a resulting \$40.8 million annual reduction in revenue.<sup>230</sup> But it also noted the countervailing advantage that the products relieved of grandfathered commission will be more attractive to clients and therefore will be more competitive market offerings.<sup>231</sup> Ultimately, Westpac said, it was preferable to make the changes because they were consistent with the intent of the legislation, the interests of customers, and the professionalisation of the financial advice industry.<sup>232</sup>

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<sup>226</sup> ASIC, Report 407, 17 September 2014, 30 [96].

<sup>227</sup> FSRC, *Interim Report*, vol 1, 94.

<sup>228</sup> ANZ, Interim Report Submission, 35–6 [175]; CBA, Interim Report Submission, 40 [215]; NAB, Interim Report Submission, 13 [32]; Westpac, Interim Report Submission, 29 [134].

<sup>229</sup> Exhibit 2.278, Witness statement of Michael Wright, 15 August 2018, 5 [27].

<sup>230</sup> The estimate was made as at 15 August 2018: see Exhibit 2.278, Witness statement of Michael Wright, 15 August 2018, 6 [33(a)].

<sup>231</sup> Exhibit 2.278, Witness statement of Michael Wright, 15 August 2018, 7 [39].

<sup>232</sup> Exhibit 2.278, Witness statement of Michael Wright, 15 August 2018, 3 [19].

In early July 2018, media reported that Macquarie had issued a statement that it would turn off commissions paid to its private wealth and private bank advisers, affecting approximately 17,000 client accounts.<sup>233</sup>

In August 2018, ANZ informed the Commission that, from April 2019, ANZ Financial Planning would no longer retain grandfathered commissions in relation to the OnePath investment and superannuation platforms, and that clients would receive the amount of the commission by way of a rebate.<sup>234</sup>

On 3 September 2018, NAB announced that customers of its Financial Planning and Direct Advice businesses would be rebated grandfathered commissions paid by NAB Wealth product providers from 1 January 2019.<sup>235</sup>

On 9 October 2018, CBA announced that it would rebate all grandfathered commissions to CFPL clients from January 2019 in respect of investment and superannuation products. CBA estimated that this would benefit around 50,000 client accounts by a total of approximately \$20 million annually.<sup>236</sup>

The submissions made in response to the *Interim Report* also supported ending grandfathered commission payments to financial advisers,<sup>237</sup> and from superannuation accounts.<sup>238</sup> In their submissions, each of the major

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<sup>233</sup> See, eg, Alice Uribe, 'Macquarie Scraps Grandfathered Commissions', *Australian Financial Review*, 3 July 2018 <[www.afr.com/business/banking-and-finance/financial-services/macquarie-scraps-grandfathered-commissions-20180703-h126n8](http://www.afr.com/business/banking-and-finance/financial-services/macquarie-scraps-grandfathered-commissions-20180703-h126n8)>.

<sup>234</sup> Letter from ANZ to Mr Simon Daley dated 20 August 2018.

<sup>235</sup> NAB, 'NAB Moves on Grandfathered Commissions' (Media Release, 3 September 2018).

<sup>236</sup> CBA, Interim Report Submission, 14 [66]–[67].

<sup>237</sup> See Mortgage Choice, Interim Report Submission, 19; ABA, Interim Report Submission, 13; FSC, Interim Report Submission, 10; AMP, Interim Report Submission, [73]; ASFA, Interim Report Submission, 4, 16–17.

<sup>238</sup> See CBA (Colonial First State Investments and Avanteos), Module 5 Policy Submission, 18–19 [99]–[100]; NAB, Module 5 Policy Submission, 16 [67]; Westpac, Module 5 Policy Submission, 13 [44]; ANZ, Module 5 Policy Submission, 7 [40]; ASIC, Module 5 Policy Submission, 20 [98]; ISA, Module 5 Policy Submission, 9 [31]; FSU, Module 5 Policy Submission, 20 [140]; TWU Super, Module 5 Policy Submission, 3–4 [15]–[16]; ASFA, Module 5 Policy Submission, 16–17; AIST, Module 5 Policy Submission, 13.

banks, along with other industry participants, supported legislation to repeal the grandfathering provisions under the Corporations Act.<sup>239</sup>

At the time the grandfathering arrangements were first introduced, participants in the industry could say that sudden change in remuneration arrangements may bring untoward consequences for countervailing benefits that would not outweigh the harms of disruption. In the seventh round of hearings, Mr Comyn cast doubt on whether that argument was ever valid. He described the decision by banks to lobby for the grandfathering exemption as a ‘poor decision’.<sup>240</sup> Even if the arguments relied on to justify the grandfathering exception were valid when that exception was introduced, it is now clear that they have outlived their validity.

#### **Recommendation 2.4 – Grandfathered commissions**

Grandfathering provisions for conflicted remuneration should be repealed as soon as is reasonably practicable.

#### *The exception for life risk insurance*

Another exception that received attention during the Commission’s hearings was the exception for commissions on life risk insurance products.

Until 1 January 2018, commissions paid in respect of life risk insurance products (other than **group life policies** and life policies for members of default superannuation funds) were exempt from the ban on conflicted remuneration. This meant that product issuers – that is, life insurance companies – could continue to pay financial advisers high rates of upfront and trail commission to encourage the advisers to recommend their products.

In the Commission’s sixth round of hearings, the witness statements received from the life insurers showed that each paid commissions to financial advisers (or financial advice entities) whose clients purchased

<sup>239</sup> ANZ, Interim Report Submission, 35–6 [175]; CBA, Interim Report Submission, 14 [66]; NAB, Interim Report Submission, 13 [31]; Westpac, Interim Report Submission, 29 [133]; ABA, Interim Report Submission, 13; FSC, Interim Report Submission, 10; FPA, Interim Report Submission, 10.

<sup>240</sup> Transcript, Matthew Comyn, 19 November 2018, 6550.

their products. Between 1 July 2013 and the sixth round of the Commission's hearings:<sup>241</sup>

- Zurich paid more than \$113 million in commissions in respect of its life insurance products;
- AMP paid more than \$380 million;
- CMLA paid more than \$460 million;
- Suncorp paid more than \$590 million;
- AIA paid more than \$690 million;
- Westpac paid more than \$697 million, and a further \$158 million in grandfathered commissions in relation to life insurance arrangements within superannuation accounts;
- TAL paid more than \$840 million;
- OnePath paid more than \$1.02 billion; and
- MLC paid more than \$1.16 billion.

That amounts to a total of more than \$6.1 billion paid in commissions to financial advisers in connection with the sale of life insurance products issued by these insurers in about five years.

As noted above, since 1 January 2018, conflicted remuneration has included volume-based benefits given to a licensee or representative

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<sup>241</sup> Exhibit 6.18, Witness statement of Tim Bailey, 21 August 2018, 26 [20]; Exhibit 6.26, Witness statement of Gregory Johnson, 10 September 2018, 47–8 [143]; Exhibit 6.20, Witness statement of Helen Troup, 31 August 2018, 19 [106]; Exhibit 6.494, 19 December 2018, Letter from CMLA Re Correction to Statement of Helen Troup; Exhibit 6.25, Witness statement of Christopher McHugh, 27 August 2018, 40 [94]; Exhibit 6.11, Witness statement of Michael Thornton, 21 August 2018, 59 Annexure F Table C; Exhibit 6.410, Witness statement of Michael Wright, 20 September 2018, 2–3 Schedule D; Exhibit 6.7, Witness statement of Timothy Thorne, 22 August 2018, 46 [171]; Exhibit 6.24, Witness statement of Gavin Pearce, 21 August 2018, 60–1 [184]; Exhibit 6.13, Witness statement of Sean McCormack, 21 August 2018, Exhibit SAM-1 Tab 20 [MLC.101.007.0060].

in relation to information given on, or dealing in, a life risk insurance product.<sup>242</sup> But a monetary benefit relating to a life risk product will not be conflicted remuneration if it is a level commission within the applicable cap<sup>243</sup> and provides a ‘clawback’ arrangement if the policy is cancelled, not continued, or the policy cost is reduced in the first two years of the policy.<sup>244</sup>

ASIC will conduct a post-implementation review in 2021 to assess the effect of the reforms.<sup>245</sup>

In the *Interim Report*,<sup>246</sup> I questioned the separate treatment of benefits given in relation to life risk products (other than a group life policy for members of a superannuation entity, or a life policy for a member of a default superannuation fund).<sup>247</sup>

In contrast to the position in relation to grandfathered commissions, few submissions in response to the *Interim Report* supported making any further changes to the exception for life risk insurance products. Many submissions pointed to the fact that the arrangements that took effect on 1 January 2018 reflect a compromise between the risk of underinsurance and the risk of adverse client outcomes arising from conflicts of interest.<sup>248</sup> Many submissions proposed that the best course would be to allow the cap on commissions to continue to reduce over the next few years, and to allow ASIC to undertake its planned post-implementation review in 2021.<sup>249</sup>

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<sup>242</sup> Corporations Regulations 2001 (Cth) reg 7.7A.11B.

<sup>243</sup> For the calendar year 2018, 80% upfront commission and 20% trail commission, reducing to 70% upfront and 20% trail in 2019 and 60% upfront and 20% trail from 1 January 2020. See ASIC, ASIC Corporations (Life Insurance Commissions) Instrument 2017/510, 31 May 2017 (Cth) Pts 2, 3; Corporations Act s 963B; Corporations Regulations 2001 (Cth) regs 7.7A.11C(1)(d), 7.7A.11D(1)(b).

<sup>244</sup> See ASIC, ASIC Corporations (Life Insurance Commissions) Instrument 2017/510, 31 May 2017 (Cth) s 6.

<sup>245</sup> ASIC, Media Release 17-168MR, 5 June 2017.

<sup>246</sup> FSRC, *Interim Report*, vol 1, 157.

<sup>247</sup> Corporations Act s 963B(1)(b).

<sup>248</sup> See, eg, NAB, Interim Report Submission, 14 [35].

<sup>249</sup> See, eg, CBA, Interim Report Submission, 14–15 [68].

I doubt that a complete ban on conflicted remuneration in respect of life insurance products would lead to significant underinsurance. At the time of writing, the overwhelming majority of life insurance policies in Australia are held through superannuation funds. As at August 2017, more than 70% of Australian life insurance policies were held in this way.<sup>250</sup> While it may not follow that every Australian who holds a life insurance policy through a superannuation fund has the same level of cover that he or she would be advised was appropriate on consulting a financial adviser, I am not convinced that a move away from commissions for life insurance products would see large numbers of Australians without an appropriate level of life insurance.

Having said that, I accept that the best way to be sure of the effect of lowering or removing commissions for life insurance products is to assess what happens as the levels of those commissions are reduced over the next few years. I also acknowledge that the financial advice industry will need time to absorb a number of changes over the next few years, and that there may be some benefit in deferring the implementation of further changes to arrangements for life insurance commissions.

I encourage ASIC to take all necessary steps to ensure that it conducts its post-implementation review in 2021 as expeditiously as possible. If that review indicates that the cap on commissions has not contributed (or, at least, not significantly contributed) to underinsurance, then I would urge ASIC to continue reducing the cap – ultimately, to zero. Unless the reduction in life insurance commissions can be shown to contribute significantly to underinsurance, I can see no justification for allowing this form of conflicted remuneration to continue to be paid. While the decision will ultimately be one for ASIC, any decision that commissions should continue to be paid and received in relation to life insurance products should be based on clear evidence that the harm that would flow from abolishing commissions would outweigh the harm that already flows from allowing this form of conflicted remuneration to continue.

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<sup>250</sup> See Peter Kell, 'Insurance in Super: The Regulators – What Do They Think?' (Speech delivered at the Association of Superannuation Funds of Australia Spotlight on Insurance, Sydney, Australia, 27 February 2018).

### **Recommendation 2.5 – Life risk insurance commissions**

When ASIC conducts its review of conflicted remuneration relating to life risk insurance products and the operation of the ASIC Corporations (Life Insurance Commissions) Instrument 2017/510, ASIC should consider further reducing the cap on commissions in respect of life risk insurance products. Unless there is a clear justification for retaining those commissions, the cap should ultimately be reduced to zero.

#### *The exceptions for general insurance, consumer credit insurance and non-monetary benefits*

In the course of the review referred to in Recommendation 2.3, a question that ought to arise is whether the exceptions to the ban on conflicted remuneration for general insurance products, consumer credit insurance products and non-monetary benefits remain justified.

Monetary and non-monetary benefits given solely in relation to general insurance products are currently wholly exempt from the ban on conflicted remuneration, and have been since the conflicted remuneration provisions of the Corporations Act commenced on 1 July 2012.<sup>251</sup> Monetary benefits given in relation to consumer credit insurance products are also exempt,<sup>252</sup> as are non-monetary benefits given in the circumstances set out in section 963C of the Corporations Act.

By the time of the review referred to in Recommendation 2.3, these exemptions from the ban on conflicted remuneration will have been in place for almost 10 years. In my view, if the exemptions are still in place at that time,<sup>253</sup> it will be appropriate for ASIC to consider whether each of them remains justified.

<sup>251</sup> Corporations Act ss 963B(1)(a), 963C(1)(a). Advice given in relation to general insurance products and consumer credit insurance products was also carved out of other aspects of the FoFA reforms, including the best interests duty: see Corporations Act s 961B(3).

<sup>252</sup> Corporations Act s 963B(1)(ba).

<sup>253</sup> On 18 December 2018, the ACCC released the first interim report of its Northern Australia Insurance Inquiry. One of the recommendations in that report was to remove the exemption for general insurance products from the conflicted remuneration provisions: see ACCC, *Northern Australia Insurance Inquiry: First Interim Report*, November 2018, 196.

### **Recommendation 2.6 – General insurance and consumer credit insurance commissions**

The review referred to in Recommendation 2.3 should also consider whether each remaining exemption to the ban on conflicted remuneration remains justified, including:

- the exemptions for general insurance products and consumer credit insurance products; and
- the exemptions for non-monetary benefits set out in section 963C of the Corporations Act.

### **3.3.2 Structural separation?**

Although the most obvious conflicts of interest affecting the provision of financial advice are the conflicts between an adviser's duty and his or her *financial* interests, they are not the only conflicts. Other conflicts can also arise from the associations or relationships between a financial adviser and the issuer of financial products. As I said earlier, advisers may be expected to know more about the products manufactured by the licensee with which the advisers are associated than they know about a rival licensee's products. Advisers will often be readily persuaded that the products 'their' licensee offers are as good as, if not better than, those of a rival. These types of conflicts direct attention to the structure of the industry.

In the *Interim Report*,<sup>254</sup> I asked: How far can, and how far should, there be a separation between providing financial advice and manufacture or sale of financial products? There are several forms that any such separation could take.

- One approach would be to require all advisers to be 'independent' advisers, in the sense that they must satisfy the requirements of section 923A(2) of the Corporations Act, which govern the use of the words 'independent', 'impartial' and 'unbiased'.

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<sup>254</sup> FSRC, *Interim Report*, vol 1, 156.

- Another approach would be to require separation between any AFSL holder authorised to issue financial products and any AFSL holder authorised to provide financial product advice.
- An alternative approach would be to prohibit any adviser who is not an ‘independent’ adviser within the meaning of section 923A of the Corporations Act from recommending any product manufactured by an entity associated with the AFSL holder with which the adviser is associated.

Adopting any of these approaches would be likely to reduce the conflicts of interest that affect the financial advice industry.<sup>255</sup> So much may be accepted. But, adopting any of these approaches would also involve significant disruption to that industry, and the financial services industry more broadly.

This point was emphasised in the submissions received by the Commission following the second round of hearings, and in response to the *Interim Report*. Almost none of those submissions supported the enforced separation of product and advice.<sup>256</sup> Many pointed to benefits of vertical integration (such as economies of scale, and the convenience for customers of a relationship with a single financial institution)<sup>257</sup> that would be lost if

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<sup>255</sup> ASIC, Treasury, ANZ, CBA, NAB and Westpac all accepted that a vertically integrated business model gives rise to conflicts of interest: ASIC, Module 2 Policy Submission, 4 [15], 29–30 [128]–[137]; Treasury, Module 2 Policy Submission, 6 [38]; ANZ, Module 2 Policy Submission, 3 [11]–[12]; CBA, Module 2 Policy Submission, 2 [6]; NAB, Module 2 Policy Submission, 6 [21]; Westpac, Module 2 Policy Submission, 28 [111].

<sup>256</sup> None of ASIC, AMP, ANZ, CBA, NAB, Westpac, the AFA or the FSU supported the enforced separation of product and advice: ASIC, Module 2 Policy Submission, 30 [137]; AMP, Module 2 Policy Submission, 26 [132]; ANZ, Module 2 Policy Submission, 3–4 [11], [15]–[18]; CBA, Module 2 Policy Submission, 1–3 [2]–[7] (in respect of platform operators and financial advisers); NAB, Module 2 Policy Submission, 5 [18], 24 [101]; Westpac, Module 2 Policy Submission, 28 [111]; AFA, Module 2 Policy Submission, 8, 26; FSU, Module 2 Policy Submission, 23 [171], 24 [183]; Westpac, Interim Report Submission, 27–8 [126]–[128]; CBA, Interim Report Submission, 49–50 [268]–[278]; ANZ, Interim Report Submission, 48 [222]–[223]; ABA, Interim Report Submission, 18–19; FSC, Interim Report Submission, 8.

<sup>257</sup> ASIC, Report 562, 1 January 2018, 16 [56]–[57].

structural separation were enforced.<sup>258</sup> This was perhaps unsurprising from those whose businesses might be affected by the changes. But it is noteworthy that ASIC was among those who did not support structural separation of product and advice.<sup>259</sup>

Ultimately, whether there should be a separation between the manufacture or sale of financial products and the provision of financial advice will depend on whether the benefits of such a separation would outweigh the costs.

The assessment of those benefits and costs must take place against the backdrop of:

- the changes to the regulation of the financial advice industry that are already in train, and will take effect in the coming years – including the improvements to adviser education standards and the introduction of the design and distribution obligations and ASIC’s product intervention power;
- the additional changes to the regulation of the financial industry that will take effect in the coming years if the recommendations in this Report are adopted – including the cessation of grandfathered commissions, and a more coherent and effective disciplinary system; and
- the changes to the industry, as many vertically integrated firms sell parts of their businesses.

I have dealt with the first two of those points elsewhere in this chapter, and I need not repeat those matters here. The third point warrants further attention.

I said earlier in this chapter that from the time of the Wallis Inquiry, banks’ accumulation of wealth management businesses accelerated. During the late 1990s and early 2000s, each of the major banks acquired or merged with a fund manager. In more recent times, banks have sold off a number of those acquisitions.

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<sup>258</sup> See, eg, AMP, Module 2 Policy Submission, 8–10 [34]–[39]; CBA, Module 2 Policy Submission, 1–3 [2]–[7]; NAB, Module 2 Policy Submission, 5 [18]–[20].

<sup>259</sup> ASIC, Module 2 Policy Submission, 30 [137].

In May 2017, Westpac sold BT Investment Management, a product manufacturer.<sup>260</sup>

- In September 2017, CBA announced that it was selling its life insurance business to AIA,<sup>261</sup> and, in July 2018, announced that it would seek to sell the remainder of that business.<sup>262</sup> In late June 2018, CBA announced that it would demerge its other wealth management and mortgage broking businesses, including Colonial First State, Colonial First State Global Asset Management, Count Financial, Financial Wisdom and Aussie Home Loans, into a separately listed entity.<sup>263</sup>
- In October 2017, ANZ sold its aligned licensees to IOOF.<sup>264</sup>
- In May 2018, NAB announced that it proposed to sell its MLC advice, platform and superannuation, and asset management businesses.<sup>265</sup>
- In October 2018, AMP announced the sale of its life business,<sup>266</sup> and throughout the course of 2018, AMP exited almost 200 'higher risk' practices.<sup>267</sup> There has also been a change to AMP's business strategy in its advice business throughout 2018. Mr Michael Wilkins' evidence in the seventh round of the Commission's hearings was that AMP's strategy for the period 2018 to 2022 is to transition AMP from primarily a face-to-face aligned advice channel structure, to more integrated and digitally enabled channels.<sup>268</sup> Each of these changes was prompted, at least in

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<sup>260</sup> Transcript, Brian Hartzler, 21 November 2018, 6834.

<sup>261</sup> CBA, 'Divestment of Australian and New Zealand Life Insurance Businesses' (ASX Announcement, 21 September 2017).

<sup>262</sup> CBA, 'Completion of New Zealand Life Insurance Divestment' (ASX Announcement, 2 July 2018).

<sup>263</sup> CBA, 'Intention to Demerge Wealth Management and Mortgage Broking Business' (ASX Announcement, 25 June 2018).

<sup>264</sup> ANZ, *Submission in Response to the Commission's Letters of 15 December 2017*, 7 [5.6]; IOOF, 'IOOF to Acquire ANZ's OnePath Pensions and Investments Business and Aligned Dealer Groups' (Media Release, 17 October 2017).

<sup>265</sup> NAB, '2018 Half Yearly Results 2018' (Half Year Results, 3 May 2018) 15, 53.

<sup>266</sup> AMP announced the sale of its life business on 25 October 2018. See Transcript, Michael Wilkins, 27 November 2018, 7216.

<sup>267</sup> Transcript, Michael Wilkins, 28 November 2018, 7246.

<sup>268</sup> Transcript, Michael Wilkins, 27 November 2018, 7208.

part, by the increased regulatory scrutiny around AMP's advice business and was, and is, intended to be a way of managing that risk.<sup>269</sup>

Of course, none of these entities has abandoned the vertically integrated business model entirely.

- ANZ continues to employ financial planners through ANZ Financial Planning.
- NAB continues to employ financial advisers through NAB Financial Planning, and intends to keep one advice licensee, JBWere.
- CBA intends to continue to employ financial advisers through CFPL.<sup>270</sup> In the seventh round of the Commission's hearings, Mr Comyn said that CBA wants to continue to provide financial advice for customers, and is exploring the best long-term model for financial advice.<sup>271</sup> Mr Comyn acknowledged difficulties with and conflicts inherent in vertically integrated business models.<sup>272</sup>
- Mr Wilkins made plain in his evidence that AMP remains committed to a vertically integrated business model, and that that model remains fundamental to AMP's business.<sup>273</sup>
- At the time of writing, Westpac has not announced its intention to sell its wealth business. In the seventh round of hearings, Mr Brian Hartzer acknowledged that there is a potential for conflict in Westpac owning both the advice licensee and product manufacturer.<sup>274</sup>

The changes that have been made appear to have resulted, at least in part, from the increased costs associated with employing professional advisers, as compared to a team of salespeople. Mr Hartzer said, in effect, that the cost of compliance to ensure that advisers are properly qualified, and

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<sup>269</sup> See Transcript, Michael Wilkins, 27 November 2018, 7208, 7216; Transcript, Michael Wilkins, 28 November 2018, 7246.

<sup>270</sup> Transcript, Matthew Comyn, 20 November 2018, 6681–2.

<sup>271</sup> Transcript, Matthew Comyn, 20 November 2018, 6682.

<sup>272</sup> Transcript, Matthew Comyn, 20 November 2018, 6682–3.

<sup>273</sup> See Transcript, Michael Wilkins, 28 November 2018, 7238–46.

<sup>274</sup> Transcript, Brian Hartzer, 21 November 2018, 6834.

that provision of advice and services is properly documented, is high.<sup>275</sup> The tenor of Mr Hartzer's evidence was that the value in Westpac owning advice licensees had changed over time – and changed to a point where the business model was not as profitable as it was once.<sup>276</sup> At least to some extent the change can be attributed to a shift in the role authorised representatives have played in Westpac's wealth business; from distribution channels to professionals providing advice and owing duties to clients.<sup>277</sup>

As further changes to the regulation of the financial advice industry take effect over the coming years, those costs are likely to increase – or, at the least, are unlikely to reduce. It follows that the trend away from vertically integrated institutions may well continue, even if structural separation is not mandated.

A further complicating factor in the analysis is the present uncertainty about the impact of technological developments on the financial advice industry. Many in the industry have recognised that technology is likely to play an important role in the future of financial advice,<sup>278</sup> but there is not yet a clear picture of what that role might be. Any recommendation directed to altering the current structure of the industry would need to grapple with the fact that the industry itself will very probably look very different in five years' time.

The industry is already undergoing significant change. Many of those changes – both those already in train, and those recommended in this Report – should improve the way that conflicts of interest are managed by financial advisers, and help to eliminate some of those conflicts. Further changes will follow as the industry adjusts to these and other changes – including, perhaps, a continued shift away from vertically integrated institutions, which would help to reduce or further eliminate conflicts of interest.

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<sup>275</sup> Transcript, Brian Hartzer, 21 November 2018, 6831.

<sup>276</sup> See, generally, Transcript, Brian Hartzer, 21 November 2018, 6832–4.

<sup>277</sup> See, generally, Transcript, Brian Hartzer, 21 November 2018, 6832–4.

<sup>278</sup> See Background Paper No 6 (Part A), 7. See also AMP, Interim Report Submission, 6 [27]; Westpac, Interim Report Submission, 1 [4]; Institute of Managed Account Professionals, Interim Report Submission, 12; ANZ, Interim Report Submission, 47 [220(c)].

**Enforced separation of product and advice would be a very large step to take. It would be both costly and disruptive. I cannot say that the benefits of requiring separation would outweigh the costs, and the Productivity Commission concluded that ‘forced structural separation is not likely to prove an effective regulatory response to competition concerns in the financial system’.<sup>279</sup> I observe, however, that the Productivity Commission recommended, and I agree, that commencing in 2019, the Australian Competition and Consumer Commission (the ACCC) ‘should undertake 5 yearly market studies on the effect of vertical and horizontal integration in the financial system’.<sup>280</sup>**

**I am not persuaded that it is necessary to mandate structural separation between product and advice.**

## **4 Professional discipline**

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### **Introduction**

The third matter that emerged in connection with the provision of financial advice related to the disciplinary system for financial advisers. That system now consists of a number of bodies, each directed at regulating different, though related, norms of behaviour, and each geared to different outcomes.

Those bodies are:

- AFSL holders;
- ASIC;
- industry associations; and
- once they are appointed, the code-monitoring bodies responsible for monitoring compliance with the Code of Ethics developed by FASEA.

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<sup>279</sup> Productivity Commission, Report 89, 29 June 2018, 272.

<sup>280</sup> Productivity Commission, Report 89, 29 June 2018, 274.

The question that I posed in the *Interim Report* was whether this segmentation imposes a satisfactory standard of behaviour on what is, as numerous witnesses noted, an aspiring profession.

It does not.

All too often, the fragmented disciplinary arrangements for financial advisers have meant that advisers who engage in poor or unlawful conduct have not faced appropriate consequences for their actions. Experience shows that those who feel they are unlikely to face consequences for their poor conduct are much more likely to engage in that conduct.

One of the case studies in the second round of the Commission's hearings illustrated some of the issues that arise from the current fragmented disciplinary arrangements for financial advisers. Mr Sam Henderson was one of two financial advisers who provided advice under the AFSL of Henderson Maxwell Pty Ltd.<sup>281</sup> Mr Henderson was also the CEO of that company.<sup>282</sup> Acting in his capacity as a representative of Henderson Maxwell Pty Ltd, Mr Henderson provided financial advice to Ms Donna McKenna. It was poor advice. If implemented, the advice would have caused Ms McKenna to forfeit her entitlement to approximately \$500,000.<sup>283</sup>

Ms McKenna made a complaint to the AFSL holder: Henderson Maxwell Pty Ltd.<sup>284</sup> The company imposed no consequences on its CEO, Mr Henderson, in respect of his poor advice.

Ms McKenna made a complaint to ASIC, but ASIC took no action against Mr Henderson at that time.<sup>285</sup>

Ms McKenna made a complaint to the Financial Planning Association of Australia (FPA), an industry association of which Mr Henderson was a

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<sup>281</sup> Transcript, Sam Henderson, 24 April 2018, 1747.

<sup>282</sup> Transcript, Sam Henderson, 24 April 2018, 1747.

<sup>283</sup> Transcript, Donna McKenna, 24 April 2018, 1739; Transcript, Sam Henderson, 24 April 2018, 1762.

<sup>284</sup> Transcript, Donna McKenna, 24 April 2018, 1740.

<sup>285</sup> Exhibit 2.197, Witness statement of Donna McKenna, 16 April 2018, 7–8 [49]–[52].

member.<sup>286</sup> The FPA investigated that complaint and, at the time of the second round of the Commission's hearings, was considering resolving the complaint with Mr Henderson on a confidential basis.<sup>287</sup> In the course of the FPA's disciplinary process, Mr Henderson did not renew his membership of that organisation as a 'protest to not being heard'.<sup>288</sup> Doing so did not affect his ability to continue to provide financial advice. In October 2018, the FPA announced that it had fined Mr Henderson \$50,000.<sup>289</sup> Given that Mr Henderson had sold his interests in the advice licensee, Henderson Maxwell, and had left the industry, it is not clear whether or how the penalty would be recovered.

Other case studies in the second round of the Commission's hearings illustrated a different set of issues that arise from the fragmented disciplinary system referred to above. The Commission heard evidence about a number of advisers whose employment or authorised representative status was terminated by the licensee for misconduct, or who resigned after allegations of misconduct were made against them. Most had been members of the FPA. But the relevant AFSL holders did not report their concerns about those advisers to that association.<sup>290</sup>

Some were also members of the AFA, another industry association. But the relevant AFSL holders did not report their concerns about those advisers to the AFA either.<sup>291</sup>

Some of the advisers became authorised representatives of a different licensee, Dover Financial Advisers Pty Ltd.<sup>292</sup> Their previous licensees

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<sup>286</sup> Transcript, Donna McKenna, 24 April 2018, 1741.

<sup>287</sup> Exhibit 2.214, 24 April 2018, Email and Attachment Concerning Agreed Disposal of CRC Disciplinary Proceedings, 10.

<sup>288</sup> Transcript, Sam Henderson, 24 April 2018, 1767. See also Transcript, Dante De Gori, 26 April 2018, 1796.

<sup>289</sup> FPA, 'FPA Conduct Review Commission Hands Down Determination for Sam Henderson Case' (Media Release, 11 October 2018).

<sup>290</sup> Transcript, Dante De Gori, 26 April 2018, 1821.

<sup>291</sup> Transcript, Philip Kewin, 26 April 2018, 1841.

<sup>292</sup> See Exhibit 2.236, Witness statement of Terrence McMaster, 10 April 2018, 4–8 [32]–[71]. See also Transcript, Michael Wright, 20 April 2018, 1459; Transcript, Darren Whereat, 20 April 2018, 1546; Transcript, Sarah Britt, 23 April 2018, 1640.

took inadequate steps to make Dover aware of their concerns about those advisers.<sup>293</sup>

These are no more than particular illustrations of problems that arise from the existing disciplinary arrangements for financial advisers. I have no doubt those examples could be multiplied.

As I have said, one hallmark of a profession is the existence of a credible and coherent system of professional discipline – the ultimate sanction available to be imposed under that system being expulsion from the profession. The financial advice industry currently lacks such a system. While ASIC has the power to ban financial advisers from providing financial services, the existing disciplinary arrangements for financial advisers are fragmented and ineffective, and are hampered by inadequate sharing of information and gaps between the overlapping roles of the different bodies referred to above.

A coherent system of professional discipline must be established for financial advisers. I begin by identifying some of the key features of such a system.

- First, each financial adviser should be individually registered.
- Second, only those who are registered should be permitted to give financial advice.
- Third, there should be a single, central disciplinary body with the power to impose disciplinary sanctions on financial advisers – the most serious sanction being cancellation of registration.
- Fourth, there should be a system of mandatory notifications, requiring AFSL holders to report particular information about the conduct of financial advisers to the disciplinary body.
- Fifth, there should be a system of voluntary notifications, enabling AFSL holders, industry associations and clients to report information about the conduct of financial advisers to the disciplinary body.

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<sup>293</sup> Transcript, Michael Wright, 20 April 2018, 1459–62; Transcript, Darren Whereat, 20 April 2018, 1546–8; Transcript, Sarah Britt, 23 April 2018, 1640–2.

In order to explain why I consider that such a system will address the issues that arise from the current fragmented disciplinary arrangements, it is necessary to say something further about the different and overlapping roles of the four types of bodies identified at the beginning of this section of the chapter.

I will take each of those types of bodies in turn.

## 4.1 Existing arrangements

### 4.1.1 AFSL holders

As mentioned earlier in this chapter, a key principle in CLERP 6 was to regulate intermediaries (including financial advisers) at firm level rather than at the individual level, in part to allow ASIC to target its resources efficiently.<sup>294</sup> Thus, individual financial advisers do not generally hold AFSLs. Instead, an individual financial adviser will usually be:

- an employee of an AFSL holder;<sup>295</sup>
- an authorised representative of an AFSL holder;<sup>296</sup> or
- an employee of an authorised representative of an AFSL holder.<sup>297</sup>

As has been mentioned elsewhere, the Corporations Act imposes obligations on AFSL holders in relation to the employees and authorised representatives who provide financial advice under their licence, including an obligation to take reasonable steps to ensure that their representatives comply with financial services laws.<sup>298</sup>

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<sup>294</sup> Background Paper No 7, 9.

<sup>295</sup> Corporations Act s 911B(1)(a).

<sup>296</sup> Corporations Act s 911B(1)(b).

<sup>297</sup> Corporations Act s 911B(1)(c).

<sup>298</sup> Corporations Act s 912A.

Thus, as ASIC submitted, primary responsibility for discipline lies with AFSL holders, who are responsible under the law for the conduct of their advisers.<sup>299</sup>

The chief means by which licensees detect both improper conduct and poor advice by their advisers remains regular and random auditing of advisers' files.

The efficacy of the audit depends first upon there being a complete and accurate file recording the dealings between adviser and client. As the examples studied in evidence show, there can be no effective audit if the adviser keeps control of the file and will not release it to the licensee.

Next, the audit must be designed to reveal significant defaults. The evidence in the second round of hearings showed that audits often were not designed this way. For example, for too long, AMP maintained an audit system in which issues of high importance (such as not pursuing the client's best interests) could be treated as 'immaterial' when forming the overall audit grading.<sup>300</sup> No departure from the central duty of an adviser can properly be regarded as 'immaterial'.

The evidence also showed that, too often, bad audit results had no, or no significant, consequences for the adviser. For example, for too long, Westpac maintained a consequence management scheme under which point deductions for poor audit results were erased before the next audit would fall due.<sup>301</sup> A system of that kind did nothing to penalise bad work and nothing to encourage better work.

I doubt whether it is possible to prescribe a single, 'ideal' audit or consequence management system. Much will depend on the way that an AFSL holder structures its business. An effective system for a large licensee is likely to look different from an effective system for a small licensee.

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<sup>299</sup> ASIC, Module 2 Policy Submission, 15–16 [77]–[83].

<sup>300</sup> See Transcript, Sarah Britt, 23 April 2018, 1620–2, 1647.

<sup>301</sup> See Transcript, Michael Wright, 19 April 2018, 1422.

However, it is likely that **more could be done to facilitate ‘better practice’ in this area. In particular, ASIC should consider whether there are ways that it could provide further guidance to the industry about ‘best practice’ in the design of audit and consequence management systems. If appropriate, that work could be informed by observations made in the course of the Close and Continuous Monitoring Program, an on-site supervisory approach taken by ASIC that commenced in October 2018.**

In circumstances where poor conduct is identified and consequences are applied, AFSL holders have done too little to share that information with others. Two particular problems should be noted.

First, licensees are not doing enough to communicate between themselves about the backgrounds of prospective employees. The ABA’s reference checking and information-sharing protocol is limited to signatories and not consistently applied.<sup>302</sup> Licensees also frequently fail to respond adequately to requests for references regarding their previous employees.<sup>303</sup> Nor do they always take the information delivered to them seriously enough. The result is that financial advisers facing disciplinary action from their employer can shop around for another licensee to employ them.

Examples of the limited or inadequate disclosures made about former employees were observed in the course of hearings. When Dover Financial Services asked Westpac for information about the conduct of Mr Andrew Smith, Westpac said only that there was an ongoing investigation and that Westpac had ‘concerns’ about Mr Smith’s conduct.<sup>304</sup> Of greater concern, when Dover asked an ANZ licensee (Millennium3) for information about Mr Christopher Harris’s conduct, Millennium3 did not provide Dover with any material information even though it had made a notification to ASIC in relation to Mr Harris.<sup>305</sup>

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<sup>302</sup> Exhibit 2.248, 20 September 2016, ABA Financial Advice – Recruitment and Termination Reference Checking and Information Sharing Protocol, 1–2; Transcript, Louise Macaulay, 27 April 2018, 1918–19.

<sup>303</sup> ASIC, Module 2 Policy Submission, 13 [64].

<sup>304</sup> FSRC, *Interim Report*, vol 2, 176, 185; Transcript, Michael Wright, 20 April 2018, 1459–62.

<sup>305</sup> FSRC, *Interim Report*, vol 2, 196; Transcript, Darren Whereat, 20 April 2018, 1547; Exhibit 2.149, undated, Letter from Millenium3 to Dover.

Compliance with the ABA's reference checking and information-sharing protocol (or, at least, requirements in the nature of those contained in the protocol) should be mandatory for all AFSL holders whose licence authorises the provision of financial advice. Submissions received from industry generally supported extending the operation of the protocol to all AFSL holders.<sup>306</sup> Consideration could be given to making a breach of the protocol (or equivalent obligations) equivalent to a breach of financial services laws for the purposes of section 912A of the Corporations Act.

Second, licensees are not sufficiently sharing information with ASIC about advisers. Licensees may fail to report, or report late, their concerns about an adviser's conduct. Obviously that impedes ASIC's ability to enforce disciplinary sanctions on those who have breached the law. That is so even though licensees themselves depend on ASIC's Financial Adviser Register (FAR) for a definitive listing of banned advisers to indicate whether an adviser has a poor history.<sup>307</sup>

ASIC established the FAR in 2015.<sup>308</sup> The Register is publicly available, and contains information about current and former financial advisers who have been active since 31 March 2015. ASIC maintains the Register using information provided by AFSL holders and authorised representatives. Unlike various other registers that it maintains, ASIC has no legal obligation to maintain a register containing all of the information in the FAR. Further, unlike registers in other industries, inclusion confers no particular legal status on a financial adviser. In particular, inclusion is not a precondition to providing financial advice.

In July 2015, ASIC began using its compulsory information-gathering powers to require AFSL holders to provide it with information about financial advisers in respect of whom licensees had 'serious compliance concerns'

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<sup>306</sup> See ASIC, Module 2 Policy Submission, 13–14 [63]–[67]; AMP, Module 2 Policy Submission, 22 [107]; NAB, Module 2 Policy Submission, 20 [81]; Westpac, Module 2 Policy Submission, 18 [79]–[80]; AFA, Module 2 Policy Submission, 19; FPA, Module 2 Policy Submission, 19–20.

<sup>307</sup> Transcript, Andrew Hagger, 24 April 2018, 1672.

<sup>308</sup> Exhibit 2.247, Witness statement of Louise Macaulay, 25 April 2018, 13 [35].

and ‘other compliance concerns’.<sup>309</sup> Serious compliance concerns are where the licensee believes and has some credible information in support of the concerns identified that a financial adviser may have engaged in dishonest, illegal, deceptive and/or fraudulent misconduct or any misconduct that, if proven, would be likely to result in an instant dismissal or immediate termination; or deliberate non-compliance with financial services laws or gross incompetence or gross negligence.<sup>310</sup> Other compliance concerns include breaches of internal business rules or standards, adverse findings from audits, and conduct resulting in actual or potential financial loss to clients.<sup>311</sup>

The evidence in the Commission’s second round of hearings revealed a number of issues in the way that AFSL holders categorised compliance concerns it had identified as ‘serious’ concerns or ‘other’ concerns in their responses to ASIC.<sup>312</sup> However, putting those problems of implementation to one side, I consider that there is significant value in information of this kind being reported to ASIC. Compliance concerns in relation to an individual adviser may not constitute a significant breach of an AFSL holder’s obligations, and therefore would not trigger the reporting requirement under section 912D of the Corporations Act. However, ASIC may consider that those concerns warrant some action being taken against the adviser. Unless it receives information about those concerns, it is difficult for ASIC to take that action. Information about compliance concerns from different licensees is also likely to reveal trends emerging in the industry, and enable ASIC to target its education and enforcement activities to address emerging issues.

The reporting of ‘serious compliance concerns’ by AFSL holders to ASIC should be formalised. Licensees should be required to report such concerns to ASIC on a quarterly basis. As I explain further below, mandatory reporting will also form an important part of a unified disciplinary system for financial advisers.

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<sup>309</sup> See Transcript, Andrew Hagger, 24 April 2018, 1672; Transcript, Louise Macaulay, 27 April 2018, 1925–6.

<sup>310</sup> See Transcript, Michael Wright, 19 April 2018, 1432.

<sup>311</sup> See Transcript, Michael Wright, 19 April 2018, 1432.

<sup>312</sup> See, eg, Transcript, Michael Wright, 19 April 2018, 1432–3; Transcript, Andrew Hagger, 24 April 2018, 1673–4.

One further point should be made. When an entity detects that an adviser has engaged in misconduct (whether by giving inappropriate advice or otherwise), it should always consider what steps it should take to see whether the adviser may have acted poorly in respect of matters other than those that are the immediate focus of attention. As the evidence before the Commission showed, entities have not always done this. The result is that the damage done by an adviser may not come to light until long after the event, which works to the detriment of both the affected clients and the entity itself. It is necessary in principle, and better in practice, for entities discovering misconduct by an adviser to make whatever inquiries are reasonably necessary to determine the nature and full extent of the adviser's conduct.

### **Recommendation 2.7 – Reference checking and information sharing**

All AFSL holders should be required, as a condition of their licence, to give effect to reference checking and information-sharing protocols for financial advisers, to the same effect as now provided by the ABA in its 'Financial Advice – Recruitment and Termination Reference Checking and Information Sharing Protocol'.

### **Recommendation 2.8 – Reporting compliance concerns**

All AFSL holders should be required, as a condition of their licence, to report 'serious compliance concerns' about individual financial advisers to ASIC on a quarterly basis.

### **Recommendation 2.9 – Misconduct by financial advisers**

All AFSL holders should be required, as a condition of their licence, to take the following steps when they detect that a financial adviser has engaged in misconduct in respect of financial advice given to a retail client (whether by giving inappropriate advice or otherwise):

- make whatever inquiries are reasonably necessary to determine the nature and full extent of the adviser's misconduct; and
- where there is sufficient information to suggest that an adviser has engaged in misconduct, tell affected clients and remediate those clients promptly.

### 4.1.2 ASIC

In its submission following the second round of the Commission's hearings, ASIC said that, as a regulator, its role is to oversee advisers' compliance with the law and not to supervise or monitor their work.<sup>313</sup> It said that primary responsibility for discipline lies with licensees, who are responsible under the law for the conduct of their advisers.<sup>314</sup> That is undoubtedly correct. In my view, however, and as I said in the *Interim Report*, ASIC's enforcement of the law with regard to individual advisers is an important part of the disciplinary system. It is for that reason that a robust approach to enforcement is critical.

Financial services licensees that breach those sections of the Corporations Act that impose the best interests duty (section 961B), oblige the provision of appropriate advice (section 961G), warn of incomplete or inaccurate advice (section 961H), and require giving priority to the client's interests (section 961J), are liable to civil penalty.<sup>315</sup> Licensees must take reasonable steps to ensure that representatives of the licensee comply with those sections (sections 961B, 961G, 961H and 961J).<sup>316</sup> Authorised representatives are themselves liable to civil penalty for contravention of any of those sections.<sup>317</sup> Clients who suffer loss or damage because of a breach of the sections can recover compensation,<sup>318</sup> and the court dealing with an action under that section can make any of several other kinds of order.<sup>319</sup>

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<sup>313</sup> ASIC, Module 2 Policy Submission, 16 [80].

<sup>314</sup> ASIC, Module 2 Policy Submission, 15 [78].

<sup>315</sup> Corporations Act s 961K.

<sup>316</sup> Corporations Act s 961L.

<sup>317</sup> Corporations Act s 961Q.

<sup>318</sup> Corporations Act s 961M.

<sup>319</sup> Corporations Act s 961N.

As I observed in the *Interim Report*, these civil penalty provisions have seldom been invoked. No civil penalty proceedings had been instigated in the five years before Ms Louise Macaulay (Senior Executive Leader of ASIC's Financial Advisers Team) gave her evidence about these issues in the second round of the Commission's hearings.<sup>320</sup> Ms Macaulay said of civil penalty proceedings generally, that they 'are time-consuming and resource intensive for ASIC', that 'their outcome is not proximate to the time of the misconduct' and that '[t]heir deterrent effect is limited by the (currently modest) size of the available penalty'.<sup>321</sup> More particularly, in the context of financial advice, she pointed out that a civil penalty order, of itself, does not include a banning order. These observations about civil penalty proceedings must be considered in the light of whether other ways of dealing with breaches of the provisions are speedier, less time-consuming or more effective in deterring similar conduct.

The chief regulatory tool ASIC has used in connection with financial advice has been the power to make a banning order prohibiting a person from providing any, or any specified, financial services either permanently or for a specified period.<sup>322</sup> Since 2008, ASIC has made 350 banning orders, of which 229 were made in relation to financial advisers.<sup>323</sup> Just under half of those banning orders were permanent orders.<sup>324</sup>

As Ms Macaulay explained, the process of making a banning order takes time. The time between ASIC becoming aware of the conduct that might warrant making a banning order and deciding to investigate the matter may vary from 'a couple of months' to 'any length of time up to a year'.<sup>325</sup> It may take six to 12 months to get a brief to the delegate and the delegate may

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<sup>320</sup> Transcript, Louise Macaulay, 27 April 2018, 1915.

<sup>321</sup> Exhibit 2.247, Witness statement of Louise Macaulay, 25 April 2018, 16 [51].

<sup>322</sup> Corporations Act ss 920A–920B.

<sup>323</sup> Exhibit 2.247, Witness statement of Louise Macaulay, 25 April 2018, 5 [20]. See also Transcript, Louise Macaulay, 27 April 2018, 1914. The figures given in Exhibit 2.247 were said not to include banning orders made by a Court in civil proceedings or undertakings not to provide financial services given pursuant to EUs.

<sup>324</sup> Transcript, Louise Macaulay, 27 April 2018, 1914.

<sup>325</sup> Transcript, Louise Macaulay, 27 April 2018, 1911.

take five months to make the decision.<sup>326</sup> Add to those times any appeal to the Administrative Appeals Tribunal or any proceedings for judicial review and the whole process may take anything up to two years.

No doubt, as Ms Macaulay said, banning orders serve a purpose of protecting the public. But a regulator's choice of regulatory steps should not be treated as requiring exercise of only one form of power. There are cases where more than one power can and should be exercised. The process of making a banning order may be every bit as long as the pursuit of civil penalties. Court processes may prove to be more costly, if the action is fought. But chosen wisely, cases pursuing civil penalty may be prosecuted to conclusions that lead to a public denunciation of conduct that has breached the law. And public denunciation of unlawful conduct is a deterrent and educative tool that is important to the proper regulation of the whole of the relevant regulated community (here financial advisers and advice licensees).

#### **4.1.3 Industry associations**

Just as there is no requirement for individual financial advisers to be registered by ASIC, there is also no requirement for advisers to be members of any particular industry association. Nevertheless, many financial advisers choose to be members of one or more of these associations. There are several bodies for advisers to choose from, including the FPA and the AFA.

Both the FPA and the AFA seek to advance the cause of financial advisers generally. Each seeks to promote the creation and growth of financial planning and advice as a profession. Both the FPA and AFA now have processes and systems for disciplining members. But the evidence before the Commission did not show that either the FPA or the AFA currently plays any significant role in maintaining or enforcing proper standards of conduct by financial advisers.

As I observed in the *Interim Report*, neither ASIC nor licensees are sharing information with industry associations. Both the FPA and the AFA find out about members under ASIC investigation from media releases and news stories. Licensees almost never report their concerns about advisers

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<sup>326</sup> Transcript, Louise Macaulay, 27 April 2018, 1911.

to industry associations. The two associations do not share disciplinary information between themselves. Members of the public are generally unaware of the FPA and AFA, and are more likely to take their complaint to a dispute resolution body than report advisers to the industry bodies. The result is that industry bodies now have little basis on which to play any effective disciplinary role.

Neither do advice licensees currently look to the associations for that purpose. Licensees may encourage advisers to join a professional association. But licensees do not routinely tell either association of misconduct by advisers.

The FPA's treatment of the complaint made to it about the conduct of Mr Henderson in connection with Ms McKenna (referred to above) did not instil confidence in FPA's disciplinary arrangements, at least as they stood when the Commission took evidence about the matter. The process described in evidence was prolonged, opaque and directed more to settling an agreed outcome to the complaint than imposing proper standards of conduct by members. And, as noted earlier, Mr Henderson chose not to renew his membership of FPA when he did not get his preferred outcome. Mr Dante De Gori, the CEO of the FPA, said that the failure to pay membership dues does not terminate the membership of a member against whom a complaint remains outstanding. Even if that is so, and even if the FPA were to expel the member concerned, it seems that the expulsion would be of little or no moment to a self-employed financial adviser.

Financial advisers are not currently required to belong to an association, and though some employers of employed financial advisers require it, few if any specify which. Advisers are free to switch between associations at any time, or, as Mr Hagger put it, 'go down the road to another association' if they are expelled.<sup>327</sup> The FPA and AFA therefore actively engage in recruitment of members from the industry and, to some necessary extent, from each other. Membership fees are their chief source of revenue.

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<sup>327</sup> Transcript, Andrew Hagger, 24 April 2018, 1671.

Representatives of each association said that promoting the profession was one of its key functions.<sup>328</sup> These characteristics sit uncomfortably with those of effective discipline that include objectivity, consistency and compulsion, and the tension was clearly borne out in the case of Mr Henderson and the FPA.

Mr De Gori said that the only compulsory sanction available to the FPA is to expel members. To encourage members to comply with disciplinary decisions, the association may threaten to name them as the subject of its proceedings, although generally, names are kept confidential. The AFA has undertaken only two disciplinary matters since 2013, both of which resulted in a reprimand.<sup>329</sup>

The Code of Ethics being developed by FASEA will come into force in January 2020.

If, as both the FPA and AFA hope, industry associations become monitoring bodies under the Corporations Act, much will depend upon how they perform those tasks. The monitoring bodies will play an important part in setting the tone and the culture of those who act as financial advisers.

#### **4.1.4 FASEA and the Code of Ethics**

As noted earlier, recent legislation<sup>330</sup> seeks to advance the ‘professionalism’ of financial advice: by requiring higher education and training standards;<sup>331</sup> and by establishing FASEA<sup>332</sup> and requiring compliance<sup>333</sup> with a Code of Ethics to be prepared by FASEA<sup>334</sup> and monitored by a ‘monitoring body’.<sup>335</sup>

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<sup>328</sup> Transcript, Dante De Gori, 26 April 2018, 1819; Transcript, Philip Kewin, 26 April 2018, 1828.

<sup>329</sup> Exhibit 2.230, Witness statement of Philip Kewin, undated, 14–15.

<sup>330</sup> *Corporations Amendment (Professional Standards of Financial Advisers) Act 2017* (Cth).

<sup>331</sup> Corporations Act Pt 7.6 Div 8A ss 921B–921D.

<sup>332</sup> Corporations Act s 921X.

<sup>333</sup> Corporations Act s 921E.

<sup>334</sup> Corporations Act s 921U.

<sup>335</sup> Corporations Act ss 921G–921T.

When the amended regulatory provisions come into effect, all advisers will be required to become members of a code monitoring body. Advisers will be prohibited from changing associations while under investigation by a monitoring body, and all breaches of the Code will have to be reported to ASIC and the adviser's licensee. Breaches of the Code and any sanctions will be listed on the FAR.<sup>336</sup>

In these ways, the new scheme will deal directly with several of the issues raised above. The requirement to share information is welcome. The restriction on advisers changing schemes mid-investigation should limit the evasion of disciplinary processes that is otherwise possible in a system where multiple bodies administer one code of ethics. However, advisers not under investigation but looking for a lighter touch will still be free to switch monitoring bodies. The consistency between various code monitoring bodies in enforcing discipline will therefore be important.

It is important to recognise the proper place of the proposed Code of Ethics. Codes of ethics are not laws. Codes of ethics are important to fostering public confidence and practitioner integrity in a profession. They are composed by industry practitioners according to agreed industry processes. Laws, by contrast, are the product of a public process conducted under the authority of democratic institutions. It is laws, and not codes of ethics, that are the proper repositories for basic norms of conduct. This qualitative disparity mandates a difference in approach to contraventions of each.

While codes of ethics have a part to play in setting professional standards of behaviour, the industry must be conscious of their boundaries. The investigation and punishment of breaches of law should not be outsourced to private bodies. Licensees and industry bodies should not try to resolve breaches of law by advisers internally, but must notify ASIC or other appropriate authorities. A breach of the code of ethics must not be allowed to obscure, or be treated as more significant than, a breach of the law.

Though laws and professional codes serve different normative purposes, the discipline they impose can have similar objectives. Both ASIC and the FPA emphasised the protection of the public as their overriding

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<sup>336</sup> Treasury, Module 2 Policy Submission, 15 [94].

disciplinary aim. For that reason, they may not take action, for example, against an unscrupulous adviser who has ceased to practice.

**Disciplinary powers do have a protective aspect. In some cases, protecting the public will be a critical aspect of disciplinary action. But the imposition of discipline in a civil or even a professional setting usually, by analogy with criminal sentencing, serves multiple purposes. Among those purposes will ordinarily be purposes of punishment, denunciation, and the identification of conduct that breaches applicable norms. To characterise disciplinary action as serving *only* to protect the public is wrong. Not only is the characterisation wrong, it hides the need for regulatory bodies to give proper weight to the other purposes that are to be achieved by taking regulatory action.**

## **4.2 A new approach to discipline**

As I said at the start of this section of the chapter, a coherent system of professional discipline must be established for financial advisers. The system should have the following key features.

- First, each financial adviser should be individually registered.
- Second, only those who are registered should be permitted to give financial advice.
- Third, there should be a single, central disciplinary body with the power to impose disciplinary sanctions on financial advisers – the most serious sanction being cancellation of registration.
- Fourth, there should be a system of mandatory notifications, requiring AFSL holders to report particular information about the conduct of financial advisers to the disciplinary body.
- Fifth, there should be a system of voluntary notifications, enabling AFSL holders, industry associations and clients to report information about the conduct of financial advisers to the disciplinary body.

I say more about each of those features below.

### 4.2.1 Mandatory individual registration

A requirement of individual registration as a condition of practice is common to most professions. For example, health practitioners (including doctors and nurses) must be registered with the Australian Health Practitioner Regulation Agency (AHPRA).<sup>337</sup> Lawyers must be admitted to practise, and hold practising certificates.<sup>338</sup> Architects and teachers must be registered with a relevant state or territory registration body.<sup>339</sup>

Mandatory individual registration is also a feature of other regulated occupations. For example, a person may not practise as a tax agent unless he or she is registered with the Tax Practitioners Board,<sup>340</sup> and a person may not practise as a migration agent unless he or she is registered with the Migration Agents Registration Authority.<sup>341</sup>

Mandatory individual registration for financial advisers is likely to have a number of benefits.

- It will formalise the existing FAR, and ensure that valuable information about financial advisers is made available to the public.
- It will facilitate the introduction of a central disciplinary body for financial advisers, focused on the conduct of individual advisers and complaints about individual advisers.
- It will ensure that the central disciplinary body can impose sanctions that have effect even if an adviser leaves a particular AFSL holder or professional association.
- It will facilitate the introduction of additional requirements for advisers directed at raising standards in the industry. To give two examples, compliance with continuing professional development requirements could be made a precondition for renewal of registration, and disclosure of

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<sup>337</sup> See the Health Practitioner Regulation National Law.

<sup>338</sup> See, eg, Legal Profession Uniform Law.

<sup>339</sup> See, eg, *Architects Act 1991* (Vic), Pt 3 and *Education and Training Reform Act 2006* (Vic), Div 3 of Pt 2.6.

<sup>340</sup> See the *Tax Agent Services Act 2009* (Cth).

<sup>341</sup> See *Migration Act 1958* (Cth), Pt 3.

particular matters relating to fitness to provide financial advice could be required on renewal of registration.

Introducing a system of mandatory individual registration may also assist in impressing upon financial advisers that they occupy a position of trust, and that their entitlement to continue to occupy that position of trust depends on their obeying the law and other standards applicable to them.

In its submissions following the second round of hearings, ASIC addressed the possibility of introducing a 'dual licensing system' for financial advisers, in which individual financial advisers would be registered not just with the AFSL holder, but with ASIC too. ASIC said that any such system must address two issues:<sup>342</sup>

- first, the possibility that individual licensing of financial advisers may dilute the responsibility of a licensee and create ambiguity and uncertainty about the relative responsibilities between a licensee and ASIC; and
- second, that the close scrutiny involved in an individual licensing regime would require substantial resources to administer effectively.

While the dual licensing system that ASIC addressed in its submissions is somewhat different from the system of individual registration that I propose, it is appropriate that I say something about both matters raised by ASIC.

The answer to the first point is that, under a system of individual registration, AFSL holders would maintain all of their existing obligations in relation to financial advisers. The new system would not detract in any way from the existing obligations of AFSL holders who employ financial advisers or appoint authorised representatives. Rather, it would ensure that financial advisers who fail to adhere to the standards expected of them would face consequences that extend beyond their employment with or appointment by a particular licensee, and affect their capacity to provide financial advice more generally.

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<sup>342</sup> ASIC, Module 2 Policy Submission, 18 [92].

This is not so different from the arrangements that govern other professions. In most cases, a system of individual registration and discipline exists alongside the consequence management frameworks of employers. So, for example, an employee solicitor who misappropriates client funds may expect to face both disciplinary consequences from the relevant statutory body, and employment consequences from his or her law firm.

The answer to the second point is that ASIC already maintains a register of financial advisers (the FAR). It is difficult to see how formalising that register, and making registration a precondition to providing financial advice, will add significantly to the cost of maintaining the existing register.

I accept that if ASIC is given other functions in connection with the registration of financial advisers (such as assessing whether advisers are fit and proper persons to provide financial advice), fulfilling those functions may require additional resources. However, whether any such additional functions are conferred on ASIC is a question for Government. If any additional functions are conferred, at least part of the cost of providing those functions could be recouped through a requirement to pay an annual registration fee.

## **4.2.2 A single, central disciplinary body**

A single, central disciplinary body for financial advisers is important because it will ensure that appropriate disciplinary consequences are imposed where a licensee fails to impose them, and that the disciplinary consequences imposed on a financial adviser can extend beyond the adviser's employment with or appointment by a particular licensee.

ASIC currently has the power to make banning orders, which extend beyond an adviser's relationship with a particular licensee. But there are several reasons why I do not consider it appropriate to continue to rely on ASIC's existing powers as the sole means by which to impose disciplinary consequences that extend beyond a particular licensee.

First, a banning order will not be an appropriate response every time a financial adviser fails to adhere to the standards expected of him or her. There is an important role for less serious sanctions in demonstrating that particular conduct is unacceptable, and encouraging or requiring individuals to change their behaviour. But, as discussed above, apart from banning

orders, ASIC has few powers that it can use to take action against individual advisers.

Second, because a banning order is a serious sanction, and because ASIC has limited resources, ASIC tends to direct its investigation and enforcement activities to the most obviously serious cases. While this is understandable, it means there may be cases where legitimate complaints warranting some form of disciplinary action are not investigated. A body dedicated to the investigation of matters concerning individual advisers could be expected to consider a broader range of cases than ASIC currently does.

Third, as explained above, the process involved in making a banning order is time-consuming. This is, again, a reflection of the more serious nature of the cases in which banning orders are imposed. It might be expected that most cases dealt with by a new disciplinary body could be dealt with more expeditiously.

In making this recommendation, I do not wish to be overly prescriptive about the form that the new disciplinary body should take, the powers that it should have, or (with the exception of the system of mandatory and voluntary notifications discussed below) the relationships that it should have with other bodies – in particular, ASIC and the code monitoring bodies. It may be that this new body is the most appropriate entity to perform the functions currently planned to be assigned to the code monitoring bodies under the Corporations Act.

However, as will be evident from what I have written, I consider that the body should have available to it a range of sanctions varying in severity, the most serious of which must be the cancellation of the registration of a financial adviser.

### **4.2.3 Mandatory and voluntary notifications**

A system of mandatory and voluntary notifications would require AFSL holders to report particular matters to the disciplinary body, and permit other stakeholders to report matters to that body.<sup>343</sup>

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<sup>343</sup> Such a system currently exists for health practitioners: see Divs 2 and 3 of Pt 8 of the Health Practitioner Regulation National Law.

The system of mandatory notifications is necessary to overcome the existing issue with licensees failing to share information with ASIC and with professional associations. I have already recommended that licensees should be required to report serious compliance concerns about advisers to ASIC on a regular basis. I consider that, at a minimum, licensees should also be required to report this information to the disciplinary body. Licensees could also be required to report other compliance concerns about advisers to the disciplinary body.

The system of voluntary notifications is necessary to overcome the existing lack of clarity about where consumers should most appropriately direct complaints about financial advisers. Complaints could be directed to, and dealt with by, the disciplinary body. It may be that an early step in dealing with each complaint (other than complaints that are plainly without substance) is to contact the adviser's licensee and invite a response.

As I have said, the system that I propose is not intended to detract in any way from the existing obligations of AFSL holders in relation to the advisers they employ and authorise. AFSL holders should continue to have primary responsibility for monitoring and disciplining advisers. The aim of the disciplinary system is to ensure that advisers who engage in misconduct face appropriate consequences, and that where appropriate, the consequences imposed on advisers extend beyond their association with a particular licensee. The disciplinary body may decide to take no action in relation to a particular adviser if it considers that the consequences already imposed by the adviser's licensee are appropriate.

### **Recommendation 2.10 – A new disciplinary system**

The law should be amended to establish a new disciplinary system for financial advisers that:

- requires all financial advisers who provide personal financial advice to retail clients to be registered;
- provides for a single, central, disciplinary body;
- requires AFSL holders to report 'serious compliance concerns' to the disciplinary body; and
- allows clients and other stakeholders to report information about the conduct of financial advisers to the disciplinary body.

## Conclusion

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The financial advice industry is part way through transformation from an industry dedicated to the sale of financial products to a profession concerned with the provision of financial advice. The interests of Australians who seek financial advice require that that transformation be completed. That will not be an easy task, but it is necessary. It will require:

- taking steps to deal with those involved in the charging of ‘fees for no service’, and to ensure that it does not happen again;
- reducing the conflicts of interest that pervade the industry; and
- introducing a credible and coherent disciplinary system for financial advisers.

Once those changes have been made and have settled, it will be time to ask whether the quality of financial advice has improved, and whether financial advisers are behaving like professionals. It will also be necessary to ask whether remaining carve outs, exceptions and safe harbour provisions continue to be justified.

# 4. Superannuation

## Introduction

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The superannuation sector of the financial services industry is important, not only to the many individuals who participate in it as members of superannuation funds, but also to the nation. Superannuation is important to individuals because it will affect, even determine, how they live after retiring from work. It is important to the nation because of the size of the superannuation savings pool, and how that pool is invested. And it is also important to the nation because the greater the capacity for individuals to support themselves from their superannuation savings in retirement, the smaller will be the total claims on public welfare outlays of all kinds, such as aged pensions, housing and health.

At March 2018, superannuation savings comprised assets worth about \$2.6 trillion: more than 140% of Australia's nominal gross domestic product in the four quarters to March 2018.<sup>1</sup>

At June 2017, more than 14.8 million Australians had a superannuation account.<sup>2</sup> About 40% held more than one account.<sup>3</sup> Superannuation represents about half of household financial assets.<sup>4</sup>

Regulated superannuation funds are organised as trusts. The trustee holds assets for the benefit of members or, on the death of a member, for dependants or beneficiaries of that member.

There are three types of superannuation trust: self-managed superannuation trusts (regulated by the ATO), exempt public sector superannuation schemes (regulated by Commonwealth, state or territory

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<sup>1</sup> Background Paper No 22, 6, Box 1.

<sup>2</sup> Background Paper No 22, 8 [3.1].

<sup>3</sup> Background Paper No 22, 8 [3.1].

<sup>4</sup> Background Paper No 22, 4–5.

legislation) and APRA-regulated funds regulated by the Australian Prudential Regulation Authority (APRA) under the *Superannuation Industry (Supervision) Act 1993* (Cth) (the SIS Act).

To understand the issues that have been considered by the Commission, it is necessary to trace the main legislative and other steps that have been taken to arrive at the regulatory regime that has applied at relevant times.

## 1 Some history

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Before 1986, there was no compulsory superannuation system in Australia. In the June 1986 National Wage Case, the Conciliation and Arbitration Commission awarded an increase of 3% of ordinary earnings to be paid into superannuation accounts.<sup>5</sup>

In the following year, 1987, the Commonwealth Parliament enacted the *Occupational Superannuation Standards Act 1987* (Cth) (the OSSA Act) and established the Insurance and Superannuation Commission to administer the Act. Regulations made under the Act set operating standards for superannuation funds.

In 1992, the Parliament enacted legislation establishing the Superannuation Guarantee, in effect, making superannuation contributions by employers compulsory.<sup>6</sup> Starting at 3%, the Superannuation Guarantee rate is now 9.5% and will rise to 12% by 1 July 2025.<sup>7</sup>

In 1993, the Parliament repealed the OSSA Act and enacted the SIS Act.

As enacted, the SIS Act provided, and it continues to provide, that if the governing rules of a superannuation entity did not contain covenants to the effect of covenants set out in the Act, the rules were taken to do so. The covenants were all expressed as covenants by the trustee,

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<sup>5</sup> *National Wage Case June 1986* (1986) 14 IR 187, 212–19; Background Paper No 23, 3.

<sup>6</sup> *Superannuation Guarantee Charge Act 1992* (Cth) and *Superannuation Guarantee (Administration) Act 1992* (Cth). See also, *Roy Morgan Research Pty Ltd v Commissioner of Taxation* (2011) 244 CLR 97.

<sup>7</sup> Background Paper No 23, 3.

and have since been amended, but in general terms they were and remain covenants that include covenants of honesty,<sup>8</sup> care, skill and diligence,<sup>9</sup> as well as a covenant to perform the trustee's duties, and exercise the trustee's powers 'in the best interests of the beneficiaries'.<sup>10</sup> The Act provided, and still provides, that the trustee of a regulated superannuation fund must ensure that the fund is maintained *solely* for one or more specified purposes.<sup>11</sup> Those purposes can be summarised as being the provision of retirement benefits and the provision of benefits in respect of a member after the member's death.<sup>12</sup> This provision of the Act is often referred to as 'the sole purpose test'.

Following the Wallis Inquiry, APRA was established in 1998, and took over responsibility for prudential supervision of the banking, superannuation and insurance sectors of the financial services industry. Administrative responsibility for **self-managed superannuation funds** (SMSFs) was given to the ATO.

In 2004, the SIS Act was amended to require all **registrable superannuation entities** (RSEs) to be licensed.<sup>13</sup>

Until 2005, industrial awards providing for superannuation contributions generally nominated the fund that was to receive the contributions. Commonly, the nominated fund was an industry fund.<sup>14</sup> The *Superannuation Legislation Amendment (Choice of Superannuation Funds) Act 2005* (Cth) permitted most employees to choose the superannuation fund that would receive their superannuation contributions. Today, if an employee does not nominate a fund, and the default fund is not specified in a relevant industrial instrument, it is the employer who will select the default fund. Treasury told the Commission that 'around one million working Australians cannot

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<sup>8</sup> See now SIS Act s 52(2)(a).

<sup>9</sup> See now SIS Act s 52(2)(b).

<sup>10</sup> See now SIS Act s 52(2)(c). As the SIS Act was originally enacted, the covenant was 'to ensure' that the trustee's duties and powers were performed and exercised in that way.

<sup>11</sup> SIS Act s 62.

<sup>12</sup> SIS Act s 62(1)(a).

<sup>13</sup> *Superannuation Safety Amendment Act 2004* (Cth).

<sup>14</sup> Background Paper No 23, 5.

currently choose their own fund, as their “choice” is deemed through an enterprise bargaining arrangement or workplace determination.”<sup>15</sup>

In 2009, the Government appointed a panel, chaired by Mr Jeremy Cooper, to review the governance, efficiency, structure and operation of Australia’s superannuation system. The 1997 Wallis Inquiry report had taken as a ‘key tenet’ that superannuation fund members should be treated as rational and informed investors. The Cooper Review challenged that proposition.<sup>16</sup>

The Cooper Review concluded that ‘a compulsory system needs to be able to cater for ... different degrees of engagement: the significant proportion of members who are not engaged with their super, or in a position to make the sorts of decisions required of them; and the informed, financially literate, or well-advised members.’<sup>17</sup> Hence, the Review recommended the creation of a new type of superannuation product – **MySuper** – and re-casting the architecture of the superannuation industry to recognise four types of members. The Review described those members as:

- ‘... [M]embers who simply want someone else to take care of it all for them. MySuper is particularly designed to cater to these members.
- ... [M]embers who want to exercise choice over the investment strategies applied to their superannuation balances, but want to have their accounts administered for them. These members can elect to be in the choice segment, though they might decide that a MySuper product meets their needs and elect to have their money invested there (or in a combination of MySuper and choice products).
- ... [Members], and the number has increased sharply in recent years, who choose to be fully responsible for the investment and administration of their superannuation arrangements. These members can choose to operate an SMSF.

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<sup>15</sup> Background Paper No 23, 6.

<sup>16</sup> Cooper Review, Final Report, 8.

<sup>17</sup> Cooper Review, Final Report, 9.

- ... [M]embers who have lost their superannuation account. The objective here is to reconnect members and their accounts quickly and efficiently and to introduce measures that make this less likely to occur in future'.<sup>18</sup>

The Review said that the 'MySuper component of the choice architecture model aims to provide a simple, cost effective product with a single, diversified portfolio of investments for the vast majority of Australian workers (roughly 80% of members) who are in the default option in their current fund'.<sup>19</sup>

What is now Part 2C of the SIS Act (sections 29R–29XC) makes provision for MySuper products and was inserted in the Act in 2012.<sup>20</sup> The substantive provisions took effect from 1 July 2013. The stated intention is that all MySuper products 'will be simple products sharing common characteristics'.<sup>21</sup> The characteristics, specified in section 29TC, include that the fund have a 'single diversified investment strategy'.<sup>22</sup>

The Act provides fee rules for MySuper products<sup>23</sup> and imposes some additional obligations on trustees and directors of trustees of funds that offer a MySuper product.<sup>24</sup>

Under the Superannuation Guarantee legislation, employers need to pay contributions for an employee without a chosen fund into a fund that offers a MySuper product if they are to avoid becoming liable to pay an increased superannuation guarantee shortfall.<sup>25</sup> In addition, if a person is a member of an RSE (other than a defined benefit member) and a contribution is made to the fund for the benefit of that person, and the person has not given the trustee 'a direction that the contribution is to be invested under one or more

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<sup>18</sup> Cooper Review, Final Report, 10–11.

<sup>19</sup> Cooper Review, Final Report, 11.

<sup>20</sup> *Superannuation Legislation Amendment (MySuper Core Provisions) Act 2012* (Cth) and *Superannuation Legislation Amendment (Further MySuper and Transparency Measures) Act 2012* (Cth).

<sup>21</sup> SIS Act s 29R(1).

<sup>22</sup> SIS Act s 29TC(1)(a).

<sup>23</sup> SIS Act ss 29V–29VE.

<sup>24</sup> SIS Act ss 29VN, 29VO.

<sup>25</sup> SIS Act s 29R(4).

specified investment options' the trustee *must* treat the contribution as a contribution to be paid into a MySuper product of the fund.<sup>26</sup> Contravention of the provision is an offence.<sup>27</sup>

An RSE licensee may offer a MySuper product only with the authority of APRA.<sup>28</sup>

## 2 Trustees' obligations to members

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### 2.1 The trustees' covenants

In order to understand the issues about superannuation that the Commission examined, it is necessary to explain briefly the obligations imposed on trustees of superannuation funds.

In addition to statutory obligations,<sup>29</sup> important obligations are imposed on trustees by covenants under the SIS Act.<sup>30</sup>

Section 52(1) of the SIS Act provides that the governing rules of an RSE are taken to contain certain covenants. Of particular relevance to the work of the Commission were the following covenants:

- to exercise, in relation to all matters affecting the entity, 'the same degree of care, skill and diligence as a prudent superannuation trustee would exercise in relation to an entity',<sup>31</sup>

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<sup>26</sup> SIS Act s 29WA.

<sup>27</sup> SIS Act s 29WA(3).

<sup>28</sup> SIS Act s 29T.

<sup>29</sup> In particular, eg, the obligations imposed on trustees who offer a MySuper product in ss 29VN and 29VO of the SIS Act. See also the proposed new Prudential Standards released by APRA on 13 December 2017 relating to member outcomes: APRA, *Strengthening Superannuation Member Outcomes* (13 December 2018) APRA <[www.apra.gov.au/strengthening-superannuation-member-outcomes](http://www.apra.gov.au/strengthening-superannuation-member-outcomes)>.

<sup>30</sup> The covenants, and obligations, imposed under the SIS Act are cumulative: SIS Act s 51A.

<sup>31</sup> SIS Act s 52(2)(b).

- to perform the trustee's duties and exercise the trustee's powers in the best interests of the beneficiaries;<sup>32</sup>
- where there is a conflict of interests and duties:
  - to give priority to the duties to and interests of the beneficiaries;
  - to ensure that the duties to the beneficiaries are met;
  - to ensure that the interests of the beneficiaries are not adversely affected; and
  - to comply with the prudential standards in relation to conflicts;<sup>33</sup>
- and
- not to enter into any contract, or do anything else, that would prevent the trustee from, or hinder the trustee in, properly performing or exercising its functions or powers.<sup>34</sup>

These covenants are central to the proper conduct of the trustee of an RSE. The trustee's covenants are buttressed by the provision, in section 52A, that the governing rules of an RSE, of which the trustee is a body corporate, are to be taken to contain covenants by each director of the corporate trustee to parallel effect (obliging the director to exercise care, skill and diligence; perform duties and exercise powers in the best interests of beneficiaries; deal with conflicts in the same way as the trustee must; and not enter into any contract or do anything else that would prevent proper performance of duties or hinder exercise of powers).

## **2.2 Best interests of members and conflicts of interest**

The best interests covenant is simply stated. Yet the conduct examined by the Commission, and submissions made by trustees, suggested that some trustees had difficulty understanding when and how the covenant applied.

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<sup>32</sup> SIS Act s 52(2)(c).

<sup>33</sup> SIS Act s 52(2)(d).

<sup>34</sup> SIS Act s 52(2)(h).

For example, one group of trustees said that the duty is not an overarching obligation to act in members' best interests.<sup>35</sup> They said that the covenant operated to qualify the performance of a particular duty, or the exercise of a particular power.<sup>36</sup> Whether or not that is a complete statement of the law, describing the covenant in this way is apt to mislead. It suggests that the covenant has only limited application. Yet whenever a trustee acts it will be performing a duty or exercising a power, and an obligation to perform duties and exercise powers necessarily covers omissions. A trustee cannot avoid its obligations by doing nothing. It follows that any suggestion that the covenant has only limited application is not right.

The same trustees emphasised the alleged complexity of the covenant and the need to consider all of the circumstances.<sup>37</sup> Another group of trustees listed six matters 'by way of example of the complex considerations' that can arise.<sup>38</sup> The tenor of this submission was that accurately identifying a breach of the covenant was fraught with difficulty. Yet the 'complex considerations' it pointed to were straightforward matters, such as recognising the importance of the superannuation context and accepting that the application of the covenant will depend upon the circumstances of the case.<sup>39</sup> Again, such observations are more likely to confuse than to assist.

At the other extreme was a trustee who, in response to a letter from APRA, suggested that 'the so-called pub test' was a 'proxy' for members' best interests.<sup>40</sup> The reduction of members' best interests to this yardstick is likely to mislead for other, more obvious, reasons.

It should be concerning to regulators that professional trustees apparently struggle to understand their most fundamental obligation. No doubt a trustee must consider all relevant circumstances when deciding what

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<sup>35</sup> NAB and NULIS, Module 5 Case Study Submission, 5 [20].

<sup>36</sup> NAB and NULIS, Module 5 Case Study Submission, 5 [20].

<sup>37</sup> NAB and NULIS, Module 5 Case Study Submission, 18 [101], 19–20 [105]–[106].

<sup>38</sup> CFSIL and Avanteos, Module 5 Case Study Submission, 17 [50(c)].

<sup>39</sup> CFSIL and Avanteos, Module 5 Case Study Submission, 17 [50(c)].

<sup>40</sup> Exhibit 5.302, Witness statement of Stephen Glenfield, 14 August 2018, Exhibit SG-1-40 [APRA.0007.0002.1765 at .1769].

is in the best interests of beneficiaries.<sup>41</sup> It may also be accepted that the role of a professional trustee is complex, and that a trustee is not responsible for every outcome that turns out to be ‘unbeneficial’ to members.<sup>42</sup> But that does not make the covenant incomprehensible or its content unknowable. Assertions of complexity must not obscure or confuse the obligations imposed on a trustee. The concept of acting in members’ best interests is not hard to understand.

A trustee ‘must do the best they can for the benefit of their beneficiaries, and not merely avoid harming them’.<sup>43</sup> This can be achieved if a trustee keeps the best interests of beneficiaries ‘front of mind’ at all times. The case studies revealed that, all too often, trustees did not. Usually, they did not because a conflict arose between the beneficiaries’ interests and the interests of the trustee or another person or entity.

It is therefore necessary to say something about the covenant in section 52(2)(d) of the SIS Act. Again, the covenant is simply stated: it requires the trustee to prioritise the beneficiaries’ interests where a conflict arises.<sup>44</sup>

By contrast to their approach to section 52(2)(c), most RSE licensees had little difficulty identifying what section 52(2)(d) requires. Their written submissions said that it could be met by ‘management frameworks’ and policies intended to ‘identify’ and ‘manage’ conflicts.<sup>45</sup>

In addition to the obligation imposed by section 52(2)(d), Prudential Standard SPS 521 requires that a trustee’s conflicts management framework provide ‘reasonable assurance that all conflicts are being

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<sup>41</sup> *Cowan v Scargill* [1985] Ch 270, 287–8. See *Finch v Telstra Super Pty Ltd* (2010) 242 CLR 254, 270–1 [32]–[33].

<sup>42</sup> *Manglicmot v Commonwealth Bank Officers Superannuation Corporation* (2010) 239 FLR 159, 179; *Invensys Australia Superannuation Fund Pty Ltd v Austrac Investments Ltd* (2006) 15 VR 87, 110–11 [118].

<sup>43</sup> *Cowan v Scargill* [1985] Ch 270, 295; *Invensys Australia Superannuation Fund Pty Ltd v Austrac Investments Ltd* [2006] 15 VR 87, 108 [107].

<sup>44</sup> *Bray v Ford* [1896] AC 44, 51–2; *Breen v Williams* (1996) 186 CLR 71, 93, 108, 135.

<sup>45</sup> AMP, Module 5 Case Study Submission, 6 [21]; NAB and NULIS, Module 5 Case Study Submission, 7 [34]; IOOF, Module 5 Case Study Submission, 19–20 [88].

clearly identified, *avoided* or prudently managed'.<sup>46</sup> I emphasise *avoidance* because the surest way to prevent a breach of the covenant is to avoid the potential conflict entirely. Yet the case studies showed that trustees rarely sought to avoid a conflict.

I accept that section 52(2)(d) and SPS 521 contemplate the existence of conflicts of interest. But care needs to be taken not to assume that their *identification* and purported *management* satisfies the obligations in the section. Rarely did entities identify how the interests of beneficiaries were prioritised over others that conflicted. None said that the trustee should have avoided the conflict in the first place. Instead, trustees relied on policies that attempted to identify and manage the conflict. As discussed further below, those policies were often ineffective.

Most of the case studies to which I am referring involved conflicts between the duties to members and the interests of, or the duties owed to, the owner of the trustee company. But it is important to recognise that conflicts can and do arise in profit-for-member funds as well as retail funds. In the case of profit-for-member funds, shareholders or nominating organisations of the trustee may have, and may seek to pursue, interests that differ from the interests of members.

One particular kind of case about conflict of interest merits separate consideration: the case in which the trustee undertakes competing obligations as both trustee of a superannuation fund and as responsible entity of a managed investment scheme, and thus becomes a 'dual-regulated entity'.

### **2.2.1 Dual-regulated entities**

The moment a trustee tries to wear two hats, conflicts will arise. The duties the trustee owes to members of the superannuation fund are not the same as the duties it will owe as responsible entity of a managed investment scheme and the duties will be owed to two different classes of members.

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<sup>46</sup> APRA, Prudential Standard SPS 521, 15 November 2012, [15] (emphasis added); see also [8].

Conflicts of this kind only arise because a trustee undertakes the obligations of responsible entity. Taking on those obligations may be seen as yielding some commercial convenience for the group of companies concerned.<sup>47</sup> But those considerations do not outweigh the practical consequences for the trustee's performance of its duties to its members.

The solution is simple: the trustee of an RSE should not be permitted to assume any obligations other than those arising from or in the course of its performance of the duties of trustee.<sup>48</sup> A prohibition of that kind would prevent a trustee from acting as a dual-regulated entity. But it would go further. It would prevent a trustee from undertaking *any* obligation that does not arise out of its holding the office of trustee. The wider prohibition is desirable because it deals directly with the fundamental issue.

To be clear, an RSE licensee may be the trustee of more than one superannuation fund. Acting as the trustee of another superannuation fund is unlikely to give rise to unmanageable conflicts. But a trustee should not be permitted to take on obligations of any other kind.

### **Recommendation 3.1 – No other role or office**

The trustee of an RSE should be prohibited from assuming any obligations other than those arising from or in the course of its performance of the duties of a trustee of a superannuation fund.

It is necessary to say something more about the position of the trustees of retail funds.

## **2.2.2 Conflicts of interest and the trustees of retail funds**

The evidence led in the Commission, and my remarks above, might be understood as suggesting that it is not possible for the trustee of a retail fund to perform its covenants to act in the best interests of members and to give priority to their interests over the interests of related parties or any

<sup>47</sup> Westpac, Module 5 Policy Submission, 19–20 [69]–[71]; CFSIL and Avanteos, Module 5 Policy Submission, 23 [126].

<sup>48</sup> APRA, Module 5 Policy Submission, 25 [73]; ASIC, Module 5 Policy Submission, 28 [135].

other person. I do not consider that the evidence showed that a trustee of a retail fund *cannot* fulfil its duties. The evidence showed that there are some recurring issues and difficulties to which trustees and the regulators need to give close and continuing attention.

The essential character of the conflict that confronts the trustee of any fund established for the profit of its parent company or corporate group is the conflict between the commercial interest of the parent company – to maximise profit – and the trustee’s obligation to give priority to the duties to, and interests of, the beneficiaries. The conflict may emerge in any number of different ways.

One way the conflict may emerge is in the choosing of what entities should perform services in connection with the administration or investment of the fund, and fixing the fees or other remuneration that is to be paid to those entities. It is in the interests of the parent company to maximise the profits earned by the administration company. But the trustee’s duty is to minimise the amount it must pay for proper administration services.

As a result, dealings between the trustee and other entities related to the trustee of the fund always require special consideration. There will always be two groups of questions. First: how and why was the related entity *chosen* to provide the particular service? Were external entities considered? Second: how was the *price* for the service struck? Has the trustee compared what is offered from within the corporate group with the performance and pricing offered by entities outside the corporate group?

Another way the conflict may emerge is in the day-to-day administration of the fund. One obvious case is when the trustee depends upon information supplied to it by administrators or others connected with the fund’s parent company. As the case studies show, the information supplied to the trustee may be based upon premises that in some way or another reflect the commercial interests of the parent company, whether that is a direct interest in maximising profit or some less direct interest such as maintaining the goodwill of advisers aligned with the parent company. Unless those premises are exposed, the trustee may take the information that it is given at face value and base the decision it takes upon an incomplete understanding of what courses of action may be available to it.

**Trustees can fulfil their duties to members only if they recognise that the interests of the fund's parent company and the interests of members are not only different but are often opposed. There are three consequences.**

**First, disclosure of conflicts of interests on its own is not enough.**

Information supplied in product disclosure statements will often tell those joining a retail fund that the trustee has arrangements with related entities and will plainly reveal to intending members that the fund is organised and run for the profit of its parent company. Disclosure of that kind is, of course, essential. But **the statutory duty to comply with the RSE licensee law and to perform properly the duties of the trustee demands action, not just disclosure.**<sup>49</sup>

**Second, as the best interests covenant makes plain, the trustee's obligation is to perform its duties and exercise its powers in the best interests of the beneficiaries.** Each time a trustee makes an arrangement for others to act in connection with the administration or investment of the fund constitutes an act done in performance of the trustee's duties and in the exercise of its powers. **Hence, both the instigation and maintenance of every arrangement about administration and investment must be judged against the best interests of members.**

Having chosen a related entity to provide services to the fund, the trustee must also be conscious of the conflicts of interest that unavoidably arise, particularly where a trustee relies on a related entity to perform core functions such as investment and management of the fund. To varying degrees, trustees who gave evidence to the Commission acknowledged the conflicts generated by such arrangements. But, again, the solutions they proposed involved policies, together with contracts expressed to enable oversight and service delivery,<sup>50</sup> which too often proved to be ineffective.

Outsourcing of the trustee's day-to-day administration and management of a fund to a related entity, or indeed, any third party, requires ongoing care and diligence on the part of a trustee. Where it is relying on information provided by the related entity, it must test the information it receives and seek further

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<sup>49</sup> SIS Act s 29E(1)(a) and (b).

<sup>50</sup> AMP, Module 5 Case Study Submission, 2 [8]; NAB and NULIS, Module 5 Case Study Submission, 4 [15].

information where necessary. The trustee must satisfy itself that the trust is being run in the best interests of the members. The case studies showed that trustees are not always discharging this responsibility and regulators have not acted on this.

**Third, regulators must be astute to observe whether trustees are giving priority to the interests of members.** As already noted, proper performance of the best interests duty is essential to trustees meeting the financial promises they make. Performance of that duty is central to achieving the best outcomes for members.

It should be remembered that Prudential Standard SPS 231 provides that an RSE licensee who outsources a material business activity to a related party ‘must be able to demonstrate that the arrangement is conducted on an arm’s length basis and in the best interests of beneficiaries’.<sup>51</sup> The case studies suggest that, to date, this obligation has not led to sufficient rigour in the selection and monitoring of related-party service providers. As later explained in the chapter on insurance, I recommend additional scrutiny for related-party engagements.<sup>52</sup>

### 2.2.3 Frameworks for managing conflicts

As already observed, many retail trustees seek to identify and manage conflicts of interest, rather than avoid them.

For example, AMP submitted that the trustees ‘ensure their responsibilities and obligations to members are met by the terms of their outsourcing arrangements, the work of Trustee Services, the use of the Business Monitoring Model (BMM) framework and other complementary monitoring activities’.<sup>53</sup> Similarly, NULIS said it engaged an administrator to act as its service provider. That administrator was legally liable for breaches of its contractual obligations in its capacity as administrator, which are required to be reported under the Administration Agreement.<sup>54</sup>

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<sup>51</sup> APRA, Prudential Standard SPS 231, 15 November 2012, [16].

<sup>52</sup> See Recommendation 4.14.

<sup>53</sup> AMP, Module 5 Case Study Submission, 2 [8].

<sup>54</sup> NAB and NULIS, Module 5 Case Study Submission, 4 [15].

The issue, however, is not whether such arrangements exist on paper. Conflicts of interest cannot be managed through box-ticking processes. The issue is how those arrangements are implemented in practice. As explained in Volume 2, all too often these arrangements failed to operate effectively. For example, the AMP trustees endorsed plans prepared by a related party for the transfer of **accrued default amounts** to MySuper products. The trustees were not told about, and did not enquire about, the related party's detailed commercial consideration of the effect that the timing of transfers would have on the profits of the AMP Group. Nor did they enquire about the effect of the proposed timing on their members. In another example, AMP's Trustee Services team considered that member fees were too high. But it also considered that this was a matter for the AMP product team, not the trustee, to address. In such cases, the existence of the BMM framework did not result in adequate management of conflicts.

Although regulators should stand ready to protect members' interests when trustees cannot, or will not, they do not always do so. In 2017, APRA conducted a review of the BMM and characterised it as 'robust'.<sup>55</sup> As explained in more detail in Volume 2, this characterisation suggests that APRA may not have grappled with how the trustees' arrangements worked in practice, and what impact those arrangements had on members. In his evidence to the Commission, Mr Byres acknowledged that the evidence received by the Commission and 'subsequent discussions' revealed that 'the application of the framework was not as one would expect it to be'.<sup>56</sup>

More broadly, Mr Byres said that in its supervision, APRA's focus had been on whether regulated entities had robust frameworks and policies, on the basis that 'if you have a good set of frameworks and policies and your audit and compliance function are doing their job ... things should broadly work as intended'.<sup>57</sup> However, he acknowledged that a 'general lesson' for APRA was that it needed to consider how to 'get deeper' and identify where frameworks and policies were not effective. He said that the AMP case study examined by the Commission was an example of where APRA's

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<sup>55</sup> Exhibit 5.291, 7 April 2017, Letter from APRA to Sansom, 3.

<sup>56</sup> Transcript, Wayne Byres, 30 November 2018, 7471.

<sup>57</sup> Transcript, Wayne Byres, 30 November 2018, 7470.

approach had been inadequate, and that a deeper examination had been required.<sup>58</sup>

The number of retail trustees who have failed to manage conflicts effectively, despite having elaborate written frameworks in place, suggests that this is not an isolated issue. No doubt APRA can and should ‘get deeper’ in its supervision and take appropriate steps to remedy issues with particular trustees. But something more is required. As the Productivity Commission identified, strategic conduct litigation – that is, bringing strategic enforcement action to both address the immediate member harm, and to deter future conduct – appears at times to be ‘missing in action’ in the superannuation industry.<sup>59</sup>

It is important to notice, therefore, that following the Commission’s taking of evidence, in August 2018, about some issues concerning the IOOF Holdings Ltd group of companies, APRA commenced proceedings in the Federal Court of Australia, on 6 December 2018, against IOOF Investment Management Ltd (IIML), Questor Financial Services Pty Ltd, and five individuals holding senior positions at IOOF.<sup>60</sup> By those proceedings, APRA seeks declarations that IIML and Questor breached their duties as trustees and contravened various provisions of the SIS Act by failing to exercise their powers in the best interests of the beneficiaries of the superannuation funds and failing to give priority to the interests of beneficiaries over the interests of all other persons. APRA seeks declarations that two of the individuals (Mr Christopher Kelaher, Managing Director of IOOF Holdings Ltd and Mr George Venardos, Chairperson of the company) contravened some provisions of the SIS Act and further seeks disqualification orders under section 126H of the SIS Act. As against the three other individual defendants (Mr David Coulter, the Chief Financial Officer, Mr Paul Vine, the General Manager – Legal, Risk and Compliance and Company Secretary, and Mr Gary Riordan, the Group General Counsel) APRA seeks disqualification orders under section 126H of the SIS Act.

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<sup>58</sup> Transcript, Wayne Byres, 30 November 2018, 7470.

<sup>59</sup> Productivity Commission, Report 91, *Superannuation: Assessing Efficiency and Competitiveness*, 21 December 2018, 459.

<sup>60</sup> *APRA v Christopher Francis Kelaher & Ors* (FCA, NSD 2274/2018).

These proceedings having been instituted, I will say nothing about what emerged in evidence before the Commission about events and circumstances referred to in the papers filed by APRA in the Federal Court.

## 2.2.4 Conflicts of interest and industry funds

As already noted, it is not only the trustees of retail funds that encounter conflicts of interest. So, too, the trustees of industry funds, and ‘profit-for-member’ funds more generally, must also recognise and deal with conflicts between the interests of members and the interests of shareholders or nominating organisations.

A deal of attention was given to the ‘Fox in the Henhouse’ advertising program sponsored by industry funds. The principal focus was upon the best interests and sole purpose obligations of the trustees of those funds that contributed to the cost of making and broadcasting of the advertisement. I have dealt with those aspects of the matter in Volume 2 of this Report and do not seek to add to or repeat what is said there about those issues.

Instead, I observe that those who criticised funds who contributed to the costs associated with that advertisement can be seen as making a complaint that has its roots in notions of conflict of interest: what is seen as the conflict between duties to members and the interests of some shareholders or nominating organisations of industry fund trustees. As I record in Volume 2, I do not find that the conduct of the trustees might have amounted to misconduct or that it was conduct falling short of community standards and expectations.

The events were of a kind, however, that some suggested should lead to some rule prohibiting funds from engaging in certain kinds of ‘political’ advertising.<sup>61</sup> I do not favour the adoption of a rule of that kind. Even if a rule of that kind could be made (and I do not stay to examine how the implied freedom of political communication might apply) it is not a rule that I consider should be made. Rather, **I consider that the existing rules, especially the best interests covenant and the sole purpose test, set the necessary standards. Those standards should be applied according to their terms and without more specific elaboration.**

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<sup>61</sup> See, eg, ANZ, Module 5 Policy Submission, 1 [3].

## 2.2.5 Extend best interests duty?

I do not consider that the difficulties the trustee of a retail fund will encounter in complying with the best interests covenant and the covenant that it give priority to members' interests over all others would be lessened by extending the class of persons who owe members those obligations. As has been noted, directors of the trustee owe parallel obligations.<sup>62</sup> And both the trustee's and the directors' obligations focus upon the performance of duties and exercise of powers, in effect, in execution of the trust.

Formulating the duties that would be imposed on other entities is not without difficulty. What would be the content of the duty that might be imposed on (say) the shareholders of the trustee company? Would it be to exercise some or all of their powers *only* in the interests of the members of the fund of which the company is trustee? What would be the content of the duty that would be imposed on (say) a company retained by the trustee to perform some administrative function or functions for the trustee? Would it be to perform its duties under the administration agreement in the best interests of members? Unless the duties were to be framed in a way that imposed on these other entities duties of the same kind as a trustee owes members, how would imposing those duties make a difference? And, even if the duties imposed were to be to the same effect as the duties that a trustee now has, the same question must be asked. How would imposing those duties make a difference?

No matter what duties other persons may owe to members of the superannuation fund, the trustee would still be bound by its duties. The bare fact that others have correlative duties would not relieve the trustee of its duties. It would still have to take the necessary steps to ensure that what its shareholders and administrators were doing did not cause it, the trustee, to be in breach of its obligations. And, at least in the case of administration arrangements, the agreements made between trustees and administrators now commonly provide that the administrator must act in a way that will not adversely affect the trustee's performance of *its* duties.

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<sup>62</sup> SIS Act s 52A. See also the additional obligations imposed on trustees and directors of trustees in respect of MySuper products by ss 29VN and 29VO of the SIS Act.

Rather than introduce a new layer of regulation, necessarily accompanied by an increased regulatory enforcement task, I think it better to focus upon the existing and central requirements: that trustees of superannuation funds (and their directors) perform *their* obligations. I do not consider that meeting those central requirements would be assisted by making persons other than the trustees (and the directors of corporate trustees) subject to parallel obligations. To do so would, I think, serve only to allow blame-shifting and to distract from the close attention that must be given to the performance of trustees and their directors.

### 2.2.6 Prohibit ‘for-profit’ funds?

The most radical response to address difficulties encountered by the trustees of for-profit superannuation funds would be to prohibit, or at least inhibit, the carrying on of a superannuation fund for profit.<sup>63</sup> For the reasons that follow, I do not favour proposals of that kind.

It would be a very large step to say that the only persons or groups of persons who can conduct a superannuation fund are those who will not seek any return on their investment in the venture. To take a step of that kind now would have several effects.

First, it would eliminate one set of existing participants in the market and thereby reduce the competitive forces at play in the overall industry. Second, it would insulate existing not-for-profit participants from whatever competitive pressures are exerted by the threat of large for-profit entities entering this part of the financial services market and providing some new and better offering to consumers. Eliminating either or both of those competitive forces is undesirable and is probably reason enough to reject the idea.

But whether or not that is right, I am not persuaded that the trustees of funds established for the profit of the parent company cannot perform their duties to act in the best interests of members and give members’ interests priority over those of the parent company. As is apparent from what I have

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<sup>63</sup> See, eg, AustralianSuper, Module 5 Policy Submission, 9 [40]–[41]; TWUSuper, Module 5 Policy Submission, 20 [94].

said in Volume 2 of this Report, I accept that trustees of for-profit funds have not always performed their duties. Further, I accept that the trustees of for-profit funds encounter particular difficulties in the performance of their duties. And I accept that trustees and regulators must give close and continuing attention to these issues. But neither separately nor together do these observations cause me to conclude that outright prohibition of for-profit funds is the only, or even preferable, solution to be adopted.

## 2.2.7 Structural separation

It may be said that some form of 'structural separation' between product manufacture and product sales is a necessary response to the issues about conflicts that have been identified in connection with for-profit superannuation funds. The separation suggested would require the party dealing with consumers (the trustee of the fund) to be controlled and managed separately, in the least, from the party or parties that manufacture the **financial products** that the trustee will acquire, and also perhaps, from the party or parties that carry out administrative, investment or insurance functions for the trustee.

Separation of the general kind described would preclude a trustee from investing the whole of the fund, as some retail funds now do, in insurance products issued by a life company associated with the parent company of the fund. It would also preclude the trustee from dealing with entities associated with the parent company of the fund to provide investment, administrative, insurance, or other services for the fund.

The premise for enforcing structural separation in any of the ways described must again be that it will reduce the nature and scale of the conflicts between the trustee's duties and the profit interest of the parent company. But, so long as the parent company seeks to make a profit there must come a point at which the interests of members and the interests of the parent company collide. It is in the interests of the members to maximise *their* returns; it is in the interests of the parent company for it to maximise *its* return.

The only way in which that conflict can be resolved is by the trustee fulfilling its duties. And to do that the trustee will have to compare what its related entities offer in investment, administrative and insurance services with what others in the market would provide and at what cost they would provide it.

Structural separation would also be a large step to take, as it would affect every person who is currently a member of any one of a significant number of funds. Apart from the members holding MySuper accounts with the relevant entities, all of those members would have chosen the fund in question. If, for any reason, those members consider it would be in their interests to move funds, they can do so. **I am not persuaded that a case has been made for imposing some form of structural separation on RSEs.**

## 2.3 Dealings with members' funds

### 2.3.1 Deduction of advice fees from superannuation accounts

One of the key elements contributing to the charging of fees for no service was the invisibility of the charges made. In almost every case the fees were charged directly to the person's investment accounts – often enough to the person's superannuation account.

On its face, it may seem odd that such fees were being deducted from superannuation accounts at all. No doubt the trustee of the fund may resort to the funds held in order to reimburse the trustee for outgoings incurred in the course of performance of the trust. No doubt the trustee may resort to the funds held to meet fees owing by members to the trustee under the rules of the fund. Hence fees like administration fees are properly charged to members' accounts.

But ongoing service fees payable to an advice licensee or the authorised representative of an advice licensee are neither outgoings that the trustee incurs in performance of the trust nor fees charged to members under the rules of the fund. They are fees charged under a contract the member has made with the advice licensee or the authorised representative for provision of advice.

More often than not, trustees of RSEs have permitted payment out of a member's account of fees certified by either the advice licensee or the authorised representative to be fees for advice about the member's superannuation arrangements. But in many cases, the services to be provided by the adviser have been so loosely defined that the advice provided may, but need not, include advice about whether to alter the client's financial plans or arrangements about post-retirement income.

I consider that using superannuation money to pay for such broad financial advice is not consistent with the sole purpose test prescribed by section 62 of the SIS Act. That requires the trustee of an RSE to '*ensure that the fund is maintained solely*'<sup>64</sup> for identified purposes. All of the core purposes specified hinge on the provision of benefits upon a member's death or retirement. So understood, it is not consistent with the sole purpose test for a trustee to apply funds held by the trustee in paying fees charged by an adviser to consider, or re-consider, how best the member may order his or her financial affairs generally or may best make provision for post-retirement income.

**It follows that the nature of the advice that may properly be paid for from a superannuation account is limited to advice about particular actual or intended superannuation investments. This may include such matters as consolidation of superannuation accounts, selection of superannuation funds or products, or asset allocations within a fund. It would not include broad advice on how the member might best provide for their retirement or maximise their wealth generally. Any practice by trustees of allowing fees for these latter kinds of financial advice to be deducted from superannuation accounts must end.**

As (in my view) this is what the law already requires, no further amendment is necessary. But I would modify the general rule in respect of MySuper accounts, and permit no deduction for advice fees of any kind. The simpler the arrangements about MySuper, the better. It is difficult to imagine circumstances in which a member would require financial advice about their MySuper account. If a member wants financial advice, the cost of that advice should be charged to and paid by the member directly.

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<sup>64</sup> Emphasis added.

### **Recommendation 3.2 – No deducting advice fees from MySuper accounts**

Deduction of any advice fee (other than for intra-fund advice) from a MySuper account should be prohibited.

It is now necessary to say something about ongoing advice fees.

#### **2.3.2 Ongoing advice fees**

Given the limited nature of the advice that may be paid for from a superannuation account, it might be thought that there are few circumstances in which paying fees for *ongoing* advice of that kind would be in the best interests of a member.

Perhaps a superannuation member invested through a platform would benefit – or believe they would benefit – from ongoing financial advice in respect of their superannuation investments. But such benefits would be relatively modest, and would accrue to relatively few members. As I said at the outset, the invisibility of ongoing advice fees was a key element in the charging of fees for no service. As long as ongoing service fees are permitted, some risk of members being charged fees for no service will endure. It may be that the benefits of eliminating that risk, by prohibiting ongoing service fees from superannuation altogether, outweigh any limited benefits these arrangements may provide.

I acknowledge the submissions from some entities that prohibiting ongoing advice fees would reduce access to financial advice for some (or many) Australians.<sup>65</sup> But if the recipient will not pay the fee that the adviser charges except out of a superannuation account, what does that say about the value to the recipient of the advice that is given? Does it show that the taxation treatment of superannuation contributions and benefits are driving the matter? And if they are, what does that reveal about how the recipient values the advice that is given?

<sup>65</sup> ANZ, Module 5 Policy Submission, 7 [41], 8–9 [44], 9 [46]; CFSIL and Avanteos, Module 5 Policy Submission, 20 [108]; NAB and NULIS, Module 5 Policy Submission, 16–17 [72]–[75]; Westpac, Module 5 Policy Submission, 18 [66]–[67].

Absent some convincing explanation from those who seek to maintain a system of charging fees against superannuation investments, the most likely conclusion must be that what is proffered by the adviser is not seen by the recipient as warranting the fee the adviser charges. And if that is right, the proposition that *needed* advice will not be given loses most if not all of its force.

**However, if ongoing advice fees continue to be permitted, they should be tightly controlled in at least two ways. First, as I have said above, the advice in respect of which fees may be charged is limited to advice about particular superannuation investments. Because this is what the law already requires, no change is necessary. And second, consistent with what is written in the chapter on financial advice, any such ongoing advice arrangements should require annual renewal. Two years without confirmation that the member wishes the arrangement to continue is too long.**

Two years is too long not only for the member, but also for the trustee. As the case studies showed, the existence of ongoing advice fee arrangements poses a danger to trustees: if they permit ongoing advice fees to be deducted, and no service is provided, they are likely to be in breach of their obligations under the SIS Act. Accordingly, **the trustee itself – separate from the advice licensee – should also receive annual confirmation of the member’s agreement to keep paying fees.** A prudent trustee would require nothing less.

If ongoing advice fees are to be retained, an issue arises as to the treatment of ongoing fee arrangements made before Division 3 of Part 7.7A of the *Corporations Act 2001* (Cth) (the Corporations Act) came into operation. For completeness, I should say that I would neither preserve those arrangements further nor provide any **grandfathering arrangements** to qualify the general principles I now propose. **Consistent with what I have said in the chapter on financial advice about ongoing fee arrangements, I would introduce the new rules with effect from a time that would give no more than 12 months’ notice of their coming into effect.** The choice of 12 months is dictated by the proposal made in that chapter that ongoing fee arrangements be renewed annually.

Finally, nothing I have said above (including in respect of MySuper) relates to what is known as ‘intra-fund advice’: the provision of advice that is not personal advice, to members of a particular fund about their interest in that

fund, where the cost of the advice is charged collectively to members of the fund in accordance with the SIS Act.<sup>66</sup> It was not suggested that any misconduct arose from such arrangements and I say nothing about them.

### **Recommendation 3.3 – Limitations on deducting advice fees from choice accounts**

Deduction of any advice fee (other than for intra-fund advice) from superannuation accounts other than MySuper accounts should be prohibited unless the requirements about annual renewal, prior written identification of service and provision of the client's express written authority set out in Recommendation 2.1 in connection with ongoing fee arrangements are met.

## **2.3.3 Paying grandfathered commissions**

As I have explained, both in the Introduction to this Report and in the chapter on financial advice, and as reflected in Recommendation 2.4, **I would bring the grandfathering arrangements made at the time of the Future of Financial Advice (FoFA) reforms to an end. The time for transition has passed.**

## **2.4 Governance**

### **2.4.1 Board composition**

Proper governance of superannuation funds is of critical importance. Directors of the trustee of an RSE have important responsibilities. Debates about the desirable composition of the boards of trustees often proceed by seeking to differentiate between directors according to their association with a shareholder or a nominating organisation of the trustee. Distinctions of that kind may distract attention from what I consider to be the central issue: the need for the board of a trustee to be skilled and efficient in the proper supervision of the fund in the best interests of members.

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<sup>66</sup> SIS Act s 99F.

Superannuation can no longer be seen only as a compact between employees and one or more employers or only as a compact between organised labour and capital. There are two reasons. First, as explained at the start of this chapter, superannuation is important to the *whole* nation. Superannuation arrangements are more than private bargains. Second, the central principles governing superannuation arrangements are, and must remain, the best interests of members and the sole purpose test. Neither of those principles refers to the interests of those who stood behind the establishment of the fund or those who continue to stand behind it. Neither of those principles permits pursuit of any objective other than the best interests of members.

Notions of ‘representative’ directors, as distinct from ‘independent’ directors do not sit easily with these basic principles. All directors of the trustee of an RSE owe the same duties, including, to perform their duties and exercise their powers as directors of the trustee in the best interests of the beneficiaries: *the members*.<sup>67</sup> Whatever may be the processes for the nomination or selection of directors, all directors must meet the best interests obligation. And in meeting that obligation all directors must give priority to the interests of members over the interests of *any* other person (including whatever person or body may have nominated the director to serve in that office).

As superannuation funds become larger and more complicated, the greater the need also grows for a skilled and efficient board of directors. The greater the need for board skills, the more pressing it is for nomination and appointment processes to recognise those needs expressly. And the more pressing it is for boards to make effective provision for regular and orderly board renewal and replacement.<sup>68</sup>

I do not consider that these matters are best dealt with by prescriptive rules about board numbers or composition or prescriptive rules about nomination or selection processes. Rules of that kind have sometimes sought to use the notion of ‘independence’ as the relevant criterion. But rules prescribing board numbers or composition or prescribing particular forms of nomination

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<sup>67</sup> SIS Act s 52A(2)(c).

<sup>68</sup> Cf Financial Reporting Council, *The UK Corporate Governance Code*, July 2018, 8, Principles J, K and L.

or selection processes distract attention from the basic requirement of ensuring that the board is, as far as possible, constituted, at all times, by directors who, *together*, will form a skilled and efficient board.

The reference to the board being constituted in such a way *at all times*, is important. Board change and renewal is essential but must be managed properly. The unexpected or wholesale turnover of trustee directors is to be avoided. Equally, term limits are a critical part of the proper management of board change and renewal. Change and renewal will bring fresh eyes to bear upon the direction of the trust and bring fresh interrogation of, and challenge to, management of the trust. Many funds now have term limits for board members but some have applied those limits only prospectively, leaving some board members in place for too long.

I do not think that the matters I have mentioned about board composition and appointment are best dealt with by legislative change. More particularly, they point firmly away from trying to develop some system of board appointment analogous to the processes applied in a publicly listed company. But they are matters to which funds seeking to apply sound governance principles need to give attention.

All the matters I have mentioned concern the proper governance of the fund. Proper governance is, in my view, a matter for the prudential regulator APRA to supervise. I will return to the subjects of governance and supervision later in this chapter in the course of considering whether the **Banking Executive Accountability Regime** (BEAR) regime should be extended to the superannuation sector.

Before doing so, however, there is one other aspect of governance of the trustees of RSEs that should be examined: mergers.

## 2.4.2 Mergers

Trustees of RSEs that offer a MySuper product must determine annually that there is sufficient scale, in terms of assets and beneficiaries, such that the financial interests of beneficiaries are not disadvantaged relative to the financial interests of beneficiaries in MySuper products of other RSEs.<sup>69</sup> Proper application of the annual scale assessment should invite

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<sup>69</sup> SIS Act s 29VN(b).

the attention of some trustees to whether their members would benefit from merging the fund with another to create a fund of larger scale, with more assets and more beneficiaries.

In its report about superannuation the Productivity Commission proposed a number of other steps designed to encourage mergers.<sup>70</sup>

The case studies examined in evidence pointed towards some recurring issues arising in consideration of possible mergers. In particular, the evidence pointed to processes related to board composition of the merged funds as being important to the success or failure of some merger proposals. Of course those examining a possible merger of funds must consider how the merger will be effected and how the merged fund will be both managed and governed. Who will constitute the board of the new entity? Who will decide who is to be the CEO of the new entity? Who will decide how the new entity will be administered and who will manage investments? All these, and more, may be proper questions for those considering a possible merger.

But the determining question must be what is in the best interests of *members*. The determining question cannot be whether one or more of those who are directors before the merger will have a place on the new board.

Likewise, care must be taken when considering whether proposals about board nomination and selection procedures for the board of the new entity are assessed according to the interests of members, or the interests of shareholders or nominating organisations of the merging trustees. On what basis can it be said that an external entity retaining control of a number of seats on the board of the trustee of the merged funds is in the interests of members? The moment the argument is framed in terms of 'control' it must be apparent that the interests of the controller are being considered above the interests of the members. And that is not consistent with the duties of the directors of the funds that are contemplating a merger. It is to fail to give priority to the interests of members over all other interests. As stated above, the formation of a new board is to be guided by the objective of constituting

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<sup>70</sup> Productivity Commission, Report 91, *Superannuation: Assessing Efficiency and Competitiveness*, 21 December 2018, 453-4.

a board comprising directors who, together, will form a skilled and efficient board.

Having discussed matters of governance related to board composition and mergers, the question then arises of what should be done if a trustee does not act in accordance with the principles that have been laid out. At the time of writing, a Bill to make a number of changes to the SIS Act, including giving APRA a power to issue directions to RSE licensees, had been introduced into the Parliament but had not yet been passed.<sup>71</sup> It may be that, in particular circumstances, addressing a stalled merger would be an appropriate use of such a power.

Finally, it is possible that in the circumstances of a particular proposed merger, a shareholder or nominating organisation could interfere despite the best efforts of the trustee (such as by refusing some consent required under the trustee's constitution). It is to be hoped that such extreme situations will be rare. Should such a situation occur, it would be for the trustee to take the necessary steps to ensure that its shareholders did not cause it, the trustee, to be in breach of its obligations.

## **2.5 Selling superannuation**

### **2.5.1 No hawking**

Superannuation is not a product to be sold. It is a compulsory product. All employees must have a superannuation account. Too many employees have more than one account. Steps taken to induce persons to hold multiple accounts should be actively discouraged. And persons having existing arrangements should not be induced to change those arrangements unless there is good reason to make the change.

Ideally all employees would make informed and rational choices about their superannuation arrangements. But many employees are not, and will not become, engaged enough to make those decisions. As the Cooper Review

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<sup>71</sup> Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No 1) Bill 2017 (Cth).

said, '[t]here are some members who simply want someone else to take care of it all for them'.<sup>72</sup>

As I pointed out in the Introduction to this Report, share hawking has long been prohibited because it too readily allows the fraudulent or the unscrupulous to prey upon the unsuspecting.<sup>73</sup> The root of the problem is that the acquirer is 'unsuspecting'. That is, the acquirer comes to the unsolicited offer of shares (or, by extension, any complex financial product), unprepared, unable to look critically at what he or she is told, and often not knowing what questions to ask.

Those problems are no less acute in connection with superannuation. The person to whom an unsolicited offer is made will very often not be in a position to judge the merit of what is offered. In particular, that person will seldom if ever be in a position to compare what he or she is offered with what he or she already has under some existing superannuation arrangement.

And that is why the attempts by ANZ and CBA to sell superannuation in bank branches under a 'general advice' model (considered in more detail in Volume 2 of this Report) may have contravened the law. In the circumstances in which the offer was made, the customer to whom an offer was made may wrongly have assumed that the seller thought that the product was suitable for the particular customer's needs, when, in fact, the seller had no basis on which to form any view about suitability. The customer may have taken what was said as personal advice that took account of the customer's particular needs and circumstances.

As a result, despite some submissions to the contrary,<sup>74</sup> I do not accept that the unsolicited offer of a superannuation product is appropriate or in the interests of consumers.

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<sup>72</sup> Cooper Review, Final Report, 10.

<sup>73</sup> United Kingdom, *Report of the Company Law Amendment Committee* (Cmnd 2657) 1926, 48 [92].

<sup>74</sup> See, eg, ANZ, Module 5 Policy Submission, 2 [13]; CFSIL and Avanteos, Module 5 Policy Submission, 14 [76]; Westpac, Module 5 Policy Submission, 6 [18].

All forms of unsolicited offering of superannuation arrangements should be prohibited. The prohibition should not prevent trustees or related entities advertising generally the availability of the fund.

The general prohibition now made by section 992A(1) of the Corporations Act (that a person must not offer financial products for issue or sale in the course of, or because of, an unsolicited meeting with another person) and the associated prohibition in section 992A(3) against telephone selling ought to apply to superannuation.

Most superannuation interests are ‘financial products’ for the purposes of the section.<sup>75</sup> However, on its face, the section does not appear to prevent a bank or other entity from offering a superannuation product to a customer where the customer has voluntarily entered a branch, or telephoned the bank or entity, in relation to a matter that is unrelated to superannuation.

The Australian Securities and Investments Commission (ASIC)’s Regulatory Guide 38 says that ‘a meeting or telephone call requested by a consumer is only solicited for any financial products ... that are reasonably within the scope of the request’.<sup>76</sup> The Regulatory Guide gives a number of examples, including where a consumer telephones their bank and leaves a message for someone to call them about obtaining a credit card. The Regulatory Guide concludes that if, during the subsequent telephone call, the call centre operator offers to sell or issue a managed investment product to the consumer then ‘[g]enerally, the telephone call would be unsolicited for the offer of the managed investment product.’<sup>77</sup>

I agree that this is how the law should work. But I am not convinced that this interpretation emerges from the words or context of this section of the Act. I therefore recommend that the section be amended to put the matter beyond doubt.

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<sup>75</sup> Section 764A(1)(g) of the Corporations Act provides that ‘a superannuation interest within the meaning of the SIS Act is a “financial product”.’ There is a limited exception for exempt public sector superannuation schemes: see Corporations Act s 765A(1)(q); Corporations Regulations 2001 (Cth) regs 7.1.05 and 7.1.06B.

<sup>76</sup> ASIC, Regulatory Guide 38, 2005, 11 [A3.1].

<sup>77</sup> ASIC, Regulatory Guide 38, 2005, 11 [A3.2(c)(c)].

As I said in the Introduction, it should be made plain that a solicited meeting, telephone call, or other contact to discuss one type of financial product may not be used for the unsolicited offering of some other type of product. Put another way, contact with a person during which a superannuation interest is offered will be considered ‘unsolicited’ if the person did not attend the meeting, make the telephone call, or initiate the contact for the purposes of entering into negotiations relating to the offer of a superannuation interest.<sup>78</sup> While common banking products such as transaction accounts and credit card accounts may be considered as one type of product, superannuation products and classes of insurance product are, and should be treated as, distinct product types.

### **Recommendation 3.4 – No hawking**

Hawking of superannuation products should be prohibited. That is, the unsolicited offer or sale of superannuation should be prohibited except to those who are not retail clients and except for offers made under an eligible employee share scheme.

The law should be amended to make clear that contact with a person during which one kind of product is offered is unsolicited unless the person attended the meeting, made or received the telephone call, or initiated the contact for the express purpose of inquiring about, discussing or entering into negotiations in relation to the offer of that kind of product.

## **2.5.2 Nominating a default fund**

Because some employees, especially those who are young and working part-time, do not make informed choices about their superannuation arrangements, default arrangements are essential. As the Cooper Review said, ‘MySuper is particularly designed to cater to those members’.<sup>79</sup>

I pause to note that I agree with the Productivity Commission that default superannuation accounts should only be created for new workers, or

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<sup>78</sup> Cf Australian Consumer Law s 69.

<sup>79</sup> Cooper Review, Final Report, 10.

workers who do not already have a superannuation account.<sup>80</sup> And that default account should then be carried over, or ‘stapled’, to members as they move jobs. The proliferation of unnecessary default accounts is not in the interests of members.

Inevitably, funds compete to be nominated as default funds. If the relevant default fund is not fixed by some industrial instrument, competition between funds will focus on securing nomination of the fund by employers.

The evidence given in the Commission showed that some large funds spend not insignificant amounts to maintain or establish good relationships with those who will be responsible for nominating the default fund for their employees. Money is spent on entertainment and sporting events at which the relevant relationships can be made and enhanced.

Section 68A of the SIS Act provides that a trustee of an RSE, or an associate of a trustee, must not (among other things) supply or offer to supply goods or services to a person ‘on the condition that one or more of the employees of the person will be, or will apply or agree to be, members of the fund’. Current practice by some funds to provide those responsible for nominating default superannuation funds with entertainment or tickets to sporting events may be considered to be the supply of goods or services to a person *in connection with* one or more of the employees of that person becoming a member of the fund. But it is not a supply on that *condition*. The fund goes no further than supply with the *hope* that this may happen and therefore is not in contravention of the Act by doing so.

For this reason, as section 68A now stands, it does not achieve its intended purpose of preventing funds ‘treating’ employers in order to gain members. Its effectiveness is further limited by the fact that the only consequence of a breach is that a person who suffers loss or damage because of the contravention may bring an action against the offender.

What I have called the ‘treating’ of employers should not be permitted. Permitting it means that decisions made by employers about default funds may be affected by considerations that should be irrelevant.

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<sup>80</sup> Productivity Commission, Report 91, *Superannuation: Assessing Efficiency and Competitiveness*, 21 December 2018, 65.

It was suggested that such a prohibition would disproportionately disadvantage industry super funds, who, unlike many retail funds, must operate without the benefit of established banking relationships with employers.<sup>81</sup> Even if that were so, I do not accept that trustees should be permitted to attempt to influence employers' decisions through irrelevant considerations.

I accept that eliminating these particular considerations as irrelevant will not ensure that employers act only on relevant considerations. It must be recognised that their decisions may not be guided only by a proper assessment of what would be in the best interests of their employees. But the manner in which default funds should be fixed goes beyond my Terms of Reference and I do no more than note that there is a more general issue beyond the particular question about the operation of section 68A that is now under consideration.

If, as I consider should be the case, there is to be an effective prohibition against funds 'treating' employers, the model for legislation lies in statutory prohibitions against the treating of electors. Legislation of that kind prohibits supply of goods or services where the supply is made with a forbidden purpose or the supply may have the forbidden effect. Section 68A should be amended in that way by prohibiting supply where the supply may reasonably be understood by a recipient to be made with a purpose of having the recipient nominate the fund as a default fund, or having one or more employees of the recipient apply or agree to become members of the fund.

Breach of the prohibition should be a civil penalty provision, enforceable by ASIC. The application of consequences for breach should not depend upon the existence and motivation of persons who have suffered loss.

Of course, if employers were not put in the position of determining an employee's default fund, the necessity for section 68A would cease. If there are to be changes made to the arrangements for default accounts, that would call for a re-evaluation of section 68A. But such a change is beyond the scope of my inquiry. And in the absence of change, section 68A should be strengthened.

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<sup>81</sup> Industry Super Australia Pty Ltd, Module 5 Policy Submission, 6 [21].

### **Recommendation 3.5 – One default account**

A person should have only one default account. To that end, machinery should be developed for ‘stapling’ a person to a single default account.

### **Recommendation 3.6 – No treating of employers**

Section 68A of the SIS Act should be amended to prohibit trustees of a regulated superannuation fund, and associates of a trustee, doing any of the acts specified in section 68A(1)(a), (b) or (c) where the act may reasonably be understood by the recipient to have a substantial purpose of having the recipient nominate the fund as a default fund or having one or more employees of the recipient apply or agree to become members of the fund.

The provision should be a civil penalty provision enforceable by ASIC.

## **2.6 Accessibility**

As is too often the case with other aspects of financial services, some Australians encounter difficulties gaining access to and making effective use of some aspects of the superannuation system. In particular, Aboriginal and Torres Strait Islander peoples encounter needless difficulties to do with identification and about binding death nominations.

### **2.6.1 Identification**

In July 2016, the Australian Transaction Reports and Analysis Centre (AUSTRAC) published guidelines that allowed entities (including superannuation funds) to follow particular identification and verification procedures for Aboriginal and Torres Strait Islander peoples that would avoid some of the difficulties that would otherwise be encountered. Evidence in the Commission suggested that these procedures may not always be followed by all entities.

**There is no reason for any entity not to have practices and procedures of these kinds and there is no reason for any entity not to have trained staff to use them.**

## 2.6.2 Binding death benefit nominations

A question arose in the course of the Commission's proceedings about whether the law as it now stands permits Aboriginal and Torres Strait Islander peoples to make binding death nominations in respect of their superannuation that reflect the kinship structures of the peoples concerned. As Treasury pointed out in its submissions, nominations can be made in respect of a person with whom the nominator has 'an interdependency relationship'.<sup>82</sup> The notion of an interdependency relationship is broad. Lest there be doubt, however, **I urge consultation with relevant Aboriginal and Torres Strait Islander peoples about whether they, as the relevant users of the system, see difficulties about binding death benefit nominations that should be met.**

## 2.6.3 Early release of superannuation benefits for severe financial hardship

The Commission also sought submissions on whether superannuation funds that do not currently permit the early release of superannuation on the basis of severe financial hardship should do so.<sup>83</sup> A number of submissions indicated that they should.<sup>84</sup>

At the time of writing, Treasury was actively considering reform of the rules governing the early release of superannuation benefits on compassionate and severe financial hardship grounds.<sup>85</sup> In December 2017, Treasury released an issues paper entitled *Early Release of Superannuation Benefits Under Compassionate and Financial Hardship Grounds and for Victims*

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<sup>82</sup> Treasury, Module 5 Policy Submission, 20–1 [95]–[96].

<sup>83</sup> FSRC, Module 5 Closing Submissions, 174 [640].

<sup>84</sup> AustralianSuper, Module 5 Policy Submission, 3 [12]; ANZ, Module 5 Policy Submission, 5 [30]; Westpac, Module 5 Policy Submission, 9 [30]; NAB, Module 5 Policy Submission, 12 [52]; CFSIL and Avanteos, Module 5 Policy Submission, 16 [88]; FSU, Module 5 Policy Submission, 18 [125]; ASIC, Module 5 Policy Submission, 14 [74]; CHOICE, Module 5 Policy Submission, 17.

<sup>85</sup> Treasury, *Review of the Early Release of Superannuation Benefits* (15 December 2018) Treasury <<https://static.treasury.gov.au/uploads/sites/1/2018/11/Issues-Paper-Early-Release-of-Superannuation-1.pdf>>.

*of Crime Compensation*.<sup>86</sup> In November 2018, Treasury released a further issues paper containing findings and draft proposals.<sup>87</sup> Responses to this further issues paper are to be provided by 15 February 2019.<sup>88</sup> In those circumstances, I do not consider that it is necessary or desirable to make any recommendations on this matter.

It is now necessary to say something about the regulation of superannuation.

## 3 Regulatory framework

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As is noted elsewhere in this Report, especially in the chapter about the Regulators, the ‘twin peaks’ model of regulation was designed so that, generally, APRA is responsible for prudential regulation and ASIC for regulation of conduct and disclosure.

### 3.1 A different regulatory task

Superannuation presents particular regulatory issues. It is a compulsory product. All who are employed, and very many of those who have been employed, will have superannuation arrangements. Superannuation performance directly affects the public purse by reducing the call on social security payments and other public welfare measures including, but not limited to, housing, care and health measures.

Unlike other financial products (where the main regulatory focus will be upon the circumstances in which the product is acquired and on the continued ability of entities to meet their obligations) the regulatory focus

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<sup>86</sup> Treasury, *Early Release of Superannuation Benefits Under Compassionate and Financial Hardship Grounds and for Victims of Crime Compensation* (December 2017) Treasury <<https://static.treasury.gov.au/uploads/sites/1/2017/12/c2017-t246586-Consultation-Paper.pdf>>.

<sup>87</sup> Treasury, *Review of Early Release of Superannuation Benefits: Further Consultation and Draft Proposals* (November 2018) Treasury <<https://static.treasury.gov.au/uploads/sites/1/2018/11/Issues-Paper-Early-Release-of-Superannuation-1.pdf>>.

<sup>88</sup> Treasury, *Review of the Early Release of Superannuation Benefits* (15 December 2018) Treasury <<https://static.treasury.gov.au/uploads/sites/1/2018/11/Issues-Paper-Early-Release-of-Superannuation-1.pdf>>.

for superannuation must extend to the *outcomes* that will be delivered to members. The superannuation provider makes no promise about what its future performance will be, but the quality of its performance is important not only to members but also to society generally. And because obtaining proper future outcomes is important, the regulatory task extends beyond issues of disclosure (at and after the time of acquisition of an interest in the product that is offered), and issues of risk management. The importance of *outcomes* in the regulation of superannuation is reflected in two prudential standards APRA has proposed<sup>89</sup> and the Bill presently before Parliament that seeks to introduce an obligation on trustees to perform an ‘outcomes assessment’ for MySuper products.<sup>90</sup>

In 2010, the Cooper Review recommended that APRA’s mandate be broadened to include the task of overseeing and promoting the efficiency of the funds it regulates and the system in which it operates.<sup>91</sup> It proposed that APRA be given general standards-making power in relation to superannuation in order, among other things, to ‘drive efficiencies in the industry’,<sup>92</sup> and ‘improve transparency of outcomes’.<sup>93</sup>

In 2012 and 2013, changes were made to the SIS Act to alter the obligations of superannuation trustees and directors to insert, relevantly, sections 29VN and 29VO, and to give APRA the power to issue prudential standards in relation to superannuation.<sup>94</sup>

More recently, the Productivity Commission said, in its report on superannuation<sup>95</sup> that ‘[c]onduct regulation arrangements for the

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<sup>89</sup> See, eg, APRA, *Response to Submissions, Strengthening Superannuation Member Outcomes*, December 2018, 4.

<sup>90</sup> Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No.1) Bill 2017 (Cth) Sched 1.

<sup>91</sup> Cooper Review, Final Report, Ch 10, Recommendation 10.1, 310.

<sup>92</sup> Cooper Review, Final Report, Ch 10, Recommendation 10.2, 311.

<sup>93</sup> Cooper Review, Final Report, Ch 4.

<sup>94</sup> *Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Act 2012* (Cth) and *Superannuation Legislation Amendment (Service Providers and Other Governance Measures) Act 2013* (Cth). See also Background Paper No 25, 14–17.

<sup>95</sup> Productivity Commission, Report 91, *Superannuation, Assessing Efficiency and Competitiveness*, 21 December 2018, 459.

superannuation system are confusing and opaque, with significant overlap and no clear delineation between the roles of APRA and ASIC'. It observed that 'APRA is best placed to focus on licensing and authorisation to promote high standards of system and fund performance', while ASIC is best placed to regulate the (mis)conduct of trustees and advisers, and to oversee the appropriateness of products (including to particular target markets) and disclosure.<sup>96</sup> No less importantly, it suggested that '[r]egulators also need to be more confident and member-focused in the manner in which they regulate – becoming “member champions”... The role of regulators is ultimately to protect member interests.'<sup>97</sup>

In a Background Paper prepared for the Commission, Professor Pamela Hanrahan identified the regulatory overlap as explained by 'the steady expansion of APRA's responsibilities into areas of non-financial risks, which often crosses into the realm of conduct regulation'.<sup>98</sup> Hence, Professor Hanrahan said, maladministration of a superannuation fund involving breach of the laws governing use of members' funds,<sup>99</sup>

if it is detected by regulators, may potentially trigger protective, remedial or enforcement action by APRA – for breach of the RSE licensing laws, breach of prudential standards, or breach by the trustee or its directors of the SIS Act duties and statutory covenants – and by ASIC – for breach of AFS licensing laws, breach of the SIS Act statutory covenants relating to reporting and disclosure, or breach by the directors of their Corporations Act duties as directors of the RSE licensee.

There is, therefore, evident scope for doubt about which regulatory agency will and should act in a given circumstance. Not only that, the powers and remedies available to the two agencies are not identical.<sup>100</sup>

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<sup>96</sup> Productivity Commission, Report 91, *Superannuation, Assessing Efficiency and Competitiveness*, 21 December 2018, 43.

<sup>97</sup> Productivity Commission, Report 91, *Superannuation, Assessing Efficiency and Competitiveness*, 21 December 2018, 43.

<sup>98</sup> Background Paper No 25, 23.

<sup>99</sup> Background Paper No 25, 24.

<sup>100</sup> Background Paper No 25, 24.

## 3.2 The present division

All trustees of APRA-regulated funds must be RSE licensees under the SIS Act.<sup>101</sup> Most RSE licensees hold an **Australian Financial Services Licence** (AFSL) under Part 7.6 of the Corporations Act.<sup>102</sup>

The SIS Act establishes the general framework for the regulation of superannuation funds. Regulations made under the SIS Act provide elaborate operating standards for trustees.<sup>103</sup> The Corporations Act deals with provision of financial services by and to superannuation trustees, mandatory disclosure requirements and dispute resolution arrangements. The ASIC Act sets out the consumer protection laws for the financial services sector.

Section 6 of the SIS Act identifies which agencies administer the provisions of the Act. Some functions are given to ASIC and some to the ATO but, subject to those more particular exceptions, section 6 gives APRA the general administration of the central provisions of the SIS Act including the provisions about licensing of RSEs, trustees' and directors' covenants and the sole purpose test.

ASIC has the general administration of the Corporations Act,<sup>104</sup> and the licensing and other functions given to it by Chapter 7 of that Act.

## 3.3 Who should regulate?

One response to doubts or difficulties about the respective roles of APRA and ASIC in connection with superannuation would be to create a new and separate regulator responsible for all aspects of supervision and regulation of the superannuation industry. The size, complexity and importance of the industry may all be said to point towards that kind of step. But the superannuation industry has so many intersections with other parts of the financial services industry that creation of a new and separate regulatory authority is likely to create more problems than it would solve.

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<sup>101</sup> Background Paper No 25, 25.

<sup>102</sup> Background Paper No 25, 29.

<sup>103</sup> Superannuation Industry (Supervision) Regulations 1993 (Cth); Background Paper No 25, 8.

<sup>104</sup> Corporations Act s 5B.

Superannuation entities are becoming very important participants in Australia's capital markets. There is, I believe, much force in APRA's submission that '[a] superannuation-only regulator would be unlikely to have a broad perspective on risks and linkages within the broader financial sector, which will become increasingly important as RSE Licensees consolidate, become more complex, and engage in more sophisticated activities such as direct lending and the provision of retirement products'.<sup>105</sup> As ASIC submitted, the 'superannuation system has evolved and is now at a level of maturity where accountability must be a key focus'.<sup>106</sup>

Creation of a separate regulator for superannuation would mark a shift back towards the sectoral model of regulation that prevailed before, and was not favoured by, the Wallis Inquiry. In itself this would not be reason enough to reject the idea, but it is good reason to think carefully before adopting it. As Treasury pointed out in its submissions, the new regulator would have to deal with prudential and conduct issues and would almost certainly take its initial cohort of staff from APRA and ASIC, thereby diminishing their resources.<sup>107</sup> And, of course, there would inevitably be a period of transition between the old and new regulatory arrangements.<sup>108</sup>

I do not favour the creation of a superannuation-only regulator. The twin peaks model of regulation should be maintained. Instead, I consider that the roles of APRA and ASIC in relation to superannuation should be adjusted.

### 3.4 Adjusting regulatory roles

In adjusting the roles of APRA and ASIC in relation to superannuation, it is very important not to draw lines in such a way that will leave gaps. If the consequence is, and it will be, that there is a degree of overlap between the remits of the two agencies, that outcome should be recognised and accommodated.

The adjustment to be made should accord with the general principle that APRA is to act as prudential regulator and ASIC as the conduct regulator.

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<sup>105</sup> APRA, Module 5 Policy Submission, 9 [19].

<sup>106</sup> ASIC, Module 5 Policy Submission, 1 [5].

<sup>107</sup> Treasury, Module 5 Policy Submission, 33 [158].

<sup>108</sup> Treasury, Module 5 Policy Submission, 33 [159].

That is, as APRA described the respective roles of the agencies:

APRA, as the prudential regulator for superannuation, is responsible for establishing and enforcing Prudential Standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by superannuation entities APRA supervises are met within a stable, efficient and competitive financial system ...

As the conduct and disclosure regulator, ASIC's role in superannuation primarily concerns the relationship between RSE Licensees and individual consumers.<sup>109</sup>

(I say more about this allocation of roles in the chapter on the regulators.)

Adjustment of this kind will result in the two agencies having common areas of interest. But each agency will have to look at those areas for different purposes and with a different perspective.

It is useful to return to the best interests covenant and conflicts of interest, which are likely to be of common interest for APRA and ASIC. These two themes frequently intersected in the case studies and often played out to the detriment of members, further emphasising the need for regulation and, where appropriate, enforcement.

### **3.4.1 Current enforcement of the trustees' covenants**

Section 55(1) of the SIS Act provides that a person must not contravene the trustees' or the directors' covenants.<sup>110</sup> But, as the SIS Act now stands, breach of a covenant attracts no penal consequence, civil or criminal.<sup>111</sup>

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<sup>109</sup> APRA, Module 5 Policy Submission, 8 [15]–[16].

<sup>110</sup> Equally, ss 29VP(1) and 29VPA(1) provide that a person must not contravene the additional MySuper obligations imposed on trustees and directors respectively.

<sup>111</sup> The Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No 1) Bill 2017 (Cth) would provide, among other things, for breach of a director's covenant to be a civil penalty provision. Section 202 of the SIS Act now provides for when contravention of a civil penalty provision is an offence. To be an offence, the contravention must meet one of two additional elements: either the person contravenes the section dishonestly and intending to gain an advantage (for that or any other person), or the person contravenes the section intending to deceive or defraud someone.

A person who suffers loss or damage as a result of the breach may bring an action to recover the amount of that loss or damage but, if the action is against a director for breach of a director's covenant, the action may be brought only with the leave of the court.<sup>112</sup>

As the law now stands, APRA may be able to say that the conduct that breaches one of the covenants is a breach of some prudential standard. It may be able to say that there has been a failure by the trustee to comply with the condition on its licence to act as an RSE – that its duties as a trustee are properly performed.<sup>113</sup> It may be able to direct the RSE licensee to comply with that condition.<sup>114</sup> But on their face, these enforcement measures are less direct than they should be, given the central importance of the obligations.

### 3.4.2 Changing enforcement of covenants

The covenants are, as I have said, central to the proper administration of a superannuation fund. Their proper application is a matter of both prudential and regulatory importance.

I have no doubt that the SIS Act should be amended to make breach of the covenants set out in sections 52 and 52A of the SIS Act and the analogous obligations imposed by sections 29VN and 29VO of the SIS Act civil penalty provisions. And if that is done, section 202 of the SIS Act should be left to operate according to its terms, making it an offence to breach those covenants or those provisions if either of the additional elements prescribed by that section are established.<sup>115</sup>

As at November 2018, a Bill to make a number of changes to the SIS Act, including making breach of section 52A and section 29VO civil penalty provisions, had been introduced into the Parliament but had not yet been passed.<sup>116</sup>

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<sup>112</sup> SIS Act ss 29VP(3), 29VPA(3), 55(4), 55(4A).

<sup>113</sup> SIS Act s 29E(1)(b).

<sup>114</sup> SIS Act s 29EB.

<sup>115</sup> The additional elements are either acting dishonestly and intending to gain an advantage or intending to deceive or defraud someone.

<sup>116</sup> Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No 1) Bill 2017 (Cth), Sched 3.

Because performance of the covenants has both a prudential significance and a significance for members of the fund, both APRA and ASIC should be able to take action in respect of breaches of the covenants.

More often than not, I would expect that ASIC would be the agency that would take any enforcement action. This would be consistent with ASIC's existing responsibility for enforcing similar obligations imposed on the responsible entities of managed investment schemes.<sup>117</sup> It would also be consistent with ASIC's existing regulation of AFSLs. RSE licensees are also AFSL holders, and have obligations that ASIC is responsible for enforcing, such as the obligation under section 912A to provide services 'efficiently, honestly and fairly'. Conduct that may give rise to a breach of the covenants may also breach the trustee's obligations under its AFSL; in such circumstances it would make sense for ASIC to deal with the breaches holistically.

That being said, APRA's prudential supervision of RSEs may be the most likely means by which issues about performance of the covenants emerge. It will not be often that individual members of a fund, or groups of members, come to be aware of facts and circumstances that may show a breach by the trustee. It is therefore essential that APRA retain the ability to take action in the case of a breach. Hence, the exercise of powers by the two agencies should be complementary, not conflicting.

The way in which dual regulation should occur is discussed more fully in the chapter dealing with the regulators.

### **Recommendation 3.7 – Civil penalties for breach of covenants and like obligations**

Breach of the trustee's covenants set out in section 52 or obligations set out in section 29VN, or the director's covenants set out in section 52A or obligations set out in section 29VO of the SIS Act should be enforceable by action for civil penalty.

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<sup>117</sup> Corporations Act s 601FC.

### **Recommendation 3.8 – Adjustment of APRA and ASIC’s roles**

The roles of APRA and ASIC with respect to superannuation should be adjusted, as referred to in Recommendation 6.3.

## **3.5 Regulators and trustees’ conflicts of interest**

As the course of evidence before the Commission shows, trustees have not always ‘managed’ conflicts of interest by giving priority to the duties to, and interests of, beneficiaries over the duties to, and interests of, other persons. Decisions have been made which, at the very least, have tried to accommodate both the interests of members and the interests of entities associated with the entity, that is either the holding company of a group of which the trustee is part, or that can be seen as the ‘sponsor’ of the fund.

This attempt to accommodate the conflicting interests has been achieved in some cases, by entities within the group that have the day-to-day administration of the fund controlling the information that goes to the trustee. So, for example, a trustee was asked to approve a proposed program for transferring accrued default amounts to a MySuper product without the trustee having been informed that the administrator had taken the decision only after considering how the proposed program would accord with the interests of aligned advisers.<sup>118</sup> And there were other cases in which the administration entity within a group did not pass information on to the trustee that, on its face, bore upon what decision would be in the best interests of all members.<sup>119</sup>

In still other cases, the trustee company took decisions that not only did not give priority to members’ interests, but sought to accommodate both members’ interests and the interests of others.

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<sup>118</sup> AMP case study: vol 2.

<sup>119</sup> For example, NULIS decided to maintain grandfathered commissions in the context of a successor fund transfer based on a management paper. That paper referred to the possibility of increased costs from member attrition due to adviser dissatisfaction, but did not attempt any estimate of the cost nor consider the amount members would continue to pay. Similarly, a management paper provided to the board of IIML about proposed pricing changes did not contain relevant information, such as IIML’s experience with grandfathering or how many members were paying trail commissions, to allow the board to make an informed decision.

Again, particular instances of matters of this kind must be of immediate concern to both APRA as prudential regulator and ASIC as conduct regulator. Again, they are matters that are more likely to be uncovered by APRA in the course of its supervisory work than to be the subject of direct complaint to ASIC. But they are, as I have said, matters that go to the very heart of the trustee's performance of its central duties.

Both APRA and ASIC should have power to act in respect of matters of these kinds. I would expect that, more often than not, ASIC would be the agency that would take any enforcement action. But APRA must perform its supervisory functions. RSEs cannot and will not meet what APRA has called their 'financial promises' without adhering closely to the trustees' covenants and the sole purpose test.

### **3.6 Governance, regulation and supervision**

As I have explained earlier in this chapter, I consider that there should be an adjustment of the roles APRA and ASIC have in relation to superannuation. And, as I have said, the role of each agency should accord with the general principle that APRA is to act as prudential regulator and ASIC as the conduct regulator.

Governance of superannuation funds inevitably raises both prudential and conduct issues. Proper governance of a fund is critical to the fund's performance. That is, proper governance is necessary in order to fulfil the basic promise of a superannuation fund that the trustee will administer the fund in the best interests of members, and in particular, in the best *financial* interests of members.

Particular governance failures must be identified. More often than not, failures may be detected by the prudential regulator in the course of its prudential supervision. But however detected, particular failures of governance must be examined by the regulator and made the subject of the appropriate regulatory response. It is this last step that is necessary if trustees of RSEs are to be held properly accountable for their failures of governance.

Failures of governance are reflected in particular decisions that are made with respect to the administration and investment of the fund. The larger superannuation funds are now large enterprises dealing with very large sums of money.

There is no reason in principle why the directors and the senior executives of at least the large superannuation funds should not be subject to statutory obligations of a kind generally similar to those imposed on members of the board and banking executives by the BEAR – to conduct the responsibilities of their positions:

- by acting with honesty and integrity, and with due skill, care and diligence;
- by dealing with APRA and ASIC in an open, constructive and co-operative way; and
- by taking reasonable steps in conducting those responsibilities to prevent matters from arising that would adversely affect the prudential standing or prudential reputation of the fund.<sup>120</sup>

I say that there is ‘no reason in principle’ not to impose obligations of this kind on the board and the senior executives of a superannuation fund on the simple basis that if the BEAR is seen as a necessary step in the proper supervision and regulation of (at least some of the) banks, proper supervision and regulation of superannuation funds needs no less. And imposing these obligations should not increase the regulatory burden to any significant extent.

This last point should be explained.

A necessary step in implementing provisions of the kind under consideration is to identify who in the regulated entity has senior executive responsibility for certain functions. Those responsibilities should either already be identified or, at least be readily identifiable. If that is correct, and it should be, preparation of accountability statements and accountability maps, though a burden, should not be a large burden. Performance of the obligations would then entail no reporting or recording beyond what prudent administration would require anyway.

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<sup>120</sup> Cf Banking Act s 37CA(1).

The advantage of this course of action is that the imposition of the obligations clarifies what is expected of the relevant senior executives. And it would provide additional and important standards against which the prudential regulator and the conduct regulator may examine the conduct of the affairs of the fund by both its board and by its senior management. (I say ‘additional’ standards because, of course, the trustees’ and directors’ covenants and obligations set standards against which the conduct of the trustee and its directors are to be judged.)

### Recommendation 3.9 – Accountability regime

Over time, provisions modelled on the BEAR should be extended to all RSE licensees, as referred to in Recommendation 6.8.

## Conclusion

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Superannuation trustees are responsible for the compulsory and voluntary retirement savings of millions of working Australians. This responsibility comes with important obligations to act in the best interests of members and to give priority to the interests of members above all others. Trustees are not always discharging those obligations, often causing financial detriment to members. Trustees must improve the performance of their duties. Their role should be restricted in order to avoid conflicts, including by precluding them from acting as dual-regulated entities and prohibiting them from the ‘treating’ of employers. And trustees and their most senior executives should be accountable, in the same way that **authorised deposit-taking institutions** are accountable under the BEAR.

Members’ interests must be protected. The deduction of fees for financial advice from their accounts should be limited to ensure that such advice is provided only when necessary and to minimise the prospect of fees being deducted for services that were not provided. For MySuper accounts, no deductions for ongoing advice fees should be permitted. The unsolicited offer, or hawking, of superannuation products to individuals should also be prohibited.

Finally, the roles and powers of APRA and ASIC should be adjusted to enable better supervision of superannuation entities and more effective enforcement of the duties owed by trustees and by directors of trustees.

# 5. Insurance

## Introduction

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In its public hearings, the Commission focused upon the life insurance and general insurance industries, not on the marine or health insurance industries. This focus was consistent with the complaints made to the Commission, with the misconduct and conduct falling below community expectations disclosed by entities in their responses to my initial inquiries, and with the material provided to the Commission by the Australian Securities and Investments Commission (ASIC) and the Financial Ombudsman Service (FOS).

I begin by making some general observations about the history of insurance in Australia, and, in particular, the life and general insurance industries.

## 1 History

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The general insurance industry began in Australia in about the 1830s.<sup>1</sup> From the 1870s, the commercial insurance industry grew rapidly.<sup>2</sup> By the early twentieth century, the focus of the Australian insurance industry was life insurance, fire insurance and marine insurance (which had by then been an important form of insurance for many centuries in England).<sup>3</sup> In 1904, there were 37 insurance companies operating in Australia, 22 of which were British, 11 of which were Australian, and three of which were based in New Zealand.<sup>4</sup> Many of those companies continue to exist in some form today.<sup>5</sup>

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<sup>1</sup> Background Paper No 14, 31 [2.1].

<sup>2</sup> Background Paper No 14, 31 [2.2].

<sup>3</sup> Background Paper No 14, 29–31 [1.1]–[1.7], [2.1].

<sup>4</sup> Background Paper No 14, 31–2 [2.2].

<sup>5</sup> Background Paper No 14, 32 [2.2].

In the first half of the twentieth century, a number of states developed their own state insurance (non-tariff) companies.<sup>6</sup> Some of these companies have since become purely commercial enterprises.<sup>7</sup>

The Federal Parliament did not become actively involved in regulating insurance until the passage of the *Insurance Act 1973* (Cth) (the Insurance Act).<sup>8</sup> Since that time, a number of significant reforms have taken place. These include the introduction of the *Insurance Contracts Act 1984* (Cth) (the Insurance Contracts Act). That Act was passed in response to the Australian Law Reform Commission's 1982 report into insurance, which contained 'a detailed analysis of the common law and also a series of almost revolutionary recommendations for reform'.<sup>9</sup> Most of the Commission's recommendations were given effect in the Insurance Contracts Act.<sup>10</sup>

As I will explain further below, the prudential regulation of insurers has developed separately, principally through the Insurance Act and the *Life Insurance Act 1995* (Cth) (the Life Insurance Act).<sup>11</sup>

## 2 The life insurance industry

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The life insurance industry is now a significant part of the Australian economy. In the year ending 31 March 2018, life insurers in Australia earned over \$18 billion in direct premiums from consumers.<sup>12</sup> At that time, the value of total assets held by life insurance companies in Australia was over \$230 billion.<sup>13</sup>

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<sup>6</sup> Background Paper No 14, 33 [2.6].

<sup>7</sup> Background Paper No 14, 33 [2.6].

<sup>8</sup> See the caveat in Background Paper No 14, 33 [3.1], and more generally at 34 [3.3].

<sup>9</sup> Background Paper No 14, 33 [3.1].

<sup>10</sup> Background Paper No 14, 33 [3.1].

<sup>11</sup> Background Paper No 14, 34 [3.3].

<sup>12</sup> Background Paper No 26, 15 [4].

<sup>13</sup> Background Paper No 26, 15 [4].

Four main types of life insurance cover are sold in Australia:<sup>14</sup>

- *life cover*, which pays a benefit on the death of a policyholder;
- *total and permanent disability (TPD) cover*, which pays a lump sum to assist with rehabilitation and living costs if the policyholder becomes totally and permanently disabled;
- *income protection cover*, which replaces income lost by the policyholder through their inability to work due to injury or sickness; and
- *trauma cover*, which provides cover to the policyholder if they are diagnosed with a specified illness or injury.

These types of cover are sold in three main ways:

- *direct sales* – an insurer sells a life insurance product directly to the consumer without any personal financial product advice;
- *retail sales* – a financial adviser sells a life insurance product to the consumer; and
- *group sales* – the trustee of a superannuation fund, or an employer, purchases a group policy under which the fund members or employees have the benefit of cover.

It is useful to analyse the three ways in which life insurance cover is sold by reference to the number of policies sold and the premiums paid for policies sold. In the 2017 calendar year, 84% of policies were sold through the retail channel, 15% were sold through the direct channel, and only 1% were sold through the group channel.<sup>15</sup> Of the premiums paid, however, retail sales represented 55%, group sales represented 40%, and direct sales represented only 5%.<sup>16</sup>

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<sup>14</sup> Background Paper No 29, 1 [1.2].

<sup>15</sup> Exhibit 6.1, Undated, How Do Australians Buy Life Insurance.

<sup>16</sup> Exhibit 6.2, Undated, Chart of Premiums from Sales of New Policies by Channel.

The figures quoted in respect of group sales record policies sold to superannuation trustees. When one looks instead at the number of insurance policies held within superannuation funds, it becomes clear that the majority of life insurance policies on issue in Australia are held through superannuation funds.<sup>17</sup> I will say more about this in the final section of this chapter.

The life insurance industry has been undergoing, and continues to undergo, substantial change:

- In March 2016, Zurich Australia announced that it had entered into an agreement to acquire Macquarie Life's life insurance business.<sup>18</sup>
- In October 2016, NAB announced that it had completed the sale of approximately 80% of its life insurance business to Nippon Life Insurance Company.<sup>19</sup> In May 2018, NAB announced that it would divest its ownership of MLC, including the remaining 20% stake in its life insurance business. This process is expected to be completed by the end of 2019.<sup>20</sup>
- In September 2017, CBA announced the sale of its life insurance businesses in Australia (CMLA) and New Zealand (Sovereign) to AIA Group. On 2 July 2018, CBA announced the completion of the sale of Sovereign to AIA.<sup>21</sup> The sale of CMLA to AIA is still pending regulatory approvals, and is now expected to be completed in the first half of 2019.<sup>22</sup>

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<sup>17</sup> Peter Kell, 'Insurance in Super: The Regulators – What Do They Think?' (Speech delivered at the Association of Superannuation Funds of Australia Spotlight on Insurance, Sydney, Australia, 27 February 2018).

<sup>18</sup> Zurich, 'Zurich Enters Agreement to Acquire Macquarie Life Insurance Business' (Media Release, 4 March 2016).

<sup>19</sup> NAB, 'NAB Completes Sale of 80% of Life Insurance Business' (Media Release, 3 October 2016). See also Exhibit 6.13, Witness statement of Sean McCormack, 21 August 2018, 3 [16].

<sup>20</sup> Stephen Letts, 'National Australia Bank to Sell MLC as Another Bank Flees Wealth Management' (Media Release, 3 May 2018).

<sup>21</sup> CBA, 'Completion of New Zealand Life Insurance Divestment' (Media Release, 2 July 2018).

<sup>22</sup> CBA, 'Update on Life Insurance Divestments' (Media Release, 23 October 2018).

- In December 2017, ANZ announced the sale of its life insurance business, OnePath Life, to Zurich Financial Services Australia.<sup>23</sup>
- In August 2018, Suncorp announced that it had entered into non-binding Heads of Agreement to sell its Australian life insurance business to TAL Dai-ichi Life Australia. Completion was expected to occur by the end of 2018.<sup>24</sup>

These divestments are expected to lead to a consolidation in the Australian life insurance market, in circumstances where TAL and AIA are already significant players in that market.<sup>25</sup>

### 3 The general insurance industry

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A broad range of products are classified as 'general insurance' products, including:<sup>26</sup>

- home insurance;
- contents insurance;
- motor vehicle insurance;
- travel insurance; and

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<sup>23</sup> ANZ, 'ANZ Completes Simplification of Wealth Australia' (Media Release, 12 December 2017).

<sup>24</sup> Suncorp, 'Heads of Agreement to Sell Australian Life Insurance Business' (Media Release, 9 August 2018); TAL, 'TAL and Suncorp Finalise Binding Legal Agreement for the Acquisition of Suncorp's Australian Life Insurance Business' (Media Release, 4 September 2018).

<sup>25</sup> In the 2017 calendar year, prior to completion of the Suncorp and CBA divestments, TAL and AIA were the largest insurers by premiums paid by reference to life insurance policies in force, receiving approximately 17.4% and 16.7% of those premiums, respectively: Exhibit 6.3, Undated, Chart of Premium Income from Policies in Force. TAL and AIA also had the highest number of new policies during this period: Exhibit 6.5, Undated, Chart of Market Share of New Policies Sold, by Number of Policies.

<sup>26</sup> See generally Insurance Contracts Act ss 11(1) (definition of 'contract of life insurance') and 11(6).

- various types of ‘add-on’ insurance, including gap insurance and tyre and rim insurance.

In Australia, general insurance products are ordinarily sold in one of two ways. They may be sold directly to the customer, either online, by telephone, or in a branch. Alternatively, general insurance products may be sold through an intermediary such as a financial institution, car dealer, underwriting agency or insurance broker.

When general insurance is sold directly to a customer, or is sold through an intermediary other than an insurance broker, it will ordinarily be sold without financial advice or with general advice only. When it is sold through an insurance broker, the customer will usually have received personal financial advice.

### 3.1 Regulatory framework

The life insurance and general insurance industries are subject to several forms of regulation.

Both industries are subject to prudential regulation by the Australian Prudential Regulation Authority (APRA). Among other things, APRA is responsible for granting or refusing applications to carry on a life insurance or general insurance business in Australia.<sup>27</sup>

In addition, most contracts of insurance are ‘**financial products**’ for the purposes of Chapter 7 of the *Corporations Act 2001* (Cth) (the Corporations Act).<sup>28</sup> By making an insurance contract, insurance companies are generally providing a ‘financial service’.<sup>29</sup> As a result, life insurance and general insurance businesses are generally required to hold an **Australian financial services licence** (AFSL), and are subject to financial services regulation under the Corporations Act and the *Australian Securities and Investments Commission Act 2001* (Cth) (the ASIC Act). ASIC administers and enforces those provisions.

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<sup>27</sup> Insurance Act s 12.

<sup>28</sup> See generally Corporations Act s 764A; Background Paper No 14, 56–7 [3.5]–[3.7]; Background Paper No 29, 16 [5.7]–[5.8].

<sup>29</sup> Background Paper No 14, 56 [3.6].

The Insurance Contracts Act governs contracts of insurance and proposed contracts of insurance, the proper law of which is or would be the law of a state or territory.<sup>30</sup> ASIC has the general administration of the Act.<sup>31</sup>

Section 13 of the Insurance Contracts Act obliges both parties to an insurance contract 'to act towards the other party, in respect of any matter arising under or in relation to it, with the utmost good faith'.<sup>32</sup> Failure to comply with that provision is a breach of the Act.<sup>33</sup> If reliance on a provision of the contract of insurance would be a breach of the duty, the party may not rely on it.<sup>34</sup> If an insurer has failed to comply with the duty in the handling or settlement of a claim or potential claim, ASIC may exercise its powers under Subdivision C of Division 4 of Part 7.6 of the Corporations Act, or Subdivision A of Division 8 of that Part, as if the insurer's failure to comply were a failure to comply with a financial services law.<sup>35</sup> The first mentioned provisions deal with variation, suspension and cancellation of an AFSL; the second mentioned provisions deal with banning persons from providing financial services.

The Insurance Contracts Act also provides for the insured's duty of disclosure,<sup>36</sup> specifies the consequences of misrepresentations by an insured,<sup>37</sup> and provides for remedies for non-disclosure and misrepresentations.<sup>38</sup>

The insurance industry has three industry codes of practice: the General Insurance Code of Practice, the Life Insurance Code of Practice, and the Insurance in Superannuation Voluntary Code of Practice.

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<sup>30</sup> Insurance Contracts Act s 8.

<sup>31</sup> Insurance Contracts Act s 11A.

<sup>32</sup> Insurance Contracts Act s 13(1).

<sup>33</sup> Insurance Contracts Act s 13(2).

<sup>34</sup> Insurance Contracts Act s 14.

<sup>35</sup> Insurance Contracts Act s 14A(2).

<sup>36</sup> Insurance Contracts Act s 21.

<sup>37</sup> Insurance Contracts Act ss 23–27.

<sup>38</sup> Insurance Contracts Act ss 27A–33.

The General Insurance Code of Practice came into effect on 1 July 1995 and has since been revised several times.<sup>39</sup> It is a voluntary code that binds all subscribing general insurers.<sup>40</sup> All members of the Insurance Council of Australia (ICA) that offer products covered by the Code are required to subscribe to the Code. Other industry participants may also subscribe. There are currently 174 subscribers to the Code, comprising approximately 97% of the general insurance industry.<sup>41</sup>

Nearly all types of general insurance are covered by the General Insurance Code, including home insurance.<sup>42</sup> The Code imposes obligations on general insurers when selling insurance, handling claims, dealing with third parties, managing catastrophes and handling complaints.<sup>43</sup> It also sets out timeframes for insurers to respond to claims and complaints.<sup>44</sup>

The Code is monitored and enforced by a Code Governance Committee, an independent body comprised of a consumer representative, an industry representative and an independent chair.<sup>45</sup>

The Life Insurance Code of Practice is binding on all members of the Financial Services Council (FSC) that issue life insurance policies, and on any other industry participant that adopts it.<sup>46</sup> The Code became binding on FSC members on 30 June 2017.<sup>47</sup> There are currently 26

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<sup>39</sup> Exhibit 6.404, Witness statement of Robert Whelan, 27 August 2018, 11 [73].

<sup>40</sup> Background Paper No 14, 64 [5.1].

<sup>41</sup> Code Governance Committee, *General Insurance in Australia 2016–17: Industry Practice and Code Compliance*, 6.

<sup>42</sup> General Insurance Code of Practice ss 3.5–3.6.

<sup>43</sup> See generally Background Paper No 14, 65 [5.6].

<sup>44</sup> See, eg, General Insurance Code of Practice ss 7.16, 10.11–10.12 and 10.17–10.18.

<sup>45</sup> General Insurance Code of Practice, *Governance and Monitoring* (7 December 2018) General Insurance Code of Practice <<http://codeofpractice.com.au/governance-and-monitoring>>. See also General Insurance Code of Practice s 12.2.

<sup>46</sup> Life Insurance Code of Practice s 2.1.

<sup>47</sup> Exhibit 6.409, Witness statement of Sally Loane, 30 August 2018, 14 [9.1]; Background Paper No 29, 15 [5.4].

subscribers to the Code,<sup>48</sup> representing the majority of APRA-registered life insurers.<sup>49</sup>

The Code imposes obligations on life insurers during the policy design phase,<sup>50</sup> when selling insurance,<sup>51</sup> and during the claims process.<sup>52</sup> It also includes provisions for dealing with consumers who require additional support.<sup>53</sup>

Compliance with the Life Insurance Code of Practice is monitored by the Life Code Compliance Committee.<sup>54</sup> Subscribers to the Code must report significant breaches of the Code to the Committee, and must implement corrective measures as agreed with the Committee.<sup>55</sup>

The Life Insurance Code of Conduct does not apply to superannuation fund trustees unless they specifically adopt it.<sup>56</sup> In late 2016, some industry bodies formed an Insurance in Superannuation Working Group to develop an industry code of practice for superannuation trustees.<sup>57</sup> The Insurance in Superannuation Voluntary Code of Practice came into effect on 1 July 2018.<sup>58</sup> It is a voluntary code dealing with matters such as benefit design, cessation of cover, claims handling, mechanisms for premium adjustment,

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<sup>48</sup> FSC, *Code of Practice* (5 December 2018) FSC <[www.fsc.org.au/policy/life-insurance/code-of-practice](http://www.fsc.org.au/policy/life-insurance/code-of-practice)>.

<sup>49</sup> APRA, *Register of Life Insurance Companies* (5 December 2018) APRA <[www.apra.gov.au/register-life-insurance-companies](http://www.apra.gov.au/register-life-insurance-companies)>.

<sup>50</sup> Life Insurance Code of Practice ss 3, 5.

<sup>51</sup> Life Insurance Code of Practice s 4.

<sup>52</sup> Life Insurance Code of Practice s 8.

<sup>53</sup> Life Insurance Code of Practice ss 6, 7.

<sup>54</sup> Life Insurance Code of Practice s 12.4.

<sup>55</sup> Life Insurance Code of Practice ss 13.4, 13.7.

<sup>56</sup> Life Insurance Code of Practice s 2.2.

<sup>57</sup> FSC, *Insurance in Super Working Group* (5 December 2018) FSC <[www.fsc.org.au/policy/life-insurance/insurance-in-superannuation-working-group-iswg/](http://www.fsc.org.au/policy/life-insurance/insurance-in-superannuation-working-group-iswg/)>.

<sup>58</sup> FSC, *Insurance in Super Working Group* (5 December 2018) FSC <[www.fsc.org.au/policy/life-insurance/insurance-in-superannuation-working-group-iswg/](http://www.fsc.org.au/policy/life-insurance/insurance-in-superannuation-working-group-iswg/)>.

communications with members and dispute resolution. Superannuation fund trustees who choose to adopt the Code agree to comply with the Code as early as they can, and by no later than 30 June 2021.<sup>59</sup>

## 3.2 Limitations in the regulatory framework

In considering the conduct that was examined during the Commission's hearings, it is useful to begin with three important limitations in the regulatory framework.

First, as I have noted above, although most life and general insurance policies are financial products, and the selling of those policies is a financial service, the handling and settling of insurance claims is not.<sup>60</sup> This means that some of the general obligations imposed by section 912A of the Corporations Act – including, in particular, the obligation on an AFSL holder to do all things necessary to ensure that the financial services covered by the licence are provided efficiently, honestly and fairly – do not apply to the handling and settlement of insurance claims.

Second, most forms of life insurance are financial products but, as I explain further below, 'funeral expenses policies' are not.<sup>61</sup>

Third, because most insurance policies are financial products, insurance companies are bound by the extensive pre-contractual disclosure provisions of Chapter 7 of the Corporations Act including, for example, the obligations to provide product disclosure statements. But section 15 of the Insurance Contracts Act provides (in effect) that insurance contracts governed by that Act are not subject to the unfair contract terms (UCT) provisions of the ASIC Act.

Instead, as already noted, **the Insurance Contracts Act imposes the duty of utmost good faith by section 13(1). But that duty is enforceable by ASIC against the insurer principally through provisions permitting action in respect of the insurer's licence to operate – a very blunt**

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<sup>59</sup> Insurance in Superannuation Voluntary Code of Practice s 3.6.

<sup>60</sup> See Corporations Regulations reg 7.1.33.

<sup>61</sup> See Corporations Regulations reg 7.1.07D.

**instrument of enforcement. The ASIC Enforcement Review Taskforce recommended that breach of section 13(1) attract a civil penalty.<sup>62</sup>**

**The recommended change should be made.** I will say more about the ASIC Enforcement Review Taskforce in the chapters concerning the regulators and other important steps.

## 4 Issues and responses

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The issues arising from the case studies examined in the Commission's sixth round of hearings are described in detail in the discussion in Volume 2 of this Report. The issues can be organised as follows:

- issues relating to the manner of selling some insurance products (which were sometimes compounded by issues relating to the low value of particular insurance products);
- issues relating to the avoidance of insurance policies as a result of pre-contractual non-disclosure or misrepresentations;
- issues relating to the use of, and reliance upon, potentially unfair contract terms;
- issues relating to claims handling;
- issues relating to the lack of enforceability of code obligations; and
- issues relating to **external dispute resolution** (EDR).

I deal with each in turn.

Issues also arise in relation to group life insurance. Because of their close association with superannuation issues, I deal with them separately.

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<sup>62</sup> ASIC Taskforce Review, Report, 77–9, 90–1.

## 4.1 Manner of sale and types of products sold

### 4.1.1 How to sell: Advice about insurance products

As I said at the start of this chapter, most life insurance policies held outside of superannuation accounts are purchased through financial advisers. In the chapter concerning financial advice, I dealt with the issues that emerged in relation to the provision of financial advice – including advice in connection with insurance products. In particular, I dealt with the provision of poor advice, which I noted is too often the result of the conflicts of interest that pervade the financial advice industry.

Conflicts between an adviser's duty to his or her client and an adviser's interests are a particular issue where financial advice is given in connection with insurance products, because insurance products were excluded from aspects of the **Future of Financial Advice** (FoFA) reforms designed to address those conflicts.

In particular, as I explained in the chapter concerning financial advice, life insurance products (other than group life policies and life policies for members of default superannuation funds) and general insurance products were exempted from the ban on **conflicted remuneration** introduced by the FoFA reforms. Since 1 January 2018, that position in relation to life insurance products has changed. Volume-based benefits given to a licensee or representative in relation to information given on, or dealing in, a life risk insurance product are now subject to the ban on conflicted remuneration,<sup>63</sup> unless the benefit is a level commission within the applicable cap<sup>64</sup> and provides a 'clawback' arrangement if the policy is cancelled, not continued, or the policy cost is reduced in the first two years of the policy.<sup>65</sup>

In 2021, ASIC will review the existing arrangements for commissions in relation to life insurance products. **In the chapter concerning financial**

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<sup>63</sup> Corporations Regulations reg 7.7A.11B.

<sup>64</sup> For the calendar year 2018, 80% upfront commission and 20% trail commission, reducing to 70% upfront and 20% trail in 2019 and 60% upfront and 20% trail from 1 January 2020. See ASIC, ASIC Corporations (Life Insurance Commissions) Instrument, 2017/510 (Cth) Pts 2, 3; Corporations Act ss 963B–963BA; Corporations Regulations regs 7.7A.11C(1)(d), 7.7A.11D(1)(b).

<sup>65</sup> See ASIC, ASIC Corporations (Life Insurance Commissions) Instrument, 2017/510 (Cth) s 6.

advice, I said that, if that review indicates that the cap on commissions has not contributed to what is judged to be a significant degree of underinsurance, then I would urge ASIC to continue reducing the cap – ultimately, to zero. I also said that in three years' time, there should be a review of the measures that have been implemented to improve the quality of advice, and that that review should consider whether the continued exemption of general insurance products and consumer credit insurance (CCI) products from the ban on conflicted remuneration remains justified.

#### **4.1.2 How to sell: Prohibit the unsolicited offer or sale of insurance products**

As foreshadowed in the Introduction of this Report, and consistently with the Recommendation in the chapter about superannuation prohibiting the hawking of superannuation products, I would prohibit the unsolicited offer or sale of insurance products, except to those who are not retail clients and except for offers made under an eligible employee share scheme.<sup>66</sup>

As I have explained, share hawking has long been prohibited because it too readily allows the fraudulent or the unscrupulous to prey upon the unsuspecting.<sup>67</sup> Some of the case studies considered in the fourth and sixth rounds of the Commission's hearings involved the offer or sale of insurance products in circumstances where the offeror was acting in a way that was (at the least) unscrupulous. With that said, as in the superannuation context, I consider that the root of the problem with unsolicited offers and sales of insurance is that the potential acquirer is 'unsuspecting'.

Most, if not all, of the case studies examined by the Commission involving the unsolicited sale of insurance pertained to hawking that occurred in a telephone call.<sup>68</sup> When the offeror called to offer their insurance product, the potential acquirer had little or no notice that an offer was likely to be made. The potential acquirer was therefore unlikely to have considered

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<sup>66</sup> Corporations Act ss 992A(3A) and (3B).

<sup>67</sup> United Kingdom, *Report of the Company Law Amendment Committee*, Cmd 2657 (1926), 48 [92].

<sup>68</sup> This was the case in respect of the Select case study in the fourth round of the Commission's hearings, and the ClearView and Freedom case studies in the sixth round of hearings.

seriously whether they needed the product that was being offered. Further, the potential acquirer was unlikely to be armed with the information that they needed to allow them to assess critically the features of the (usually complex) product that was being offered. Without this information, the potential acquirer did not know what questions they needed to ask to test the truth of what was being said or to request the details necessary to assess the suitability of the product for their circumstances.

This final point was highlighted in the evidence of Mr Gregory Martin, the Chief Actuary and Risk Officer of the ClearView Group.<sup>69</sup> Asked whether it was ‘possible to sell life insurance in outbound calls in a way that [was] both financially viable and legally compliant’, Mr Martin said:<sup>70</sup>

In retrospect I find it difficult to understand how you can reconcile those things ... it would be possible to make it legally compliant. My difficulty personally with it is I just don’t understand how a customer in a phone call that lasts 20 minutes can come to a view of ... understanding exactly what they’ve bought in a fairly complex sort of area of financial services.

Mr Martin distinguished that situation from the situation in which a consumer had researched the product that they wanted and then ‘rang in’ to buy it.<sup>71</sup>

In the course of the sixth round of hearings, the possible prohibition of the direct sale of life insurance was raised for consideration. To my mind, the preferable course is to prohibit generally the hawking of insurance products. To explain why this is so, I should say something about ASIC Report 587: *The Sale of Direct Life Insurance*, which was published in August 2018,<sup>72</sup> and which was the subject of discussion during the hearings.

In that report, ASIC examined the practices of six insurers and three distributors who sold life insurance directly to consumers.<sup>73</sup> In order to examine those practices, ASIC reviewed hundreds of outbound sales calls conducted both before and after the Life Insurance Code of Practice came

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<sup>69</sup> Exhibit 6.28, Witness statement of Gregory Martin, 21 August 2018, 1 [1].

<sup>70</sup> Transcript, Gregory Martin, 11 September 2018, 5402.

<sup>71</sup> Transcript, Gregory Martin, 11 September 2018, 5402.

<sup>72</sup> ASIC, Report 587, 30 August 2018.

<sup>73</sup> ASIC, Report 587, 30 August 2018, 4 [6].

into effect.<sup>74</sup> In ASIC's first review of sales calls – relating to calls made between 2010 and 2016 – ASIC found that all of the firms included in its review had engaged in pressure selling.<sup>75</sup> ASIC also found that sales calls frequently included 'inadequate explanations of future cost and product exclusions, [offers of] promotional gifts, and tactics to reduce informed decision-making'.<sup>76</sup>

In ASIC's second review of sales calls – relating to calls made in July and August 2017, after the introduction of the Life Insurance Code of Practice – ASIC observed that sales conduct had improved.<sup>77</sup> ASIC nonetheless found that pressure selling techniques were used by some firms,<sup>78</sup> and that firms did not consistently provide adequate explanations of the likely future cost of the policy or of exclusions for pre-existing medical conditions.<sup>79</sup>

ASIC concluded that the outbound sale of life insurance was 'more commonly associated with poor sales conduct and increase[d] the risk of poor consumer outcomes'.<sup>80</sup> Among other things, ASIC observed high cancellation rates of policies sold directly to consumers:

- ASIC found that 20% of all policies taken out between 2012 and 2017 were cancelled during the cooling-off period. ASIC considered that this may be taken to 'indicate that customers had immediately realised they had made a bad decision or had been pressured into buying a policy they did not need'.<sup>81</sup>
- ASIC also found that 'almost half of all policies held beyond the cooling-off period lapsed within three years'.<sup>82</sup>

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<sup>74</sup> ASIC, Report 587, 30 August 2018, 5.

<sup>75</sup> ASIC, Report 587, 30 August 2018, 7 [20].

<sup>76</sup> ASIC, Report 587, 30 August 2018, 7 [20].

<sup>77</sup> ASIC, Report 587, 30 August 2018, 7 [21]–[22].

<sup>78</sup> ASIC, Report 587, 30 August 2018, 8 [24].

<sup>79</sup> ASIC, Report 587, 30 August 2018, 8 [23].

<sup>80</sup> ASIC, Report 587, 30 August 2018, 58 [290].

<sup>81</sup> ASIC, Report 587, 30 August 2018, 6 [11(a)].

<sup>82</sup> ASIC, Report 587, 30 August 2018, 6 [11(c)].

ASIC said that claim outcomes for direct life insurance were poorer than for policies sold through other channels. Of the entities that ASIC reviewed, 27% of reported claims were withdrawn, 15% were declined, and 58% admitted.<sup>83</sup>

Each of these matters is concerning. But they are not problems that arise because an insurer or a distributor deals directly with a consumer. Rather, they are problems that arise because individuals are offered complex financial products – sometimes very forcefully – when they have not turned their minds to, and do not have adequate information about, what value the product has for them. Hence, the most appropriate course is to prohibit the *unsolicited* sale of such products.

A number of entities broadly favoured this approach, including consumer groups<sup>84</sup> and at least one industry body.<sup>85</sup> Both ASIC and the Consumer Action Law Centre (CALC) expressed the view that the current regulatory regime governing the unsolicited sale of financial products is ‘inadequate to avoid consumer detriment’.<sup>86</sup> ASIC said that:<sup>87</sup>

the anti-hawking prohibition in s[ection] 992A of the Corporations Act does not operate as a general prohibition against outbound and unsolicited sales calls, but only against offering a financial product in an unsolicited call when certain requirements (both before and during the call) are not met. The technical nature of the anti-hawking prohibition means that conduct will be exempt from the prohibition if the offeror complies with the technical requirements stipulated in the Corporations Act. Yet, even where there is compliance with these technical requirements, the risk of mis-selling and inappropriate consumer outcomes remains.

To similar effect, the Consumer Action Law Centre emphasised that the anti-hawking prohibition:<sup>88</sup>

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<sup>83</sup> ASIC, Report 587, 30 August 2018, 6 [12], [14].

<sup>84</sup> CALC, Module 6 Policy Submission, 16–17 [48]–[53]; FRLC, Module 6 Policy Submission, 13.

<sup>85</sup> AFA, Module 6 Policy Submission, 13.

<sup>86</sup> ASIC, Module 6 Policy Submission, 20 [74]; see also CALC, Module 6 Policy Submission, 17 [51].

<sup>87</sup> ASIC, Module 6 Policy Submission, 20 [74].

<sup>88</sup> CALC, Module 6 Policy Submission, 17 [51].

allows unsolicited selling if the seller meets certain requirements. For ClearView, and perhaps other insurers, the watered-down anti-hawking requirement has seen unsolicited selling take place within structures and systems which do not ensure compliance with the law. This type of non-compliance is an inevitable risk of any laws which are relatively complex and contain loopholes which may enable businesses to go further with their practices than the ‘spirit’ of the law dictates. The anti-hawking provision is an example of laws being complicated by industry lobbying. Laws such as these, which have been heavily influenced by industry interests rather than implementation of evidence-based policy solutions, are ineffective at protecting people from harm.

I agree with both sets of observations.

Of the submissions that opposed a prohibition on unsolicited offering or selling, at least two submitted that **financial services entities** should be permitted to offer financial products to existing customers or members in the course of, or because of, an unsolicited meeting.<sup>89</sup> Consistently with the views that I have expressed in the chapter on superannuation, I do not consider that such an approach should be adopted. It would not prevent the detriments I have identified. I emphasise that I do not intend to place any restriction on the ability of insurers to contact current policyholders in relation to *existing* policies, including in order to notify policyholders that their insurance cover will shortly lapse.<sup>90</sup> But hawking insurance products should be generally prohibited.

Before leaving this topic, I add one point. To make the proposed prohibition on unsolicited offer and sales effective, and to eliminate some arguments about what is ‘unsolicited’,<sup>91</sup> it is desirable to introduce a statutory definition of that concept. The definition should have a breadth that achieves the purpose of the prohibition. To that end, the definition might usefully be based upon the definition now used by ASIC: that a meeting or telephone call is unsolicited ‘unless it takes place in response to a

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<sup>89</sup> See, eg, NAB, Module 6 Policy Submission, 7–9 [26]–[28]; AIST, Module 6 Policy Submission, 9 [10]. See also ICA, Module 6 Policy Submission, 12–13.

<sup>90</sup> Cf FSU, Module 6 Policy Submission, 5 [33]–[36].

<sup>91</sup> As not infrequently occurred in the context of the anti-hawking provision: see, eg, Transcript, Gregory Martin, 10 September 2018, 5336–44.

*positive, clear and informed request* from a consumer'.<sup>92</sup> And, as I have explained in the chapter on superannuation, it should be made plain that a solicited meeting, call or contact to discuss one type of product may not be used for the unsolicited offering of some other type of product.

#### **Recommendation 4.1 – No hawking of insurance**

Consistently with Recommendation 3.4, which prohibits the hawking of superannuation products, hawking of insurance products should be prohibited.

### **4.1.3 Specific steps in respect of particular products**

A number of case studies considered the sale of low value products, including funeral insurance for the very young,<sup>93</sup> accidental death and accidental injury insurance, and add-on insurance sold in connection with motor vehicle purchases or credit transactions. Each of these were products that had to be 'sold', often very aggressively, by those who were paid commissions for every sale made. Each of them is a product that yields high profits for the issuer, almost always because the claims ratio is very low.

Many of the problems raised in connection with the sale of low value products will be met by prohibiting the unsolicited sale of financial products. Doing that should remove the pressure now associated with the sale of the products and should allow consumers to think more carefully about purchasing the product.

There are two products where I think that further steps are necessary. I outline those steps below, and then say something about ASIC's proposed design and distribution obligations and product intervention powers.

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<sup>92</sup> ASIC, Regulatory Guide 38, 2005, 9 [A2.1] (emphasis in original).

<sup>93</sup> FSRC, *Interim Report*, vol 2, 443–57.

## Funeral insurance

The present exclusion of some forms of funeral insurance from the definition of ‘financial product’ should be brought to an end.<sup>94</sup>

As I explained in the *Interim Report*, the Commission took evidence about two types of funeral insurance: funeral life policies and funeral expenses policies.<sup>95</sup> A consumer buying a funeral life insurance policy nominates a benefit amount (typically between \$5,000 and \$20,000) payable, on the death of the nominated life, to a person nominated by the policyholder.<sup>96</sup> The recipient may apply the benefit as the recipient thinks fit.<sup>97</sup> By contrast, a funeral expenses policy will pay funeral costs up to a nominated limit.<sup>98</sup> Funeral expenses may be less than the nominated limit of cover.<sup>99</sup> Both types of policy are frequently sold directly to consumers.<sup>100</sup>

As I observed in the *Interim Report*, the statistics gathered by ASIC as at 30 June 2014 suggest that funeral insurance policies sold directly to consumers are of little value.<sup>101</sup> Those statistics indicate that at that time, there were about 430,000 policies covering about 740,000 insured lives.<sup>102</sup> In the 2014 financial year, more than 12,500 claims were accepted by insurers.<sup>103</sup> The amount paid out in claims was about one-third of the value of premiums collected over the same period. In the preceding year, the proportion was one-fifth.<sup>104</sup>

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<sup>94</sup> Amongst other things, this will allow the prohibition on unsolicited selling to apply to these products.

<sup>95</sup> FSRC, *Interim Report*, vol 1, 262–3. See also ASIC, Report 454, 29 October 2015, 11 [26(b)].

<sup>96</sup> FSRC, *Interim Report*, vol 1, 263.

<sup>97</sup> FSRC, *Interim Report*, vol 1, 263.

<sup>98</sup> FSRC, *Interim Report*, vol 1, 263; see also ASIC, Report 454, 29 October 2015, 11 [26(b)].

<sup>99</sup> ASIC, Report 454, 29 October 2015, 11 [26(b)], 27 [84]; Exhibit 4.151, April 2014, ASIC Analysis of the Funeral Insurance Sector in Australia as at 30 June 2013, 13 [50], 14.

<sup>100</sup> ASIC, Report 454, 29 October 2015, 9 [16].

<sup>101</sup> FSRC, *Interim Report*, vol 1, 263.

<sup>102</sup> FSRC, *Interim Report*, vol 1, 263; ASIC, Report 454, 29 October 2015, 14 [32].

<sup>103</sup> FSRC, *Interim Report*, vol 1, 263; ASIC, Report 454, 29 October 2015, 14 [35].

<sup>104</sup> ASIC, Report 454, 29 October 2015, 14 [35].

There was a high rate of policy cancellations.<sup>105</sup> Most insurers identified the cost of premiums as the most common reason for cancellation.<sup>106</sup>

To those statistics, I added the observations that many consumers hold policies with stepped premiums increasing with age,<sup>107</sup> and that many funeral insurance products carry ‘the potential for consumers to pay more in premiums over the life of the policy than they will receive as a benefit when they die’.<sup>108</sup>

Both the ASIC Report and the evidence given in the Commission’s fourth round of hearings indicated that Aboriginal and Torres Strait Islander people, especially those living regionally or remotely, may have been particularly likely to be sold funeral insurance policies in circumstances where those policies held little value for them.<sup>109</sup>

In the *Interim Report*, I explained that both funeral life policies and funeral expenses policies are life policies under the Life Insurance Act and contracts of life insurance under the Insurance Contracts Act.<sup>110</sup> However, as mentioned above, funeral expenses policies are carved out from the definition of ‘financial product’ by section 765A(1)(y) of the Corporations Act and regulation 7.1.07D of the Corporations Regulations 2001 (Cth). The effect of this carve out is that providers of funeral expenses policies are not required to hold AFSLs, are not bound by the general obligations contained in section 912A of the Corporations Act and are not presently restrained by the **anti-hawking provision**.

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<sup>105</sup> FSRC, *Interim Report*, vol 1, 263; ASIC, Report 454, 29 October 2015, 16 [38]–[39].

<sup>106</sup> ASIC, Report 454, 29 October 2015, 16 [40].

<sup>107</sup> FSRC, *Interim Report*, vol 1, 263; ASIC, Report 454, 29 October 2015, 19 [46].

<sup>108</sup> ASIC, Report 454, 29 October 2015, 20 [47]; see also FSRC, *Interim Report*, vol 1, 263.

<sup>109</sup> ASIC, Report 454, 29 October 2015, 18 [43]; Transcript, Lynda Edwards and Nathan Boyle, 3 July 2018, 3747–52.

<sup>110</sup> FSRC, *Interim Report*, vol 1, 264.

The exclusion of funeral expenses policies from the definition of ‘financial product’ cannot be justified. All forms of funeral insurance should be subject to the same regulatory regime and supervision. This is particularly important given the concerns that I hold about the value of these types of products. Many submissions received by the Commission expressed a similar view.<sup>111</sup> The Corporations Regulations should be amended accordingly.

As I explained in the *Interim Report*, some doubts have been raised about whether the consumer protection provisions of Part 2, Division 2 of the ASIC Act apply to funeral expenses policies, by reason of section 12BAA(8)(o) of that Act (it being accepted that the provisions do apply to funeral life policies). A number of submissions received by the Commission indicate that the ASIC Act provisions should be understood as applying to funeral expenses policies.<sup>112</sup> Nonetheless, the submissions express the view that the ASIC Act should be amended to put beyond doubt that the consumer protection provisions do apply to such policies.<sup>113</sup> For the reasons set out above, I agree that the ASIC Act should be amended in this way.

By taking these steps – bringing funeral expenses policies within the definition of ‘financial product’, confirming that they are within the reach of the consumer protection provisions of the ASIC Act, and, more generally, prohibiting the unsolicited sale of these products – I consider that many of the problems raised in ASIC Report 454 and in the fourth round of hearings will be resolved.<sup>114</sup>

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<sup>111</sup> See ASIC, Module 4 Policy Submission, 14 [32], [33(a)]; ASIC, Interim Report Submission, 30 [139(a)]; APRA, Module 4 Policy Submission, 7 [24]; CALC, Module 4 Policy Submission, 3 [12]; CALC, Interim Report Submission, 44 [192], 45 [4.14]–[4.15]; FCA, Module 4 Policy Submission, 4 [15]; FRLC, Interim Report Submission, 15; Legal Aid NSW, Interim Report Submission, 19–20.

<sup>112</sup> FSRC, *Interim Report*, vol 1, 264. Cf ASIC, Module 4 Policy Submission, 19 [43]; CALC, Module 4 Policy Submission, 5 [16]; Legal Aid NSW, Interim Report Submission, 20.

<sup>113</sup> See also ASIC, Module 4 Policy Submission, 19 [43]; CALC, Module 4 Policy Submission, 5 [16]; CALC, Interim Report Submission, 44 [193]; FCA, Module 4 Policy Submission, 5 [16]; Legal Aid NSW, Interim Report Submission, 20.

<sup>114</sup> See, eg, Transcript, Nathan Boyle, 3 July 2018, 3750.

## **Recommendation 4.2 – Removing the exemptions for funeral expenses policies**

The law should be amended to:

- remove the exclusion of funeral expenses policies from the definition of ‘financial product’; and
- put beyond doubt that the consumer protection provisions of the ASIC Act apply to funeral expenses policies.

### *Add-on insurance*

I consider that two further steps should be taken in respect of the sale of add-on insurance. First, I consider that add-on insurance should generally be sold under a deferred sales model, with the exception of policies of comprehensive motor insurance. Under a deferred sales model, insurers or their representatives would be required to wait for a specified period of time before attempting to sell add-on insurance products to their customers. Second, I consider that caps on commissions should be introduced for add-on insurance sold in connection with the sale of a motor vehicle.

Turning first to the need for a deferred sales model, in the chapter on banking, I explained that I considered that the sale of add-on insurance, including add-on insurance offered in connection with the sale of motor vehicles, should move to a deferred sales model. As I said above, I exclude from this proposal policies of comprehensive motor insurance.

This proposal is consistent with ASIC’s proposal in its Consultation Paper 294: *The Sale of Add-on Insurance and Warranties Through Caryard Intermediaries*.<sup>115</sup> That proposal built on a substantial amount of earlier work done by ASIC,<sup>116</sup> and was motivated by concerns that:<sup>117</sup>

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<sup>115</sup> ASIC, Consultation Paper 294, 24 August 2017, 6 [6(a)].

<sup>116</sup> ASIC, Consultation Paper 294, 24 August 2017, 8 [13]–[16].

<sup>117</sup> ASIC, Consultation Paper 294, 24 August 2017, 11–12 [30].

- add-on insurance products represent poor value for consumers;
- insurers pay more in commissions than in claims;
- consumer outcomes are considerably worse than in markets where there is meaningful competition; and
- consumers are at risk of unfair sales and adverse outcomes.

The justification for a deferred sales model in this context was neatly explained by ASIC:<sup>118</sup>

In the current sales environment, combining the sale of the car, finance and add-on products into one process restricts the capacity of consumers to consider these matters and make rational, informed purchasing decisions. The deferred sales model aims to address this by inserting a pause into the sales process.

We consider that a well-designed model would give consumers additional time to navigate the complexities of add-on products and facilitate improved decision making.

In its submissions in response to the policy questions arising from the sixth round of hearings, ASIC made substantially similar points.<sup>119</sup> ASIC said that it intended to conduct further consultation before finalising the details of its proposed model, and that it ultimately planned to implement that model ‘primarily by using its existing statutory powers to modify provisions of the Corporations Act’.<sup>120</sup>

Other submissions received by the Commission also supported the move towards a deferred sales model for add-on insurance sold in connection with motor vehicles.<sup>121</sup>

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<sup>118</sup> ASIC, Consultation Paper 294, 24 August 2017, 48 [181]–[182].

<sup>119</sup> ASIC, Module 6 Policy Submission, 23–4 [87]–[93].

<sup>120</sup> ASIC, Module 6 Policy Submission, 24 [89]–[90].

<sup>121</sup> As to the industry peak bodies, see FSC, Module 6 Policy Submission, 17 and ICA, Module 6 Policy Submission, 15–16 and Attachment 1. As to the consumer groups, see CALC, Module 6 Policy Submission, 20–1 [64]–[68]; Consumer Credit Insurance Legal Service (WA), Module 6 Policy Submission, 9–10 [4.13]–[4.17]; FRLC, Module 6 Policy Submission, 16–17; Legal Aid NSW, Module 6 Policy Submission, 3–4.

The move towards a deferred sales model for add-on insurance is not confined to the motor vehicle context. The 2019 Code of Banking Practice will introduce a deferred sales model in respect of CCI for credit cards and personal loans sold in branches or over the phone.<sup>122</sup> The purpose of this reform is said to be to reduce ‘the risk that a consumer will feel pressured to purchase the CCI product, or purchases a CCI product that does not meet their needs’.<sup>123</sup>

As will be apparent from what I have said, these changes will not cover the field. In particular, they will not deal with add-on insurance products sold in branches or over the phone in connection with home loans,<sup>124</sup> or with add-on insurance products that are purchased online.<sup>125</sup>

This raises difficulties of the kind the Productivity Commission recently acknowledged in its report into competition in the Australian financial system:<sup>126</sup>

At present, the regulatory paradigm [for add-on insurance] appears to involve ASIC in a game of whack-a-mole with insurers and their retailing partners. Legislators cannot expect the regulator to be effective in this game.

The observations made by the Productivity Commission in that report indicate that the problems evident in the motor vehicle add-on and CCI add-on contexts extend across the add-on insurance market.<sup>127</sup>

To deal with these issues at a systemic level, the Productivity Commission proposed introducing a deferred sales model for all add-on insurance products, ‘with a consultation period to deal with solid cases for exceptions’.<sup>128</sup> Several submissions to this Commission supported

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<sup>122</sup> 2019 Code cls 67–68.

<sup>123</sup> ASIC, Media Release 17-255MR, 1 August 2017.

<sup>124</sup> See generally Productivity Commission, Report No 89, 29 June 2018, 429.

<sup>125</sup> As to which, see ASIC, Media Release 17-255MR, 1 August 2017.

<sup>126</sup> Productivity Commission, Report No 89, 29 June 2018, 430.

<sup>127</sup> Productivity Commission, Report No 89, 29 June 2018, 415.

<sup>128</sup> Productivity Commission, Report No 89, 29 June 2018, 430.

that approach.<sup>129</sup> The Productivity Commission has recommended establishing ‘a Treasury-led working group to take this objective forward’.<sup>130</sup> I agree that a Treasury-led working group should develop an industry-wide deferred sales model, and that it should be implemented as soon as reasonably practicable.

Second, evidence given in the Commission’s sixth round of hearings showed that the levels of commissions paid to motor vehicle dealers in connection with the sale of add-on insurance products contributed to the mis-selling of those products.<sup>131</sup> In its September 2016 report on the sale of add-on insurance through dealers, ASIC noted that, in the 2015 financial year, the commissions paid to dealers for the sale of add-on insurance products were as high as 79% of the premium.<sup>132</sup> ASIC also observed that the amounts paid in *commissions* on these products exceeded the amounts paid out to customers who made claims.<sup>133</sup>

One reason why commissions paid to dealers were so high was that insurance companies competed with each other to gain market share of distribution networks. Mr Benjamin Bessell, who gave evidence about the sale of add-on insurance policies by Swann Insurance through dealers, said that Swann viewed the *dealers* as its customers, rather than the consumer who purchased the insurance policy.<sup>134</sup>

In 2017, in recognition of the problems created by the high commissions paid to dealers, the ICA prepared a submission to the Australian Competition and Consumer Commission (the ACCC) proposing that insurers cap commissions at 20% of the premium.<sup>135</sup> The ACCC refused to authorise

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<sup>129</sup> See ASIC, Module 6 Policy Submission, 23 [87], 24 [91]; FSC, Module 6 Policy Submission, 17–18; CALC, Module 6 Policy Submission, 20 [64]; FRLC, Module 6 Policy Submission, 17; Professors Allan Fels AO and David Cousins AM, Module 6 Policy Submission, 8. Cf ICA, Module 6 Policy Submission, 17.

<sup>130</sup> Productivity Commission, Report No 89, 29 June 2018, 431.

<sup>131</sup> See, in particular, Transcript, Robert Whelan, 21 September 2018, 6408.

<sup>132</sup> ASIC, Report 492, 12 September 2016, 16 [55].

<sup>133</sup> ASIC, Report 492, 12 September 2016, 17–18 [61]–[62].

<sup>134</sup> Transcript, Benjamin Bessell, 18 September 2018, 6098.

<sup>135</sup> Transcript, Robert Whelan, 21 September 2018, 6399, 6401, 6407.

that proposal.<sup>136</sup> Since then, some insurance companies have taken steps to reduce the level of commissions paid to dealers.<sup>137</sup> But, because general insurance products and CCI products are exempt from the ban on conflicted remuneration, there is no requirement for any of those companies to limit the amount of commissions paid.

Mr Robert Whelan, the Executive Director and CEO of the ICA, accepted that commissions and volume-based bonuses paid to dealers are a significant cause of the problems that ASIC identified in its reports about the sale of add-on insurance through motor vehicle dealers. He also accepted that given many dealers were dependent on revenue from commissions, commissions and volume-based payments were particularly likely to create incentives to engage in poor sales practices.<sup>138</sup>

In circumstances where the peak industry body recognises that commissions can create these issues, and where the industry has indicated willingness in the past to limit the level of commissions paid to dealers, I recommend that a cap be imposed on the amount of commissions paid to motor vehicle dealers in relation to the sale of add-on insurance products. Like the existing arrangements for commissions paid in relation to life insurance products, I recommend that the level of the cap should be determined from time to time by an ASIC legislative instrument.

#### **Recommendation 4.3 – Deferred sales model for add-on insurance**

A Treasury-led working group should develop an industry-wide deferred sales model for the sale of any add-on insurance products (except policies of comprehensive motor insurance). The model should be implemented as soon as is reasonably practicable.

#### **Recommendation 4.4 – Cap on commissions**

ASIC should impose a cap on the amount of commission that may be paid to vehicle dealers in relation to the sale of add-on insurance products.

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<sup>136</sup> Transcript, Robert Whelan, 21 September 2018, 6407.

<sup>137</sup> Transcript, Robert Whelan, 21 September 2018, 6408.

<sup>138</sup> Transcript, Robert Whelan, 21 September 2018, 6408.

### *Product intervention, disclosure and design*

Before leaving the topic of low value insurance products, it is important to say something about ASIC's proposed design and distribution powers and product intervention powers.

As I explained in the chapter on financial advice, if the Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2018 (Cth) is passed, it will give ASIC powers that may go some way to altering the kinds of, and the characteristics of, products that may be sold, including low value products.

As Treasury explained, the design and distribution obligations:<sup>139</sup>

will require product issuers (such as insurers) to develop a 'target market determination' that will specify the target market for each of their products. This target market must be such that the product will likely be consistent with the likely objectives, financial situation and needs of customers within that target market.

The effect of these obligations is that if an issuer designs a product that does not meet the likely objectives, financial situation and needs of any customers – or only does so for such a narrow target market, so as to be commercially unviable – the issuer is effectively precluded from offering that product.

These obligations will also require issuers 'who distribute their own products and third-party distributors to take reasonable steps, such that the way they market, advise on or sell products is consistent with the target market determination for that product'.<sup>140</sup>

The proposed product intervention power is, therefore, a complementary power 'to make a range of intervention orders to prohibit specified conduct in relation to financial or credit products, [and] to proactively reduce the risk of significant consumer detriment'.<sup>141</sup>

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<sup>139</sup> Treasury, Module 6 Policy Submission, 2 [11]–[12].

<sup>140</sup> Treasury, Module 6 Policy Submission, 3 [16].

<sup>141</sup> Treasury, Module 6 Policy Submission, 4 [20].

I say that the introduction of these powers may go ‘some way’ to altering the kinds and characteristics of the products that may be sold because there are some restrictions on the breadth of the proposed powers. **The design and distribution powers do not now extend to credit products. More significantly for present purposes, those powers do not extend to financial products that are not regulated by the Corporations Act, but are regulated by Division 2 of Part 2 of the ASIC Act.<sup>142</sup> The product intervention powers have a broader reach, but nonetheless do not extend to all ASIC Act products.<sup>143</sup> It is not apparent why the powers should not extend, as ASIC has requested, to all financial products and credit products within ASIC’s regulatory responsibility.<sup>144</sup>**

In its present form, the proposed statutory regime imposes some restrictions on ASIC’s exercise of its product intervention powers. One restriction is that ASIC must be satisfied that a financial product ‘has resulted in, or will or is likely to result in, significant detriment to retail clients’.<sup>145</sup> ‘Significant detriment’ is said to include ‘the nature and extent of the detriment’, ‘the actual or potential financial loss to retail clients resulting from the product’ and ‘the impact that the detriment has had, or will or is likely to have, on retail clients’.<sup>146</sup> Another restriction is that the product intervention order is, generally speaking, limited to a period of 18 months,<sup>147</sup> although that period can be extended.<sup>148</sup> A third is that ASIC is required to consult prior to making a product intervention order.<sup>149</sup>

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<sup>142</sup> ASIC, Submission to Government, Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Power) Bill 2018, August 2018, 14 [52], 19 [64].

<sup>143</sup> ASIC, Submission to Government, Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Power) Bill 2018, August 2018, 28 [90].

<sup>144</sup> ASIC, Submission to Government, Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Power) Bill 2018, August 2018, 21 [69], 28 [89]–[90].

<sup>145</sup> Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill cl 1023D(1)(b).

<sup>146</sup> Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill cl 1023E(1).

<sup>147</sup> Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill cl 1023G(2)(a).

<sup>148</sup> Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill cl 1023H.

<sup>149</sup> Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill cl 1023F.

I do not mention these restrictions for the purpose of calling into doubt the value of the proposed design and distribution powers and product intervention powers, or the relevance and importance of the limitations imposed. Rather, I mention them to make the point that the powers go some way to altering the kinds and characteristics of products that may be sold, but may not solve all of the problems and issues that can arise in connection with the sale of low value products.

**ASIC has said that it intends to use its product intervention powers to intervene in the sale of accidental death insurance if it remains concerned about consumer outcomes.<sup>150</sup> ASIC should also consider whether it should intervene in the sale of accidental injury insurance or funeral insurance if it continues to hold concerns about consumer outcomes.<sup>151</sup>**

## 4.2 Pre-contractual non-disclosure and misrepresentations

Part IV of the Insurance Contracts Act governs disclosures and misrepresentations by an insured. The TAL case study raised serious questions about whether the provisions contained in that Part strike an appropriate balance between the interests of insurers and insureds.

I consider that two amendments are necessary.

- First, I consider that Part IV of the Act should be amended in respect of consumer insurance contracts. For those types of contract, I consider that the duty of disclosure should be replaced with a duty to take reasonable care not to make a misrepresentation to an insurer. Any necessary consequential amendments should be made to the remedial provisions contained in Division 3.

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<sup>150</sup> ASIC, Report 587, 30 August 2018, 17 [79]. See also the analysis of the witness statements provided to the Commission relating to accidental death policies at Transcript, Senior Counsel Assisting, 12 September 2018, 5527–33.

<sup>151</sup> See generally ASIC, Report 454, 29 October 2015, 18 [43].

- Second, I consider that section 29(3) of the Insurance Contracts Act should be amended so that an insurer may only avoid a contract of life insurance on the basis of non-disclosure or misrepresentation if it can show that it would not have entered into a contract on any terms.

I set out my views on each of these matters in turn.

#### **4.2.1 The duty of disclosure**

The TAL case study demonstrated the difficulties of placing a duty on consumers seeking insurance to disclose to their potential insurer, before the contract of insurance is entered into, information about the matters specified by section 21 of the Insurance Contracts Act.

Section 21 provides that:<sup>152</sup>

an insured has a duty to disclose to the insurer, before the relevant contract of insurance is entered into, every matter that is known to the insured, being a matter that:

- (a) the insured knows to be a matter relevant to the decision of the insurer whether to accept the risk and, if so, on what terms; or
- (b) a reasonable person in the circumstances could be expected to know to be a matter so relevant ...

The effect of section 21 has been modified by sections 21A and 21B of the Insurance Contracts Act in respect of ‘eligible contracts of insurance’.

If a contract is an ‘eligible contract of insurance’,<sup>153</sup> then the insured’s duty of disclosure will be governed by section 21A (in relation to disclosures made before a contract is entered into) or by section 21B (in relation to disclosures made before a contract is renewed). These provisions are complex, but in simple terms, they operate so that prior to the entry into, or renewal of,

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<sup>152</sup> Insurance Contracts Act s 21(1).

<sup>153</sup> ‘Eligible contracts of insurance’ are prescribed by regulation to include contracts for motor vehicle insurance, home buildings insurance, home contents insurance, sickness and accident insurance, CCI and travel insurance, if certain conditions are met: Insurance Contracts Regulations reg 6(2). Other types of contracts of insurance may also qualify in particular circumstances, under reg 6(3).

a contract, an insurer may request that an insured answer one or more specific questions that are relevant to the insurer's decision about whether to accept the risk (and if so, on what terms).<sup>154</sup>

If, following such a request, the insured discloses each matter that is known to them and that a reasonable person could be expected to have disclosed in the circumstances, then the insured will be taken to have complied with their duty of disclosure.<sup>155</sup> If the insurer does not make any request at all, the insurer is taken to have waived compliance with the duty of disclosure.<sup>156</sup>

Sections 21A and 21B do not in terms apply to all consumer contracts for insurance. The classes of contract specified to be 'eligible contract[s] of insurance' under regulation 6(2) of the Insurance Contracts Regulations 2017 (Cth) are wholly or predominantly classes of general insurance contracts. The practices of individual life insurers *may*, but will not necessarily, lead them to fall within the further definition of 'eligible contract of insurance' contained in regulation 6(3) of the Insurance Contracts Regulations. It is not apparent to me why life and general insurance contracts have been treated differently.<sup>157</sup>

If a consumer contract of insurance is not governed by sections 21A or 21B of the Insurance Contracts Act, then it will fall to be governed by the duty of disclosure contained in section 21 of the Act.

In my view, the duty of disclosure presently contained in section 21 of the Act does not recognise the breadth and depth of the gap between what a consumer knows and what an insurer knows. That is, the duty fails to recognise the extent of the information asymmetry between a consumer and an insurer. And that gap is not closed by referring to what 'a reasonable person in the circumstances could be expected to know to be a matter so relevant'.<sup>158</sup> It is not closed because the question will always arise *after* the insurer has said that certain information *was* relevant and has said *why* it is

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<sup>154</sup> Insurance Contracts Act ss 21A(2), 21B(3).

<sup>155</sup> Insurance Contracts Act ss 21A(5), 21B(7).

<sup>156</sup> Insurance Contracts Act ss 21A(3), 21B(4).

<sup>157</sup> See Explanatory Memorandum, Insurance Laws Amendment Bill 1997 (Cth), 31 [117], which explains the rationale for introducing s 21A in a way that appears equally applicable to general and life insurance contracts.

<sup>158</sup> Insurance Contracts Act s 21(1)(b).

relevant. The question will be asked and answered after the event (ex post) rather than before the event (ex ante). Or, putting the same points another way, a duty framed in this way fails to recognise that insurers are always better placed than an insured to identify the categories of information that they consider to be relevant to their decision of whether to insure a risk.<sup>159</sup>

These issues were considered by the UK Law Commission and the Scottish Law Commission in their 2009 report entitled *Consumer Insurance Law: Pre-Contract Disclosure and Misrepresentation*.<sup>160</sup> The report recognised that framing the duty in the way now reflected in section 21 of the Insurance Contracts Act has its roots in common law developments in the course of the eighteenth and nineteenth centuries that were later codified by the UK Parliament in 1906.<sup>161</sup> But times (and the parties to insurance contracts) have since changed markedly. Insurance is no longer the province of a mercantile class. It is a universal product.

A summary accompanying the joint report of the two British Law Commissions explained that:<sup>162</sup>

The current law requires a consumer to volunteer information about anything which a ‘prudent insurer’ would consider relevant. This no longer corresponds to the realities of a modern mass consumer insurance market. Most consumers are unaware that they are under a duty to volunteer information. Even if they are aware of it, they usually have little idea of what an insurer might think relevant.

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<sup>159</sup> See similar observations in CALC, Module 6 Policy Submission, 33–4 [127]–[131] and FRLC, Module 6 Policy Submission 31–2; see also Professors Allan Fels AO and David Cousins AM, Module 6 Policy Submissions, 10–11.

<sup>160</sup> The Law Commission and The Scottish Law Commission, *Consumer Insurance Law: Pre-Contract Disclosure and Misrepresentation* (2009), 14 [2.20]. It should be noted that there had been previous calls for reform in this area: The Law Commission and The Scottish Law Commission, *Consumer Insurance Law: Pre-Contract Disclosure and Misrepresentation – Joint Report – Summary* (2009), 2 [1.8].

<sup>161</sup> The Law Commission and The Scottish Law Commission, *Consumer Insurance Law: Pre-Contract Disclosure and Misrepresentation – Joint Report – Summary* (2009), 2 [1.6].

<sup>162</sup> The Law Commission and The Scottish Law Commission, *Consumer Insurance Law: Pre-Contract Disclosure and Misrepresentation – Joint Report – Summary* (2009), 1 [1.2]–[1.3].

It is clearly important that insurers receive the information they need to assess risks. Most insurers, however, now accept that they should ask questions about the things they want to know ...

The joint report observed that one practical manifestation of these issues was that:<sup>163</sup>

policyholders may be denied claims even when they act honestly and reasonably. Our survey of ombudsman cases shows that some insurers continue to use extremely general questions, where it is not clear what information the insurer is seeking. It is easy for consumers to misunderstand such questions, and therefore give inaccurate answers, even if they are doing their best to answer truthfully.

These observations apply as much in Australia as they do in the United Kingdom.

The UK Law Commission and the Scottish Law Commission recommended that legislation be passed to replace the duty of pre-contractual disclosure with a duty to take reasonable care not to make a misrepresentation to an insurer.<sup>164</sup> In 2012, the UK Parliament enacted the *Consumer Insurance (Disclosure and Representations) Act 2012* (UK), which introduced a duty in the terms recommended by the Law Commissions.<sup>165</sup> The Act applies to all consumer insurance contracts.<sup>166</sup>

The Commission received a range of submissions on the topic of whether the duty of disclosure should be replaced with a duty to take reasonable care not to make a misrepresentation.

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<sup>163</sup> The Law Commission and The Scottish Law Commission, *Consumer Insurance Law: Pre-Contract Disclosure and Misrepresentation* (2009), 14 [2.20].

<sup>164</sup> The Law Commission and The Scottish Law Commission, *Consumer Insurance Law: Pre-Contract Disclosure and Misrepresentation – Joint Report – Summary* (2009), 1 [1.1].

<sup>165</sup> *Consumer Insurance (Disclosure and Representations) Act 2012* (Cth) s 2(1), (2), (4).

<sup>166</sup> In general terms, contracts of insurance between an insurer and ‘an individual who enters into the contract wholly or mainly for purposes unrelated to the individual’s trade, business or profession’: see *Consumer Insurance (Disclosure and Representations) Act* s 1 (definition of ‘consumer insurance contract’).

Several entities – including ASIC and a number of consumer bodies – considered that moving to a duty to take reasonable care not to make a misrepresentation would bring benefits.<sup>167</sup> Other entities – principally APRA, insurance industry bodies and insurers – did not consider that this sort of modification would be beneficial.<sup>168</sup> As I understood APRA's position, it was that to change the rules would affect the pricing of risk. It may. Even so, I favour making the change. It is of the essence of insurance that risk is spread between the holders of insurance. If the consequence of this change is that pricing may rise, the benefits of having more persons with *effective* insurance outweigh the detriments of increased pricing.

For the reasons given by the UK Law Commission and the Scottish Law Commission, I recommend that the Insurance Contracts Act be amended, for consumer insurance contracts, to replace the duty of disclosure with a duty to take reasonable care not to make a misrepresentation to an insurer. I consider that this style of duty is more appropriate for consumer insurance contracts than the duty that currently exists in section 21 of the Insurance Contracts Act. It is also substantially less complex than the modified forms of duty contained in sections 21A and 21B of the Insurance Contracts Act. A duty to take reasonable care not to make a misrepresentation to an insurer places the burden on an insurer to elicit the information that it needs in order to assess whether it will insure a risk and at what price. The duty does not require an individual to surmise, or guess, what information might be important to an insurer.

**In saying this, I do not propose to affect the operation of section 21 in respect of other classes of contracts. My recommendation will likely result, however, in sections 21A and 21B of the Insurance Contracts Act having little or no work to do, and it may be thought desirable for those sections to be repealed.**

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<sup>167</sup> Westpac, Module 6 Policy Submission, 36–8 [118]–[125]; PIAC, Module 6 Policy Submission, 12; FRLC, Module 6 Policy Submission, 31–2; ASIC, Module 6 Policy Submission, 39–40 [163]–[165]; CALC, Module 6 Policy Submission, 33–5 [127]–[132]; Professors Allan Fels AO and David Cousins AM, Module 6 Policy Submission, 10–11.

<sup>168</sup> AAI Limited, Module 6 Policy Submission, 10 [46]–[47]; ANZ, Module 6 Policy Submission, 19–20 [87]–[88]; AMP, Module 6 Policy Submission, 20–1 [98]–[100]; ICA, Module 6 Policy Submission, 25–6; APRA, Module 6 Policy Submission, 3 [11]–[12]; AFA, Module 6 Policy Submission, 19–20.

Breach of the duty of an insured not to misrepresent will engage the provisions of Division 3 of Part IV of the Act (sections 27A–33). Some consequential amendments to those provisions will be needed to recognise that there will no longer be a duty, in some cases, to make disclosures, only a duty not to misrepresent. The particular form of those amendments need not be examined here.

#### **4.2.2 Section 29(3) of the Insurance Contracts Act**

As I have said, I consider that section 29(3) of the Insurance Contracts Act should be amended.

Before 2014, section 29(3) provided that:

If the insurer would not have been prepared to enter into a contract of life insurance with the insured on any terms if the duty of disclosure had been complied with or the misrepresentation had not been made, the insurer may, within 3 years after the contract was entered into, avoid the contract.

The effect of this framing was that an insurer could avoid a contract of life insurance for non-disclosure or as a result of a misrepresentation only if the insurer would not have entered into a contract with the insured on *any* terms.

Following the passage of the *Insurance Contracts Amendment Act 2013* (Cth),<sup>169</sup> the subsection was amended to take its current form. Subsection 29(3) now reads:

If the failure was not fraudulent or the misrepresentation was not made fraudulently, the insurer may, within 3 years after the contract was entered into, avoid the contract.

Given that a number of changes to section 29 were effected by the amending Act, the shift in the standard for avoidance may not be immediately apparent. However, the submissions to the Commission showed that the amendment has been understood, at least by some, as expanding the circumstances in which an insurer could avoid a contract of life insurance, so that a life insurer can now avoid a contract of life insurance

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<sup>169</sup> See Sched 5, Pt 2 of the *Insurance Contracts Amendment Act 2013* (Cth).

if it can show that it would not have entered into *the same* contract of life insurance.<sup>170</sup> As explained in Westpac's submissions to the Commission:<sup>171</sup>

In effect, the removal of the words 'on any terms' meant that an insurer is no longer required to demonstrate that it would not have entered into a policy on alternative terms had the non-disclosure or misrepresentation not occurred.

When understood in this way, I consider that the amendment results in an 'avoidance' regime that is unfairly weighted in favour of insurers. A number of entities recognised that the effect of the 2013 amendments was to tilt the balance in favour of insurers.<sup>172</sup>

I recommend that the position that existed prior to the amendment of section 29(3) be restored, so that an insurer may only avoid a contract of life insurance on the basis of non-disclosure or misrepresentation if it can show that it would not have entered into a contract on *any* terms. A change of this nature was supported by a number of consumer organisations<sup>173</sup> and by the FSC.<sup>174</sup>

#### **Recommendation 4.5 – Duty to take reasonable care not to make a misrepresentation to an insurer**

Part IV of the Insurance Contracts Act should be amended, for consumer insurance contracts, to replace the duty of disclosure with a duty to take reasonable care not to make a misrepresentation to an insurer (and to make any necessary consequential amendments to the remedial provisions contained in Division 3).

<sup>170</sup> See generally PIAC, Module 6 Policy Submission, 11; Westpac, Module 6 Policy Submission, 35–6 [114]–[116].

<sup>171</sup> Westpac, Module 6 Policy Submission, 35–6 [116].

<sup>172</sup> PIAC, Module 6 Policy Submission, 11–12; Slater + Gordon Lawyers, Module 6 Policy Submission, 13 [49]–[50]; Westpac, Module 6 Policy Submission, 35–6 [114]–[116]; CALC, Module 6 Policy Submission, 33 [125]–[126]; FRLC, Module 6 Policy Submission, 31. See more generally ASIC, Module 6 Policy Submission, 38–9 [160]–[162].

<sup>173</sup> See PIAC, Module 6 Policy Submission, 11–12; CALC, Module 6 Policy Submission, 33 [125]–[126]; FRLC, Module 6 Policy Submission, 31.

<sup>174</sup> The FSC proposed this as part of a broader package of reforms to s 29: see FSC, Module 6 Policy Submission, 26–7.

### **Recommendation 4.6 – Avoidance of life insurance contracts**

Section 29(3) of the Insurance Contracts Act should be amended so that an insurer may only avoid a contract of life insurance on the basis of non-disclosure or misrepresentation if it can show that it would not have entered into a contract on any terms.

## **4.3 Unfair contract terms**

In 2010, unfair contract terms (UCT) laws were introduced which apply to all sectors of the economy and to all businesses operating in those sectors who use standard form contracts in their dealings with consumers.<sup>175</sup> Since 2016, they have applied to standard form contracts made between businesses and small businesses.<sup>176</sup> The UCT regime contained in the ASIC Act applies to contracts for financial products and financial services.<sup>177</sup> UCT provisions do not apply to insurance contracts regulated by the Insurance Contracts Act. They should.

Speaking generally, the UCT regime renders void a term in a consumer or small business contract that is ‘unfair’, in the sense that it causes a significant imbalance in the contracting parties’ rights and obligations, it is not reasonably necessary to protect the legitimate interests of the party that receives the benefit of the term, and it would cause detriment to a party if it were relied upon.<sup>178</sup> The regime does not apply to certain types of contractual terms, including terms that define the ‘main subject matter’ of the contract, terms that set the upfront price payable under the contract, and terms that are required or permitted by law.<sup>179</sup>

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<sup>175</sup> Treasury, UCT Proposals Paper, June 2018, 1.

<sup>176</sup> Treasury, UCT Proposals Paper, June 2018, 1.

<sup>177</sup> ASIC Act s 12BF(1).

<sup>178</sup> ASIC Act s 12BG; Treasury, UCT Proposals Paper, June 2018, 3.

<sup>179</sup> ASIC Act s 12BI(1); Treasury, UCT Proposals Paper, June 2018, 3.

Despite the UCT provisions in the ASIC Act being expressed to apply to contracts for financial products and financial services, it does not now apply to contracts regulated by the Insurance Contracts Act.<sup>180</sup> As I have said, section 15 of the Insurance Contracts Act provides that a contract of insurance is not capable of being made the subject of relief under ‘any other Act’ on the ground that it is harsh, unconscionable, unjust, unfair or inequitable. Insurance contracts were excluded from the operation of the UCT regime on the basis that the Insurance Contracts Act included ‘its own protections for standard insurance contracts’, and because ‘insurance contracts may have special characteristics due to the nature of the risk involved which make them unsuitable for UCT protections’.<sup>181</sup>

In late 2017, the Government announced that it would extend the UCT regime to cover insurance contracts, and in June 2018, Treasury published a Proposals Paper outlining its proposed model.<sup>182</sup>

Treasury’s paper summarises the extensive consideration that has been given in recent years – in Australia and overseas – to the question of whether UCT regimes should apply to insurance contracts.<sup>183</sup> I need not repeat here the details of those inquiries or the experiences in comparable overseas jurisdictions. The important point is that this body of work consistently tends in favour of the application of such a regime to insurance contracts. In my view, this is unsurprising. The considerations that render a UCT regime appropriate for other contracts for financial products and services apply equally to insurance contracts. None of the matters raised against the extension of the regime suggests to me that contracts regulated by the Insurance Contracts Act should stand apart from UCT provisions. It appears that the submissions received by Treasury in response to its

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<sup>180</sup> Treasury, UCT Proposals Paper, June 2018, 1, 4.

<sup>181</sup> Treasury, UCT Proposals Paper, June 2018, 4.

<sup>182</sup> Treasury, UCT Proposals Paper, June 2018, 1.

<sup>183</sup> Treasury, UCT Proposals Paper, June 2018, 7–10.

paper tend in a similar direction,<sup>184</sup> as did the submissions received by the Commission.<sup>185</sup>

The model proposed by Treasury would apply (with some modification) the existing UCT provisions of the ASIC Act to contracts regulated by the Insurance Contracts Act.<sup>186</sup> The proposal has two key elements.<sup>187</sup> The first is the amendment of section 15 of the Insurance Contracts Act. Treasury proposes that section 15 be amended to permit the ASIC Act UCT regime to apply to insurance contracts regulated by the Insurance Contracts Act.<sup>188</sup>

The second key element is tailoring the UCT provisions in the ASIC Act to contracts of insurance, to accommodate some specific features of those contracts.<sup>189</sup> Treasury has proposed that this tailoring should include the following:<sup>190</sup>

- defining the ‘main subject matter’ of an insurance contract narrowly, to encompass terms that describe what is being insured (for example, a house, a person or a car);
- clarifying that the ‘upfront price’ of the contract includes the premium and the excess payable, and that these matters will not be subject to review;

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<sup>184</sup> Treasury, Module 6 Policy Submission, 7 [33].

<sup>185</sup> See, eg, Professors Allan Fels AO and David Cousins AM, Module 6 Policy Submission, 3, 9–10; AMP, Module 6 Policy Submission, 19 [92]–[93]; ANZ, Module 6 Policy Submission, 17–18 [76]–[79]; APRA, Module 6 Policy Submission, 6–7 [20]–[21]; ASIC, Module 6 Policy Submission, 36–7 [152]–[156]; CHOICE, Module 6 Policy Submission, 12; CALC, Module 6 Policy Submission, 31–2 [117]–[120]; FRLC, Module 6 Policy Submission, 29–30; FSC, Module 6 Policy Submission, 24–5; ICA, Module 6 Policy Submission, 21–4; Legal Aid NSW, Module 6 Policy Submission, 9–10; PIAC, Module 6 Policy Submission, 10; Westpac, Module 6 Policy Submission, 32–4 [106]–[108]. See also ACCC, Northern Australia Insurance Inquiry: First Interim Report, November 2018, x (Recommendation 6), 151.

<sup>186</sup> Treasury, UCT Proposals Paper, June 2018, 2.

<sup>187</sup> Treasury, UCT Proposals Paper, June 2018, 1.

<sup>188</sup> Treasury, UCT Proposals Paper, June 2018, 1–2.

<sup>189</sup> Treasury, UCT Proposals Paper, June 2018, 2.

<sup>190</sup> Treasury, UCT Proposals Paper, June 2018, 2.

- making clear that when assessing whether a term is unfair, ‘a term will be reasonably necessary to protect the legitimate interests of an insurer if it reasonably reflects the underwriting risk accepted by the insurer in relation to the contract and it does not disproportionately or unreasonably disadvantage the insured’; and
- expanding the range of remedial options that flow from a term being found to be unfair (so that the court may make orders other than the term being void).

Treasury’s submissions in response to the Commission’s policy questions following the sixth round of hearings indicate that Treasury is continuing to consider the key features of the model.<sup>191</sup> Treasury identified four ‘key issues regarding policy design’ on which I consider it appropriate to express my views.<sup>192</sup>

The first is whether the UCT regime should be located in the ASIC Act or the Insurance Contracts Act. I support Treasury’s suggestion in its Proposals Paper that the regime should be located in the ASIC Act.<sup>193</sup> As Treasury notes, there is evident benefit in having all provisions governing UCT in respect of financial products and services ‘located in a single piece of legislation’.<sup>194</sup>

The second issue is the way in which the ‘main subject matter’ of a contract is framed.<sup>195</sup> The ASIC Act does not presently include a definition of the ‘main subject matter’ of a contract.<sup>196</sup> Most submissions to Treasury supported introducing a statutory definition, although views differed on what definition was appropriate.<sup>197</sup> Consumer groups appeared to favour the narrow definition proposed by Treasury, which, as noted above, would

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<sup>191</sup> Treasury, Module 6 Policy Submission, 7 [34]–[35].

<sup>192</sup> Treasury, Module 6 Policy Submission, 7 [34]. See also Treasury, UCT Proposals Paper, June 2018, 12.

<sup>193</sup> Treasury, UCT Proposals Paper, June 2018, 11–12.

<sup>194</sup> Treasury, Module 6 Policy Submission, 7 [34].

<sup>195</sup> Treasury, Module 6 Policy Submission, 7 [34].

<sup>196</sup> Treasury, UCT Proposals Paper, June 2018, 14.

<sup>197</sup> Treasury, Module 6 Policy Submission, 7 [34].

include only terms that describe what is being insured.<sup>198</sup> Industry groups favoured a broader definition, which would include within the ‘main subject matter of the contract’ terms that ‘clearly define or circumscribe the insured risk and the insurer’s liability’.<sup>199</sup> In my view, the former approach is preferable. The purpose of extending the UCT regime to insurance contracts would be undermined if the broader definition endorsed by industry were adopted.

The third issue is said to be some uncertainty about how the UCT regime is to interact with the duty of utmost good faith contained in section 13 of the Insurance Contracts Act.<sup>200</sup> I endorse Treasury’s suggestion that the two obligations should operate independently of each other.<sup>201</sup>

The fourth and final issue is whether a 12 month transition period is adequate.<sup>202</sup> I offer no concluded view beyond saying that it is desirable not to delay their introduction or their coming into effect beyond what is reasonable.

When these reforms are implemented, I expect that they may have a material impact on some standard form insurance contracts. Taking just one example from the AAI case study relating to AAMI’s Complete Replacement Cover home insurance policy, I expect attention to be given to the application of the provisions to contractual terms like the second term in AAMI’s Supplementary Product Disclosure Statement, which provided:<sup>203</sup>

If we decide to pay you what it would cost us to rebuild or repair ... we will pay you ... the amount that we determine to be the reasonable cost of repairing or rebuilding. *The amount that we determine to be the reasonable cost will be the lesser amount of any quotes obtained by us and/or by you for the rebuild or repair. Discounts may be available to us if we were to rebuild or repair.*

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<sup>198</sup> Treasury, Module 6 Policy Submission, 7 [34]; Treasury, UCT Proposals Paper, June 2018, 2.

<sup>199</sup> Treasury, Module 6 Policy Submission, 7 [34].

<sup>200</sup> Treasury, Module 6 Policy Submission, 7 [34].

<sup>201</sup> Treasury, Module 6 Policy Submission, 7 [34].

<sup>202</sup> Treasury, Module 6 Policy Submission, 7 [34].

<sup>203</sup> Exhibit 6.369, Witness statement of Gary Dransfield, 24 June 2018, Exhibit GCD-4 (Tab 2) [SUN.0760.0200.0033] (emphasis added).

As Treasury indicated, ‘terms that permit an insurer to pay a claim based on the cost of repair or replacement that may be achieved by the insurer, but could not be reasonably achieved by the policyholder’, are terms that may be unfair.<sup>204</sup>

#### **Recommendation 4.7 – Application of unfair contract terms provisions to insurance contracts**

The unfair contract terms provisions now set out in the ASIC Act should apply to insurance contracts regulated by the Insurance Contracts Act. The provisions should be amended to provide a definition of the ‘main subject matter’ of an insurance contract as the terms of the contract that describe what is being insured.

The duty of utmost good faith contained in section 13 of the Insurance Contracts Act should operate independently of the unfair contract terms provisions.

## **4.4 Claims handling**

The handling and settlement of insurance claims, or potential insurance claims, is now carved out from the definition of ‘financial service’ by regulation 7.1.33 of the Corporations Regulations.<sup>205</sup> As a result, some of the general obligations set out in section 912A of the Corporations Act, including in particular the obligation to do all things necessary to ensure that financial services are provided efficiently, honestly and fairly, do not govern the ways in which insurers:<sup>206</sup>

- make a decision about a claim, including investigating claims and interpreting policy provisions;
- conduct negotiations in respect of settlement amounts;
- prepare estimates of loss or damage, or likely repair costs; and
- make recommendations about mitigation of loss.

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<sup>204</sup> Treasury, UCT Proposals Paper, June 2018, 2.

<sup>205</sup> See also Corporations Act s 766A(2).

<sup>206</sup> See also ASIC, Module 6 Policy Submission, 27 [107].

In my view, there is no basis in principle for continuing to exclude claims handling from the definition of ‘financial service’. It is as much the provision of a financial service as any other financial service. And as ASIC rightly said:<sup>207</sup>

For consumers, the intrinsic value of an insurance product lies in the ability to make a successful claim when an insured event occurs.

A number of the case studies examined in the sixth round of hearings demonstrated the need to remove the ‘claims handling’ exemption. In the life insurance context, this was demonstrated by the CommInsure and TAL case studies. In the general insurance context, this was demonstrated by the Youi and AAI case studies, which related to the handling of home insurance claims following natural disasters or severe weather events.

Because of the claims handling exemption, ASIC is limited in the regulatory interventions it can take in this regard.<sup>208</sup> Numerous submissions supported the removal of the claims handling exemption.<sup>209</sup>

There can be no basis in principle or in practice to say that obliging an insurer to handle claims efficiently, honestly and fairly is to impose on the individual insurer, or the industry more generally, a burden it should not bear. If it were to be said that it would place an extra burden of cost on one or more insurers or on the industry generally, the argument would itself be the most powerful demonstration of the need to impose the obligation. The argument can be made only if claims handling is not now conducted efficiently, honestly and fairly. And if that is the case, it should no longer be tolerated by the industry or by the law.

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<sup>207</sup> ASIC, Module 6 Policy Submission, 27 [110]; see also CALC, Module 6 Policy Submission, 24 [81].

<sup>208</sup> ASIC, Module 6 Policy Submission, 27 [110]; see also CALC, Module 6 Policy Submission, 24 [81].

<sup>209</sup> See, eg, Professors Allan Fels AO and David Cousins AM, Module 6 Policy Submission, 8–9; AFA, Module 6 Policy Submission, 15; AIST, Module 6 Policy Submission, 11–12 [17]; APRA, Module 6 Policy Submission, 7 [24]; CALC, Module 6 Policy Submission, 24 [79]–[82]; FPA, Module 6 Policy Submission, 12 [17]; FRLC, Module 6 Policy Submission, 18–19; FSU, Module 6 Policy Submission, 7 [55]–[56]; ISA, Module 6 Policy Submission, 3 [8]; Legal Aid NSW, Module 6 Policy Submission, 5.

I recommend that the Corporations Regulations be amended, so that the handling or settlement of insurance claims, or potential insurance claims, is no longer excluded from the definition of ‘financial service’. I recognise that the Government has commissioned Treasury to undertake work on this issue, and that Treasury is currently considering the preferable way forward.<sup>210</sup> No doubt the views I have expressed will be considered.

#### **Recommendation 4.8 – Removal of claims handling exemption**

The handling and settlement of insurance claims, or potential insurance claims, should no longer be excluded from the definition of ‘financial service’.

### **4.5 Status of Industry Codes**

As I explained in the Introduction to this Report and in the chapter on banking, I consider it important that some provisions of industry codes be picked up and applied as law, so that breaches of those provisions will constitute a breach of the law. In the insurance context, the provisions to be picked up and applied are those that govern the terms of the contract made or to be made between the insurer and the policyholder.

I have explained my reasons for this conclusion earlier in this Report, in both the Introduction and the chapter on banking. I will not repeat those reasons here beyond noting that, as Treasury has recognised, self-regulation through an industry code carries with it a number of limitations and difficulties, including that:<sup>211</sup>

- the standards set may not be adequate;
- not all industry participants may subscribe to, and be bound by, the code;
- monitoring and enforcement of compliance with the code may be inadequate; and

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<sup>210</sup> Treasury, Module 6 Policy Submission, 8 [38], [40].

<sup>211</sup> Treasury, Interim Report Submission, 9–10 [58].

- consequences for breach of the code may not be enough to make industry participants correct and prevent systemic failures in its application.

As in the context of banking, I would add one further point. The range and diversity of code obligations, and some developments at common law,<sup>212</sup> may have contributed to there being some uncertainty about which provisions of industry codes may be relied upon, and enforced by, individuals. Uncertainty of this kind is highly undesirable. Participants in the financial services industry must know what rules govern their dealings.

To that end, I have recommended that the law<sup>213</sup> should be amended to provide that breach of an enforceable code provision will constitute a breach of the Act. The law should also be amended to provide for remedies that may follow from such a breach. Those remedies should be modelled on those now set out in Part VI of the *Competition and Consumer Act 2010* (Cth) (the Competition and Consumer Act).

As I explained in the chapter on banking, I anticipate that the process of identifying and rendering enforceable these code provisions will proceed in four steps:

- Industry should identify the provisions that it says govern the terms of the contract made or to be made between the financial services entity and the customer or guarantor.
- Industry should seek ASIC's approval of those provisions. If industry does not put forward its proposed enforceable code provisions in a timely manner, consideration will need to be given to whether a mandatory industry code should be established, using a similar process to that which currently exists under the Competition and Consumer Act.<sup>214</sup>

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<sup>212</sup> *Brighton v Australia and New Zealand Banking Group Ltd* [2011] NSWCA 152; *Doggett v Commonwealth Bank of Australia* (2015) 47 VR 302.

<sup>213</sup> The Corporations Act may be the preferable option, given that it already contains ASIC's code approval power: see s 1101A.

<sup>214</sup> See Competition and Consumer Act s 51AE, and more generally Treasury, *Industry Codes of Conduct: Policy Framework*, November 2017, 14–15.

- ASIC should review the provisions put forward by industry. ASIC's role must go beyond being the passive recipient of industry proposals. Rather, ASIC should assess whether industry has appropriately identified, from the provisions contained in the code, those provisions that should be made enforceable. ASIC should also assess whether those provisions are expressed clearly and unambiguously, so as to be capable of enforcement.
- Once ASIC has approved the enforceable code provisions, they will be enforceable by statute. Those to whom the promises are made will be able to elect whether to enforce any breaches of those provisions through existing internal dispute resolution (IDR) or EDR mechanisms or through the courts. Use of IDR mechanisms would not constitute any election about future action, but use of EDR mechanisms will be treated as an election not to pursue court action unless good cause is shown to the contrary.

I explained each of those steps in some detail in the chapter on banking. However, I should say something more about the first and second steps here because of some particular features of the insurance codes.

The first and second steps require industry to identify the enforceable code provisions and to seek ASIC's approval of those provisions. The three insurance codes are still being developed. They are not at the same stage of maturity (or particular specificity) as the 2019 Banking Code.

As I have explained, the Life Insurance Code of Practice became binding on FSC members on 30 June 2017.<sup>215</sup> On 12 November 2018, the FSC released a further draft version of the Code for public consultation.<sup>216</sup> The draft explicitly identifies numerous areas 'where the content is new or where the policy intent has changed'.<sup>217</sup> These include, but are not limited to, issues relating to policy design and disclosure, sales practices and advertising, the use of health (including genetic) information and family

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<sup>215</sup> Exhibit 6.409, Witness statement of Sally Loane, 30 August 2018, 14 [9.1]; Background Paper No 29, 15 [5.4].

<sup>216</sup> FSC, *FSC Life Insurance Draft Code of Practice 2.0* (5 December 2018) FSC <[www.fsc.org.au/event-list/website-events/Code-Roadshow/](http://www.fsc.org.au/event-list/website-events/Code-Roadshow/)>.

<sup>217</sup> FSC, *Consultation Draft: Life Insurance Code of Practice* (5 December 2018) FSC <[www.fsc.org.au/event-list/website-events/Code-Roadshow/](http://www.fsc.org.au/event-list/website-events/Code-Roadshow/)>, 1.

medical history, policy cancellation, claims handling, and the obligations of superannuation trustees.<sup>218</sup> The next iteration of the Code may be significantly different from the present version.

I have also noted that the Insurance in Superannuation Voluntary Code of Practice was introduced on 1 July 2018.<sup>219</sup> Superannuation fund trustees who have chosen to adopt the Code agree to comply with the Code as early as they can, and by no later than 30 June 2021.<sup>220</sup> It appears that the FSC is presently contemplating incorporating the Insurance in Superannuation Voluntary Code of Practice into the next version of the Life Insurance Code of Practice.<sup>221</sup>

At the time of the sixth round of hearings, the ICA was in the process of reviewing the General Insurance Code of Practice, with the intention of releasing a new version of that Code in 2019.<sup>222</sup>

Taken together, these points lead me to conclude that it is undesirable to require the insurance industry to seek to identify now (and give to ASIC) the provisions that it sees as being proposed enforceable code provisions. Instead, I recommend that in respect of the three insurance codes, the FSC, the ICA and ASIC take all necessary steps, by 30 June 2021, to have the provisions of those codes that govern the terms of the contract made or to be made between the insurer and the policyholder designated as 'enforceable code provisions'. The process will most likely occur in conjunction with the Insurance in Superannuation Voluntary Code of Practice becoming mandatory.

In the chapter on banking, I made two broader points about industry codes. I need to say something about each of those points here.

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<sup>218</sup> FSC, *Consultation Draft: Life Insurance Code of Practice* (5 December 2018) FSC <[www.fsc.org.au/event-list/website-events/Code-Roadshow/](http://www.fsc.org.au/event-list/website-events/Code-Roadshow/)>, 9–11 [3.5A]–[3.6B]; 12–16 [4.1]–[4.3A], [4.11]; 17–19 [5.2A]–[5.5]; 23 [6.6A]; 25–31 [8.2]–[8.18]; 41–2 [13.9] and 43–4 [13.22]–[13.23].

<sup>219</sup> FSC, *Insurance in Super Working Group* (5 December 2018) FSC <[www.fsc.org.au/policy/life-insurance/insurance-in-superannuation-working-group-iswg/](http://www.fsc.org.au/policy/life-insurance/insurance-in-superannuation-working-group-iswg/)>.

<sup>220</sup> Insurance in Superannuation Voluntary Code of Practice s 3.6.

<sup>221</sup> FSC, *Consultation Draft: Life Insurance Code of Practice* (5 December 2018) FSC <[www.fsc.org.au/event-list/website-events/Code-Roadshow/](http://www.fsc.org.au/event-list/website-events/Code-Roadshow/)>, 2, Ch 2.

<sup>222</sup> Exhibit 6.404, Witness statement of Robert Whelan, 27 August 2018, 11 [73]; see also Transcript, Robert Whelan, 21 September 2018, 6398.

The first is that by creating a system of enforceable code provisions, I do not intend to modify or limit ASIC's existing, and more general, power under section 1101A of the Corporations Act to approve industry codes. As I have said, industry should continue to be given the option to seek general ASIC approval of its codes. To that end, I have recommended that the law be amended to provide that:

- ASIC's power to approve codes of conduct (relevantly) extends to codes relating to all APRA-regulated institutions, including insurers; and
- industry codes of conduct approved by ASIC may include 'enforceable code provisions', which are provisions in respect of which a contravention will constitute a breach of the law.

More broadly, I do not wish to interfere with the continued development of industry codes. The witness statements tendered in the sixth round of hearings indicated that the Life Insurance Code of Practice has played an important role in addressing previously problematic behaviours within that industry. The two clearest examples related to reducing the use of surveillance of claimants<sup>223</sup> and reducing the use of outdated medical definitions.<sup>224</sup> I consider it important that industry continue to identify opportunities for improvement. It is equally important for industry to commit, in its codes, to making those improvements.

The second point relates to the basic structure of IDR and EDR under the codes. In the chapter on banking, I said that subject to one caveat, I did not consider that any amendment was required to that structure.

The caveat I make in the context of insurance relates to the sanctions powers given to the Code Governance Committee in respect of general insurance, and to the Life Code Compliance Committee in respect of life insurance.

The Commission received a statement from the Chairperson of the Code Governance Committee.<sup>225</sup> In that statement, the Chairperson said that

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<sup>223</sup> Transcript, Senior Counsel Assisting, 14 September 2018, 5787–8.

<sup>224</sup> See, eg, Transcript, Senior Counsel Assisting, 13 September 2018, 5655–7.

<sup>225</sup> Exhibit 6.401, Witness statement of Lynelle Briggs, 14 September 2018.

since 1 July 2014, the Committee had determined that there had been breaches of the Code on 33 occasions.<sup>226</sup> Code subscribers had conceded breaches of the Code in the course of an investigation on a further 689 occasions,<sup>227</sup> and had self-reported over 13,000 breaches of the Code.<sup>228</sup> Despite this, the Code Governance Committee had never exercised its powers to impose sanctions in response to those breaches.<sup>229</sup> Nor had the equivalent power been exercised by the Life Code Compliance Committee since its formation on 1 July 2017.<sup>230</sup>

The evidence indicated that the power to impose sanctions had not been exercised because the Committees could only impose sanctions where an insurer had failed to *correct* a Code breach.<sup>231</sup> Sanctions could not be imposed in response to a *breach* of the Code, in and of itself.

In my view, the sanctions power in the General and Life Insurance Codes of Practice should not be limited in this way.<sup>232</sup> Rather, the FSC and the ICA should amend section 13.10 of the Life Insurance Code of Practice and section 13.11 of the General Insurance Code of Practice to empower (as the case requires) the Life Code Compliance Committee or the Code Governance Committee to impose sanctions on a subscriber that has breached the applicable Code. When considering whether to impose sanctions following a breach, the Committees should continue to be guided by the matters referred to in section 13.14 of the General Insurance Code of Practice and section 13.13 of the Life Insurance Code of Practice.

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<sup>226</sup> Exhibit 6.401, Witness statement of Lynelle Briggs, 14 September 2018, 4 (Question 1(c)).

<sup>227</sup> Exhibit 6.401, Witness statement of Lynelle Briggs, 14 September 2018, 4 (Question 1(f)).

<sup>228</sup> Exhibit 6.401, Witness statement of Lynelle Briggs, 14 September 2018, 7 (Question 1(j)).

<sup>229</sup> Exhibit 6.401, Witness statement of Lynelle Briggs, 14 September 2018, 32 [180].

<sup>230</sup> Exhibit 6.402, Witness statement of Anne Brown, 28 August 2018, 2 [8].

<sup>231</sup> In the general insurance context, see Exhibit 6.401, Witness statement of Lynelle Briggs, 14 September 2018, 32 [182]; General Insurance Code of Practice s 13.11. In the life insurance context, see Exhibit 6.402, Witness statement of Anne Brown, 28 August 2018, 1–2 [6]–[8]; Life Insurance Code of Practice s 13.10.

<sup>232</sup> General Insurance Code of Practice s 13.11; Life Insurance Code of Practice s 13.10.

#### **Recommendation 4.9 – Enforceable code provisions**

As referred to in Recommendation 1.15, the law should be amended to provide for enforceable provisions of industry codes and for the establishment and imposition of mandatory industry codes.

In respect of the Life Insurance Code of Practice, the Insurance in Superannuation Voluntary Code and the General Insurance Code of Practice, the Financial Services Council, the Insurance Council of Australia and ASIC should take all necessary steps, by 30 June 2021, to have the provisions of those codes that govern the terms of the contract made or to be made between the insurer and the policyholder designated as ‘enforceable code provisions’.

#### **Recommendation 4.10 – Extension of the sanctions power**

The Financial Services Council and the Insurance Council of Australia should amend section 13.10 of the Life Insurance Code of Practice and section 13.11 of the General Insurance Code of Practice to empower (as the case requires) the Life Code Compliance Committee or the Code Governance Committee to impose sanctions on a subscriber that has breached the applicable Code.

## **4.6 External dispute resolution**

A number of case studies examined in the sixth round of hearings involved problematic dealings between an insurer and the EDR body: previously FOS, now AFCA (the Australian Financial Complaints Authority). These included the CommInsure, TAL and AAI (Hunter Valley Storm) case studies.

Two policy questions, asked after the sixth round of hearings, were whether the duty of utmost good faith in section 13 of the Insurance Contracts Act *does* apply to the way that an insurer interacts with an EDR body, and whether it *should* apply. The Commission received a range of responses. The thrust of many of those responses was that it was appropriate for insurers to be subject to some form of duty when interacting with the EDR

body.<sup>233</sup> I agree. The issue then becomes what duty and where should the duty be recorded.

I consider it preferable for this duty to sit alongside a pre-existing related duty in section 912A(1)(g) of the Corporations Act. That relevantly provides that an AFSL holder must:

if ... financial services are provided to persons as retail clients:

(i) have a dispute resolution system complying with subsection (2) ...

Subsection (2) of section 912A specifies that an AFSL holder's dispute resolution system must consist of both an IDR procedure that meets certain standards, as well as 'membership of the AFCA scheme'.<sup>234</sup>

As they presently stand, sub-sections 912A(1)(g) and (2) mandate the form of AFSL holders' IDR and EDR systems, but they do not impose any conduct-related obligations on AFSL holders when providing or using those systems. I consider this to be an important omission. There is little benefit in mandating the existence of systems if there is no obligation to comply with those systems. As a result, I recommend that section 912A be amended to require that AFSL holders take reasonable steps to co-operate with AFCA in its resolution of particular disputes including, in particular, by making available to AFCA all relevant documents and records relating to the issues in dispute.

This proposal would address issues broader than those that were observed in the CommInsure, TAL and AAI (Hunter Valley storm) case studies, but I do not see any difficulty with this. There is no reason in principle to confine the class of affected entities to insurers (rather than all AFSL holders). The proposal will serve to give statutory force to the promises that AFSL holders have made to the EDR body, and will allow ASIC to take action if those promises are not kept.

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<sup>233</sup> See, eg, AFA, Module 6 Policy Submission, 19; AIST, Module 6 Policy Submission, 20 [30]; ALA, Module 6 Policy Submission, 32 [92]; ASIC, Module 6 Policy Submission, 37–8 [157]–[159]; CALC, Module 6 Policy Submission, 32–3 [121]–[124]; FRLC, Module 6 Policy Submission, 30; Legal Aid NSW, Module 6 Policy Submission, 10; Slater + Gordon Lawyers, Module 6 Policy Submission, 21 [89].

<sup>234</sup> Corporations Act s 912A(2)(c).

#### **Recommendation 4.11 – Co-operation with AFCA**

Section 912A of the Corporations Act should be amended to require that AFSL holders take reasonable steps to co-operate with AFCA in its resolution of particular disputes, including, in particular, by making available to AFCA all relevant documents and records relating to issues in dispute.

## **4.7 Accountability**

As I explain in the chapter relating to the regulators, I consider that provisions modelled on the **Banking Executive Accountability Regime** (BEAR) should be expanded to all APRA-regulated financial services institutions. I also explain in that chapter why I consider it to be appropriate to adopt a sequential approach to the extended application of these provisions. After these provisions have been applied to the balance of the **authorised deposit-taking institutions**, and to **registrable superannuation entity** (RSE) licensees, they should be applied to the largest insurers and, thereafter, the balance of insurers.

#### **Recommendation 4.12 – Accountability regime**

Over time, provisions modelled on the BEAR should be extended to all APRA-regulated insurers, as referred to in Recommendation 6.8.

## **5 Group life insurance**

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As I explained in the introduction to this chapter, an important feature of the life insurance market is that life cover, total and permanent disability cover, income protection cover and trauma cover are available not only through individual policies but also through group arrangements.

Most life insurance policies in Australia are held within superannuation funds.<sup>235</sup> In its report, *Superannuation: Assessing Efficiency and Competitiveness*, the Productivity Commission said that about 12 million Australians have one or more forms of life insurance through their superannuation.<sup>236</sup> That may be compared with the individual life insurance market. ASIC Report 498, *Life Insurance Claims, An Industry Review*, said that in 2015, there were 4 million retail policies and 3.9 million direct or non-advised policies.<sup>237</sup> In 2016/2017, Australians paid a total of \$9 billion in group life premiums.<sup>238</sup>

Notwithstanding the prevalence of group life policies, consumers' awareness of the content, or even existence, of their policy is relatively low. The Productivity Commission's Draft Report stated that about a quarter of superannuation fund members do not know whether they have a policy.<sup>239</sup>

## 5.1 The structure of group life insurance

Group life insurance involves a policy owner – commonly an employer or superannuation trustee – holding a policy on behalf of a defined group of individuals.

Under an employer group scheme, an employee's life is insured. The employer is the policy owner and can be the agent of the life insured for the purposes of the insurance.<sup>240</sup>

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<sup>235</sup> Peter Kell, 'Insurance in Super: The Regulators – What Do They Think?' (Speech delivered at the Association of Superannuation Funds of Australia Spotlight on Insurance, Sydney, Australia, 27 February 2018).

<sup>236</sup> Productivity Commission, Report 91, *Superannuation: Assessing Efficiency and Competitiveness*, 21 December 2018, 365.

<sup>237</sup> Background Paper No 28, 1–2 [1.3] citing ASIC, Report 498, 12 October 2016, 35.

<sup>238</sup> Productivity Commission, Report 91, *Superannuation: Assessing Efficiency and Competitiveness*, 21 December 2018, 365.

<sup>239</sup> Productivity Commission, Report 91, *Superannuation: Assessing Efficiency and Competitiveness*, 21 December 2018, 365.

<sup>240</sup> Background Paper No 28, 2 [2.2]. See also the definition of 'group life contract' in Insurance Contracts Act ss 11(1), 32, on misrepresentation and non-disclosure in that context.

Superannuation fund schemes are structured on the basis that the life insured is a member and beneficiary of the trust fund and the policy owner is the trustee of the fund.<sup>241</sup>

In both schemes, it is the employer or trustee, as the policy owner, and not the life insured, who enters into the contract, is obliged to pay the premium, has standing to claim and is entitled to receive the benefit amounts paid by the life insurer.<sup>242</sup>

## 5.2 MySuper

Section 68AA of the *Superannuation Industry (Supervision) Act 1993* (Cth) (the SIS Act) requires each trustee<sup>243</sup> authorised to offer a **MySuper product** to provide MySuper members with a permanent incapacity benefit and a death benefit by way of life insurance.<sup>244</sup> These benefits must be provided unless the member opts out of either or both of the insurances.<sup>245</sup> A failure to provide the benefits is a breach of an RSE licence condition.<sup>246</sup>

Section 68AA was inserted to protect members against the risk of not being able to accumulate a sufficient amount of retirement savings (for themselves or their dependants) as a result of being unable to work because of injury, illness or death.<sup>247</sup> Section 68AA was a way of setting minimum levels of default life insurance and total and permanent disability insurance.<sup>248</sup>

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<sup>241</sup> Background Paper No 28, 2 [2.3]. See also the references to 'superannuation or retirement scheme' in Insurance Contracts Act ss 23, 26, 48A. This description, from *Sutton on Insurance Law*, was cited with approval in *Montclare v Metlife Insurance Ltd* [2015] VSC 306, 18 [61].

<sup>242</sup> Background Paper No 28, 2–3 [2.4]; *Erzurumlu v Kellogg Superannuation Pty Ltd* [2013] NSWSC 1115, 22–3 [52]–[55].

<sup>243</sup> Being each trustee of a regulated superannuation fund. See SIS Act s 19 for the definition of 'regulated superannuation fund'.

<sup>244</sup> SIS Act s 68AA(1).

<sup>245</sup> SIS Act s 68AA(5).

<sup>246</sup> SIS Act s 29E(1)(a).

<sup>247</sup> Explanatory Memorandum, Superannuation Legislation Amendment (Further MySuper and Transparency Measures) Bill 2012 (Cth) 23 [2.3].

<sup>248</sup> Explanatory Memorandum, Superannuation Legislation Amendment (Further MySuper and Transparency Measures) Bill 2012 (Cth) 23 [2.4].

As with all policies of insurance, group life policies are contractual arrangements that hinge, first and foremost, on the terms agreed between the parties. Those terms, and their operation, may also be affected by relevant legislation including the Insurance Contracts Act. But the ordinary operation of the policy as between insurer and insured will turn most significantly on the coverage provided by the terms of the contract, including any key definitions of, and exclusions to, that coverage.

There are particular requirements relevant to the insurance that must be offered to MySuper members under section 68AA of the SIS Act. I describe these below. Importantly, none prescribes any particular forms of key definitions, terms or exclusions.

The first requirement concerns minimum levels of cover for death benefits offered through a MySuper product. The minimum level of coverage varies depending on the member's age:<sup>249</sup>

- if the person is aged from 20 to 34 years – \$50,000;
- if the person is aged from 35 to 39 years – \$35,000;
- if the person is aged from 40 to 44 years – \$20,000;
- if the person is aged from 45 to 49 years – \$14,000; and
- if the person is aged from 50 to 55 years – \$7,000.

The second requirement concerns the minimum cost of that cover. Both are set by the Superannuation Guarantee (Administration) Regulations 2018 (Cth).<sup>250</sup> The minimum premium is \$0.50 per week, or the equivalent, for a person who is under 56 years of age.

The third requirement relates to the conditions for the release of benefits.<sup>251</sup> These include retirement, death, terminal medical condition and permanent incapacity.<sup>252</sup>

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<sup>249</sup> Superannuation Guarantee (Administration) Regulations 2018 (Cth) reg 14(5).

<sup>250</sup> Superannuation Guarantee (Administration) Regulations 2018 (Cth) reg 14(1).  
See also *Superannuation Guarantee (Administration) Act 1992* (Cth) s 32C(2)(d).

<sup>251</sup> Superannuation Industry (Supervision) Regulations 1994 (Cth) reg 4.07D, Sched 1.

<sup>252</sup> Superannuation Industry (Supervision) Regulations 1994 (Cth) Sched 1 Items 101–103.

The minimum level of cover, minimum cost of that cover and the prescribed conditions of release comprise the irreducible core minimum of a MySuper group life policy for death insurance. Aside from conditions of release, there are no mandatory or proscribed terms for default group life policies.

### **5.2.1 Standardising MySuper insurance**

Key definitions, terms and exclusion clauses are central to the rights of an insured under a policy of insurance. They are the machinery that, when triggered, will require payment to be made by an insurer to an insured. The amount of cover offered under a policy is evidently an important aspect of cover. But it is only one aspect. Alone, the amount of cover offered says nothing about the insured's rights to claim under the policy, or about the value of one policy compared with other policies.

Insurance contracts can often be difficult for the average consumer to navigate and understand. And subtle differences in definitions, terms and exclusions from one policy to another can make the task of comparing policies particularly challenging.

In many cases, default members will not have made any active choice about the fund they have joined or considered the insurance offered through that product. Often a member will join the default fund chosen by their employer.

Even when a member chooses the fund or product, the choice will almost always be made without advice. It will be for the member alone to form a view about the merits or demerits of the product, and the insurance offered through it. But members are not always able to identify how key terms, definitions and exclusions will affect their coverage under their policy.<sup>253</sup> And whatever consideration a member gives to these issues will be given in the course of considering the broader benefits of a superannuation fund.

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<sup>253</sup> See, eg, ASIC, Module 6 Policy Submission, 31 [133].

ASIC Report 591 noted the difficulties that consumers face when comparing definitions in policies such as the definition of total and permanent disability. ASIC considered there was scope for improvement in this regard, including by the use of standardised definitions in policies.<sup>254</sup>

Because life insurance within MySuper is default insurance, and because the value of a policy turns so heavily on key definitions, terms and exclusions, there is merit in considering the extent to which insurance within MySuper funds can be standardised, or at least standardised in key respects.

The Insurance in Superannuation Voluntary Code of Practice is a step in that direction.<sup>255</sup> But it is not a mandatory code. Its effect will not be uniform, and it is not enforceable. To achieve a consistent result, standardisation should be effected by or under the relevant legislation. Only then will it apply across the industry.

Changes to key terms, definitions or exclusions will affect when an insured can claim under the policy. Changes will almost certainly affect the cost of insurance premiums, and will affect how much superannuation the member will have at retirement.<sup>256</sup> Hence, the adoption of standardised terms should be carefully considered, and the consequences of change identified, before they are implemented.

I recommend that Treasury, in consultation with industry, determine the practicability, and likely pricing effects, of legislating universal key definitions, terms and exclusions for default MySuper group life policies.

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<sup>254</sup> ASIC, Report 591, 7 September 2018, 20; see also ASIC, Module 6 Policy Submission, 31 [132].

<sup>255</sup> See also ASIC, Module 6 Policy Submission, 32 [134].

<sup>256</sup> See Treasury, Module 6 Policy Submission, 13 [67].

**That review should also consider:**

- **the merits of prescribing higher minimum coverage for life insurance than is currently provided for by the Superannuation Guarantee (Administration) Regulations;**
- **the merits of prescribing minimum coverage for permanent incapacity insurance;**
- **the merits of prescribing maximum coverage for life and/or permanent incapacity insurance; and**
- **the merits of prescribing a fixed level of coverage for life and/or permanent incapacity insurance so as to set a standard amount of default insurance across all MySuper products.**

#### **Recommendation 4.13 – Universal terms review**

Treasury, in consultation with industry, should determine the practicability, and likely pricing effects, of legislating universal key definitions, terms and exclusions for default MySuper group life policies.

## **5.3 Associated entities**

### **5.3.1 Trustee obligations for insurance**

Trustees of superannuation funds are currently subject to certain obligations under the SIS Act and the Prudential Standards relevant to insurance.

For example, the trustee of a superannuation fund covenants to do the following things in respect of insurance offered through the fund:<sup>257</sup>

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<sup>257</sup> SIS Act s 52(7).

- to formulate, review regularly and give effect to an insurance strategy for the benefit of beneficiaries of the fund. This strategy addresses the kinds and levels of insurance to be offered or acquired on behalf of beneficiaries, as well as the basis for the decision to offer or acquire the insurance and the method by which the insurer is to be determined;<sup>258</sup>
- to consider the costs to all beneficiaries of offering or acquiring insurance of a particular kind or at a particular level;<sup>259</sup>
- to offer or acquire insurance of a particular kind or at a particular level only if the cost of the insurance does not inappropriately erode beneficiaries' retirement income;<sup>260</sup> and
- to do everything that is reasonable to pursue an insurance claim for the benefit of a beneficiary, if that claim has a reasonable prospect of success.<sup>261</sup>

The RSE licensee remains bound by its obligations to promote the financial interests of members holding MySuper products,<sup>262</sup> and its general covenants to perform its duties and exercise its powers in the best interests of the beneficiaries,<sup>263</sup> and to act fairly in dealing with beneficiaries within each class of membership,<sup>264</sup> including MySuper.

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<sup>258</sup> SIS Act s 52(7)(a).

<sup>259</sup> SIS Act s 52(7)(b).

<sup>260</sup> SIS Act s 52(7)(c).

<sup>261</sup> SIS Act s 52(7)(d).

<sup>262</sup> SIS Act s 29VN(a).

<sup>263</sup> SIS Act s 52(2)(d).

<sup>264</sup> SIS Act s 52(2)(e).

APRA has issued Prudential Standard SPS 250: Insurance in Superannuation (SPS 250), which has the force of law.<sup>265</sup>

SPS 250 imposes various requirements on superannuation trustees. These include to have: an ‘insurance management framework’;<sup>266</sup> an ‘insurance strategy’;<sup>267</sup> and a process for monitoring and selecting the insurance provided.<sup>268</sup>

SPS 250 also imposes requirements on trustees about the selection and monitoring of insurers. It provides that:

22. An RSE licensee must:

- (a) develop and implement a selection process for choosing an insurer that includes, at a minimum, consideration of the prospective insurer’s terms of cover and exclusions, claims philosophy, the reasonableness of the premiums to be charged and terms of any delegation to any other person of functions associated with making available insured benefits;
- (b) undertake a due diligence review of the selected insurer; and
- (c) be able to demonstrate to APRA the appropriateness of the selection process and the due diligence review and how it is applied.

23. An RSE licensee must be able to satisfy itself, and demonstrate to APRA, that the engagement of an insurer is conducted at arm’s length and is in the best interests of beneficiaries.

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<sup>265</sup> A breach of a Prudential Standard is a breach of the ‘RSE licensee law’: see par (aa) of the definition of ‘RSE licensee law’ in s 10(1) of the SIS Act. Any breach of the RSE licensee law results in a breach of the conditions of the RSE licensee’s licence (s 29E(1) (a) of the SIS Act). APRA may direct an RSE licensee to comply with a condition of its licence where it has reasonable grounds to believe that the RSE licensee has breached that condition (s 29EB of the SIS Act). APRA may cancel an RSE licensee’s licence where it fails to comply with a direction (s 29G of the SIS Act) and that failure gives rise to an offence (s 29JB of the SIS Act).

<sup>266</sup> APRA, Prudential Standard SPS 250, 15 November 2012, [8]–[16].

<sup>267</sup> APRA, Prudential Standard SPS 250, 15 November 2012, [17].

<sup>268</sup> APRA, Prudential Standard SPS 250, 15 November 2012, [22]–[24].

24. An RSE licensee must ensure it has sufficient and appropriate resources to manage and monitor its relationship with an insurer at all times. At a minimum, the monitoring must include:
- (a) maintaining regular contact with the insurer at an appropriate frequency and level of seniority; and
  - (b) a process for regular monitoring of performance under the insurance arrangement, including reporting to senior management against service levels.

### **5.3.2 Increased requirements for related insurers**

Engaging a related entity as insurer presents particular issues.

The AMP case study in the sixth round of hearings provided an example of an RSE licensee that engaged another entity within the AMP Group (AMP Life) as the group life insurer of many of its funds. AMP Life also acted as the administrator of all of AMP Super's funds, and some of NM Super's funds.<sup>269</sup>

One of AMP Life's responsibilities as administrator of the AMP trustees' funds was to undertake 'assessments of potential insurers', recommend replacement insurance arrangements and assist the trustees to 'negotiate the terms and appointment with the preferred insurer' and to ensure compliance with SPS 250.<sup>270</sup>

When asked about the suitability of AMP Life undertaking tasks connected with the selection of the group life insurer, Mr Paul Sainsbury (a senior executive within AMP) said that there was sufficient separation of roles within AMP Life to satisfy the requirements of SPS 250.<sup>271</sup> Whether or not this is right, it highlights that, where an entity that is required to act in the interests (or best interests) of another elects to engage a related entity to provide services at the expense of those to whom the duty is owed, questions of conflict immediately arise.

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<sup>269</sup> Transcript, Paul Sainsbury, 17 September 2018, 5861.

<sup>270</sup> Exhibit 6.233, Witness statement of Paul Sainsbury, 10 September 2018, 17 [67].

<sup>271</sup> Transcript, Paul Sainsbury, 17 September 2018, 5863.

I have set out elsewhere in this Report my concerns about the conflicts that arise where related parties are engaged. Those concerns have equal force in the context of group life insurance. Entities that elect to integrate their businesses do so, overwhelmingly, for their own reasons. The entity's motivation will usually be to increase market share, to increase revenue, to increase profit, to place commercial pressure on its competitors, or some combination of those factors. That is not to deny that benefits may ultimately flow to consumers from the integrated arrangement. But because the motivation for the integration is, ordinarily, a self-interested one, the congruence of the arrangement with the duty to act in the interests of the other must be closely examined.

The need for assurance of the appropriateness of the arrangements is all the stronger in circumstances where, as with the introduction of MySuper and the requirements for default superannuation, a policy decision has been made that is, by design, protective of the interests of members.

Entities in the position of conflict described above can reasonably, and should, be subjected to a higher degree of regulatory scrutiny. As the number and nature of conflicts increases, so too should the intensity of regulatory supervision.

In the context of group life insurance, RSE licensees who engage related parties as insurers should be required to demonstrate to APRA how they are meeting the expectations of SPS 250. In particular, RSE licensees that engage related parties as insurers should be required to demonstrate that the engagement is at arm's length and is in the best interests of beneficiaries. And because conflicts can arise not only from legal structure but also from contractual arrangements, the same obligation should apply to any RSE licensee that has a contract, arrangement or understanding with a life insurer by which the life insurer is afforded a priority or privilege in connection with the provision of group life insurance to the RSE licensee. I recommend that RSE licensees in the position I have described be required to obtain a report from an appropriately independent and qualified firm certifying that the engagement is in the best interests of members and otherwise satisfies legal and regulatory requirements.

At a minimum, that certification should be obtained before any policy of insurance is entered into and each time any policy is renewed. But because the terms of group life policies are often very long, certification should otherwise be required every two years.

The requirement for independent certification will reinforce to RSE licensees the paramountcy of member's interests and give members comfort that the arrangements are appropriate.

The independent report should also be provided to APRA by the author of the report at the same time as it is provided to the RSE licensee. The contemporaneous provision of the report will allow APRA to form a view more quickly on the appropriateness of the arrangement and to take such action as it thinks necessary, including by referring the matter to ASIC so that it can take action to protect the interests of members.

#### **Recommendation 4.14 – Additional scrutiny for related party engagements**

APRA should amend Prudential Standard SPS 250 to require RSE licensees that engage a related party to provide group life insurance, or who enter into a contract, arrangement or understanding with a life insurer by which the insurer is given a priority or privilege in connection with the provision of life insurance, to obtain and provide to APRA within a fixed time, independent certification that the arrangements and policies entered into are in the best interests of members and otherwise satisfy legal and regulatory requirements.

## **5.4 Statistically appropriate rates**

Default arrangements are those arrangements between an employer and a trustee of a superannuation fund under which the employer agrees to direct contributions paid on behalf of those employees – who make no election about where the employer is to pay their contributions – to a default product in the trustee's fund.

Due to the compulsory nature of superannuation in Australia, default arrangements are a significant feature of Australia's superannuation system. When starting a new job, up to two-thirds of members make no election about where their contributions should be paid, and default to their employer's default fund, and about half the accounts in Australia's superannuation system are in MySuper (or default) products.<sup>272</sup>

The features of the default product offered through an employer's plan will often be different to the standard default product offered by the trustee. For example, sometimes the default product for the employer is 'tailored', in that features such as investment strategies and insurance policies are suited to the circumstances of the employee members. In respect of insurance, the premium costs charged through the employer plan are usually discounted by insurers, or subsidised by employers.<sup>273</sup>

Where members cease employment with the employer, they will cease to be part of the employer plan. On this happening, the member will be transferred from the employer plan to a personal plan and be subject to the terms of the standard default product offered by the trustee. These members are often referred to as 'delinked' members.

ASIC Report 591 observed that, on transferring members from an employer plan to a personal plan within the same superannuation fund, some trustees were automatically classifying members as 'smokers' or 'blue-collar workers' unless they received specific information from the member to the contrary.<sup>274</sup> The rates that are charged for members classified in this way are generally at the higher end of the scale of premiums.

Defaulting members to these higher rates does not reflect the likelihood of the member being a smoker or a blue-collar worker. As ASIC noted in Report 591, only around 14.5% of the adult population of Australia are daily smokers, and only around 25% of all workers are engaged in 'blue-collar' work.<sup>275</sup>

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<sup>272</sup> Productivity Commission, Report 91, *Superannuation: Assessing Efficiency and Competitiveness*, 21 December 2018, 104.

<sup>273</sup> See ASIC, Report 591, 7 September 2018, 17.

<sup>274</sup> See ASIC, Report 591, 7 September 2018, 17.

<sup>275</sup> See ASIC, Report 591, 7 September 2018, 17.

In charging members premiums for insurance offered through the fund, trustees are subject to their general covenants under section 52(2) of the SIS Act, including the obligation to act in the member's best interests, and to their insurance related covenants under section 52(7) of the SIS Act, including only to offer or acquire insurance of a particular kind, or at a particular level, if the cost does not inappropriately erode the retirement income of beneficiaries. Both are relevant to the assumptions a trustee may make when charging premiums to a default member.<sup>276</sup>

Where a trustee complies with its covenants under section 52 of the SIS Act, there is no need for any further protections to be put in place to ensure that the rate being charged to default members, where they have given no indication or information to the trustee about their circumstances, is statistically appropriate. But, as ASIC's work shows, default members are vulnerable. There is, therefore, merit in providing some further protection.

Trustees must be required to make proper arrangements about the premiums that will be charged to default members. That can be achieved by APRA amending SPS 250 to require that any status attributed to default members (such as 'blue-collar', 'smoker', or other status affecting the premium to be charged for insurance) is fair and reasonable. Ordinarily that would require consideration of whether the status attributed is statistically appropriate.

#### **Recommendation 4.15 – Status attribution to be fair and reasonable**

APRA should amend Prudential Standard SPS 250 to require RSE licensees to be satisfied that the rules by which a particular status is attributed to a member in connection with insurance are fair and reasonable.

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<sup>276</sup> See, eg, ASIC, Module 6 Policy Submission, 33 [144].

## Conclusion

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Insurance, as a means for spreading risk, brings significant benefits for both individuals and for communities.<sup>277</sup> But some changes should be made to bring the regulation of insurance into line with that of other financial products, and to balance better the rights and obligations of insurers and insureds.

These objectives require a prohibition on hawking, reforms to the sale of add-on insurance, reforms to the disclosure and misrepresentation regime, the removal of the 'claims handling' and 'funeral expenses policies' legislative carve outs, the application of UCT provisions to insurance contracts, statutory consequences for breaching key provisions of industry codes and close scrutiny of group life insurance arrangements.

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<sup>277</sup> Background Paper No 14, 7–9 [1.1]–[1.9].

# 6. Culture, governance and remuneration

## Introduction

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I said in the first chapter of this Report that there can be no doubt 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. Nothing that is said in this Report can be understood as diminishing that responsibility. Everything that is said in this Report is to be understood in the light of that one undeniable fact: it is those who engaged in misconduct who are responsible for what they did and for the consequences that followed.

Because that is so, every **financial services entity**, named in the Commission's reports or not, must look to its culture. Every financial services entity must look again at the way in which it governs itself and manages not only its employees but also the entities and individuals who act as its intermediaries or are seen by consumers as representing or associated in some other way with the entity. In looking at culture and governance, every entity must consider how it manages regulatory, compliance and conduct risks. And it must give close attention to the connections between compensation, incentive and remuneration practices and regulatory, compliance and conduct risks.

Every entity must ask the questions provoked by the Prudential Inquiry into CBA:<sup>1</sup>

- Is there adequate oversight and challenge by the board and its gatekeeper committees of emerging non-financial risks?
- Is it clear who is accountable for risks and how they are to be held accountable?

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<sup>1</sup> CBA Prudential Inquiry, Final Report, 3.

- Are issues, incidents and risks identified quickly, referred up the management chain, and then managed and resolved urgently? Or is bureaucracy getting in the way?
- Is enough attention being given to compliance? Is it working in practice? Or is it just 'box-ticking'?
- Do compensation, incentive or remuneration practices recognise and penalise poor conduct? How does the remuneration framework apply when there are poor risk outcomes or there are poor customer outcomes? Do senior managers and above feel the sting?

Those questions direct attention to three topics – culture, governance and remuneration. Each of those words can provoke a torrent of clichés. Each can provoke serious debate about definition. But there is no other vocabulary available to discuss issues that lie at the centre of what has happened in Australia's financial services entities and with which this Report must deal.

The culture of an entity can be described as the 'shared values and norms that shape behaviours and mindsets' within the entity.<sup>2</sup> It has been described as 'what people do when no-one is watching'<sup>3</sup> and that description captures what might be called the essentially 'internalised' or 'instinctive' application of shared values and norms. The shared values and norms can be seen as both reflecting and constituting the culture of an entity. It is evident that culture can drive or discourage misconduct.<sup>4</sup>

Governance refers to the entirety of structures and processes by which an entity is run. By shaping *how* the business is run, governance shapes culture. The systems, controls and risk management processes of the

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<sup>2</sup> Cf CBA Prudential Inquiry, Final Report, 81. I deliberately omit reference to a 'system' of shared values and norms if only to emphasise that culture is observed and described, not created apart from, or imposed on, the entity.

<sup>3</sup> G30, *Banking Conduct and Culture: A Call for Sustained and Comprehensive Reform*, July 2015, 17.

<sup>4</sup> See generally FSB, Toolkit.

business affect its culture.<sup>5</sup> But governance is not limited to questions of risk. Nor is it defined only by reference to how the board operates or what matters the board deals with. It embraces not only how, and by whom, decisions are made, but also the values or norms that the processes of governance are intended to effect. Hence, it is rightly said that the ‘tone’ of the entity is, and must be, set at the top. But that tone must also be echoed from the bottom and reinforced at every level of the entity’s management and supervision; it must always ‘sound from above’. And a culture that fosters poor leadership, poor decision-making or poor behaviour will undermine the governance framework of the entity.<sup>6</sup>

Remuneration and incentives, especially variable remuneration programs, tell staff what the entity rewards. Hence, remuneration and incentives tell staff what the entity values. Remuneration both affects and reflects culture. As the Commission’s work has shown, and is now not disputed, poor remuneration and incentive programs can lead, and have led, to poor customer outcomes.

If what has happened in the past is to be avoided in the future, entities have no choice but to grapple with culture, governance and remuneration. All three are related. Culture obviously affects governance but it also affects remuneration (because remuneration will be structured to reward what the entity values). Governance obviously affects culture but governance will not only affect, it will ultimately determine, how remuneration and incentive arrangements are given practical effect. And remuneration and governance inform and reinforce the culture of the entity.

The relationships between culture, governance, remuneration and misconduct have been the subject of increasing attention since the Global Financial Crisis (GFC). Particular attention has been directed to what role prudential supervision may have in the formation and maintenance of sound culture, governance and remuneration practices.

In this chapter, I will consider culture, governance and remuneration separately. I will examine the attention that each has been given since the GFC – both in Australia and overseas – as well as the failings identified

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<sup>5</sup> FSB, Toolkit, 9. See also APRA, Information Paper, Risk Culture, October 2016, 8.

<sup>6</sup> FSB, Toolkit, 8.

in relation to culture, governance and remuneration and the ways in which those failings can be met.

While I will consider culture, governance and remuneration separately, that separate consideration should not be taken as denying the close connections between all three. Positive steps taken in one area will reinforce positive steps taken in the others. Failings in one area will undermine progress in the others.

# 1 Remuneration

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I begin with remuneration. As I said in the *Interim Report*, ‘the conduct identified and criticised in [that] report was driven by the pursuit of profit – the entity’s revenue and profit, and the individual actor’s profit’.<sup>7</sup>

Of the topics dealt with in this chapter – culture, governance and remuneration – remuneration is the most concrete. It is also the topic that received the most immediate attention in the wake of the GFC. It is, therefore, a convenient place to begin an account of local and international efforts to improve governance, culture and remuneration practices since the GFC.

I start by providing an outline of those efforts. They form an important part of the backdrop for my recommendations in relation to remuneration practices. I will then consider some of the failings that have been identified in relation to the remuneration practices of financial services entities, and the ways in which those failings can be addressed.

## 1.1 Background

### 1.1.1 Responses to the GFC

As the report of the Australian Prudential Regulation Authority (APRA) Prudential Inquiry into CBA noted, ‘remuneration practices at financial institutions globally came under a harsh spotlight during the Global Financial

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<sup>7</sup> FSRC, *Interim Report*, vol 1, 302.

Crisis’.<sup>8</sup> The report said that remuneration practices ‘were exposed as promoting behaviours and outcomes that were inconsistent with sound risk management and the best interests of customers’.<sup>9</sup>

In 2009, in response to this exposure, the Financial Stability Board (FSB),<sup>10</sup> an international body that monitors and makes recommendations about the global financial system, released its Principles for Sound Compensation Practices (the Principles) and accompanying Implementation Standards. As the panel inquiring into CBA recorded, the Principles ‘sought to realign executive remuneration systems with prudent risk management and long-term financial sustainability’.<sup>11</sup> They were not explicitly directed to issues about the interests of customers, but instead aimed to ensure that:

- the boards of financial institutions would have adequate oversight of the institution’s compensation arrangements;
- compensation would be adjusted to take account of the risks to which employees exposed the financial institution; and
- there would be effective supervisory oversight of compensation practices.

Although the Principles stated that compensation should be adjusted to account for all types of risk, including difficult to measure risks, they appear to have been understood as being directed to promoting financial soundness and stability, rather than addressing misconduct. Mr Wayne Byres, Chairman of APRA, described the Principles as having been ‘strongly focused on financial soundness’ and accepted that, in this respect, the Principles may have been ‘too narrowly focused’.<sup>12</sup>

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<sup>8</sup> CBA Prudential Inquiry, Final Report, 65.

<sup>9</sup> CBA Prudential Inquiry, Final Report, 65.

<sup>10</sup> Established in 2009 as the successor to the Financial Stability Forum that had been founded in 1999 by the G7 Finance Ministers and Central Bank Governors as a mechanism (among other things) for developing and implementing strong regulatory, supervisory and other policies in the interest of financial stability. See FSB, *Our History* (2018) FSB <[www.fsb.org/about/history/](http://www.fsb.org/about/history/)>.

<sup>11</sup> CBA Prudential Inquiry, Final Report, 65.

<sup>12</sup> Transcript, Wayne Byres, 29 November 2018, 7397; FSB, Principles, 2.

This narrow focus was reflected in the way that APRA incorporated the Principles into its prudential guidance and prudential standards.<sup>13</sup>

In 2009, APRA issued a Prudential Practice Guide, PPG 511, about remuneration.<sup>14</sup> The guide was directed to all institutions regulated by APRA including **authorised deposit-taking institutions** (ADIs), general insurers and life companies. The guide said that ‘APRA’s remuneration requirements and guidance relate to managing or limiting risk incentives associated with remuneration’.<sup>15</sup> The guide did not identify the kinds of risk, or risk incentives, to which it was directed. In particular, it said nothing about conduct risk, compliance or regulatory risk and nothing about reputational risk.

In 2010, APRA amended its Prudential Standard about governance, CPS 510, to include requirements about remuneration. Among other things, these amendments introduced requirements for ADIs, general insurers and life companies to:

- maintain a documented remuneration policy;
- design performance-based components of remuneration to encourage behaviour that supports:
  - the institution’s long-term financial soundness; and
  - the risk management framework of the institution;
- design performance-based components of remuneration to align remuneration with prudent risk-taking; and
- provide for the board to adjust performance-based components of remuneration downwards, including to zero, if such adjustments are necessary to:
  - protect the financial soundness of the institution; or
  - respond to significant unexpected or unintended consequences.

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<sup>13</sup> Transcript, Wayne Byres, 29 November 2018, 7394–5.

<sup>14</sup> APRA, Prudential Practice Guide PPG 511, 30 November 2009.

<sup>15</sup> APRA, Prudential Practice Guide PPG 511, 30 November 2009, 5 [2].

Like the guide issued in the previous year, the standard did not identify the kinds of risk to which it was directed. But coming, as they did, in the immediate wake of the GFC, it seems probable that the guide and the standard would have been understood by those to whom they were addressed as being directed primarily, even exclusively, to the management of financial risks. Mr Byres accepted that both documents focused on the financial safety and soundness of financial institutions.<sup>16</sup>

Although APRA's guide and standards did not deal expressly with the relationship between remuneration arrangements and misconduct, other developments in Australia in the wake of the GFC prompted legislators to consider that issue.

As I have explained in the chapter dealing with financial advice, several **financial product** and financial services providers in Australia collapsed during or after the GFC. In particular, in late 2008 and early 2009, many clients of Storm Financial sustained significant losses.<sup>17</sup> And many clients of Commonwealth Financial Planning Limited, many of whom were nearing retirement or had already retired, lost millions of dollars because they had followed bad financial advice. In response to these and other events, the **Future of Financial Advice (FoFA)** reforms were proposed.

The FoFA reforms, which were enacted in 2012, drew an explicit connection between remuneration and poor customer outcomes. The legislation did that in the provisions made about conflicted remuneration, defined as: benefits (monetary and non-monetary) given to a **financial services licensee**, or a representative of a licensee, who gives financial product advice to persons as retail clients that 'because of the nature of the benefit or the circumstances in which it is given' could reasonably be expected to influence the choice of product recommended or product advice given to the client.<sup>18</sup>

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<sup>16</sup> Transcript, Wayne Byres, 29 November 2018, 7395–6.

<sup>17</sup> ASIC, Media Release 18-081MR, 22 March 2018.

<sup>18</sup> Corporations Act s 963A.

To the extent to which banks or their subsidiaries participated in the personal financial advice market, these provisions applied directly. But no wider application of the guiding premise of these FoFA amendments (that remuneration affects conduct) to general remuneration arrangements within the banks seems to have been identified or considered by APRA, the Australian Securities and Investments Commission (ASIC), Treasury, or the banks themselves until several years after the FoFA reforms came into effect.

### 1.1.2 International developments

By 2015, instances of serious misconduct associated with financial institutions in the United States, the United Kingdom and elsewhere had attracted much publicity. For example, in June 2012, Barclays plc, one of the world's largest and most important banks, had admitted that it had manipulated LIBOR (a benchmark rate fundamental to the operation of financial markets and the basis of trillions of dollars of financial transactions).<sup>19</sup> Between 2012 and 2015, other banks admitted their parts in similar conduct.

These and other scandals prompted prudential concerns about effective governance, risk management, controls, and incentive-based compensation in Europe and North America.<sup>20</sup> Over \$320 billion in fines and restitution imposed in the United Kingdom, the United States and the European Union were thought to have affected banks' prudential standing and significantly reduced the value of their issued capital.<sup>21</sup> Banks and regulatory authorities began to consider how to address misconduct.

In 2015, the FSB launched a work plan to reduce the risk of misconduct at financial institutions around the world. The work plan had a number of elements. It looked at:

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<sup>19</sup> Clayton S Rose and Aldo Sesia, 'Barclays and the LIBOR Scandal', *Harvard Business School Case 313-075*, January 2013, revised October 2014 <[www.hbs.edu/faculty/Pages/item.aspx?num=43888](http://www.hbs.edu/faculty/Pages/item.aspx?num=43888)>.

<sup>20</sup> FSB, Supplementary Guidance, 3.

<sup>21</sup> FSB, Supplementary Guidance, 3–4.

- the relationship between governance frameworks and the risk of misconduct, including the ways in which ‘responsibility mapping’ could be used to strengthen the governance of conduct risk in financial institutions;<sup>22</sup>
- the relationship between organisational culture and the risk of misconduct, and the work that supervisors can do to form a view about the culture of financial institutions;<sup>23</sup> and
- the relationship between remuneration and misconduct.<sup>24</sup>

In 2016, as part of its work on the relationship between remuneration and misconduct, the FSB agreed to develop guidance on better practice in applying the Principles to manage the risk of misconduct. In March 2018, the FSB published the product of that work – the ‘Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices’ (the Supplementary Guidance). The Supplementary Guidance was directed specifically to the use of compensation tools to address misconduct. It recognised that:<sup>25</sup>

Inappropriately structured compensation arrangements can provide individuals with incentives to take imprudent risks ... Costs may be imposed on firms and their customers not only by inappropriate risk-taking but also by misconduct that can result in harm to institutions, and their customers and other stakeholders, and impair trust in the financial system more generally. Compensation tools, along with other measures, can play an important role in addressing misconduct risk by providing both ex ante incentives for good conduct and ex post adjustment mechanisms for appropriate accountability when misconduct occurs.

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<sup>22</sup> FSB, *Reducing Misconduct Risks in the Financial Sector: Progress Report to G20 Leaders*, 4 July 2017, 1–2.

<sup>23</sup> FSB, *Reducing Misconduct Risks in the Financial Sector: Progress Report to G20 Leaders*, 4 July 2017, 3.

<sup>24</sup> FSB, *Reducing Misconduct Risks in the Financial Sector: Progress Report to G20 Leaders*, 4 July 2017, 3–4.

<sup>25</sup> FSB, *Supplementary Guidance*, 1.

The Supplementary Guidance did not alter the Principles, or establish additional principles. It explained how the Principles should be applied to address misconduct. The Supplementary Guidance emphasised that the compensation systems of financial services entities should be *designed* to promote ethical behaviour and compliance with laws and standards, and that they should be *implemented* so as to manage the risk of misconduct.<sup>26</sup> Among other things, the Supplementary Guidance said that compensation systems should include:<sup>27</sup>

- ‘ex ante processes that embed non-financial assessment criteria such as the quality of risk management, degree of compliance with laws and regulations and the broader conduct objectives of the firm including the fair treatment of customers, into individual performance management and compensation plans at all levels of the organisation’; and
- ‘mechanisms to adjust variable compensation, including ... through in-year adjustment, and malus or clawback arrangements, which can reduce variable compensation after it is awarded or paid’.

Importantly, the Supplementary Guidance also said that prudential supervisors should ‘monitor and assess the effectiveness of firms’ compensation policies and procedures, including the application of compensation tools in addressing misconduct risk and related misconduct outcomes’.<sup>28</sup> That is, the Supplementary Guidance proposed that supervisors, like APRA, should play a central part in monitoring the way that remuneration systems are designed and implemented to address misconduct. FSB is continuing to work in this area. In November 2018, it published ‘Recommendations for National Supervisors: Reporting on the Use of Compensation Tools to Address Potential Misconduct Risk’ (the Recommendations).

### 1.1.3 Australian developments

While the work of the FSB progressed overseas, further attention was given to the relationship between remuneration and misconduct in Australia.

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<sup>26</sup> FSB, Supplementary Guidance, 6.

<sup>27</sup> FSB, Supplementary Guidance, 6–7.

<sup>28</sup> FSB, Supplementary Guidance, 7.

In 2016, the Australian Bankers' Association (ABA) launched its 'Banking Reform Program'. As part of that program, the ABA appointed Mr Stephen Sedgwick AO to conduct an independent review into remuneration practices in retail banking. The review began in July 2016 and Mr Sedgwick provided his final report in April 2017. The report said that:<sup>29</sup>

[S]ome current [remuneration] practices carry an unacceptable risk of promoting behaviour that is inconsistent with the interests of customers and should be changed. Some of these relate to management practices that may reduce the effectiveness of the bank's risk mitigation strategies. Other practices relate to the way incentives and remuneration are structured. The need for change is true of both direct (ie staff) and some third party channels ...

New approaches to retail bank remuneration are by no means a panacea. But the Issues Paper (issued by Mr Sedgwick in January 2017) has documented instances in retail banking and across the financial services sector more broadly, both in Australia and abroad, in which incentives have at least appeared to drive behaviour that was not in the best interests of customers and, on occasion, scandalously so.

Mr Sedgwick made 21 recommendations. He summarised the effect of the recommendations he made about retail bank staff (as distinct from introducers, referrers, franchisees and **mortgage brokers**) as being that:<sup>30</sup>

- incentives will no longer be paid to any retail staff based directly or solely on sales performance (see Recommendations 2 and 7);
- eligibility to receive any personal incentive payments will instead be based on an assessment of that individual's contribution across a range of measures, of which sales (if included at all) will not be the dominant component (Recommendations 3, 4, 5 and 6), and the maximum available payments will be scaled back significantly for some roles (Recommendation 8);

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<sup>29</sup> Sedgwick Review, Report, i.

<sup>30</sup> Sedgwick Review, Report, 7.

- retail bank culture will be demonstrably ethically and customer oriented (Recommendation 9);
- a significant investment will be undertaken, as necessary, to ensure that performance is managed consistently with such a philosophy, and supported by proactive steps to develop leadership and management skills at all levels so that management practices match the intent of the recommendations (Recommendations 10,11 and 12); and
- the board and the most senior managers of the bank will show clear and consistent leadership (Recommendations 13 and 14).

Each of the major banks told the Commission that it is committed to implementing the recommendations made by Mr Sedgwick.<sup>31</sup>

In 2017, APRA reviewed remuneration policies and practices across a sample of large financial institutions. One of the purposes of the review, focusing on APRA-regulated institutions, was ‘to gauge how their stated remuneration frameworks and policies were translated into outcomes for senior executives’.<sup>32</sup> In April 2018, APRA published an information paper based on the review.

The paper noted that ‘other financial regulators and industry bodies’ had conducted reviews focused on remuneration ‘largely from the perspective of limiting the potential for misconduct’.<sup>33</sup> It went on to say that the link between remuneration and misconduct ‘is also of interest to APRA as a prudential supervisor’ but explained that this was ‘because conduct issues can provide additional insights into an organisation’s attitudes towards risk more generally’.<sup>34</sup> Unlike the FSB and other international bodies, however, APRA appears not to have considered dealing with the risk of misconduct

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<sup>31</sup> Transcript, Matthew Comyn, 19 November 2018, 6587; Transcript, Andrew Thorburn, 26 November 2018, 7040; Transcript, Shayne Elliott, 28 November 2018, 7318; Exhibit 7.48, Statement of Brett Tollmann, 6 November 2018, 17–18 [46], 20 [53].

<sup>32</sup> CBA Prudential Inquiry, Final Report, 65.

<sup>33</sup> APRA, Information Paper, Remuneration Practices at Large Financial Institutions, April 2018, 6.

<sup>34</sup> APRA, Information Paper, Remuneration Practices at Large Financial Institutions, April 2018, 6.

as being an end in itself. Instead, for APRA, understanding an entity's attitude to the risk of misconduct was a means to understanding the entity's attitude to risk more generally.<sup>35</sup>

In the *Interim Report*, I expressed the view that it would be surprising, and a cause for concern, if APRA's approach to prudential governance of remuneration remained as narrowly focused as its information paper suggested.<sup>36</sup> When he gave evidence in the seventh round of hearings, Mr Byres explained that the narrow focus of the information paper reflected the narrow focus of the prudential standards in their current form.<sup>37</sup> He acknowledged that the standards need to 'evolve and improve',<sup>38</sup> and said that APRA was in the process of changing its prudential standards and guidance to deal expressly with the potential for poorly designed and implemented remuneration systems to increase the risk of misconduct.<sup>39</sup>

**APRA must revise its prudential standards and guidance about remuneration. Mr Byres said that work is already underway at APRA to identify 'what ... good look[s] like',<sup>40</sup> and that he expects a revised standard will be made available for consultation next year.<sup>41</sup> I encourage APRA to continue that work as expeditiously as possible.**

I make some specific recommendations in relation to the content of the revised standards below, but those recommendations should not be taken to exhaust the changes that will be required. In preparing the revised standards and guidance, **APRA must bear steadily in mind that entities can and should use both the design and the implementation of remuneration and incentive systems to reduce the risk of misconduct. Misconduct can have significant consequences for financial soundness and stability. It undermines trust in the financial system.**

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<sup>35</sup> APRA, Information Paper, Remuneration Practices at Large Financial Institutions, April 2018, 6.

<sup>36</sup> FSRC, *Interim Report*, vol 1, 320.

<sup>37</sup> Transcript, Wayne Byres, 29 November 2018, 7401.

<sup>38</sup> Transcript, Wayne Byres, 29 November 2018, 7401.

<sup>39</sup> Transcript, Wayne Byres, 29 November 2018, 7402.

<sup>40</sup> Transcript, Wayne Byres, 29 November 2018, 7405.

<sup>41</sup> Transcript, Wayne Byres, 29 November 2018, 7405–6.

**The use of remuneration systems to reduce the risk of misconduct is a legitimate – and necessary – subject of concern for a prudential regulator. Prudential regulation and supervision of remuneration arrangements must have, as one of its aims, the reduction of misconduct at financial institutions.**

### **1.1.4 Further observations**

Poorly designed and implemented remuneration arrangements can increase the risk of misconduct. Well designed and implemented remuneration arrangements can play an important role in reducing that risk.

What I have said about local and international efforts to improve remuneration practices since the GFC shows that, until recently, the regulator with the power to create binding standards in relation to remuneration arrangements for ADIs, insurers and superannuation entities was focused on the potential for remuneration arrangements to affect the financial soundness of those entities. It had not focused, or not focused sufficiently directly, on the potential for remuneration arrangements to affect misconduct and compliance and, as a result, to diminish trust in and the reputation of individual entities and the Australian financial system generally.

In the sections that follow, I consider some of the failings that have been identified in relation to the remuneration practices of financial services entities, and the ways in which those failings can be addressed. In doing so, I will deal with the remuneration of executives separately from the remuneration of front line staff. While there are common features of the remuneration of both, there are important differences.

Like most international work in this area, APRA's prudential standards and guidance are directed to the remuneration of senior employees: the entities' executives.<sup>42</sup> Accordingly, I begin by considering those employees.

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<sup>42</sup> APRA, Prudential Standard CPS 510, July 2017, [57]. I note that the requirements do encompass the remuneration arrangements for more junior staff, where their collective activities may affect the financial soundness of the institution.

## 1.2 Executive remuneration

Regulatory and other bodies considering the links between remuneration practices and misconduct have given particular attention to the remuneration of executives because it is the board and senior management of financial services entities who are responsible for, and have the greatest degree of control over, the way that risks – including compliance risk, conduct risk and regulatory risk – are managed within those entities.

To put that in more concrete terms, it is the board and senior management of financial services entities who are responsible for, and have the greatest degree of control over:

- whether the entity has a culture that encourages good customer outcomes and the sound management of risk – a culture in which employees ask, ‘what *should* I do?’ instead of ‘what *can* I do?’, and feel comfortable speaking up when they see that something is not right;
- whether the entity ensures that compliance issues are identified, escalated as required, and addressed promptly and effectively; and
- whether the entity has an open, transparent and constructive relationship with regulators.

When remuneration arrangements are designed or implemented in a way that sees executives rewarded with large bonuses despite their poor management of risks, those remuneration arrangements increase the likelihood that the entity will engage in misconduct, or conduct that falls below what the community expects. By contrast, when remuneration arrangements are designed and implemented in a way that properly takes into account the way that executives have managed risks – including compliance risk, conduct risk and regulatory risk – those remuneration arrangements will decrease the likelihood that the entity will engage in misconduct, or conduct falling below community standards and expectations. As I said earlier, an entity’s remuneration arrangements, especially variable remuneration programs, tell staff what the entity rewards and what the entity values.

I referred above to the way that remuneration arrangements are ‘designed’ and the way that those arrangements are ‘implemented’. Both the evidence before the Commission, and the work of APRA and the FSB, have shown

that problems can arise in each of these areas. A well-designed system can be undermined by poor implementation. Equally, a well-implemented but poorly-designed system is unlikely to achieve good results. And, a poorly-designed system is even less likely to achieve good results however competently it is implemented. The two areas (design and implementation) present different issues, and require separate consideration.

The issues demonstrated by the evidence before the Commission were often more about implementation than design. This is, perhaps, unsurprising, given that the focus of APRA's standards in relation to remuneration has been on the design of remuneration systems, and the focus of APRA's work on remuneration has, until recently, been on monitoring compliance with those standards of design.<sup>43</sup>

### **1.2.1 Issues of design**

The Commission received a large body of evidence about the design of executive remuneration systems in Australian banks and some other financial services entities. Unsurprisingly, the systems differed from entity to entity, but there were some features common to all the banks that gave evidence in the seventh round of the Commission's hearings.

- First, each system rewarded executives with a combination of fixed remuneration and variable remuneration. The proportion of fixed and variable remuneration varied depending on the role of the particular executive – for example, staff in risk and compliance roles often had a higher proportion of fixed remuneration compared to staff in other roles. The proportion of fixed and variable remuneration varied between entities. Notably, Bendigo and Adelaide Bank had a much higher proportion of fixed remuneration than the other entities,<sup>44</sup> and Macquarie had a much higher proportion of variable remuneration.<sup>45</sup>
- Second, each system deferred part of the executives' variable remuneration. Notably, Bendigo also deferred part of its executives'

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<sup>43</sup> Transcript, Wayne Byres, 29 November 2018, 7401–2.

<sup>44</sup> See generally Exhibit 7.141, Witness statement of Robert Johanson, 7 November 2018.

<sup>45</sup> See generally Exhibit 7.60, Witness statement of Nicholas Moore, 19 November 2018.

fixed remuneration.<sup>46</sup> Since 1 July 2018, for large ADIs, the minimum proportion of variable remuneration that must be deferred, and the minimum period of deferral, have been prescribed by the **Banking Executive Accountability Regime (BEAR)**.

- Third, many systems distinguished between short-term variable remuneration and long-term variable remuneration. The key differences between these types of variable remuneration tended to be that:
  - the amount of short-term variable remuneration that was payable depended on criteria assessed over the most recent financial year;
  - the amount of long-term variable remuneration that was payable depended on criteria assessed over several years;
  - while a proportion of short-term variable remuneration was often deferred, all long-term variable remuneration was always deferred; and
  - generally, only the most senior executives were eligible to receive long-term variable remuneration.
- Fourth, each system allowed the board of the entity to adjust executives' variable remuneration to reflect their management of risk. All systems allowed for this to occur through in-year adjustment of short-term variable remuneration, and through forfeiture of deferred remuneration that had not yet vested (referred to as 'malus'). Some systems also allowed for deferred remuneration that had already vested to be clawed back. I will consider how these mechanisms were applied in dealing with issues of implementation.<sup>47</sup>

Those common features help to provide a framework within which to examine issues relating to the design of executive remuneration systems. There are four issues about which I will say something further:

- experimentation in the design of remuneration systems;

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<sup>46</sup> See generally Exhibit 7.141, Witness statement of Robert Johanson, 7 November 2018.

<sup>47</sup> Exhibit 7.108, Witness statement of Lynda Dean, 2 November 2018, 7–8 [23(c)], 27 [87(f)].

- the proportion of fixed and variable remuneration;
- the design of variable remuneration; and
- the availability of clawback.

### *Experimentation in the design of remuneration systems*

It was apparent from the evidence before the Commission as well as international work in this area – and unsurprising – that no-one has identified an ‘ideal’ or ‘optimal’ system of executive remuneration for financial services entities. Many have identified particular features of executive remuneration systems for those entities that are desirable – perhaps even necessary – to ensure that the remuneration systems of those entities properly reward and encourage good risk management, and contribute to reducing the risk of misconduct. I will say something further about some of those features below. But there being no agreed ‘ideal’ or ‘optimal’ remuneration system, there are limits to what can or should be regulated or prescribed. And it must be recognised and accepted that it may never be possible to identify a single ‘ideal’ or ‘optimal’ system. As the FSB said in its Principles, ‘financial firms differ in goals, activities and culture, as do jobs within a firm’.<sup>48</sup> One size does not fit all.

This is not necessarily a bad thing. Experience shows that better outcomes – and valuable information – often emerge only through trial and error. Financial services entities must be able (within limits) to try different forms of remuneration and incentive systems.

The qualification – ‘within limits’ – is, of course, critical. But those limits have been identified in the work of the FSB: in its Principles and in its Supplementary Guidance. As the Principles say, ‘[c]ompensation must be adjusted for all types of risk ... Risk adjustments should account for all types of risk, including difficult-to-measure risks such as liquidity risk, reputation risk and cost of capital’.<sup>49</sup> That is, financial metrics must not determine remuneration. Risk of all kinds, including reputation risk, compliance risk, and conduct risk, must be taken into account in both designing and implementing the remuneration system.

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<sup>48</sup> FSB, Principles, 1.

<sup>49</sup> FSB, Principles, 2.

Within those limits, different forms of remuneration and incentive systems will be devised and applied. But trying new or different systems will have value only if:

- the systems are genuinely directed to encouraging good risk management and reducing the risk of misconduct; and
- the results of applying the system are reliably identified and, if possible, measured.

I say measured ‘if possible’ not only because the FSB’s Principles acknowledge that some risks are difficult to measure, but also because, in the end, what is being assessed is not just *what* people do but *how* they do it. ‘What’ can be measured; ‘how’ cannot.

APRA has an important part to play.

**Mr Byres said that APRA was in the process of updating its prudential standards and guidance in relation to remuneration.**<sup>50</sup> He said that, in doing so, APRA would incorporate lessons learned from the review that led to its information paper on remuneration practices in large financial services entities, as well as the Prudential Inquiry into CBA, and the FSB’s Supplementary Guidance.<sup>51</sup>

**This work is important. It must be completed as soon as reasonably possible. I make three points about it.**

**First, the prudential standards should expressly require APRA-regulated institutions to design their remuneration systems to encourage sound management of non-financial risks, and to reduce the risk of misconduct.** There may be several ways to do that. At a minimum, it could be added to the existing requirement that performance-based components of remuneration must be designed to encourage behaviour that supports an institution’s long-term financial soundness and risk management framework.<sup>52</sup>

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<sup>50</sup> Transcript, Wayne Byres, 29 November 2018, 7402.

<sup>51</sup> Transcript, Wayne Byres, 29 November 2018, 7402.

<sup>52</sup> APRA, Prudential Standard CPS 510, July 2017, [54].

**Second, the prudential standards should expressly require the board of a financial institution (whether through its remuneration committee or otherwise) to make regular assessments of the effectiveness of the remuneration system in encouraging sound management of non-financial risks, and reducing the risk of misconduct.** While it is currently a requirement for a remuneration committee to assess the effectiveness of the entity's remuneration policy,<sup>53</sup> I have seen little evidence to indicate that these assessments provide the board with sufficient information about how the remuneration system is being applied in practice and whether it is having the desired outcomes.

**Third, APRA (and, where appropriate, ASIC) should do more to gather information about the way that remuneration systems are being applied in practice, and about whether those systems are actually encouraging sound management of non-financial risks, and reducing the risk of misconduct.** I will say more about the approach that APRA has taken with respect to supervision of remuneration arrangements later in this section. For now, it is sufficient to observe that documents like the report of the Prudential Inquiry into CBA, and APRA's information paper on remuneration practices in large financial institutions, have great value in showing entities what good and bad remuneration practices look like. Further work of that kind will be important.

### *Proportion of fixed and variable remuneration*

Effective management of the risk of misconduct does not depend on an entity dividing fixed and variable remuneration in one way rather than another. Here, too, there is no single 'right answer'. But if remuneration is to be divided between fixed and variable, the purposes of allowing variable remuneration must be clearly understood both by those who are to decide what should be paid and those who are to receive the payment.

Is part, or all of the variable remuneration to be paid *unless* there are disqualifying reasons? Or is part or all of it to be paid *only if* certain conditions are met? Effective management of risk, in all its forms, will depend on, among other things, how those questions are answered. In particular, effective management of risk will depend upon the criteria that will be applied in determining variable remuneration.

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<sup>53</sup> APRA, Prudential Standard CPS 510, July 2017, [68(a)].

### *Design of variable remuneration*

All of the four large banks, and both Macquarie and Bendigo, have remuneration arrangements under which:

- the performance of executives is assessed against a range of measures, including management of risk; and
- the board is able to make adjustments to the variable remuneration of executives to reflect their management of risk.

But each bank gives effect to those principles in different ways in respect of both short-term and long-term variable remuneration. The particular detail of the differences need not be described. But it is important to make some observations about long-term variable remuneration and, in particular, the conditions that determine whether an employee receives this part of the remuneration.

In its information paper on remuneration practices at large financial institutions, APRA observed that:<sup>54</sup>

[F]or the majority of cases, the conditions which allow [long-term variable remuneration] to vest focused wholly on annual investor return measures such as total shareholder return (TSR) and return on equity (RoE). No apparent links to measures of long-term financial soundness or risk-adjusted performance measures (such as metrics relating to risk-adjusted return on capital) were observed.

Mr Byres described the current structure of long-term variable remuneration in Australia as being ‘particularly problematic in this regard’, and ‘out of step with how best practices in remuneration are evolving internationally’.<sup>55</sup> He considered that there was too much focus on ‘relative total shareholder return’ measures in determining whether long-term variable remuneration should vest, and described that as not being conducive to a broader, more holistic assessment of performance’.<sup>56</sup> He said that, internationally, APRA

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<sup>54</sup> APRA, Information Paper, Remuneration Practices at Large Financial Institutions, April 2018, 18.

<sup>55</sup> Exhibit 7.145, Witness statement of Wayne Byres, 27 November 2018, 109 [448].

<sup>56</sup> Transcript, Wayne Byres, 29 November 2018, 7403.

was seeing a shift away from financial metrics towards a greater emphasis on non-financial metrics.<sup>57</sup>

In the last few years, some financial services entities in Australia have attempted to give greater weight to non-financial measures in the design of their long-term variable remuneration arrangements. It is instructive to take CBA as an example.

For many years, senior executives at CBA were entitled to participate in a long-term variable remuneration scheme. At the end of the financial year, each executive who was eligible to participate in the scheme would receive a particular number of reward rights. At the end of a four-year 'performance period', a determination would be made about whether those rights would vest. That determination depended on whether particular 'performance hurdles' had been met.<sup>58</sup> If the reward rights vested, they would be converted to CBA shares.

In the 2016 financial year, there were two performance hurdles:

- The first was a relative total shareholder return hurdle. This hurdle determined whether 75% of the reward rights would vest. It involved comparing CBA's total shareholder return over the four-year performance period with the total shareholder return of the 20 largest ASX-listed companies (excluding resources companies). If CBA was below the 50th percentile, none of the reward rights attributable to this hurdle would vest. If CBA was at or above the 75th percentile, all of the reward rights attributable to this hurdle would vest. In between those two figures, there was a sliding scale that determined how many reward rights would vest.<sup>59</sup>
- The second hurdle was a customer satisfaction hurdle. This hurdle determined whether the other 25% of the reward rights would vest. It involved comparing CBA's performance on a customer satisfaction survey to the performance of other financial services entities.<sup>60</sup>

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<sup>57</sup> Transcript, Wayne Byres, 29 November 2018, 4703.

<sup>58</sup> Transcript, Catherine Livingstone, 21 November 2018, 6758.

<sup>59</sup> Transcript, Catherine Livingstone, 21 November 2018, 6758–9; CBA, Annual Report, 2016, 55.

<sup>60</sup> Transcript, Catherine Livingstone, 21 November 2018, 6759; CBA, Annual Report, 2016, 55.

In its 2016 remuneration report, CBA announced that it planned to make changes to these performance hurdles for the 2017 financial year. In particular, it planned to reduce the share of the reward rights to which the relative total shareholder return hurdle applied from 75% to 50%, and to add a new ‘people and community’ hurdle that would apply to 25% of the reward rights. The people and community hurdle would ‘measur[e] long-term progress in the areas of diversity and inclusion, sustainability and culture’.<sup>61</sup>

At CBA’s annual general meeting in 2016, more than 50% of the votes cast on the resolution to adopt the remuneration report were against the adoption of that report.<sup>62</sup> Ms Catherine Livingstone, now Chair of CBA, attributed that result, in part, to the proposed changes to the structure of CBA’s long-term variable remuneration arrangements.<sup>63</sup> The following year, CBA abandoned that proposal, and replaced its customer satisfaction hurdle with two different non-financial measures, each applicable to 12.5% of the reward rights.<sup>64</sup> That year, more than 92% of the votes cast on the resolution to adopt the remuneration report were in favour of the adoption of that report.<sup>65</sup>

Each year, a listed company must prepare a remuneration report,<sup>66</sup> and give its shareholders the opportunity at the company’s annual general meeting to vote on a resolution to adopt that report.<sup>67</sup> If more than 25% of the votes cast on that resolution are against the adoption of that report at two consecutive AGMs, the company must put to the vote a resolution calling for a spill of board positions.<sup>68</sup> This is referred to as the ‘two strikes’ rule.

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<sup>61</sup> Transcript, Catherine Livingstone, 21 November 2018, 6759–60; CBA, Annual Report, 2016, 56.

<sup>62</sup> Transcript, Catherine Livingstone, 21 November 2018, 6757.

<sup>63</sup> Transcript, Catherine Livingstone, 21 November 2018, 6757.

<sup>64</sup> Transcript, Catherine Livingstone, 21 November 2018, 6764.

<sup>65</sup> CBA, *Results of 2017 Annual General Meeting* (16 November 2017) CBA <[www.commbank.com.au/content/dam/commbank/about-us/shareholders/pdfs/2017-asx/2017-annual-general-meeting-results.pdf](http://www.commbank.com.au/content/dam/commbank/about-us/shareholders/pdfs/2017-asx/2017-annual-general-meeting-results.pdf)>.

<sup>66</sup> Corporations Act s 300A.

<sup>67</sup> Corporations Act s 250R.

<sup>68</sup> Corporations Act ss 250U, 250V.

It is intended to align the interests of the board (in setting the remuneration policy) and managers (via the incentives created by the remuneration policy) with the interests of the shareholders.<sup>69</sup>

Several witnesses were asked whether they considered that the ‘two strikes’ rule was impeding boards from adjusting their remuneration policies to encourage positive outcomes not only for those shareholders looking to realise profit on sale of their shares but also customers and longer-term shareholders.

Ms Livingstone observed that some institutional shareholders appeared not to be using the vote on the remuneration report for its intended purpose. Instead, they used that vote, and the two strikes rule, to register dissatisfaction with other matters, not related to remuneration.<sup>70</sup> However, she observed that it was possible, with some work, to convince shareholders that ‘appropriate non-financial measures can be included in the long-term variable remuneration plan’.<sup>71</sup>

Dr Kenneth Henry, Chair of NAB said that he considered that the ‘two strikes’ rule requires boards to focus too much on financial measures in the design of their remuneration systems, at the expense of measures directed to things like reducing the risk of misconduct or ensuring good outcomes for customers.<sup>72</sup>

Mr Robert Johanson, the Chair of Bendigo and Adelaide Bank observed that because institutional shareholders are more likely than other shareholders to vote at annual general meetings, they can have a significant influence on the direction of the company.<sup>73</sup> However, like Ms Livingstone, he indicated that with work, boards could convince institutional shareholders to support the use of non-financial measures. Fewer than 5% of votes cast on the resolution to adopt Bendigo and Adelaide Bank’s 2018 remuneration report

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<sup>69</sup> See Explanatory Memorandum, Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011 (Cth), [8.30].

<sup>70</sup> Transcript, Catherine Livingstone, 21 November 2018, 6761–2.

<sup>71</sup> Transcript, Catherine Livingstone, 21 November 2018, 6761.

<sup>72</sup> Transcript, Kenneth Henry, 27 November 2018, 7184.

<sup>73</sup> Transcript, Robert Johanson, 29 November 2018, 7375–6.

were against the adoption of that report, despite the fact that Bendigo increased the weighting given to the non-financial performance measure for its long-term variable remuneration scheme from 30% to 35%.<sup>74</sup>

Given that the ‘two strikes’ rule applies to all listed companies, any question about modifying that rule is beyond my Terms of Reference. Any review of its operation would be for others to undertake.

There remains, however, the point made by Mr Byres – that focusing only, or largely, on a measure of total shareholder return when deciding whether long-term variable remuneration should be paid does not allow consideration of all relevant aspects of the executive’s performance. In particular, I would add, it does not allow consideration of how the executive has managed risk.

APRA has been considering whether, in its prudential standards, it should set limits on the use of financial metrics in connection with long-term variable remuneration.<sup>75</sup> Consistent with what I have said about the principles that must inform the proper design of variable remuneration arrangements, and with international best practice, I consider that, in its revised prudential standards dealing with remuneration, APRA should set limits on the use of financial metrics in connection with long-term variable remuneration.

### *Availability of clawback*

The final issue can be addressed briefly. Although the remuneration arrangements examined by the Commission generally allowed for the board to take the decision to forfeit part or all of the *unvested* portion of deferred remuneration, they very rarely provided for remuneration that had *vested* to be clawed back.

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<sup>74</sup> Transcript, Robert Johanson, 29 November 2018, 7376–7.

<sup>75</sup> Transcript, Wayne Byres, 29 November 2018, 7403–5.

In many of the case studies considered by the Commission, the relevant misconduct was revealed only after some or all of the accountable executives had left, and their deferred remuneration had vested. This was a particular issue in relation to fees for no service conduct, where the full scale of the issue only became apparent many years after the introduction of ongoing fee arrangements.<sup>76</sup> Where entities lacked arrangements to claw back remuneration from those accountable executives, there was no step that they could take.

This could have been avoided if entities had made provision to claw back remuneration that had vested. I can see no reason why every financial services entity should not have such arrangements. Doing so would be consistent with the FSB's Supplementary Guidance. And it would be consistent with the report of the Prudential Inquiry into CBA:<sup>77</sup>

Clawback is not a feature of remuneration frameworks in financial institutions in Australia but this tool, were it designed to be readily exercised, would help to drive behaviours that avoid unsound risk management and strengthen accountability for senior management and other material risk-takers. The FSB Supplementary Guidance sets out eight recommendations, one of which includes clawback as a tool for how remuneration can be used to promote ethical behaviours and good conduct. The Panel believes that as part of adopting these recommendations, clawback could be a particularly effective tool for cases of serious misconduct.

In its revised prudential standards dealing with remuneration, APRA should require all APRA-regulated institutions to provide for the entity to claw back remuneration that has vested, in appropriate circumstances.

In this, as in all other aspects of remuneration, the effectiveness of the provision will depend on how it is applied.

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<sup>76</sup> See, eg, Transcript, Kenneth Henry, 27 November 2018, 7121–2, 7130–2. See also Exhibit 7.80, Witness statement of Andrew Thorburn, 19 November 2018, 58 [201].

<sup>77</sup> CBA Prudential Inquiry, Final Report, 78–9.

## 1.2.2 Issues of implementation

Although good design of remuneration arrangements is critical to reducing the risk of misconduct, the issues demonstrated by the evidence before the Commission were often issues of implementation rather than design.

There are three issues connected with implementing remuneration arrangements about which I will say something further:

- risk-related adjustments to remuneration;
- supervision of the implementation of remuneration arrangements; and
- disclosure of the fact of, or reasons for, risk-related adjustments to remuneration.

### *Risk-related adjustments*

Several of the problems that can arise in connection with the implementation of risk-related adjustments to remuneration were demonstrated by the evidence about the process by which CBA's board determined the remuneration of the CEO and Group Executives in the 2016 financial year.

CBA released its 2016 remuneration report in August 2016. At that time, both ASIC and APRA had continuing investigations into CBA's life insurance business. CBA was aware of a number of other issues that became public over the course of the following year. These included: the anti-money laundering and counter-terrorism financing (or AML/CTF) issues that resulted in the Australian Transaction Reports and Analysis Centre (AUSTRAC) commencing a civil penalty proceeding; the 'fees for no service' issues; and the mis-selling of credit card insurance.<sup>78</sup> Further, in late 2015, APRA had expressed concerns to CBA about the effectiveness of its operational risk management framework.<sup>79</sup> APRA was concerned about a number of persistent significant risk issues that were not being dealt with effectively.<sup>80</sup>

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<sup>78</sup> Transcript, Catherine Livingstone, 21 November 2018, 6745.

<sup>79</sup> See Exhibit 7.31, 24 December 2015, Letter APRA to Narev Concerning Operational Risk Framework and Attached Report.

<sup>80</sup> Transcript, Wayne Byres, 29 November 2018, 7409.

Despite those issues, in that financial year, CBA's board rated the CEO and all but one of the Group Executives as having 'fully met' relevant requirements in relation to the management of risk.<sup>81</sup>

How did that come about?

The Chief Risk Officer told the board remuneration committee (and thus, the board) that he did not believe there were any risk issues or risk behaviours that would suggest that the short-term variable remuneration of the CEO or any of the Group Executives should be modified in any way.<sup>82</sup> That opinion was supported by information that Ms Livingstone described in her evidence as 'not sufficient' and 'inadequate'.<sup>83</sup>

Based on that opinion, the CEO recommended to the remuneration committee that there be no risk-related adjustment to the variable remuneration of any of the Group Executives in the 2016 financial year.<sup>84</sup> Despite the inadequacy of the information provided by the Chief Risk Officer, and the fact that the issues referred to above were known to the board, the remuneration committee accepted the Chief Risk Officer's recommendation not to modify the short-term variable remuneration of the CEO or any of the Group Executives, subject to one change – it made a 5% reduction to the variable remuneration of one of the Group Executives, to reflect the CommInsure matters.<sup>85</sup> The board accepted the remuneration committee's recommendation.

Ms Livingstone described the process that led to those remuneration outcomes as 'significantly inadequate',<sup>86</sup> and said that the outcomes themselves were 'patently inadequate' and 'inappropriate'.<sup>87</sup> I agree.

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<sup>81</sup> Transcript, Catherine Livingstone, 21 November 2018, 6752, 6757.

<sup>82</sup> Transcript, Catherine Livingstone, 21 November 2018, 6749.

<sup>83</sup> Transcript, Catherine Livingstone, 21 November 2018, 6748.

<sup>84</sup> Transcript, Catherine Livingstone, 21 November 2018, 6752.

<sup>85</sup> Transcript, Catherine Livingstone, 21 November 2018, 6754.

<sup>86</sup> Transcript, Catherine Livingstone, 21 November 2018, 6746.

<sup>87</sup> Transcript, Catherine Livingstone, 21 November 2018, 6754, 6755.

## What went wrong?

First, the information made available to the board about the risk management performance of the senior executives was plainly deficient. Among other things, it did not adequately inform the board of the nature or seriousness of issues that had been identified. It did not identify to the board who, among the Group Executives, was accountable for the issues. It made no real assessment of whether those executives had behaved in a way that exemplified the sound management of risks.

It is concerning that the information made available to the board was deficient in those ways. It is more concerning that the board did not seek more detailed information.

In subsequent years, the quality of the information provided to CBA's board about the risk management performance of CBA's executive has improved.<sup>88</sup>

But I cannot say that the problem may not exist in other entities. As recently as April 2018, APRA observed in its information paper on remuneration practices at large financial institutions that its review 'noted instances of poor quality, incomplete or inadequate documentation' about risk management performance being provided to board committees.<sup>89</sup>

All financial services entities, not just the largest, must examine carefully the findings set out in the report of the CBA Prudential Inquiry, and in APRA's information paper. All entities must consider, and keep considering, how they can improve the quality of information provided to boards and their committees in connection with remuneration decisions. And in this regard, as in all other aspects of board governance, 'quantity' of information is *not* the same as 'quality' of information. APRA should consider how it can require and encourage APRA-regulated institutions to improve the quality of that information when it updates its prudential standards and guidance in relation to remuneration.

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<sup>88</sup> See Transcript, Catherine Livingstone, 21 November 2018, 6767–9.

<sup>89</sup> APRA, Information Paper, Remuneration Practices at Large Financial Institutions, April 2018, 26.

The second point to make about CBA's treatment of remuneration in 2016 is more general. Up to and including 2016, the CBA board appears to have been unwilling to make any significant adjustment to variable remuneration as a result of risk-related matters. Between the 2011 financial year and the 2016 financial year, there were only seven instances, involving five executives where an executive's short-term remuneration was reduced as a result of a risk issue.<sup>90</sup> With one exception, the reductions were 20% or less.<sup>91</sup> And, in each case, the reason given for the reduction was damage to CBA's reputation.<sup>92</sup> That is, it appears that, unless and until risk and compliance issues became publicly known, accountability for those issues was not reflected in adjustments to executive remuneration.

Of course, all of that changed at CBA in the 2017 financial year, when the short-term variable remuneration for the CEO and all Group Executives was reduced to zero, following the filing of AUSTRAC's proceeding alleging significant breaches of AML/CTF laws.<sup>93</sup> Further, less dramatic reductions were made in the 2018 financial year.<sup>94</sup>

In the 2016 financial year, none of ANZ, NAB or Westpac made significant risk-related adjustments to the remuneration of its senior executives. By contrast, in the 2018 financial year:

- ANZ's board reduced the variable remuneration of four senior executives, including its CEO, for reasons related to risk, compliance or conduct.<sup>95</sup>
- CBA's board reduced the short-term variable remuneration of all of its Group Executives by 20% for reasons relating to the findings of the Prudential Inquiry. CBA's CEO offered to forego all of his short-term variable remuneration for the 2018 financial year, and the board accepted this offer. Further reductions were applied to other senior executives for reasons related to risk compliance or conduct.<sup>96</sup>

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<sup>90</sup> Transcript, Catherine Livingstone, 21 November 2018, 6767.

<sup>91</sup> Transcript, Catherine Livingstone, 21 November 2018, 6767.

<sup>92</sup> Transcript, Catherine Livingstone, 21 November 2018, 6767–8.

<sup>93</sup> CBA, Annual Report, 2017, 67.

<sup>94</sup> CBA, Annual Report, 2018, 98–100.

<sup>95</sup> Exhibit 7.120, Witness statement of Shayne Elliott, 22 November 2018, 28–9 [115].

<sup>96</sup> CBA, Annual Report, 2018, 98.

- NAB's board reduced the variable remuneration of its senior executives by 10% to 75% for reasons related to risk, compliance or conduct.<sup>97</sup>
- Westpac's board reduced the short-term variable remuneration of the CEO, Brian Hartzer, by 15%, and of all other Group Executives (except two) by 10%. It also made further reductions to the variable remuneration of three Group Executives.<sup>98</sup>

It is encouraging to see that boards appear to have grasped the importance of implementing their remuneration policies in a way that encourages the sound management of non-financial risks, and reduces the risk of misconduct. It remains to be seen whether boards continue this practice in the coming years, where issues of remuneration and misconduct are not subject to the same public scrutiny as they have been during the life of this Commission.

### *Supervision of implementation*

One way to ensure that boards continue to implement their remuneration policies in a way that encourages the sound management of non-financial risks, and reduces the risk of misconduct, is to ensure that there is ongoing and effective supervision of the way that boards discharge that responsibility.

In the case of APRA-regulated institutions, that supervision is properly the role of APRA. However, the evidence before the Commission indicated that, in the past, APRA's supervision of remuneration practices has been lacking.

Mr Byres explained that APRA's supervision teams do not normally collect information about the way that the remuneration arrangements of APRA-regulated institutions are applied in practice.<sup>99</sup> This is despite the fact that as long ago as 2009, the FSB's Principles stated that '[s]upervisory review of compensation practices must be rigorous and sustained and deficiencies must be addressed promptly with supervisory action'.<sup>100</sup> When APRA did collect information about the way that remuneration arrangements were

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<sup>97</sup> NAB, Annual Report, 2018, 39.

<sup>98</sup> Westpac Group, Annual Report, 2018, 48.

<sup>99</sup> Transcript, Wayne Byres, 29 November 2018, 7410.

<sup>100</sup> FSB, Principles, 3.

applied in practice – in the context of the review that led to its information paper on remuneration practices at large financial institutions, and in the course of the Prudential Inquiry – it identified serious deficiencies in the way that those arrangements were being implemented. However, both of those reviews occurred in 2017 and 2018. For most of the period that APRA's standards and governance in relation to remuneration have been in force, APRA has not collected detailed information about the way remuneration arrangements have been applied in practice.<sup>101</sup>

As noted above, in November 2018, the FSB published its 'Recommendations for National Supervisors: Reporting on the Use of Compensation Tools to Address Potential Misconduct Risk'. The Recommendations complement the FSB's Supplementary Guidance by setting out the types of data that can support improved monitoring by supervisory authorities on the use of remuneration arrangements to address the risk of misconduct in financial services entities.<sup>102</sup>

**APRA should increase the intensity of its supervision of the way APRA-regulated institutions implement their remuneration frameworks. This will require APRA to collect more information about the way those frameworks are applied in practice, including information of the kind described in the FSB's Recommendations.**

**I recognise that increasing the intensity of supervision in this area will require additional resources. Mr Byres noted several times in his evidence that APRA's supervisory resources were limited, and that it was necessary for APRA to prioritise particular activities.<sup>103</sup> Mr Byres explained that the Government had recently provided APRA with additional resources to undertake this sort of work.<sup>104</sup> As the work of FSB shows, supervisory review of compensation practices should be rigorous and sustained. It is an essential part of the prudential supervisor's work and that should be reflected in the way in which APRA is funded.<sup>105</sup>**

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<sup>101</sup> Transcript, Wayne Byres, 29 November 2018, 7410.

<sup>102</sup> FSB, *Recommendations for National Supervisors: Reporting on the Use of Compensation Tools to Address Potential Misconduct Risk*, 23 November 2018.

<sup>103</sup> See Transcript, Wayne Byres, 29 November 2018, 7411.

<sup>104</sup> Transcript, Wayne Byres, 29 November 2018, 7411.

<sup>105</sup> FSB, *Principles*, 3.

**In addition to the activities and processes associated with the monitoring of remuneration arrangements, the work of FSB also shows that increased supervision of remuneration practices must be supported, where necessary, with prompt supervisory action.**<sup>106</sup>

Mr Byres said that since APRA introduced remuneration requirements into its prudential standards in 2010, it had never taken action against an APRA-regulated institution for failing to comply with those requirements.<sup>107</sup>

I have already described the course of events about CBA's 2016 determination of variable remuneration for the CEO and senior executives. Mr Byres rightly accepted that APRA could, and should, have done more than it did in response to these events.<sup>108</sup> He said that APRA did not take these steps because it was an area in which APRA did not yet have 'sufficient expertise to really be confident challenging [CBA]'.<sup>109</sup>

**It is to be hoped that, following its more recent work in the Prudential Inquiry, and its review of remuneration practices at large financial institutions, APRA does now have the confidence and expertise that Mr Byres felt it lacked in 2016. If it does not, APRA should seek to develop that confidence and expertise as quickly as possible. As I have said, this is a necessary part of the prudential supervisor's work.**

### *Disclosure of consequences*

The final issue can again be addressed briefly. Should entities disclose more information about risk-related adjustments to executive remuneration?

At the moment, listed companies are required to disclose prescribed information about executive remuneration in their annual reports, including the total amount of variable remuneration received by senior executives. Companies are not required, however, to disclose information about whether risk-related adjustments have been made to the remuneration of senior executives, and therefore are not required either to set out why the board made particular risk-related adjustments to executive remuneration.

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<sup>106</sup> FSB, Principles, 3.

<sup>107</sup> Transcript, Wayne Byres, 29 November 2018, 7422.

<sup>108</sup> Transcript, Wayne Byres, 29 November 2018, 7417.

<sup>109</sup> Transcript, Wayne Byres, 29 November 2018, 7418.

When asked about that situation, Ms Livingstone said that ‘there would probably be merit in [disclosing] more detail on an individual basis as to what the risk-adjusted outcomes were’,<sup>110</sup> and agreed that that would send a powerful message about the way that CBA responds to misconduct.<sup>111</sup>

Mr Byres described disclosure of this kind of information as a ‘double-edged sword’.<sup>112</sup> His chief concern was that public disclosure of that kind might deter boards from making risk-related adjustments, if explaining the reasons for doing so would require the board to disclose risk-related issues that were otherwise known only within the institution.<sup>113</sup>

As I have said, **the remuneration arrangements of an entity show what the entity values. If the board reduces the variable remuneration of executives for their poor management of non-financial risks, and tells other staff that the variable remuneration of those who are accountable for particular events or forms of conduct has been reduced, it sends a clear message to all staff about both accountability and what kinds of conduct the board regards as unacceptable. No public disclosure should be required.**

#### **Recommendation 5.1 – Supervision of remuneration – principles, standards and guidance**

In conducting prudential supervision of remuneration systems, and revising its prudential standards and guidance about remuneration, APRA should give effect to the principles, standards and guidance set out in the Financial Stability Board’s publications concerning sound compensation principles and practices.

Recommendations 5.2 and 5.3 explain and amplify aspects of this Recommendation.

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<sup>110</sup> Transcript, Catherine Livingstone, 21 November 2018, 6782.

<sup>111</sup> Transcript, Catherine Livingstone, 21 November 2018, 6782.

<sup>112</sup> Transcript, Wayne Byres, 29 November 2018, 7407.

<sup>113</sup> Transcript, Wayne Byres, 29 November 2018, 7407.

### **Recommendation 5.2 – Supervision of remuneration – aims**

In conducting prudential supervision of the design and implementation of remuneration systems, and revising its prudential standards and guidance about remuneration, APRA should have, as one of its aims, the sound management by APRA-regulated institutions of not only financial risk but also misconduct, compliance and other non-financial risks.

### **Recommendation 5.3 – Revised prudential standards and guidance**

In revising its prudential standards and guidance about the design and implementation of remuneration systems, APRA should:

- require APRA-regulated institutions to design their remuneration systems to encourage sound management of non-financial risks, and to reduce the risk of misconduct;
- require the board of an APRA-regulated institution (whether through its remuneration committee or otherwise) to make regular assessments of the effectiveness of the remuneration system in encouraging sound management of non-financial risks, and reducing the risk of misconduct;
- set limits on the use of financial metrics in connection with long-term variable remuneration;
- require APRA-regulated institutions to provide for the entity, in appropriate circumstances, to claw back remuneration that has vested; and
- encourage APRA-regulated institutions to improve the quality of information being provided to boards and their committees about risk management performance and remuneration decisions.

## **1.3 Front line remuneration**

Much of the evidence the Commission obtained about remuneration of front line staff related to the front line or ‘customer-facing’ staff in banks. Much of the discussion below is framed with that context in mind. But what is said applies to any financial services entity that provides products or services to consumers. And, as will become apparent, many of the problems with which

I deal emerged most vividly in connection with the direct sale of life insurance products.<sup>114</sup>

Like senior executives, front line employees in banks, until recently, have typically been paid fixed and variable remuneration.

Front line variable remuneration has typically been awarded, at least in part, on the basis of financial metrics, which encourage the employee to sell products.

On its face, this is unsurprising. Banks are commercial enterprises. Why not encourage and reward sales? And focusing on sales or profits provides concrete, quantifiable measures of performance. What could be simpler or better?

There is a short and obvious answer. **Focusing only on *what* is to be sold is not enough. *How* the employee does the job is at least as important as *what* the employee does.**

***How as well as *what* is important because it is not now, and cannot be, disputed that variable remuneration can pose ‘an unacceptable risk of promoting behaviour that is inconsistent with the interests of customers’.***<sup>115</sup> **Yet the focus on *what* continues.**

In an example of this narrow focus, CBA CEO Mr Matthew Comyn described short-term variable remuneration as a way of ‘eliciting discretionary effort’ from front line staff, defining discretionary effort as ‘the difference between what [staff] might have otherwise done ... if they were paid a fixed remuneration, versus if they had at least a proportion of their remuneration’ that was variable.<sup>116</sup> Yet, when the expression ‘discretionary effort’ is unpacked, it is evident that it is used as a euphemism for selling the bank’s products.<sup>117</sup> And Mr Hartzer also provided some more concrete

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<sup>114</sup> See, eg, the Select case study from the fourth round of hearings and the ClearView and Freedom case studies from the sixth round of hearings.

<sup>115</sup> Sedgwick Review, Report, i; Transcript, Matthew Comyn, 19 November 2018, 6535–6; Transcript, Brian Hartzer, 22 November 2018, 6868, 6872; Transcript, Andrew Thorburn, 26 November 2018, 7043; Transcript, Shayne Elliott, 28 November 2018, 7322.

<sup>116</sup> Transcript, Matthew Comyn, 19 November 2018, 6530–1.

<sup>117</sup> Transcript, Matthew Comyn, 19 November 2018, 6537.

examples of the activities that Westpac sought to encourage by including financial metrics as part of a variable remuneration balanced scorecard for its staff: contributing to a net growth in deposits, a net growth in the number of customers and a net growth of loan balances.<sup>118</sup>

Of course, variable remuneration is not the only way to encourage desired behaviour. Banks can provide staff with positive feedback on their performance, encourage them to take pride in their work, encourage them to take satisfaction from assisting customers, give them additional responsibilities and offer them a promotion or a higher base salary.<sup>119</sup>

Nor is variable remuneration the only way to discourage poor behaviour, or to respond to poor behaviour.<sup>120</sup> Disapproval of the behaviour of front line staff can be demonstrated in many different ways, including withholding a promotion, removing some of their duties, or taking a range of disciplinary actions.<sup>121</sup>

In the end, as Mr Shayne Elliott, CEO of ANZ emphasised, ANZ's 'experience and research [has shown that] the most powerful tool' to influence the conduct of staff is the influence exercised by a staff member's manager.<sup>122</sup> And that is unsurprising. Good management of staff produces good outcomes for the business and for the customer.

The ends that entities are seeking to achieve through variable remuneration can be achieved through other means. Those other means are to be preferred, if they carry fewer intrinsic risks with them. And, as indicated by the evidence given by Mr Johanson, those other means may be no less effective. Mr Johanson explained that Bendigo had removed all sales-based incentives and commissions for front line staff more than 10 years before.<sup>123</sup> Those incentives and commissions had not been prevalent within

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<sup>118</sup> Transcript, Brian Hartzler, 22 November 2018, 6869.

<sup>119</sup> See, eg, Transcript, Matthew Comyn, 19 November 2018, 6532.

<sup>120</sup> Transcript, Matthew Comyn, 19 November 2018, 6535; Transcript, Shayne Elliott, 28 November 2018, 7322.

<sup>121</sup> Transcript, Matthew Comyn, 19 November 2018, 6535.

<sup>122</sup> Transcript, Shayne Elliott, 28 November 2018, 7322.

<sup>123</sup> Transcript, Robert Johanson, 29 November 2018, 7379.

the bank prior to that time.<sup>124</sup> When asked whether the lack of sales-based incentives and commissions had affected employees' motivation to serve their customers, Mr Johanson said that it had not: the bank's employees got their satisfaction from 'being trusted' and from customers 'feeling [that] they're doing a good job'.<sup>125</sup>

Ultimately, Mr Comyn said that he was 'open-minded' about removing variable remuneration for CBA's front line staff.<sup>126</sup>

Banks have recently made, and are continuing to make, significant changes to the ways in which they remunerate front line staff.<sup>127</sup> Many of these changes appear to have been made in response to the recommendations contained in the Sedgwick Report, which I have discussed above.<sup>128</sup>

**In my view, full implementation of the Sedgwick recommendations is an important first step towards improving front line remuneration practices. But implementation will only improve these practices if banks implement the Sedgwick recommendations *both in letter and in spirit*.** To give just a few examples, as indicated in the Sedgwick Report, banks must give careful attention to the way in which they structure any balanced scorecard that is used to award variable remuneration. Any financial metrics must be capped at 33% or less by 2020, and any non-financial metrics must be genuinely non-financial (Mr Sedgwick gave the example of classifying particular metrics as 'customer' metrics when they were arguably financial in character).<sup>129</sup> Banks must ensure that, where their remuneration systems allow for discretion, that discretion is exercised

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<sup>124</sup> They had for a period been offered by a wealth business that the bank acquired: Transcript, Robert Johanson, 29 November 2018, 7379.

<sup>125</sup> Transcript, Robert Johanson, 29 November 2018, 7380.

<sup>126</sup> Transcript, Matthew Comyn, 19 November 2018, 6556.

<sup>127</sup> Transcript, Matthew Comyn, 19 November 2018, 6530, 6540; Transcript, Andrew Thorburn, 26 November 2018, 7045; Transcript, Shayne Elliott, 28 November 2018, 7316–20, 7322–3.

<sup>128</sup> Transcript, Matthew Comyn, 19 November 2018, 6540; Transcript, Brian Hartzer, 22 November 2018, 6868; Transcript, Andrew Thorburn, 26 November 2018, 7040–1, 7044; Transcript, Shayne Elliott, 28 November 2018, 7316.

<sup>129</sup> Sedgwick Review, Report, 8, note following Recommendation 3; FSRC, *Interim Report*, vol 1, 309–13.

consistently with the recommendations put forward by Mr Sedgwick.<sup>130</sup> And banks must avoid giving an unduly narrow meaning to particular terms within recommendations that are clearly intended to have some breadth (for example, the concept that banks are to ‘remove variable reward payments and campaign related incentives that are *directly* linked to sales or the achievement of sales targets’).<sup>131</sup>

**But implementation of the Sedgwick recommendations is only the first step. As I have sought to emphasise above, banks must continue to give frequent and considered thought to how their variable remuneration systems are structured: to whether they are geared not only to *what* employees do but *how* they do it.**

The evidence showed that a number of entities have taken, or are taking, these types of steps.

For example, in 2017, CBA removed financial metrics from the scorecard for its tellers.<sup>132</sup> Mr Comyn said that this decision was made after a ‘lot of work’ considering appropriate remuneration structures, and in the hope that it might improve customer outcomes.<sup>133</sup> Since removing these metrics, Mr Comyn had not observed a deterioration in tellers’ performance.<sup>134</sup> He considered that, if asked, his staff members would consistently say that they preferred an environment without financial metrics, because:<sup>135</sup>

there’s a very strong sense of [the] customer in our customer-facing teams, who actually take a lot of pride in doing a good job for their customers, and having their performance solely evaluated on their advocacy as opposed to an element of financial performance, I would say certainly for many ... if not the majority, [that] would be their preference.

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<sup>130</sup> See, eg, Sedgwick Review, Report, 8, Recommendations 4 and 5 and note following Recommendation 5.

<sup>131</sup> Sedgwick Review, Report, 8, Recommendation 2 (emphasis in original).

<sup>132</sup> Transcript, Matthew Comyn, 19 November 2018, 6545–6; Exhibit 7.2, Witness statement of Matthew Comyn, 14 November 2018, 70 [253(e)].

<sup>133</sup> Transcript, Matthew Comyn, 19 November 2018, 6545.

<sup>134</sup> Transcript, Matthew Comyn, 19 November 2018, 6545, 6556.

<sup>135</sup> Transcript, Matthew Comyn, 19 November 2018, 6546.

ANZ has also experimented with its remuneration structures. By early 2017, prior to the publication of the Sedgwick Report, ANZ had conducted what it termed a ‘test and learn trial’ in one of its retail banking districts over 15 months.<sup>136</sup> During the trial, staff had individual sales targets removed from their incentive plans, and customer-based metrics were added in their place.<sup>137</sup> Customers reported increased levels of satisfaction with their branch experience, and good levels of staff engagement were recorded.<sup>138</sup> However, ANZ recorded that overall sales figures declined and that the district ‘performed worse on sales than the average across the entire Australian branch network’.<sup>139</sup> From this trial, ANZ concluded that there was ‘a role for sales targets and that incentive plans that take into account “whole of role” performance through a balanced scorecard approach are likely to be optimal’.<sup>140</sup>

ANZ is now undertaking a broader project that is assessing whether ANZ’s reward structure – including its remuneration, performance management, recognition and benefits system – is properly aligned to ANZ’s purpose, culture and strategic direction.<sup>141</sup> The project covers the whole organisation, including front line staff.<sup>142</sup> Mr Elliott emphasised that the project is still being developed, and has not yet been approved,<sup>143</sup> but he said that ANZ expects to be able to implement any revised model in the financial year beginning 1 October 2019.<sup>144</sup>

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<sup>136</sup> Transcript, Shayne Elliott, 28 November 2018, 7317; Exhibit 7.131, February 2017, ANZ Response to Sedgwick Issues Paper, 1 [6.1].

<sup>137</sup> Transcript, Shayne Elliott, 28 November 2018, 7317; Exhibit 7.131, February 2017, ANZ Response to Sedgwick Issues Paper, 1 [6.1].

<sup>138</sup> Transcript, Shayne Elliott, 28 November 2018, 7317; Exhibit 7.131, February 2017, ANZ Response to Sedgwick Issues Paper, 1 [6.1].

<sup>139</sup> Transcript, Shayne Elliott, 28 November 2018, 7317; Exhibit 7.131, February 2017, ANZ Response to Sedgwick Issues Paper, 1 [6.1].

<sup>140</sup> Transcript, Shayne Elliott, 28 November 2018, 7317; Exhibit 7.131, February 2017, ANZ Response to Sedgwick Issues Paper, 2 [6.1].

<sup>141</sup> Transcript, Shayne Elliott, 28 November 2018, 7319; Exhibit 7.132, 6 August 2018, Reimagining Reward Slide Pack, 4.

<sup>142</sup> Transcript, Shayne Elliott, 28 November 2018, 7319.

<sup>143</sup> Transcript, Shayne Elliott, 28 November 2018, 7319.

<sup>144</sup> Transcript, Shayne Elliott, 28 November 2018, 7320.

Three key remuneration changes are being considered as part of ANZ's project.<sup>145</sup> Two are significant for present purposes. The first is changing the staff remuneration mix, so that staff receive an increased proportion of fixed remuneration and a decreased proportion of variable remuneration.<sup>146</sup> Mr Elliott explained that this proposal was in part motivated by a concern that ANZ had 'become too reliant on variable remuneration'.<sup>147</sup>

The second is changing the basis for *allocating* variable remuneration: ANZ is considering moving to a system in which at least a portion of variable remuneration is awarded based on a group, rather than individual, financial metric. Mr Elliott explained that ANZ had formed the view that 'too many' of its staff members had individual performance-based variable remuneration as part of their remuneration mix.<sup>148</sup> Mr Elliott suggested that individual performance-based variable remuneration was:<sup>149</sup>

flawed in an organisation like [ANZ's] where we require far more collaboration and team work to achieve good outcomes than ... the summation of an individual.

Mr Elliott indicated that he saw value in introducing **variable remuneration that was largely based on group performance for 'a broad range' of staff members** within ANZ, including call centre staff, branch staff, most operational staff, customer complaints staff and technology staff.<sup>150</sup>

As part of the project, ANZ has trialled a pilot program in 50 branches, in which staff members no longer have individual financial targets but contribute to collective branch targets.<sup>151</sup> The purpose of the program was to test the hypothesis that 'having team financial targets [would] improve

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<sup>145</sup> Exhibit 7.132, 6 August 2018, Reimagining Reward Slide Pack, 9.

<sup>146</sup> Exhibit 7.132, 6 August 2018, Reimagining Reward Slide Pack, 9.

<sup>147</sup> Transcript, Shayne Elliott, 28 November 2018, 7320.

<sup>148</sup> Transcript, Shayne Elliott, 28 November 2018, 7320.

<sup>149</sup> Transcript, Shayne Elliott, 28 November 2018, 7320.

<sup>150</sup> Transcript, Shayne Elliott, 28 November 2018, 7321.

<sup>151</sup> Transcript, Shayne Elliott, 28 November 2018, 7322; Exhibit 7.133, August 2018, Simplifying Performance Management Pilot CCC Roll Out, 2.

customer experience and banker experience, without adversely impacting business performance'.<sup>152</sup> All other performance metrics remained unchanged.<sup>153</sup>

Mr Elliott described the results of the pilot as 'encouraging'.<sup>154</sup> Among other things, customers appeared to be 'achieving better outcomes' or having a 'better experience', there has been 'no diminution in business performance', and ANZ staff 'say they prefer it'.<sup>155</sup> The feedback received from ANZ staff included that this system seemed to encourage better teamwork, better utilisation of staff members' individual areas of expertise and better education between staff, resulting in a 'more seamless experience' for ANZ's customers.<sup>156</sup> Mr Elliott accepted that 'a large number of positives ... have flowed from this pilot' and that there have not been any 'obvious drawbacks'.<sup>157</sup>

**There are evident advantages, and no obvious disadvantages, in moving to this type of model. And there may be advantages, and no disadvantages, in moving to other models, such as models that increase the amount of fixed remuneration paid to staff and decrease variable remuneration, or that remove variable remuneration altogether. The point is that this work should continue. Entities must challenge assumptions about how they can and should encourage certain behaviours and discourage others. In the end, good management, at all levels, is the best and most effective way to obtain the best results.**

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<sup>152</sup> Transcript, Shayne Elliott, 28 November 2018, 7323; Exhibit 7.133, August 2018, Simplifying Performance Management Pilot CCC Roll Out, 2.

<sup>153</sup> Transcript, Shayne Elliott, 28 November 2018, 7323–4; Exhibit 7.133, August 2018, Simplifying Performance Management Pilot CCC Roll Out, 3.

<sup>154</sup> Transcript, Shayne Elliott, 28 November 2018, 7324.

<sup>155</sup> Transcript, Shayne Elliott, 28 November 2018, 7324; see also Exhibit 7.133, August 2018, Simplifying Performance Management Pilot CCC Roll Out, 2.

<sup>156</sup> Transcript, Shayne Elliott, 28 November 2018, 7325; see also Exhibit 7.133, August 2018, Simplifying Performance Management Pilot CCC Roll Out, 5.

<sup>157</sup> Transcript, Shayne Elliott, 28 November 2018, 7325.

### **Recommendation 5.4 – Remuneration of front line staff**

All financial services entities should review at least once each year the design and implementation of their remuneration systems for front line staff to ensure that the design and implementation of those systems focus on not only on what staff do, but also how they do it.

### **Recommendation 5.5 – The Sedgwick Review**

Banks should implement fully the recommendations of the Sedgwick Review.

## **2 Culture**

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I have said more than once in this chapter that an entity's remuneration and incentive arrangements show what the entity values. Hence, consideration of those arrangements may provide a useful starting point for an examination of the entity's culture. But an entity's remuneration and incentive arrangements are not the same as its culture. Culture is a broader concept that is also influenced by other matters.

As I have said, the culture of an entity can be described as 'the shared values and norms that shape behaviours and mindsets' within the entity.<sup>158</sup> It is 'what people do when no-one is watching'.<sup>159</sup> Culture can drive or discourage misconduct.<sup>160</sup>

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<sup>158</sup> Cf CBA Prudential Inquiry, Final Report, 81. I deliberately omit reference to a 'system' of shared values and norms if only to emphasise that culture is observed and described, not created apart from, or imposed on, the entity.

<sup>159</sup> G30, *Banking Conduct and Culture: A Call for Sustained and Comprehensive Reform*, July 2015, 17.

<sup>160</sup> See generally FSB, Toolkit.

Three general points should be made:

- First, the culture of each entity is unique, and may vary widely within different parts of the entity.
- Second, there is no single ‘best practice’ for creating or maintaining a desirable culture, but one necessary aspect of a desirable culture is adherence to the basic norms of behaviour that I have described elsewhere in this Report:
  - obey the law;
  - do not mislead or deceive;
  - act fairly;
  - provide services that are fit for purpose;
  - deliver services with reasonable care and skill; and
  - when acting for another, act in the best interests of that other.
- Third, culture cannot be prescribed or legislated. Proper governance, a healthy culture, and accountability are desired outcomes, but they cannot be imposed by rules that say, ‘You must ...’ or ‘You may not ...’. ‘Culture is about behaviors. Behaviors in general are not amenable to legislation or regulation. ... Sustainable cultures need to arise from, and be embedded in banks’ [and other entities’] DNA’.<sup>161</sup>

Although culture cannot be prescribed or legislated, it can be assessed. As the report of the Prudential Inquiry into CBA shows, a careful and detailed assessment of the culture of an entity can be of great value. It can show how issues relating to culture are at the root of misconduct. And if those issues can be identified early, then steps can be taken to address them before the misconduct eventuates.

Culture can – and must – be assessed by financial services entities themselves. As I will explain, that is a requirement of APRA’s prudential standards (at least in relation to ‘risk culture’). It is also common sense.

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<sup>161</sup> G30, *Banking Conduct and Culture: A Call for Sustained and Comprehensive Reform*, July 2015, 55.

Given the potential for aspects of an entity's culture to drive misconduct, an entity must form a view of its own culture, identify problematic aspects of that culture, develop and implement a plan to change them, and then re-assess to determine whether it has succeeded. Each financial services entity has primary responsibility for its own culture.

Of course, there are dangers in leaving questions of culture to financial services entities. Everyone can be blind to their own faults, and the same is true for financial institutions. This will often be so with those institutions that have the most problematic culture. It is these entities that will be unwilling to acknowledge problems and deal with them. Unwillingness of this kind is a feature of organisational culture that is highly likely to allow, even drive, misconduct. There is, therefore, an important role for regulators to supervise culture – that is, to:

- assess the entity's culture;
- identify what is wrong with the culture;
- 'hold up a mirror' to the entity,<sup>162</sup> and educate the entity about its own culture;
- agree what the entity will do to change its culture; and
- supervise the implementation of those steps.

In this section of the chapter, I say something further about the assessment of culture by financial services entities, and by supervisors. I will begin with supervisors, before returning to consider what entities themselves have done, and must do.

## 2.1 Supervising culture

### 2.1.1 Responses to the GFC

While prudential supervisors have no doubt formed views about the culture of financial institutions for many years, the idea that the culture of financial institutions was directly linked to financial soundness and stability only appears to have taken hold in the wake of the GFC.

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<sup>162</sup> Exhibit 7.152, April 2018, Refocusing Risk Culture Pilot Reviews, 3.

As I have said, immediate responses focused on the potential for poor remuneration practices to undermine financial soundness and stability. But before long, attention turned to the failings of culture that had contributed to the crisis.

This focus on the culture of financial institutions was first (and most clearly) evident in the Netherlands. Mr Byres said that this:<sup>163</sup>

Reflect[ed] the fact that their financial system had essentially imploded [and] their large banks ... all had to be rescued, effectively, by their governments ... [The Dutch] were thinking very hard about how do we avoid getting into this situation again.

Mr Byres said that, in looking for ways to avoid repeating the effects of the financial crisis on Dutch banks, the central bank – De Nederlandsche Bank (DNB) – ‘went quite assertively into the area of culture and risk culture’, and created a team, including organisational psychologists, that would make assessments of culture within financial institutions.<sup>164</sup>

Since 2011, the DNB has overseen assessments of behaviour and culture in the institutions within its remit.<sup>165</sup> The DNB’s program is predicated on the idea that ‘[c]ulture and behaviour are essential elements for financial and prudential supervision, since the behaviour and culture of a financial organisation influence its financial and organisational performance’.<sup>166</sup> By 2015, the DNB had conducted 52 assessments of ‘banks, insurance companies, pension funds and trust offices’.<sup>167</sup> Most assessments focused

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<sup>163</sup> Transcript, Wayne Byres, 30 November 2018, 7429.

<sup>164</sup> Transcript, Wayne Byres, 30 November 2018, 7429.

<sup>165</sup> See DNB, *Supervision of Behaviour and Culture: Foundations, Practice and Future Developments*, 2015, 13, 305–6. See also DNB, *The Seven Elements of an Ethical Culture: Strategy and Approach to Behaviour and Culture at Financial Institutions 2010–2014*, November 2009, 4, 8–9.

<sup>166</sup> See DNB, *Supervision of Behaviour and Culture: Foundations, Practice and Future Developments*, 2015, 37.

<sup>167</sup> See DNB, *Supervision of Behaviour and Culture: Foundations, Practice and Future Developments*, 2015, 16–17.

on senior management.<sup>168</sup> According to the DNB, more than half of the boards assessed ‘showed serious problems with regard to their board culture’.<sup>169</sup>

Although the DNB appears to have acted first in this area, it was not alone. In November 2012, the FSB published a paper about the need for more intense and effective supervision of systemically important financial institutions.<sup>170</sup> Among other things, the paper recommended that supervisors, like APRA, explore ways to formally assess the risk culture of financial institutions.<sup>171</sup>

Following on from that recommendation, in April 2014, the FSB published its ‘Guidance on Supervisory Interaction with Financial Institutions on Risk Culture’ (the Guidance).<sup>172</sup> Consistent with the FSB’s focus on financial soundness and stability in the period following the GFC, the Guidance focused specifically on the ‘risk culture’ of financial institutions, rather than their organisational culture more generally. The Guidance said that:<sup>173</sup>

Weaknesses in risk culture are often considered a root cause of the global financial crisis, headline risk and compliance events. A financial institution’s risk culture plays an important role in influencing the actions and decisions taken by individuals within the institution and in shaping the institution’s attitude toward its stakeholders, including its supervisors.

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<sup>168</sup> See DNB, *Supervision of Behaviour and Culture: Foundations, Practice and Future Developments*, 2015, 19.

<sup>169</sup> See DNB, *Supervision of Behaviour and Culture: Foundations, Practice and Future Developments*, 2015, 19.

<sup>170</sup> FSB, *Increasing the Intensity and Effectiveness of SIFI Supervision: Progress Report to the G20 Ministers and Governors*, 1 November 2012.

<sup>171</sup> FSB, *Increasing the Intensity and Effectiveness of SIFI Supervision: Progress Report to the G20 Ministers and Governors*, 1 November 2012, 3.

<sup>172</sup> FSB, *Guidance on Supervisory Interaction with Financial Institutions on Risk Culture: A Framework for Assessing Risk Culture*, 7 April 2014.

<sup>173</sup> FSB, *Guidance on Supervisory Interaction with Financial Institutions on Risk Culture: A Framework for Assessing Risk Culture*, 7 April 2014, 1.

A sound risk culture consistently supports appropriate risk awareness, behaviours and judgements about risk-taking within a strong risk governance framework. A sound risk culture bolsters effective risk management, promotes sound risk-taking, and ensures that emerging risks or risk-taking activities beyond the institution's risk appetite are recognised, assessed, escalated and addressed in a timely manner.

Like other documents released before the launch of the FSB's work plan in relation to misconduct in 2015, the Guidance did not identify particular risks with which it was concerned. Instead, it was directed to 'risk culture' and 'risk management' generally. Having been framed as part of the FSB's response to the GFC, it is likely that those to whom the Guidance was addressed would have understood it as referring principally to financial risks – that is, those risks with the most obvious and immediate potential to affect the financial soundness of the firm.

APRA's work on culture – in particular, risk culture – began at around this time.<sup>174</sup>

In 2014, APRA released a draft of CPS 220, a new prudential standard in relation to risk management.<sup>175</sup> That draft prudential standard would have introduced a requirement for the board of an APRA-regulated institution to 'ensure that a sound risk management culture is established and maintained throughout the institution'.<sup>176</sup> Mr Byres said that this proposed requirement met with considerable opposition, particularly from company directors.<sup>177</sup> There was a general concern among directors about the extent to which non-executive directors could 'ensure' anything (without descending into management), and a more specific concern about the extent to which directors could influence the risk culture of an institution.<sup>178</sup>

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<sup>174</sup> Transcript, Wayne Byres, 29 November 2018, 7393.

<sup>175</sup> Transcript, Wayne Byres, 30 November 2018, 7430.

<sup>176</sup> Transcript, Wayne Byres, 30 November 2018, 7430.

<sup>177</sup> Transcript, Wayne Byres, 30 November 2018, 7430.

<sup>178</sup> Transcript, Wayne Byres, 30 November 2018, 7430–1.

In response to those concerns, APRA changed the draft.<sup>179</sup> The prudential standard that was ultimately issued in January 2015 required the board of an APRA-regulated institution,<sup>180</sup> among other things, to ensure that it:<sup>181</sup>

- *forms a view* of the risk culture in the institution, and the extent to which that culture supports the ability of the institution to operate consistently within its risk appetite;
- identifies any desirable changes to the risk culture; and
- ensures the institution takes steps to address those changes.

Risk culture is a narrower concept than organisational culture. An entity's risk culture is one aspect of its culture. Risk culture depends on the organisational norms and behaviours that determine how risks are identified, understood, discussed and acted on.<sup>182</sup> Although the relevant risks are described in CPS 220 as the material risks facing the institution –being ‘those that could have a material impact, both financial and non-financial, on the institution or on the interests of depositors [or] policyholders’<sup>183</sup> – it appears that the emphasis at the time CPS 220 was issued was on financial risks.<sup>184</sup>

Another important development in Australia at this time was the establishment of a Governance, Culture and Remuneration (GCR) team within APRA.<sup>185</sup> Mr Byres explained that the creation of this team reflected a number of considerations:<sup>186</sup>

- that risk culture was a nebulous concept, and that APRA needed to develop a more systematic approach to examining and assessing how boards were approaching their new obligations;

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<sup>179</sup> Transcript, Wayne Byres, 30 November 2018, 7431.

<sup>180</sup> Defined for the purposes of this prudential standard as not including an RSE licensee. APRA's Prudential Standard SPS 220 applies to RSE licensees.

<sup>181</sup> APRA, Prudential Standard CPS 220, April 2018, cl 9(b) (emphasis added).

<sup>182</sup> APRA, Information Paper, Risk Culture, October 2016, 7–8.

<sup>183</sup> APRA, Prudential Standard CPS 220, April 2018, 5–6 [20].

<sup>184</sup> See APRA, Prudential Standard CPS 220, April 2018, 7 [26].

<sup>185</sup> Transcript, Wayne Byres, 29 November 2018, 7398.

<sup>186</sup> Exhibit 7.145, Witness statement of Wayne Byres, 27 November 2018, 94 [375].

- that APRA's supervisors were not well equipped to tackle a new area of interest without additional specialist support;
- that supervising risk culture was, internationally, at an embryonic stage, and that stronger connections with peer agencies were needed to draw on international experience; and
- that APRA lacked a central core of expertise in remuneration (and, to a lesser extent, governance), and that the three issues were inextricably linked.

### 2.1.2 Linking culture and conduct

In the first half of 2015, international bodies began to draw more explicit links not only between risk culture and financial soundness, but also between organisational culture and misconduct.

As I have said, the FSB launched its work plan on measures to address the risk of misconduct in May 2015. Part of that work plan concerned the relationship between organisational culture and the risk of misconduct, and the work that supervisors could do to form a view about the culture of financial institutions.<sup>187</sup>

In July 2015, the Group of Thirty (G30) published 'Banking Conduct and Culture: A Call for Sustained and Comprehensive Reform'.<sup>188</sup> The report said that, because '[b]anking is, in 2015, at a low point in terms of customer trust, reputation, and economic returns':<sup>189</sup>

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<sup>187</sup> See FSB, *Reducing Misconduct Risks in the Financial Sector: Progress Report to G20 Leaders*, 4 July 2017, 2–3.

<sup>188</sup> G30, the Consultative Group on International Economic and Monetary Affairs Inc, is an international body of leading financiers and academics that aims to deepen understanding of international economic and financial issues, and to explore the international repercussions of decisions taken in the public and private sectors. See <[www.group30.org](http://www.group30.org)>.

<sup>189</sup> G30, *Banking Conduct and Culture: A Call for Sustained and Comprehensive Reform*, July 2015, 11.

[t]here must be a sustained focus on conduct and culture by banks and the banking industry, boards, and management. Firms and their leaderships need to make major improvements in the culture within the banking industry and within individual firms.

The report insisted that prudential supervisors should have an important monitoring function, saying that ‘conduct-related prevention, using a range of informal and formal supervisory tools, backed up by robust enforcement, can produce a better outcome for society.’<sup>190</sup> The report also emphasised that:<sup>191</sup>

Supervisors should look on cultural questions as root cause analysis and intervene when they see demonstrably serious problems as opposed to making culture a generalized additional supervisory add-on.

Despite the emphasis on the relationship between conduct and culture in the G30’s paper, until very recently, there has only been limited *overt* attention given in Australia, by entities or by regulators, to issues about conduct and culture. Particular events of misconduct have been dealt with when they came to light, but regulators gave little or no public attention to what general responses should be made either to events that were then coming to light in Australia or to what had happened in other jurisdictions.

That proposition is perhaps best illustrated by considering the work of APRA’s GCR team following its establishment in 2015.

One of the first major pieces of work that team completed was a review of how APRA-regulated institutions were complying with the requirement for the board to form a view of the institution’s risk culture.<sup>192</sup> That review resulted in an information paper entitled ‘Risk Culture’, which APRA published in October 2016.<sup>193</sup>

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<sup>190</sup> G30, *Banking Conduct and Culture: A Call for Sustained and Comprehensive Reform*, July 2015, 15.

<sup>191</sup> G30, *Banking Conduct and Culture: A Call for Sustained and Comprehensive Reform*, July 2015, 64.

<sup>192</sup> Transcript, Wayne Byres, 30 November 2018, 7435.

<sup>193</sup> Transcript, Wayne Byres, 30 November 2018, 7435.

For the most part, the information paper focused on risk culture as it related to the management of financial risk. The examples APRA gave in the information paper of poor risk culture were the failure of HIH Insurance in 2001; increased risk-taking in the life insurance industry, particularly with respect to **group life insurance**; and what it called the sacrificing of sound market practices for the origination of residential mortgage loans in favour of preserving market share and growth.<sup>194</sup>

Towards the end of the information paper, APRA indicated that it intended to 'refine and sharpen its approach to assessing risk culture' through a program of pilot risk culture reviews.<sup>195</sup> Mr Byres explained that 'what we were flagging [there] was that instead of [risk culture] being a part-time or adjunct or add-on to some other primary activity, that we would actually try and do some reviews where the primary purpose was to assess culture or risk culture'.<sup>196</sup>

The first of those reviews commenced in July 2017, and was completed in November 2017.<sup>197</sup> APRA made an independent assessment of the relevant entity's culture, through work including surveys, interviews, document reviews, focus groups and observations.<sup>198</sup> A second review had been planned to commence in October 2017, but was overtaken by the announcement of APRA's Prudential Inquiry into CBA.<sup>199</sup>

APRA's Prudential Inquiry into CBA marked a watershed in APRA's approach to issues of governance, culture and remuneration.

Mr Byres said that, from 2016, the APRA supervision team responsible for CBA had identified 'a raft of issues that [the team was] pursuing' with CBA.<sup>200</sup> He acknowledged that APRA's ordinary supervisory activity

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<sup>194</sup> APRA, Information Paper, Risk Culture, October 2016, 4.

<sup>195</sup> APRA, Information Paper, Risk Culture, October 2016, 24.

<sup>196</sup> Transcript, Wayne Byres, 30 November 2018, 7436.

<sup>197</sup> Transcript, Wayne Byres, 30 November 2018, 7436.

<sup>198</sup> Transcript, Wayne Byres, 30 November 2018, 7436.

<sup>199</sup> Transcript, Wayne Byres, 30 November 2018, 7436–7.

<sup>200</sup> Transcript, Wayne Byres, 29 November 2018, 7420.

had not been fully effective at addressing these issues, or bringing about cultural change at CBA.<sup>201</sup>

On 3 August 2017, AUSTRAC instituted proceedings against CBA alleging failures to comply with AML/CTF laws.<sup>202</sup> On 28 August 2017, APRA appointed a panel to conduct an inquiry into CBA. The panel's terms of reference were 'to examine the frameworks and practices in relation to governance, culture and accountability within the CBA group' so as to identify, assess and consider certain identified matters and recommend (in effect) what initiatives or remedial actions (over and above those then being undertaken by CBA) needed to be undertaken.<sup>203</sup>

For the first time, APRA took public steps to examine a regulated institution's 'frameworks and practices in relation to governance, culture and accountability'.<sup>204</sup> And one of the particular matters the panel was required to examine was whether CBA's remuneration frameworks, or their implementation, were conflicting with 'sound risk management and compliance outcomes'.<sup>205</sup>

The panel made its report in April 2018. In that report, the panel made 35 recommendations, in relation to: the board and senior leadership; risk management and compliance; issue identification and escalation; financial objectives and prioritisation; accountability; remuneration; culture and leadership; and remediation initiatives.<sup>206</sup> CBA has agreed to implement all of the recommendations.<sup>207</sup>

But the value of the Inquiry goes beyond its application to CBA. The report provides a very valuable, publicly available account of the ways in which

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<sup>201</sup> Transcript, Wayne Byres, 30 November 2018, 7438; Exhibit 7.150, Undated, Reflections Following Prudential Inquiry by James Douglas, 4.

<sup>202</sup> *Chief Executive Officer of AUSTRAC v CBA*, FCA, NSD1305 of 2017, Statement of Agreed Facts and Admissions <[www.austrac.gov.au/sites/default/files/statement-agreed-facts-admissions-3june2018.pdf](http://www.austrac.gov.au/sites/default/files/statement-agreed-facts-admissions-3june2018.pdf)>.

<sup>203</sup> CBA Prudential Inquiry, Final Report, 105.

<sup>204</sup> CBA Prudential Inquiry, Final Report, 105.

<sup>205</sup> CBA Prudential Inquiry, Final Report, 105.

<sup>206</sup> CBA Prudential Inquiry, Final Report, 102–4.

<sup>207</sup> See Enforceable Undertaking, APRA and CBA, 30 April 2018 <[www.apra.gov.au/sites/default/files/20180430-CBA-EU-Executed.pdf](http://www.apra.gov.au/sites/default/files/20180430-CBA-EU-Executed.pdf)>.

failings of culture, governance and remuneration can act as drivers of misconduct. And it explains how those problems can be addressed.

Recognising the broader value of the Inquiry, APRA required each of the major banks (and many other large APRA-regulated institutions) to complete a self-assessment of the entity against the matters identified in the Prudential Inquiry report. Some made that assessment without external assistance; others engaged one or more consultants. The final versions of those self-assessments were provided to APRA at the end of November 2018.

### 2.1.3 The way forward

Despite recognising the value of analysing organisational culture as the Prudential Inquiry and the first of the pilot risk culture reviews did,<sup>208</sup> the evidence indicated that APRA was not planning to undertake further work of that kind. Instead, it was planning to refocus its risk culture review program. Rather than making independent assessments of the culture of financial services entities, APRA would seek to assess the way that the boards of financial institutions form a view of the risk culture of those institutions.<sup>209</sup>

**On its face, this refocusing of the risk culture review program represents a retreat to the approach adopted by APRA in connection with its information paper on risk culture. If that is right, I consider that the direction in which APRA is headed is not desirable.**

**As both the FSB and the G30 have made clear, there is an important role for supervisors in assessing the culture of financial services entities. I agree with the view of the G30 that '[s]upervisors should look on cultural questions as root cause analysis and intervene when they see demonstrably serious problems as opposed to making culture a generalized supervisory add-on'.<sup>210</sup> I also agree with the view of the G30 that:<sup>211</sup>**

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<sup>208</sup> Transcript, Wayne Byres, 30 November 2018, 7438.

<sup>209</sup> Transcript, Wayne Byres, 30 November 2018, 7437.

<sup>210</sup> G30, *Banking Conduct and Culture: A Call for Sustained and Comprehensive Reform*, July 2015, 64.

<sup>211</sup> G30, *Banking Conduct and Culture: A Call for Sustained and Comprehensive Reform*, July 2015, 64.

**It is essential that there be enough supervision resources, and with the right skill sets/seniority and expert support if needed, to engage constructively with banks on these issues. The main objective should be early problem identification and bank-led corrective action. Conduct and values should be part of mainstream supervisory processes as opposed to a separate add-on.**

In April 2018, the FSB released ‘Strengthening Governance Frameworks to Mitigate Misconduct Risks: A Toolkit for Firms and Supervisors’. Among other things, the Toolkit states that supervisors should:<sup>212</sup>

- build a supervisory programme focused on culture to mitigate the risk of misconduct;
- use a risk-based approach to prioritise for review the firms or groups of firms that display significant cultural drivers of misconduct;
- use a broad range of information and techniques to assess the cultural drivers of misconduct; and
- engage firms’ leadership with respect to observations on culture and misconduct.

In its November 2018 Recommendations for National Supervisors, FSB made recommendations ‘intended to support supervisors in their dialogue with firms, and to foster the development of better practice’.<sup>213</sup>

**Each of the steps and recommendations proposed by FSB should inform APRA’s supervision of the culture of APRA-regulated institutions.**

**I recognise that increasing the intensity of supervision in this area will require additional resources. As I noted earlier, Mr Byres explained that APRA’s supervisory resources were limited, and that it was necessary for APRA to prioritise particular activities.**<sup>214</sup>

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<sup>212</sup> FSB, Toolkit, 5.

<sup>213</sup> FSB, *Recommendations for National Supervisors: Reporting on the Use of Compensation Tools to Address Potential Misconduct Risk*, 23 November 2018, 4

<sup>214</sup> See Transcript, Wayne Byres, 29 November 2018, 7411.

**But, the work of the FSB, G30 and international practice more generally shows that this work is essential to the proper prudential supervision of banks and, in my view, other large APRA-regulated institutions. Because it is an essential part of prudential supervision, APRA must have the resources to do it.**

## 2.2 Changing culture

As I have said, each financial services entity is responsible for its own culture. Each must form a view of its culture, identify problems, develop and implement a plan to deal with them, and then determine whether the changes it has made have been effective.

Doing this will take time and effort. How much time and how much effort are shown by what ANZ has been doing.

Mr Elliott said that, during 2016, ANZ's internal audit team designed a cultural assessment tool, focused on organisational culture.<sup>215</sup> The tool measures four key 'levers' that are thought to affect ANZ's culture and the way that people within ANZ work:<sup>216</sup>

- leadership (tone from the top);
- middle management (tone from the middle);
- risk environment; and
- transparency ('speak up' culture).

The internal audit team makes its assessments in four steps. First, it engages with 'business leadership' to clarify the assessment process and determine its scope, and to seek input on the questions that it will ask.<sup>217</sup> Second, it conducts an online survey of the relevant employees,

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<sup>215</sup> Transcript, Shayne Elliott, 29 November 2018, 7344.

<sup>216</sup> Transcript, Shayne Elliott, 29 November 2018, 7345; Exhibit 7.136, 4 October 2017, Internal Audit Culture Assessment Board Presentation, 6, Appendix 1.

<sup>217</sup> Transcript, Shayne Elliott, 29 November 2018, 7345; Exhibit 7.136, 4 October 2017, Internal Audit Culture Assessment Board Presentation, 7, Appendix 1.

with a target response rate of 60%.<sup>218</sup> The team then undertakes a statistical analysis of the data returned.<sup>219</sup> Third, it conducts focus groups and individual interviews to clarify what are the cultural strengths and challenges, and it undertakes associated root cause analysis.<sup>220</sup> Fourth, it engages with the business about the outcomes of the survey.<sup>221</sup> ‘Engagement with the business’ has a number of different aspects, including:<sup>222</sup>

- presenting an executive summary to the leadership team;
- the leadership team developing an action plan over a three-month period, with oversight from the internal audit team; and
- continuing engagement with management to discuss the effectiveness of the agreed actions, with further formal re-assessments undertaken as needed.

By 30 June 2018, ANZ’s internal audit team had conducted more than 30 culture assessment reviews, covering more than 21,000 of ANZ’s employees.<sup>223</sup> Sixteen of those assessments were completed in ANZ’s 2018 financial year.<sup>224</sup> ANZ has begun re-assessing certain business units so that it can evaluate how the culture of those units has changed over time.<sup>225</sup> Mr Elliott explained the need for re-assessment by saying that

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<sup>218</sup> Transcript, Shayne Elliott, 29 November 2018, 7345; Exhibit 7.136, 4 October 2017, Internal Audit Culture Assessment Board Presentation, 7, Appendix 1.

<sup>219</sup> Transcript, Shayne Elliott, 29 November 2018, 7345; Exhibit 7.136, 4 October 2017, Internal Audit Culture Assessment Board Presentation, 7, Appendix 1.

<sup>220</sup> Transcript, Shayne Elliott, 29 November 2018, 7345; Exhibit 7.136, 4 October 2017, Internal Audit Culture Assessment Board Presentation, 7, Appendix 1.

<sup>221</sup> Transcript, Shayne Elliott, 29 November 2018, 7345; Exhibit 7.136, 4 October 2017, Internal Audit Culture Assessment Board Presentation, 7, Appendix 1.

<sup>222</sup> Transcript, Shayne Elliott, 29 November 2018, 7345; Exhibit 7.136, 4 October 2017, Internal Audit Culture Assessment Board Presentation, 7, Appendix 1.

<sup>223</sup> Transcript, Shayne Elliott, 29 November 2018, 7346.

<sup>224</sup> Transcript, Shayne Elliott, 29 November 2018, 7346.

<sup>225</sup> Transcript, Shayne Elliott, 29 November 2018, 7346.

sampling needs to be done ‘on a regular basis so that you can see change. Otherwise ... it’s all very interesting, but [without] see[ing] any actual outcome, it’s largely pointless’.<sup>226</sup>

When asked how the results of these audits were received by the relevant business units, Mr Elliott said:<sup>227</sup>

[W]hen this first idea came up, I have to admit I was a little sceptical about doing a cultural audit, how exactly would that work, what exactly would they ask, how reliable would the data be, because we already do a lot of surveys. So we piloted it ... And the feedback from the team, the recipients, a very senior person at the bank ... was that this [feedback] was enormously valuable information, and it gave them the ability to not only get this feedback, but do something about it.

Mr Elliott said that this work had played a part in changing ‘the culture and the conversation at the most senior level of the bank’ and he said that his team, the Board and the Human Resources Committee all cared about, and are giving consistent consideration to, the results of the culture audits.<sup>228</sup>

In addition to these area-based culture reviews, ANZ also undertakes much larger-scale culture reviews. Every year or two years, ANZ conducts entity-wide ‘My Voice’ surveys.<sup>229</sup> The 2018 survey received more than 15,000 responses.<sup>230</sup> Mr Elliott described the findings of these surveys as ‘an incredibly valuable piece of data’, because, he said, they tell ANZ what its staff ‘really think’ about the business.<sup>231</sup>

In its most recent report on banking culture, the G30 identified what it said were some of the ‘key lessons ... repeatedly raised in the interviews by financial sector leaders as they reflected on the lessons learned and the future of banking culture’.<sup>232</sup>

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<sup>226</sup> Transcript, Shayne Elliott, 29 November 2018, 7348–9.

<sup>227</sup> Transcript, Shayne Elliott, 29 November 2018, 7348.

<sup>228</sup> Transcript, Shayne Elliott, 29 November 2018, 7349.

<sup>229</sup> Transcript, Shayne Elliott, 29 November 2018, 7350.

<sup>230</sup> Transcript, Shayne Elliott, 29 November 2018, 7350.

<sup>231</sup> Transcript, Shayne Elliott, 29 November 2018, 7351.

<sup>232</sup> G30, *Banking Conduct and Culture: A Permanent Mindset Change*, November 2018, xii–xiii.

- ‘Managing culture is not a one-off event, but a continuous and ongoing effort that must be integrated into day-to-day business operations.’
- ‘Leadership always matters, and banks must embed conduct and culture messages and expectations from the top down, through middle management down to the teller in their organization. There is increasing awareness that tone from above is as important as tone from the top, and this requires a shift in how managers at all levels of the organization are trained, promoted and supported.’
- ‘While cultural norms and beliefs cannot be explicitly measured, the behaviours and outcomes that culture drives can and should be measured’.

The G30 also observed that the decade since the GFC had been a decade of ‘slow progress and uneven results’ for banking culture.<sup>233</sup>

It cannot be doubted that reform of organisational culture is difficult. Dr Henry said that it could take 10 years to embed the culture that NAB was striving to achieve.<sup>234</sup> Mr Elliott was more optimistic. He said that with an ‘obsessive focus by management to say that [culture] is really important [and] to lead by example’, cultural shifts could begin to be seen within two or three years.<sup>235</sup>

As I have said, every financial services entity, named in the Commission’s reports or not, must look to its culture. Given the conduct and events described in the Commission’s reports, some entities must change their culture and their governance. That will require continuing effort ‘integrated into day-to-day business operations’. It will require leadership from within the entities and continued attention by boards, senior executives and others within the entities as well as consideration and attention by APRA as prudential regulator.

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<sup>233</sup> G30, *Banking Conduct and Culture: A Permanent Mindset Change*, November 2018, xii–xiii.

<sup>234</sup> Transcript, Kenneth Henry, 26 November 2018, 7115.

<sup>235</sup> Transcript, Shayne Elliott, 29 November 2018, 7354.

### **Recommendation 5.6 – Changing culture and governance**

All financial services entities should, as often as reasonably possible, take proper steps to:

- assess the entity's culture and its governance;
- identify any problems with that culture and governance;
- deal with those problems; and
- determine whether the changes it has made have been effective.

**What entities must do can be stated in the form of a recommendation expressed only at a level of generality that some may too easily say 'does not apply to us'. But it does. It applies to every financial services entity, named or not named in the work of the Commission.** And to ignore the recommendation would be foolish and ignorant. It would be foolish because one of the chief lessons financial services entities must take from the work of this Commission is that every entity is and must be accountable for what it does. It would be ignorant because those who will not learn from history will repeat it.

**What the Recommendation requires is much more than an exercise in 'box-ticking'. Its proper application demands intellectual drive, honesty and rigour. It demands thought, work and action informed by what has happened in the past, why it happened and what steps are now proposed to prevent its recurrence. Above all, it demands recognition that the primary responsibility for misconduct in the financial services industry lies with the entities concerned and with those who manage and control them: their boards and senior management.**

**The Recommendation, although it is expressed generally, can and should be seen as both reflecting and building upon all the other recommendations that I make.** As I have explained in the introduction to this Report, all of the recommendations are informed by underlying principles that reflect basic norms of conduct and seek to answer four key questions. That is why, in the Introduction, I set out the recommendations not only in the order in which they appear in this Report but also in a way that drew out connections between them. This particular Recommendation requires entities to take all that is set out in this Report, including all the other recommendations that are made, and apply, re-apply, and keep re-applying what is said to their culture and their governance.

#### **Recommendation 5.7 – Supervision of culture and governance**

In conducting its prudential supervision of APRA-regulated institutions and in revising its prudential standards and guidance, APRA should:

- build a supervisory program focused on building culture that will mitigate the risk of misconduct;
- use a risk-based approach to its reviews;
- assess the cultural drivers of misconduct in entities; and
- encourage entities to give proper attention to sound management of conduct risk and improving entity governance.

### 3 Governance

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Coming now to the third of the principal themes of this chapter, as I said earlier, governance refers to all of the structures and processes by which an entity is run. It embraces not only by whom, and how, decisions are made, but also the values or norms to which the processes of governance are intended to give effect. Notions of accountability lie at the heart of governance. Who is to be held accountable for what is done or not done? How are those who are accountable held to account?

In 2006, in response to major corporate collapses, both in Australia (HIH Insurance) and overseas (Enron, Worldcom), APRA published prudential standards about governance.<sup>236</sup> The increased regulation of corporate governance in response to those collapses:<sup>237</sup>

sought to ensure that companies [would] operate in a way that is transparent and open and that minimises the risk of loss to stakeholders from mismanagement, fraud and conflicts of interest, as well as other factors that may motivate directors and managers of companies to operate in a manner that is detrimental to the interests of stakeholders.

Failings of corporate governance received less direct attention in the wake of the GFC than did failings in compensation practices and organisational culture (in particular, attitudes to risk). The GFC was seen as having been precipitated by compensation practices and problems of culture that contributed to the poor management of financial risks.

More recently, however, issues of governance have again received explicit attention.

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<sup>236</sup> Prudential Standards APS 510, GPS 510 and LPS 510 were all introduced in May 2006 and took effect from 1 October 2006. Prudential Standard CPS 510 was introduced in 2011, consolidating the three earlier Prudential Standards.

<sup>237</sup> Explanatory Statement, Banking (Prudential Standard) Determination No 2 of 2006 (Cth); Explanatory Statement, Insurance (Prudential Standard) Determination No 5 of 2006 (Cth).

In particular, the Prudential Inquiry into CBA highlighted the ways in which governance failings at CBA contributed to the reputational damage it had suffered. The panel concluded that:<sup>238</sup>

- there was inadequate oversight and challenge by the CBA Board and its gatekeeper committees of emerging non-financial risks;
- it was unclear who in CBA was accountable for risks, and how they were to be held accountable;
- issues, incidents and risks were not identified quickly, and were not managed and resolved with sufficient urgency; and
- not enough attention was being given to compliance.

The introduction of the BEAR for large ADIs in July 2018 has intensified the attention given to accountability.

Connections between failings in governance and the occurrence of misconduct can be examined under three headings: the role of the board, the entity's priorities and accountability.

The evidence before the Commission showed that too often, boards did not get the right information about emerging non-financial risks; did not do enough to seek further or better information where what they had was clearly deficient; and did not do enough with the information they had to oversee and challenge management's approach to these risks.

The evidence also showed that too often, financial services entities put the pursuit of profit above all else and, in particular, above the interests of their customers, and above compliance with the law. When financial services entities did have regard to risks, they gave priority to financial risks, leaving their frameworks for the management of non-financial risks underdeveloped.

The evidence further showed that too often, it was unclear who within a financial services entity was accountable for what. Without clear lines of accountability, consequences were not applied, and outstanding issues were left unresolved.

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<sup>238</sup> CBA Prudential Inquiry, Final Report, 3.

### 3.1 The role of the board

Boards cannot operate properly without having the right information. And boards do not operate effectively if they do not challenge management.

Two instances examined in evidence can be used to explain and justify those propositions. Both show the importance of a board getting the right information and using it effectively.

#### 3.1.1 CBA and AML/CTF

CBA's internal audit department identified issues with CBA's compliance with AML/CTF laws in 2013, 2015 and 2016.<sup>239</sup> In each of those years, internal audits gave the issues a 'red' rating – the most serious rating available.<sup>240</sup>

In 2016, although the 'red' rating was reported to the board's audit committee, the audit report on which that rating was based was not provided to the committee.<sup>241</sup> Ms Livingstone said that during her time on the audit committee, she could not recall anybody asking for a copy of that audit report, or any other audit report.<sup>242</sup>

The minutes of the meeting at which the 'red' rating was reported to the audit committee did not record the committee members challenging management's assurances that the matter was being dealt with.<sup>243</sup> Ms Livingstone said that at the board meeting in October 2016, she had challenged management about the AML/CTF issues.<sup>244</sup> The minutes of the meeting make no reference to an exchange of that kind.<sup>245</sup> Ms Livingstone said that at the meeting, she did not receive satisfactory answers to her questions, stating:<sup>246</sup>

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<sup>239</sup> Transcript, Catherine Livingstone, 20 November 2018, 6697.

<sup>240</sup> Transcript, Catherine Livingstone, 20 November 2018, 6697.

<sup>241</sup> Transcript, Catherine Livingstone, 20 November 2018, 6702.

<sup>242</sup> Transcript, Catherine Livingstone, 20 November 2018, 6702.

<sup>243</sup> Transcript, Catherine Livingstone, 20 November 2018, 6707–8.

<sup>244</sup> Transcript, Catherine Livingstone, 21 November 2018, 6727–8.

<sup>245</sup> Transcript, Catherine Livingstone, 21 November 2018, 6730.

<sup>246</sup> Transcript, Catherine Livingstone, 21 November 2018, 6727–8.

My judgment as a director at that time was further questioning of that detail would serve little purpose at that time, because it would simply elicit further unsatisfactory answers. What was clear to me was that neither management nor internal audit could articulate the problem that they were trying to solve, let alone identify the root cause of that problem. And, unfortunately, that judgment was borne out by subsequent events.

I cannot say whether other directors held a similar view.

What is clear is that when the audit committee was informed in December 2016 of the third 'red' rated audit report for AML/CTF issues, it did not do enough. The committee did not ask to see a copy of the audit report. It did not challenge, or at least adequately challenge, management about why three audit reports for the same issue over four years had all been rated 'red', or about management's assurances that the matter was being dealt with. When asked what the committee did to hold management to account for the failings and require management to fix those failings, Ms Livingstone said:<sup>247</sup>

the discussion ... would have been ... how long is it going to take and what's happening, but I think, as is clear from what has happened, those matters were being addressed over time. It was taking too long. And there were always responses, 'Yes, we're doing this, yes, we're spending that money'. So these responses were taken as assurance that the issue was being addressed, but I absolutely accept that ... that was an inadequate conclusion on the part of the audit committee and the board.

Ms Livingstone accepted that she and her colleagues on the audit committee did not give sufficient attention to the significant non-financial risks associated with CBA's failings in relation to AML/CTF. And she accepted that she did not do enough to hold management to account to ensure that the AML/CTF problems were fixed in a timely manner.<sup>248</sup>

### **3.1.2 NAB and adviser service fees**

The second example concerned NAB, and its conduct in relation to the charging of adviser service fees to members of superannuation funds.

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<sup>247</sup> Transcript, Catherine Livingstone, 20 November 2018, 6708.

<sup>248</sup> Transcript, Catherine Livingstone, 20 November 2018, 6709.

The relevant subsidiaries of NAB began charging superannuation fund members adviser service fees in 2008 or 2009.<sup>249</sup> In about the middle of 2014, NAB's subsidiaries began to identify issues with the charging of those fees.<sup>250</sup> Although one of NAB's subsidiaries reported a significant breach in relation to those issues to ASIC and APRA in December 2014,<sup>251</sup> the issues were not brought to the attention of NAB's board until August 2015.<sup>252</sup>

When the issues were reported to the board, the information that was provided about them was inadequate. Not enough was done to make it clear that the issues were not new, but were being reported to the board for the first time.<sup>253</sup> Not enough was done to convey to the board the seriousness of the issues, and the fact that ASIC was already engaged in relation to those issues.<sup>254</sup> And not enough was done to make clear to the board the potential consequences of the issues for the business.<sup>255</sup>

Negotiations between NAB and ASIC in relation to the adviser service fees issues dragged on for years. NAB made many proposals to ASIC about how it would investigate the issues and compensate members, and ASIC rejected those proposals – describing them more than once as not being 'customer centric'.<sup>256</sup> While these negotiations dragged on, NAB was not remediating its customers.

NAB's board did not do enough to impress upon management the importance of getting the issue resolved, and making an appropriate proposal to ASIC. This was most evident when, in April 2018 – more than three years after issues about adviser service fees were first reported to ASIC – NAB made a proposal to ASIC, a proposal that NAB CEO Mr Andrew Thorburn accepted, with the benefit of hindsight, should not have

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<sup>249</sup> Transcript, Kenneth Henry, 27 November 2018, 7121.

<sup>250</sup> Transcript, Kenneth Henry, 27 November 2018, 7121.

<sup>251</sup> Transcript, Kenneth Henry, 27 November 2018, 7121.

<sup>252</sup> Transcript, Kenneth Henry, 27 November 2018, 7127.

<sup>253</sup> Transcript, Kenneth Henry, 27 November 2018, 7128.

<sup>254</sup> Transcript, Kenneth Henry, 27 November 2018, 7129.

<sup>255</sup> Transcript, Kenneth Henry, 27 November 2018, 7131–2.

<sup>256</sup> See Transcript, Kenneth Henry, 27 November 2018, 7160.

been made.<sup>257</sup> The proposal prompted a blunt response from ASIC in May 2018:<sup>258</sup>

The proposed resolution set out in your letter fails to adequately reflect any insight into the seriousness of the suspected misconduct, which took place over an extended period of time and affects a substantial number of customers.

...

For a significant period of time, NAB has suggested various remediation methodologies that ASIC has consistently rejected as unacceptable, and the latest proposal retreats even further from what we would expect NAB to consider to be in the interests of its customers.

Dr Henry said that when he read what ASIC wrote, he was ‘appalled’.<sup>259</sup> But, despite that reaction, it still took NAB until September 2018 to agree a position with ASIC about the remediation of some of its customers. Even as late as November 2018 (when NAB’s Chair and CEO were to give evidence to the Commission) NAB had not agreed with ASIC what NAB would do in relation to the customers of its aligned licensees.<sup>260</sup>

It is plainly not the role of the board to review every piece of correspondence that goes out the door. But it is the role of the board to be aware of significant matters arising within the business, and to set the strategic direction of the business in relation to those matters. When management is acting in a way that is delaying the remediation of customers, and damaging the bank’s relationship with regulators, it is appropriate for the board to intervene and say, ‘Enough is enough. Fix this, and fix it now’.

Dr Henry would go no further than saying that he wished NAB’s board had stepped in sooner.<sup>261</sup> In my view, it is clear that NAB’s board should have acted sooner to impress on management the importance of resolving this

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<sup>257</sup> Transcript, Andrew Thorburn, 26 November 2018, 7078.

<sup>258</sup> Exhibit 5.77, 9 May 2018, Letter from ASIC to Cook and Smith, 1–2.

<sup>259</sup> Transcript, Kenneth Henry, 27 November 2018, 7162.

<sup>260</sup> Transcript, Kenneth Henry, 27 November 2018, 7165.

<sup>261</sup> Transcript, Kenneth Henry, 27 November 2018, 7166.

issue quickly, and resolving it in a way that was in the interests of NAB's customers.

### 3.1.3 What the examples show

Boards must have the right information in order to discharge their functions. In particular, boards must have the right information in order to challenge management on important issues including issues about breaches of law and standards of conduct, and issues that may give rise to poor outcomes for customers. Without the right information a board cannot discharge its functions effectively.

When I refer to boards having the *right* information, I am not referring to boards having *more* information. As I noted earlier, it is the quality, not the quantity, of information that must increase. Often, improving the *quality* of information given to boards will require giving directors *less* material and more information.

I do not pretend to be able to offer any single answer to how boards can ensure that they receive the right information. But boards and management must keep considering how to present information about the right issues, in the right way.

Boards must also use the information that they have to hold management to account. Boards cannot, and must not, involve themselves in the day-to-day management of the corporation. Nothing in this Report should be taken to suggest that they should. The task of the board is overall superintendence of the company, not its day-to-day management. But an integral part of that task is being able and willing to challenge management on key issues, and doing that whenever necessary.

The two examples I have given are both instances where the board did not have the information necessary to challenge management effectively; did not seek out that information; and did not do enough to challenge management about serious issues that had the ability to affect the interests of the banks' customers, the banks' relationships with regulators, and the reputation of the bank more broadly.

## 3.2 Priorities

Proper governance requires setting priorities. Setting priorities requires choices. Sometimes the choice is between conflicting goals or conflicting courses of action; often the choice is about application of resources, timing or relative importance.

In the present context, two different, but closely related choices are considered:

- first, the choice to pursue profit above all else – in particular, above the interests of customers, and above compliance with the law; and
- second, when financial services entities have had regard to risks, the choice to give priority to financial risks, leaving their frameworks for management of non-financial risks underdeveloped.

### 3.2.1 The pursuit of profit

As I said in the *Interim Report*, many of the case studies considered in the Commission showed that the financial services entity involved had chosen to give priority to the pursuit of profit over the interests of customers and above compliance with the law.<sup>262</sup>

Some have sought to explain this emphasis on the pursuit of profit as reflecting the fact that a financial services entity is ultimately accountable to its shareholders. That proposition requires close examination.

All entities that are incorporated and have a share capital have responsibilities, and are accountable, to their shareholders. It is shareholders who will elect directors and, in the case of publicly listed companies, will vote to adopt, or not adopt, remuneration reports. It is shareholders who will give effect to the ‘two strikes rule’ that may see the entire board spilled.<sup>263</sup>

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<sup>262</sup> To give only one example, see Transcript, Michael Winter, 17 September 2018, 5955.

<sup>263</sup> Corporations Act ss 250U–250Y.

These forms of accountability are, of course, important. But they do not mark the boundaries of the matters that the boards of financial services entities must consider in the course of performing their duties and exercising their powers. That other considerations bear upon those decisions is most evident in the case of the largest financial services entities.

Each of the largest entities is systemically important. The long-term stability and performance of each is important to the proper performance of the national economy. It follows, therefore, that the boards of those entities must have regard to those enduring requirements. And the requirements are neither wholly captured by nor completely reflected in the day-to-day share price of the entity or some measurement of 'total shareholder return' over some period. The horizon of these larger entities must lie well beyond the next announcement of results.

This gives rise to a further point about the nature and extent of directors' duties. Directors must exercise their powers and discharge their duties in good faith in the best interests of the corporation, and for a proper purpose.<sup>264</sup> That is, it is the *corporation* that is the focus of their duties. And that demands consideration of more than the financial returns that will be available to shareholders in any particular period. Financial returns to shareholders (or 'value' to shareholders) will always be an important consideration but it is not the *only* matter to be considered. The best interests of the corporation cannot be determined by reference *only* to the current or most recent accounting period. They cannot be determined by reference only to the economic advantage of those shareholders on the register at some record date. Nor can they be judged by reference to whatever period *some* of those shareholders think appropriate for determining *their* results.

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<sup>264</sup> Corporations Act s 181(1). See also the 'business judgment rule' in s 180(2), which depends, among other things, on the director or other officer rationally believing that the judgment made 'is in the best interests of the corporation'.

It is not right to treat the interests of shareholders and customers as opposed. *Some* shareholders may have interests that are opposed to the interests of other shareholders or the interests of customers. But that opposition will almost always be founded in differences between a short term and a longer-term view of prospects and events. Some shareholders may think it right to look only to the short term.

The longer the period of reference, the more likely it is that the interests of shareholders, customers, employees and all associated with any corporation will be seen as converging on the corporation's continued long-term financial advantage. And long-term financial advantage will more likely follow if the entity conducts its business according to proper standards, treats its employees well and seeks to provide financial results to shareholders that, in the long run, are better than other investments of broadly similar risk.

Financial services entities are no different. In the longer term, the interests of all stakeholders associated with the entity converge. And the burden of the evidence from the chief executives of all four large banks was that a bank's best earnings opportunity comes from long-term relationships with its customers. That is why, as Mr Hartzler said: 'banking is an annuity business'.<sup>265</sup>

Regardless of the period of reference, the best interests of a company cannot be reduced to a binary choice. And financial services entities are no different. Pursuit of the best interests of a financial services entity is a more complicated task than choosing between the interests of shareholders and the interests of customers.

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<sup>265</sup> Transcript, Brian Hartzler, 22 November 2018, 6863: 'So the way we think about this business is that banking is ultimately an annuity business, the value comes from having long-term relationships with customers, and that, that is – it's best thought of as a service business rather than a product business.'

### 3.2.2 The importance of non-financial risks

When financial services entities have considered risk and risk management, they have focused on financial risks, rather than non-financial risks.

Mr Comyn said that one of the key things that CBA had learned from the report of the Prudential Inquiry was that there was '[n]ot enough capability in the management of non-financial risk, particularly in operational risk and in ... compliance'.<sup>266</sup> He acknowledged that CBA had 'an enormous amount of work to do to improve our management of non-financial risk'.<sup>267</sup> Dr Henry also accepted that at NAB there was 'insufficient attention given to the management' of non-financial risks.<sup>268</sup>

Given the focus on financial soundness and stability in the wake of the GFC, it is not surprising that after 2009, financial services entities placed significant emphasis on the management of financial risk.

This emphasis was also apparent in APRA's prudential standard about risk management, CPS 220, which was released in January 2015. As well as introducing the requirement for boards to 'form a view' of an institution's risk culture, mentioned earlier, CPS 220 requires APRA-regulated institutions<sup>269</sup> to take various steps associated with the prudent management of risk, including maintaining a risk management framework and a risk appetite statement.<sup>270</sup> Although an entity's risk management framework and risk appetite statement must deal with all material risks, including non-financial risks, the apparent focus of CPS 220 is on financial risks. Of the different types of risk enumerated in CPS 220, only one – operational risk – specifically directs attention to the non-financial risks referred to above.

As discussed earlier in this chapter, from about 2015, the focus internationally shifted to misconduct in financial institutions, and the ways in which the risk of misconduct could be reduced.

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<sup>266</sup> Transcript, Matthew Comyn, 19 November 2018, 6523. See CBA Prudential Inquiry, Final Report, 6.

<sup>267</sup> Transcript, Matthew Comyn, 19 November 2018, 6521.

<sup>268</sup> Transcript, Kenneth Henry, 26 November 2018, 7101.

<sup>269</sup> Defined for the purposes of CPS 220 as not including an RSE licensee. Prudential Standard SPS 220 applies to RSE licensees.

<sup>270</sup> APRA, Prudential Standard CPS 220, July 2017, 3–4 [13].

The types of risk associated with misconduct – compliance risk, conduct risk, regulatory risk, operational risk – are more difficult to measure than most types of financial risk. In the period following the introduction of CPS 220, many financial services entities struggled to develop frameworks for the effective management of these types of risks (and other non-financial risks).

So, for example, in November 2015, APRA conducted a review of CBA's operational risk management framework.<sup>271</sup> APRA expressed concern that CBA's existing framework was not effectively identifying, escalating and addressing significant operational risks, and required CBA to take steps to improve that framework.<sup>272</sup> And, by the time of the Prudential Inquiry in 2017 and 2018, APRA still had concerns about the effectiveness of CBA's systems and processes for the management of operational and compliance risk.

The Prudential Inquiry into CBA recommended that CBA establish a 'non-financial risk committee' at the Group Executive level. One aim of the committee is to 'increase the visibility of operational risk and compliance at senior management and Board level'.<sup>273</sup> CBA has established that committee<sup>274</sup> with Mr Comyn saying that:<sup>275</sup>

All of the participants would say that it's invaluable and, obviously, there was a clear deficiency and gap in the way we operated previously.

Some financial services entities devoted inadequate resources to compliance, and did not give compliance staff a strong enough voice in the business. But this, too, is changing.

One example makes the point sufficiently. Allianz's Chief Risk Officer, Ms Lori Callahan, accepted that in the past, Allianz had not devoted

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<sup>271</sup> Transcript, Catherine Livingstone, 20 November 2018, 6710.

<sup>272</sup> Transcript, Catherine Livingstone, 20 November 2018, 6710.

<sup>273</sup> CBA Prudential Inquiry, Final Report, 25–6.

<sup>274</sup> Transcript, Matthew Comyn, 20 November 2018, 6667.

<sup>275</sup> Transcript, Matthew Comyn, 20 November 2018, 6670.

adequate resources to compliance.<sup>276</sup> She noted that Allianz had taken steps to increase the seniority of some risk and compliance roles and she emphasised the importance of risk and compliance staff having sufficient seniority to challenge management.<sup>277</sup>

Paragraph 43 of CPS 220 requires entities to have ‘a designated compliance function that assists senior management of the institution in effectively managing compliance risks’,<sup>278</sup> and provides that the compliance function ‘must be adequately staffed by appropriately trained and competent persons who have sufficient authority to perform their role effectively, and have a reporting line independent from business lines’.<sup>279</sup>

Mr Byres accepted that the references to compliance and internal audit in the prudential standards were ‘fairly cursory and short’, and that APRA would ‘need to think about how we give them more prominence in our assessment of risk management because it has traditionally been ... [assessed from a] financial soundness perspective’.<sup>280</sup> He said that his reflection on the instances of misconduct reported to the Commission in response to the requests for information sent in January 2018 was that ‘compliance and audit functions are not strong enough in organisations’.<sup>281</sup>

**Obviously, the prudent management of financial risks by financial services entities is and will always remain important. But financial services entities must now accept that financial risks are not the only risks that matter. The prudent management of non-financial risks is equally important. Financial services entities must give sufficient attention, and devote sufficient resources, to the effective management of non-financial risks. APRA should give consideration to how that requirement can be made more prominent in its prudential standards.**

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<sup>276</sup> Transcript, Lori Callahan, 18 September 2018, 5991. See also Transcript, Lori Callahan, 18 September 2018, 6057.

<sup>277</sup> Transcript, Lori Callahan, 18 September 2018, 5989, 6021.

<sup>278</sup> APRA, Prudential Standard CPS 220, April 2018, 11 [43].

<sup>279</sup> APRA, Prudential Standard CPS 220, April 2018, 11 [43].

<sup>280</sup> Transcript, Wayne Byres, 30 November 2018, 7443.

<sup>281</sup> Transcript, Wayne Byres, 30 November 2018, 7443.

### 3.3 Accountability

Accountability is centrally important to any consideration of culture, governance and remuneration.

Clear accountability is vital to effective governance. It ensures that issues are resolved, and resolved effectively. It fosters a culture where risks are managed soundly. It lies at the heart of the proper operation of any variable remuneration and incentive system. It is accountability that determines what consequences must follow when things go wrong (and where credit is due when things are done well).

The report of the Prudential Inquiry into CBA observed that:<sup>282</sup>

A lack of accountability is a common theme underlying several of the issues observed in this Inquiry. This contributed to: an inability to identify who is accountable when things have gone wrong; inadequate remuneration outcomes for adverse risk and compliance outcomes; weak issue escalation, management and closure; insufficient Executive Committee oversight; and inadequate business unit supervision of functions performed elsewhere in the Group.

When asked to comment on the G30's observation that 'the Australian banking industry is only beginning its long journey to repair its conduct and culture',<sup>283</sup> Mr Byres said:<sup>284</sup>

[T]he general concept of clarity of accountability, or, more to the point, the problem of diffused responsibility and no clarity of accountability has been at the heart of many problems that have happened. No one had responsibility. No one has actually taken responsibility for issues. Boards have not known how to apply consequences because it's not clear who was responsible for things.

I agree.

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<sup>282</sup> CBA Prudential Inquiry, Final Report, 59.

<sup>283</sup> G30, *Banking Conduct and Culture: A Permanent Mindset Change*, November 2018, 6.

<sup>284</sup> Transcript, 30 November 2018, Wayne Byres, 7443.

### 3.3.1 The BEAR

The enactment of the Banking Executive Accountability Regime (BEAR) will provide entities and regulators (both APRA and ASIC) with a clearer understanding of the responsibilities that attach to particular offices or positions within banks. It will allow those individuals to be held to account if they fail in performing their obligations.

I have already indicated in the chapter about the banking sector that I consider APRA should determine, under section 37BA(4) of the *Banking Act 1959* (Cth), an additional responsibility of accountable persons within each of the banks subject to the BEAR. That additional responsibility would be for the end-to-end management of product design, delivery, maintenance and, where necessary, remediation. It would then be for each bank to identify the relevant accountable person.

As is also evident from what I have written about the superannuation sector and the regulators, **I consider that provisions of the kind now made by the BEAR should be made in respect of all APRA-regulated institutions.** Given that systems of even greater reach have been implemented in other jurisdictions, there is, in my view, every reason to go down this path, and no satisfactory reason to draw back.

Obviously, **a change of this kind should be introduced only after allowing a sufficient time for both the regulators and the regulated to prepare for its introduction. And it may very well be that the change should be made first in the superannuation sector and then after a further interval, in the insurance sector.** (I say that superannuation sector should be the first chosen because of the particular size and importance of that sector to members and to the economy generally.) Regardless, there is no reason in principle or in practice to confine the reach of accountability provisions of the kind set out in the BEAR to the banking sector.

**Obviously, enactment of the BEAR has introduced an additional form of accountability for senior banking executives. But the BEAR is not a substitute for proper processes within entities for identifying who is accountable for risk and how they are to account for it and be held accountable.** As the CBA Prudential Inquiry showed, that accountability must include financial risk but must extend to all forms of risk including, in particular, conduct and compliance risk. Under the BEAR,

the Chief Risk Officer of a bank will have certain responsibilities with respect to risk management. That responsibility is, of course, important.

But it cannot be seen as a *complete* or *comprehensive* identification of who within the organisation should be held accountable for risks or as a complete or comprehensive statement of how they are to account and be held accountable.

### 3.3.2 This Commission

The proceedings of this Commission have brought an additional, and different, form of accountability to bear on the entities whose conduct has been examined. The Commission's examination of conduct that might amount to misconduct and conduct falling short of community standards and expectations has attracted close public attention.

The last oral evidence the Commission received, in the seventh round of public hearings, was given by the chairs of three bank boards, the CEOs of the five largest banks and AMP, and the chairs of APRA and ASIC. Each was asked many questions intended to show how their entities or agencies assessed what had been looked at in the course of the Commission's work.

As would be expected, each of these witnesses gave evidence suggesting that their respective entities or agencies had its own distinctive understanding of, and response to, the events considered in and issues raised by the Commission. Most professed to having learned from what had happened and proffered their ideas about causes and responses. But the nature and extent of their engagement with the issues differed rather more markedly than I had expected. It seemed to me that there remain elements of unwillingness to recognise, and to accept responsibility for, poor conduct of the kinds examined in this inquiry.

Unwillingness to recognise and to accept responsibility for misconduct explains the prolonged and repeated failures by large entities to make breach reports required by the law. That same unwillingness explains the prolonged negotiation with the regulator about what should be done in response to misconduct, whether by compensating affected customers or altering defective practices and processes.

There remains unwillingness, in at least some entities, to recognise and give effect to the obligation to ensure that the relevant services are provided efficiently, honestly and fairly, without first having the regulator agree with what the entity judges to be required in order to meet that standard.<sup>285</sup> That is, there remains a reluctance in some entities to form and then to give practical effect to *their* understanding of what is ethical, of what is efficient honest and fair, of what is the 'right' thing to do.<sup>286</sup> Instead, the entity contents itself with statements of purpose, vision or values, too often expressed in terms that say little or nothing about those basic standards that underpin both the concept of misconduct and the community's standards and expectations.

These observations do not apply to all entities. It was apparent from the evidence that some entities recognise now the need to respond to *what* has happened by confronting *why* it happened and then seeking to prevent recurrence. And it was also apparent that they recognise that the task is not easy.

CBA has been compelled by the Prudential Inquiry to confront why it has had 'a succession of conduct and compliance issues' and has not met the community's 'high expectations' for it as an institution.<sup>287</sup> As a result of that Inquiry, CBA gave an **enforceable undertaking** (EU) that obliged it to undertake a remedial action plan responding to each of the recommendations in the Inquiry's report. An independent reviewer must report to APRA every three months until all items on the remediation action plan have been completed. The reports must explain the status of compliance with the EU and the items on the remediation action plan that CBA considers are nearing completion.<sup>288</sup>

I was persuaded that Mr Comyn, CEO of CBA, is well aware of the size and nature of the tasks that lie ahead of CBA.

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<sup>285</sup> Transcript, Kenneth Henry, 27 November 2018, 7134.

<sup>286</sup> Transcript, Andrew Thorburn, 26 November 2018, 7091–2.

<sup>287</sup> CBA Prudential Inquiry, Final Report, 3.

<sup>288</sup> Enforceable Undertaking, APRA and CBA, 30 April 2018, cls 12–13.

None of the other large banks have been confronted so directly with why each has had its own conduct and compliance issues.

I have little doubt that Mr Elliott, CEO of ANZ, is also well aware of the size and nature of the tasks that lie ahead of ANZ.

Westpac stands apart from the other three major banks by seeking to maintain at least some aspects of its wealth business. The challenges for Westpac may therefore differ from those facing the other major banks. And while I do not doubt Mr Hartzler, CEO of Westpac, when he says that Westpac has sought to ‘reset’ its relationship with ASIC,<sup>289</sup> only time will tell whether that proves to be right.

NAB also stands apart from the other three major banks. Having heard from both the CEO, Mr Thorburn, and the Chair, Dr Henry, I am not as confident as I would wish to be that the lessons of the past have been learned. More particularly, I was not persuaded that NAB is willing to accept the necessary responsibility for deciding, for itself, what is the right thing to do, and then having its staff act accordingly. I thought it telling that Dr Henry seemed unwilling to accept any criticism of how the board had dealt with some issues. I thought it telling that Mr Thorburn treated all issues of fees for no service as nothing more than carelessness combined with system deficiencies when the total amount to be repaid by NAB and NULIS on this account is likely to be more than \$100 million.<sup>290</sup> I thought it telling that in the very week that NAB’s CEO and Chair were to give evidence before the Commission, one of its staff should be emailing bankers urging them to sell at least five mortgages each before Christmas. Overall, my fear – that there may be a wide gap between the public face NAB seeks to show and what it does in practice – remains.

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<sup>289</sup> Transcript, Brian Hartzler, 22 November 2018, 6878.

<sup>290</sup> See ASIC, Media Release 18-229MR, 7 August 2018.

## Conclusion

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Failings of organisational culture, governance arrangements and remuneration systems lie at the heart of much of the misconduct examined in this Commission. Improvements in the culture of financial services entities, their governance arrangements and their remuneration systems should reduce the risk of misconduct in future. Culture, governance and remuneration march together. Improvements in one area will reinforce improvements in others; inaction in one area will undermine progress in others. Making improvements in each area is the responsibility of financial services entities. But regulators also have an important role to play in the supervision of culture, governance and remuneration. In the past, that supervision has focused on financial soundness and stability. But, as events here and overseas show, that is too narrow. Supervision must extend beyond financial risks to non-financial risks, and that requires attention to culture, governance and remuneration.

# 7. Regulators

## Introduction

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I said in the *Interim Report* that almost all of the conduct identified and criticised in that Report contravened existing norms of conduct and that the most serious conduct broke existing laws.<sup>1</sup> Notwithstanding that, the law was too often not enforced at all, or not enforced effectively.<sup>2</sup>

In its response to the *Interim Report*, the Australian Securities and Investments Commission (ASIC) accepted that its enforcement approach must change.<sup>3</sup> The Australian Prudential Regulation Authority (APRA)'s response to the *Interim Report* emphasised that its core role is 'proactive *ex ante* supervision ... rather than *ex post* enforcement'.<sup>4</sup> It also said that recent developments, including the work of the Royal Commission, had caused it to review its approach to enforcement.<sup>5</sup>

This chapter considers the regulatory model currently in place, the remit given to APRA and ASIC under that model, and the powers currently available to APRA and ASIC. The overarching question is: to what extent, if any, should the model, the remits, or the powers be changed?

Consideration of the question must proceed from an understanding of the current regulatory framework and its history.

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<sup>1</sup> FSRC, *Interim Report*, vol 1, 267.

<sup>2</sup> FSRC, *Interim Report*, vol 1, 269–70.

<sup>3</sup> ASIC, Interim Report Submission, 5 [24]–[25], 9–10 [43]–[45].

<sup>4</sup> APRA, Interim Report Submission, 8 [44].

<sup>5</sup> APRA, Interim Report Submission, 9 [46]–[48].

# 1 History

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## 1.1 Twin peaks

Australia's financial regulatory system is often said to be a 'twin peaks' model. Two principles inform its structure:

- Prudential regulation is (largely) separated from conduct regulation and is the province of APRA; and
- Conduct regulation of the financial services industry is separated from conduct regulation of other parts of trade and commerce and is (largely) the province of ASIC.

The twin peaks model originated in the Wallis Inquiry.

## 1.2 The Wallis Inquiry

The Wallis Inquiry into the Australian financial system was conducted between 1996 and 1997.

It proposed a new prudential regulator that would combine existing prudential regulation undertaken by several government agencies into one.<sup>6</sup> That regulator became APRA.

The Inquiry proposed a new market-conduct and consumer-protection regulator for financial services.<sup>7</sup> That regulator became ASIC. It was to have comprehensive responsibilities for regulation of market integrity, consumer protection and corporations law. The consumer protection aspect of that regulator's remit was directed principally towards disclosure.<sup>8</sup> ASIC's regulation of consumer protection in the financial services industry was

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<sup>6</sup> Wallis Inquiry, Final Report, 18 March 1997, 42 Recommendation 31; see also 20.

<sup>7</sup> Wallis Inquiry, Final Report, 18 March 1997, 32 Recommendations 1 and 2; see also 17.

<sup>8</sup> Wallis Inquiry, Final Report, 18 March 1997, 246–52. See also Recommendation 41 at page 46 in respect of superannuation: 'Regulation to ensure the compliance of superannuation funds, other than excluded funds, with retirement income requirements should be undertaken by [the entity that became APRA] in conjunction with prudential regulation. Disclosure regulation should be undertaken by [the entity that became ASIC]'.

to include all types of businesses offering banking and deposit products, insurance products and superannuation, as well as investment products and advisory services.<sup>9</sup>

The Inquiry recommended that the two regulators be operationally autonomous,<sup>10</sup> but work closely together, where appropriate.<sup>11</sup> It proposed separating prudential regulation from market conduct and consumer protection regulation, leaving the Reserve Bank of Australia (RBA) responsible for monetary policy and the payments system. It proposed establishing the Council of Financial Regulators (the CFR), chaired by the Governor of the RBA, to act as a co-ordinating forum, to discuss developments in the financial system and to co-ordinate responses to any areas of concern. The CFR was to have (and now has) no formal mandate or powers separate from those held by its members.

### 1.3 The Cooper Review

The Cooper Review into Australia's superannuation system, also known as the Super System Review, was undertaken between 2009 and 2010. The focus of the Review was on promoting efficiencies and improving outcomes for members in the superannuation system. One of its recommendations resulted in the creation of **MySuper**.

The Review considered that there were gaps in APRA's mandate.<sup>12</sup> Those gaps were said to be the result of the piecemeal way in which APRA's role as the prudential regulator had developed over time.<sup>13</sup> It recommended that a new role be given to APRA that was more focused on member outcomes, and proposed that APRA would oversee and promote the overall efficiency and transparency of the superannuation system, to the ultimate benefit of members.<sup>14</sup> The Review expected APRA's role to extend from routine fund reviews to matters such as trustees' approaches to meeting their new

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<sup>9</sup> Wallis Inquiry, Final Report, 18 March 1997, 248 fn 5.

<sup>10</sup> Wallis Inquiry, Final Report, 18 March 1997, 67–8 Recommendation 103.

<sup>11</sup> Wallis Inquiry, Final Report, 18 March 1997, 22.

<sup>12</sup> Cooper Review, Final Report, 30 June 2010, 309.

<sup>13</sup> Cooper Review, Final Report, 30 June 2010, 309.

<sup>14</sup> Cooper Review, Final Report, 30 June 2010, 310 Recommendation 10.1.

duties, but not to extend to intervening in the trustee's decisions.<sup>15</sup> The Review thought that APRA would need to have a broader range of regulatory functions to regulate member outcomes, and that this might call for new skills, resources and perspectives.<sup>16</sup>

The Review also said that there should be closer co-operation between APRA and ASIC, and recommended that the Government should explore how they could work more closely together in discharging their superannuation mandates.<sup>17</sup>

Following the recommendations of the Cooper Review, the *Superannuation Industry (Supervision) Act 1993* (Cth) (the SIS Act) was amended in 2012 to give APRA power to determine prudential standards for superannuation under section 34C; to expand the duties of trustees under section 52; to apply duties to directors of trustees under sections 52A; and to impose additional obligations on trustees, and directors of trustees, under sections 29VN and 29VO of the SIS Act, respectively.<sup>18</sup> ASIC's remit and powers under the SIS Act were unchanged.

## 1.4 The Murray Inquiry

The Murray Inquiry undertook a review of Australia's financial system between 2013 and 2014.

The Inquiry said that, while it did not recommend 'major changes to the overall regulatory system', it believed that action should be taken in five areas to improve the current arrangements 'and ensure regulatory settings remain fit for purpose in the years ahead'.<sup>19</sup>

The five recommendations were to:

- improve the regulator accountability framework;<sup>20</sup>

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<sup>15</sup> Cooper Review, Final Report, 30 June 2010, 309–10.

<sup>16</sup> Cooper Review, Final Report, 30 June 2010, 311.

<sup>17</sup> Cooper Review, Final Report, 30 June 2010, 315–6 Recommendation 10.5.

<sup>18</sup> See *Superannuation Legislation (Trustee Obligations and Prudential Standards) Act 2012* (Cth).

<sup>19</sup> Murray Inquiry, Final Report, November 2014, 235.

<sup>20</sup> Murray Inquiry, Final Report, November 2014, 235.

- improve the effectiveness of our regulators;<sup>21</sup>
- strengthen ASIC;<sup>22</sup>
- rebalance the regulatory focus towards competition;<sup>23</sup> and
- improve the process of implementing new financial regulations.<sup>24</sup>

The Inquiry said that its first recommendation, to improve the regulator accountability framework, was made because ‘Australia needs a better mechanism to allow Government to assess the performance of financial regulators’.<sup>25</sup> To that end, the Inquiry recommended establishing a new Financial Regulator Assessment Board ‘to undertake annual ex post reviews of overall regulator performance against their mandates’.<sup>26</sup>

The recommendation to establish a new assessment board was not taken up by Government.<sup>27</sup> The Government Response to the Murray Inquiry made three points. First, it said that the requirements of the *Public Governance, Performance and Accountability Act 2013* (Cth) and the Government’s Regulator Performance Framework provided ‘avenues to strengthen regulator accountability [as did] other existing mechanisms such as Parliamentary hearings’.<sup>28</sup> Second, it said that it proposed to reconstitute the Financial Sector Advisory Council ‘with refreshed Terms of Reference to include providing advice on the performance of the financial regulators’.<sup>29</sup> And third, it said that Government supported providing regulators with clearer guidance in Statements of Expectations and that a proposal had

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<sup>21</sup> Murray Inquiry, Final Report, November 2014, 235.

<sup>22</sup> Murray Inquiry, Final Report, November 2014, 236.

<sup>23</sup> Murray Inquiry, Final Report, November 2014, 237.

<sup>24</sup> Murray Inquiry, Final Report, November 2014, 237.

<sup>25</sup> Murray Inquiry, Final Report, November 2014, 235.

<sup>26</sup> Murray Inquiry, Final Report, November 2014, 235.

<sup>27</sup> Australian Government, *Improving Australia’s Financial System: Government Response to the Financial System Inquiry*, 2015, 23.

<sup>28</sup> Australian Government, *Improving Australia’s Financial System: Government Response to the Financial System Inquiry*, 2015, 23.

<sup>29</sup> Australian Government, *Improving Australia’s Financial System: Government Response to the Financial System Inquiry*, 2015, 23.

been made to update the regulators' Statements of Expectations in the first half of 2016.<sup>30</sup>

The Financial Services Advisory Council was reconstituted and, among other things, given the task of providing 'advice to the Government on the performance of the financial system regulators'.<sup>31</sup> In 2018, the work of the Council was suspended pending the completion of this Commission's work.<sup>32</sup>

## 1.5 ASIC Capability Review

When the Government responded to the Murray Inquiry, it had already announced, in June 2015, a review to consider the capabilities of ASIC. The panel appointed to conduct that review provided its report to Government in December 2015. The panel recommended changing the governance of ASIC 'to achieve a clear separation of the non-executive (governance) and executive line management roles'.<sup>33</sup> ASIC Commissioners would form a full-time non-executive internal board of the Commission, and operational decision-making and execution of operational matters would be delegated to the senior executive level, reporting directly to a new Head of Office of ASIC.<sup>34</sup>

Against the background of these recommendations about governance, the panel endorsed the Government's position not to proceed with the Murray Inquiry recommendation to establish a Financial Regulator Assessment Board, not seeing the need for 'another regulator to regulate the regulators'.<sup>35</sup>

ASIC did not adopt the governance model the panel had proposed but did 'adopt new initiatives to support [ASIC's] role and focus on strategy

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<sup>30</sup> Australian Government, *Improving Australia's Financial System: Government Response to the Financial System Inquiry*, 2015, 23.

<sup>31</sup> Productivity Commission, Report 89, 29 June 2018, 533.

<sup>32</sup> Productivity Commission, Report 89, 29 June 2018, 533.

<sup>33</sup> ASIC Capability Review, Report, 14.

<sup>34</sup> ASIC Capability Review, Report, 14.

<sup>35</sup> ASIC Capability Review, Report, 17.

and accountability'.<sup>36</sup> ASIC identified three initiatives: enhanced management information and performance reporting; a review of the mandate, membership, effectiveness and role of committees; and a review of Commissioners' engagement with stakeholders.<sup>37</sup>

## 1.6 ASIC Enforcement Review

On 19 October 2016, the Minister for Revenue and Financial Services appointed a Taskforce to conduct a review of ASIC's enforcement regime (the Enforcement Review).

The Terms of Reference required the Taskforce to examine relevant Commonwealth legislation to determine the adequacy of, among other things: the civil and criminal penalties for serious contraventions relating to the financial system; existing penalties for serious contraventions; enforcement-related licensing powers; ASIC's power to ban company officers; ASIC's information gathering powers; and the frameworks for notifying ASIC of breaches of law.<sup>38</sup> The Taskforce was required to identify any gaps in ASIC's powers and make recommendations to the Government to address gaps or deficiencies it identified in a way that would allow more effective enforcement of the regulatory regime.<sup>39</sup>

The Taskforce issued its report in December 2017. It made 50 recommendations.<sup>40</sup> The recommendations included reforming section 912D of the *Corporations Act 2001* (Cth) (the Corporations Act) (about reporting significant breaches, or likely breaches, of certain provisions); strengthening ASIC's licensing and banning powers; increasing penalties for contraventions; and giving ASIC a new directions power.<sup>41</sup>

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<sup>36</sup> Exhibit 7.63, Witness statement of James Shipton, 7 November 2018, Exhibit JS-7 [ASIC.0800.0016.0905 at .0001–.0002].

<sup>37</sup> Exhibit 7.63, Witness statement of James Shipton, 7 November 2018, Exhibit JS-7 [ASIC.0800.0016.0905 at .0002].

<sup>38</sup> ASIC Enforcement Review, Report, ix.

<sup>39</sup> ASIC Enforcement Review, Report, ix.

<sup>40</sup> ASIC Enforcement Review, Report, xiv–xviii.

<sup>41</sup> ASIC Enforcement Review, Report, xiv–xviii.

On 16 April 2018, the Government published its response to the Taskforce's final recommendations, in which it agreed, or agreed in principle, to all 50 recommendations. Implementation of some of the recommendations was deferred pending the work of this Royal Commission. I deal separately with those recommendations in the chapter about other important steps.

When implemented, the recommendations of the Enforcement Review will provide ASIC with considerable new or enhanced powers and will lead to significant increases to the maximum penalties that may be imposed for breaches of financial services laws.

## 1.7 Productivity Commission Competition Report

The Murray Inquiry had recommended that 'Government should provide more clarity around its expectations of regulators' and that 'regulators should develop better performance indicators'.<sup>42</sup> In its report on competition in the Australian financial system, the Productivity Commission emphasised the importance it attached to both Government statements of expectations and regulators' statements of intent. The Productivity Commission urged the swift publication of updated statements of expectations written in clear language,<sup>43</sup> and recommended that regulators publish their statements of intent within three months of receiving the statement of expectations. It recommended further, that regulators provide in their annual reports 'information on the actions they have taken in line with their statements of intent and outcomes on performance measures'.<sup>44</sup>

One other recommendation made by the Productivity Commission should be noted. It recommended that the Australian Competition and Consumer Commission (the ACCC) be made a permanent member of the CFR and that it 'be given a mandate by the Australian Government to champion competition in the financial system, including in decisions taken by regulators that have or may have the outcome of restricting competition'.<sup>45</sup>

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<sup>42</sup> Murray Inquiry, Final Report, November 2014, 235.

<sup>43</sup> Productivity Commission, Report 89, 29 June 2018, 535 Recommendation 18.1.

<sup>44</sup> Productivity Commission, Report 89, 29 June 2018, 535 Recommendation 18.1.

<sup>45</sup> Productivity Commission, Report 89, 29 June 2018, 556 Recommendation 19.1.

This goes to matters beyond this Commission's Terms of Reference and I offer no comment on it.

These matters of history explain how and why we have come to the present regulatory arrangements.

Further consideration of whether to modify those arrangements may usefully begin by recognising the size of ASIC's remit as conduct regulator.

## 2 ASIC's remit

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### 2.1 Size of the existing remit

ASIC's remit is very large. It has increased greatly since ASIC was first established.

As I noted in the *Interim Report*,<sup>46</sup> ASIC now administers 11 pieces of legislation and their associated regulations.<sup>47</sup> The legislation itself has grown longer and more complex. The length of the Corporations Act, for example, has increased by 178% since 1981.<sup>48</sup> In preparing Background Papers for its hearings, this Commission found that an introductory overview of the law governing consumer credit in Australia required 86 pages of explanation; financial advice and sale of **financial products** required 114; and small business lending law that did not overlap with that governing consumer lending, required 41 pages to explain.

ASIC's remit in respect of consumer protection has evident parallels with the ACCC's remit in respect of consumer protection in other sectors of the economy. Consumer protection provisions administered by ASIC are often expressed in terms that are not materially different from how those administered by the ACCC are expressed.<sup>49</sup>

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<sup>46</sup> FSRC, *Interim Report*, vol 1, 294–5.

<sup>47</sup> See also ASIC Capability Review, Report, 133.

<sup>48</sup> ASIC Capability Review, Report, 134.

<sup>49</sup> See, eg, the unfair contract terms discussed in the *Interim Report*: FSRC, *Interim Report*, vol 1, 281–5.

The ACCC has chief responsibility for competition questions in the Australian economy. Competition in parts of the Australian financial services industry is not always strong and has not prevented the misconduct considered by this Commission.

All of these are matters that might suggest there would be some advantages to be gained by detaching some aspects of ASIC's remit and requiring the ACCC to take responsibility for their administration. And the force of those arguments would not be lessened if, as ASIC urges, it were to take on a larger role with respect to conduct regulation of **registrable superannuation entities** (RSEs) than it now has.

All this being so, why not alter ASIC's remit? Why not modify the twin peaks model?

## 2.2 Change the remit?

Altering ASIC's remit would mark a sharp departure from the twin peaks model. I am not persuaded that the two principles underpinning the twin peaks model of financial regulation should now be abandoned or should be given substantially different effect by dividing ASIC's regulatory role.

Detaching significant parts of ASIC's remit and transferring them to another agency would disrupt the processes of responding to what has happened in the Australian financial services industry, and has now been brought into the public gaze by the Commission's work. I think the costs of that disruption outweigh the possible benefits.

There is force in Treasury's submission that there are some functions 'that are core to the conduct regulator under the twin peaks model – and that should be kept together'.<sup>50</sup> The functions Treasury identified as 'core' were: 'administering the necessary licensing regimes for financial services; preventing consumer detriment from inappropriate products and contracts; enabling consumers' access to redress via dispute resolution and compensation; and enforcing the relevant law'.<sup>51</sup>

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<sup>50</sup> Treasury, Interim Report Submission, 37 [184].

<sup>51</sup> Treasury, Interim Report Submission, 37 [184].

Further, as Treasury submitted, shifting responsibilities between agencies does not diminish the size of the tasks that have to be performed. Hence, what Treasury called ‘the overall resource demand’ is largely unchanged.<sup>52</sup> And any shift in responsibilities will necessarily have transitional costs of the kind Treasury mentioned (likely loss of experienced staff coupled with the costs of accommodating the new responsibilities in the new agency) accompanied by some measure of regulatory uncertainty.<sup>53</sup>

Importantly, I have no doubt that Treasury was right to say that ‘the impact of the breadth of remit on a regulator is largely a function of its leadership and resourcing (including staffing)’.<sup>54</sup> As Treasury said ‘[w]ith strong leadership and adequate resources (including staff), a broad remit is not a problem’.<sup>55</sup> But one of the chief challenges for leadership of a regulatory agency is fostering a proper culture. And as I sought to make plain in the *Interim Report*, the criticisms I made of ASIC were about the ways in which it responded to reports of misconduct, ways that might be seen as reflecting the prevailing culture of the agency.

In my view the enforcement culture of ASIC, not the size of ASIC’s remit, should be the focus of change.

### **Recommendation 6.1 – Retain twin peaks**

The ‘twin peaks’ model of financial regulation should be retained.

<sup>52</sup> Treasury, Interim Report Submission, 38 [188].

<sup>53</sup> Treasury, Interim Report Submission, 38 [189].

<sup>54</sup> Treasury, Interim Report Submission, 38 [188].

<sup>55</sup> Treasury, Interim Report Submission, 38 [188].

## 3 Changing ASIC's enforcement culture

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### 3.1 Why change?

In the *Interim Report*, I said that '[w]hen deciding what to do in response to misconduct, ASIC's starting point appears to have been: How can this be resolved by agreement?'<sup>56</sup> I said also that '[t]his cannot be the starting point for a conduct regulator'.<sup>57</sup> I remain of those views.

ASIC is charged with enforcing financial services laws on behalf of the community. One of ASIC's objectives is to 'take whatever action it can take, and is necessary, in order to enforce and give effect to the laws of the Commonwealth'.<sup>58</sup> The community is entitled to expect, and does expect, that financial services entities will comply with those laws.

Financial services entities are not ASIC's 'clients'. ASIC does not perform its functions as a service to those entities. And it is well-established that 'an unconditional preference for negotiated compliance renders an agency susceptible to capture' by those whom it is bound to regulate.<sup>59</sup> As one leading American scholar has written, 'corporate behavior moves quickly to take advantage of any perceived softening. Social norms act less upon complex organizations than upon individuals'.<sup>60</sup>

All of these considerations show that improving compliance with financial services laws cannot be achieved by focusing only on negotiation and persuasion. Compliance with the law is not a matter of choice. The law is, in that sense, coercive and its coercive character can be neither hidden nor ignored. Negotiation and persuasion, without enforcement, all too readily

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<sup>56</sup> FSRC, *Interim Report*, vol 1, 277.

<sup>57</sup> FSRC, *Interim Report*, vol 1, 277.

<sup>58</sup> ASIC Act s 1(2)(g).

<sup>59</sup> Malcolm K Sparrow, *The Regulatory Craft: Controlling Risks, Solving Problems, and Managing Compliance* (Brookings Institution Press, 2000) 63 (footnote omitted).

<sup>60</sup> Malcolm K Sparrow, *The Regulatory Craft: Controlling Risks, Solving Problems, and Managing Compliance* (Brookings Institution Press, 2000) 63.

leads to the perception that compliance is voluntary. It is not. All financial services entities must obey the law, not just those who are willing to do so. And all financial services entities must comply with all the laws that apply to them, not just with those bits of the law that they find to be commercially acceptable.

In the *Interim Report* I said that there were already signs that ASIC may be seeking to alter its approach to enforcement, but that there were five reasons for caution.<sup>61</sup>

First was the size of ASIC's remit. The reforms I have proposed, particularly regarding the **Banking Executive Accountability Regime** (BEAR) and enforcement of breaches of the SIS Act, will further enlarge that remit. ASIC will require deft management, a stable and appropriate level of funding and effective oversight to discharge its duties. But, as I have sought to explain, the size of ASIC's remit is not an insurmountable obstacle to effective enforcement.

My second reason for caution was what seemed to me to be a deeply entrenched culture of negotiating outcomes rather than insisting upon public denunciation of, and punishment for, wrongdoing. Third, I referred to remediation of consumers being important but not the only consideration relevant to the regulator. Fourth, I said that there seemed to be no recognition of the fact that the amount outlaid to remedy a default may be much less than the advantage an entity has gained from the default. Fifth, I said that there appeared to be no effective mechanism for keeping ASIC's enforcement policies and practices congruent with the needs of the economy more generally.

ASIC said in its written response to the *Interim Report* that it accepts that it needs to make changes.<sup>62</sup> More particularly, ASIC said that it accepts 'that it must alter its enforcement priorities and practices within the financial sector – and particularly for larger financial institutions – so as to be more agile in initiating and prosecuting court action, and in many instances even commencing with it'.<sup>63</sup> It said that it 'recognises that its enforcement priorities

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<sup>61</sup> FSRC, *Interim Report*, vol 1, 293–4.

<sup>62</sup> ASIC, *Interim Report Submission*, 2 [7].

<sup>63</sup> ASIC, *Interim Report Submission*, 5 [25].

must change to emphasise deterrence and public denunciation more strongly in its use of various regulatory tools (inside and, where applicable, outside court) as mechanisms by which to change behaviours'.<sup>64</sup> ASIC said that it now accepts that, when considering enforcement measures, it should start with the question '[W]hy not litigate?'.<sup>65</sup>

Consideration of the way ahead begins, then, from the accepted premise that change is needed. What is that change? How is it to be made and then maintained?

### 3.2 What change?

As I said in the *Interim Report*, legislation allowing criminal or civil punishment of conduct proceeds from the premise that engaging in the conduct is harmful to society. In financial services legislation, the premise is more likely to be that the conduct will be harmful to the economy generally. Hence, the ways in which ASIC (or APRA) enforce these laws will affect the overall health of the economy.<sup>66</sup>

It is as well to repeat some basic points made in the *Interim Report*.

The first point relates to negotiated outcomes. Of course there can and will be some cases of contravention of the law in which the outcome is negotiated between contravener and regulator. Sometimes the negotiations will be completed before proceedings are commenced; sometimes not. Often, institution of proceedings should be, and will be, a step the parties recognise will be taken. But whether or not proceedings are on foot or anticipated, there can be no satisfactory negotiated outcome if ASIC has not *first* decided what *it* wants from the negotiation (as distinct from what it thinks the entity is prepared to give).<sup>67</sup>

The second point is about remediation. The regulator is not called on to choose between remediation and enforcement. Remediation for consumers

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<sup>64</sup> ASIC, Interim Report Submission, 9 [41]. See also, Exhibit 7.159, 6 January 2019, Summary of Review of ASIC's Enforcement Policies.

<sup>65</sup> ASIC, Interim Report Submission, 9 [45] (footnote omitted).

<sup>66</sup> FSRC, *Interim Report*, vol 1, 296.

<sup>67</sup> FSRC, *Interim Report*, vol 1, 295–6.

is one important goal. It is not the *only* goal to be pursued. Often, enforcement will induce an entity to set about remedying the consequences of its default, or committing to doing so, before the penalty is fixed.<sup>68</sup>

The third concerns the size of remedies relative to profits. Financial services entities will often have profited from their contraventions of the law. The regulator *must* do whatever can be done to ensure that breach of the law is not profitable.<sup>69</sup>

In the end, the critical question whenever ASIC is considering any contravention of the law must be the question ASIC now accepts must be asked: ‘Why not litigate?’. And, much more often than not, ASIC will ask and answer that question in circumstances where the entity has provided a breach notification. That is, ASIC will have to ask and answer ‘why not litigate’ in circumstances where the entity itself has reported that its conduct may have breached a relevant provision of the financial services law. ASIC will approach litigation knowing that the first document to be tendered in evidence will show what the *entity* has said it has done or may have done in contravention of the law.

**Answering the question ‘why not litigate’ calls for skill and judgment. Especially will that be so when it appears that the issue is systemic** (as with, for example, the issues about add-on credit and loan insurance products). As Mr James Shipton, Chair of ASIC, pointed out in his evidence, add-on insurance was an industry-wide issue affecting many thousands of consumers.<sup>70</sup>

Issues of that kind will often present in a form such that the way ahead seems anything but clear because they appear to present ‘an overwhelming amount of work’.<sup>71</sup> But from first contact with the matter, whether that is a breach report or a complaint, **the regulator must approach the work ahead with a clear view of what kinds of outcome are being considered. And unless and until it is plain that the public interest**

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<sup>68</sup> FSRC, *Interim Report*, vol 1, 296.

<sup>69</sup> FSRC, *Interim Report*, vol 1, 296.

<sup>70</sup> Transcript, James Shipton, 23 November 2018, 6952.

<sup>71</sup> Transcript, James Shipton, 23 November 2018, 6952.

**requires that there be no litigation, all forms of regulatory enforcement must remain under active consideration.**

When I say that all forms of regulatory outcome must remain under active consideration, **what will be required will be consideration of what forms of regulatory response will be appropriate for the *kind of conduct in issue*.** So, for example, in the case of add-on insurance, the possible responses would require identification and examination against what appeared to be the essential character of the conduct that is in issue: the selling to consumers of insurance on which they could not claim. As investigation proceeds, the conduct will be better understood and its essential character will be more accurately and easily described. Possible responses will become more detailed and more refined. But at every stage along the way, the regulator is working towards one or more identified end-points. Those end-points may require re-definition from time to time. But the work will remain focused. And if the work is focused, that which is apparently an overwhelming mass is rendered intelligible and manageable.

### 3.3 Radical change?

For the first 90 years of Federation, civil penalty provisions were rarely found in the Commonwealth statute book.<sup>72</sup> In 1989, the Senate Standing Committee on Legal and Constitutional Affairs (the Cooney Committee) inquired into directors' duties.<sup>73</sup> The Cooney Committee recommended the enactment of civil penalty provisions for breaches of directors' duties. That recommendation was legislated in 1992.<sup>74</sup> Since then, there has been a significant increase in the number of civil penalty provisions in the various financial services statutes.

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<sup>72</sup> See ALRC, Report 95, December 2002, 87 [2.108].

<sup>73</sup> Commonwealth, *Company Director's Duties: Senate Standing Committee on Legal and Constitutional Affairs*, Parl Paper No 395 (1989).

<sup>74</sup> The civil penalty regime was introduced into the *Corporations Act 1989* (Cth) by the *Corporate Law Reform Act 1992* (Cth), with effect from 1 February 1993. See also Vicky Comino, 'The Challenge of Corporate Law Enforcement in Australia' (2009) *Australian Journal of Corporate Law*, 233, 234–5; Treasury, *Australian Securities and Investments Commission Enforcement Review Report*, 18 December 2017, 72.

In 2002, civil penalty provisions relating to financial services were first inserted into the Corporations Act by the *Financial Services Reform Act 2001* (Cth).<sup>75</sup> That Act extended the civil penalty regime to apply to offences relating to all market misconduct.<sup>76</sup> By 2015, there were 50 civil penalty provisions in the Corporations Act.<sup>77</sup> By November 2018, there were 72.<sup>78</sup>

If the recommendations of the ASIC Enforcement Review are implemented,<sup>79</sup> there will be 37 new civil penalty provisions in the Corporations Act, and 11 new civil penalty provisions across the *National Consumer Credit Protection Act 2009* (Cth) (the NCCP Act), the Credit Code and the *Insurance Contracts Act 1984* (Cth) (the Insurance Contracts Act).<sup>80</sup> ASIC is, or will be, responsible for enforcing those provisions.<sup>81</sup>

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<sup>75</sup> See, eg, Michelle Welsh, 'Enforcing Contraventions of the Continuous Disclosure Provisions: Civil or Administrative Penalties' (2007) 25 *Corporate and Securities Law Journal* 315, 318.

<sup>76</sup> For example, provisions concerning insider trading, continuous disclosure obligations, market manipulation, false trading and market rigging and dissemination of information about an illegal transaction. See, eg, Vicky Comino, 'Civil or Criminal Penalties for Corporate Misconduct: Which Way Ahead?' (2006) 34(6) *Australian Business Law Review* 428, 432–3 fn 37; Michelle Welsh, 'Enforcing Contraventions of the Continuous Disclosure Provisions: Civil or Administrative Penalties' (2007) 25 *Corporate and Securities Law Journal* 315, 318 fn 10.

<sup>77</sup> See Jasper Hedges et al, 'An Empirical Analysis of Public Enforcement of Directors' Duties in Australia: Preliminary Findings' (Working Paper No 3, Melbourne Law School, 31 December 2015), 9.

<sup>78</sup> See Corporations Act s 1317E. This number includes each subsection that is a civil penalty provision.

<sup>79</sup> The Bill that proposes to amend these Acts to insert the civil penalty provisions was passed in the House of Representatives on 29 November 2018, and read for the second time in the Senate on 3 December 2018.

<sup>80</sup> See Explanatory Memorandum, Treasury Laws Amendment (Strengthening Corporate and Financial Sector Penalties) Bill 2018 (Cth), 43–6.

<sup>81</sup> As to the ASIC Act, see the unconscionable conduct and consumer protection provisions in Pt 2, Div 2, Sub-div G. As to the Credit Act, see the civil penalty regime in Pt 4.1. As to the Credit Code, see s 111. See generally, also, Treasury, *ASIC Enforcement Review: Positions Paper 7 – Strengthening Penalties for Corporate and Financial Sector Misconduct*, 2017, 37.

As civil penalty provisions have proliferated, and been more regularly litigated, a body of law has developed. Though the courts must apply civil procedure rules to civil penalty proceedings,<sup>82</sup> proceedings for a civil penalty have both civil and criminal characteristics.<sup>83</sup> Because of that, the common law privilege against self-incrimination,<sup>84</sup> and the privilege against exposure to a penalty,<sup>85</sup> extend to natural person defendants to civil penalty proceedings. The penal nature of the proceeding also means that satisfaction that an issue has been proved ought not to be reached by ‘inexact proofs, indefinite testimony, or indirect inferences’.<sup>86</sup>

The growth in the number of civil penalty provisions, in the law relating to the specific provisions, and in the related procedural law, coupled with ASIC’s ineffective enforcement culture, have caused me to consider whether radical change is required. I have already ruled out transferring part of ASIC’s remit to the ACCC. Another option would be to establish a specialist *civil* enforcement agency, just as the Commonwealth and all of the states and territories have specialist agencies to prosecute criminal breaches.

The creation of a specialist civil enforcement agency would preserve all of ASIC’s regulatory tools, save for the right to litigate in respect of civil penalty provisions. ASIC would be required to prepare a brief of materials to the new agency if a particular evidentiary threshold was reached. It would then be for the enforcement agency to make any decision about whether to commence proceedings. In other words, ASIC would act as the investigators, but not make the decision to commence civil penalty proceedings.

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<sup>82</sup> See, eg, Corporations Act s 1317L; *Rich v ASIC* (2004) 220 CLR 129, 143–4 [27].

<sup>83</sup> See *Chief Executive Officer of Customs v Labrador Liquor Wholesale Pty Ltd* (2003) 216 CLR 161, 198–9 [114]. It is now understood that civil penalties punish, but do not provide any form of retribution or rehabilitation: *Commonwealth v Director, Fair Work Building Industry Inspectorate* (2015) 258 CLR 482, 506 [55]. See also ALRC, Report 95, December 2002, 72–3 [2.45]–[2.50].

<sup>84</sup> *The Daniels Corporation International Pty Ltd v ACCC* (2002) 213 CLR 543, 559 [31].

<sup>85</sup> *The Daniels Corporation International Pty Ltd v ACCC* (2002) 213 CLR 543, 553–4 [13]; *Rich v ASIC* (2004) 220 CLR 129, 141 [23].

<sup>86</sup> *Briginshaw v Briginshaw* (1938) 60 CLR 336, 362.

There would be some benefits in such an arrangement. A specialised litigation agency would have to develop core skills in what is an increasingly specialised area of the law. This arrangement would repose responsibility for determining whether public interest considerations required action or no action in a professional body that would become skilled in making those judgments.

At the same time, the twin peaks model would be preserved. ASIC would retain its licensing authority and the power to take action under a licence. It would remain the entity in regular contact with the regulated population. And the risk of industry capture affecting litigation decisions would be removed, by placing that decision in an independent agency.

Notwithstanding the prospect of those benefits, I do not recommend such a radical change. It may be that the removal of a regulatory tool as important as civil penalty litigation would have other effects for ASIC's work.<sup>87</sup> Those effects would need to be properly understood before taking such a large step. But, more importantly, ASIC has acknowledged that its enforcement culture must change.<sup>88</sup> It should be given time to demonstrate that changes can be made and to demonstrate that, once made, the changes are durable.

**Although I do not now recommend the establishment of a specialist civil enforcement agency, ASIC's progress in reforming its enforcement function should be closely monitored. If, over the coming years, it becomes apparent that ASIC is not sufficiently enforcing the laws within its remit, or if the size of its remit comes at the expense of its litigation capability, further consideration should be given to developing a specialist agency of the type I have described.**

It is important, then, for me to say something further about the conduct of regulatory litigation.

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<sup>87</sup> Civil penalties were intended to be a feature of an enforcement regime that provided ASIC with gradations of sanctions, based on 'strategic regulation theory' and the enforcement pyramid model. See ALRC, Report 95, December 2002, 76 [2.60]–[2.61]; see also Anne Rees, 'Civil Penalties: Emphasising the Adjective or the Noun' (2006) 34 *Australian Business Law Review* 139, 140; Vicky Comino, 'James Hardie and the Problems of the Australian Civil Penalties Regime' (2014) 37(1) *University of New South Wales Law Journal* 195, 202.

<sup>88</sup> Transcript, James Shipton, 22 November 2018, 6930; Transcript, James Shipton, 23 November 2018, 6991.

### 3.4 Litigation

Litigation (of any sort) must never be undertaken without a clear understanding of what the initiating party seeks to achieve. For a regulator alleging contravention of law, that means identifying what conduct it alleges, what law it alleges the defendant has contravened by that conduct, and how the alleged conduct amounted to a contravention. That is, at its most basic, the regulator:

- must know what case it seeks to make;
- must be able to prove the necessary facts; and then
- must be able to show how what was done breached the law.

Often, a regulator must choose how best to frame the case. Often the information available may reveal more than one, and often many, different contraventions of different provisions. What is the provision that best captures the true nature and character of what was done in breach of the law? Confronted with a mass of material, often relating to events that have occurred over a long period, what are the critical facts? How will those facts be proved?

Litigation takes time. It costs money and often great effort. There is always some uncertainty. What is to be made of time, cost and uncertainty? All three considerations will always be there. Why not avoid them? If a compromise can be reached without those risks, why not take it?

The answer lies in recognising that **litigation of the kind now under consideration is the exercise of public power for public purposes. It is litigation by a public authority to enforce the law. A private plaintiff can always choose not to pursue, to abandon or to compromise that plaintiff's private rights. A private plaintiff may take any of these steps for any reason or no reason. But altogether different considerations arise in connection with the public enforcement of the law.**

**Breach of the law carries consequences. Parliament, not the regulators, sets the law and the consequences.** There are cases where there is good public reason not to seek those consequences. Prosecution policies have always recognised that there may be good *public* reasons not to pursue a particular case. **But the starting point for consideration is,**

**and must always be, that the law is to be obeyed and enforced. The rule of law requires no less. And, adequate deterrence of misconduct depends upon visible public denunciation and punishment.**

The regulatory pyramid, to which so much reference has been made in evidence and submissions, reflects two very practical observations: not all contraventions of law are of equal significance; and regulators do not have unlimited time or resources. But it is wholly consistent with the analyses that are expressed by the metaphor of the regulatory pyramid, that serious breaches of law by large entities call for the highest level of regulatory response. And that is what has been missing. Too often serious breaches of law by large entities have yielded nothing more than a few infringement notices,<sup>89</sup> an **enforceable undertaking** (EU) not to offend again (with or without an immaterial ‘public benefit payment’)<sup>90</sup> or some agreed form of media release.<sup>91</sup>

I remain of the view that breaches of the offence and civil penalty provisions of the financial services laws are not to be dismissed as ‘*just* a breach of *those* laws’ as if the laws governing the conduct of financial services entities are some less important form of law. The financial services laws regulate the conduct of central actors in the Australian economy. Their enforcement should be governed by the same principles that inform enforcement of the general law.<sup>92</sup>

A regulator may go to court only if there is a proper basis for doing so. If ASIC has a reasonable prospect of proving contravention of the law, the starting point for its consideration of what to do must be that the consequences of contravention should be determined by a court. As I said in the *Interim Report*, this neither departs from the model litigant requirements set out in Appendix B to the Legal Services Directions 2017 nor precludes negotiation about resolving those proceedings.<sup>93</sup>

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<sup>89</sup> Transcript, Gary Dransfield, 20 September 2018, 6321.

<sup>90</sup> ASIC, Media Release 18-092MR, 6 April 2018; ASIC, Media Release 18-102MR, 13 April 2018; ASIC, Media Release 18-206MR, 6 July 2018.

<sup>91</sup> Transcript, Gregory Martin, 11 September 2018, 5399.

<sup>92</sup> FSRC, *Interim Report*, vol 1, 278.

<sup>93</sup> FSRC, *Interim Report*, vol 1, 278.

Nor is it the case that a regulator is only permitted to commence proceedings when there are reasonable prospects of success. Paragraph 4.7 of the Legal Services Directions provides that an agency is not to start civil proceedings unless the agency has received written legal advice that there are reasonable grounds for starting proceedings. However, the requirement for 'reasonable grounds' directs attention to other factors, interests and considerations than just prospects of success. And so, there may be reasonable grounds for commencing a civil penalty proceeding where the issue raised is systemic or will assist to clarify the law, notwithstanding that the prospects of success may be uncertain.

Central to all of the observations I have made about litigation is the need for a regulator to decide what it seeks to achieve. Starting litigation, especially litigation to enforce the law, is not an end in itself. It is never more than a step towards some other end. What is that end? When starting enforcement proceedings the intended end must always be to demonstrate the alleged contravention and have the court impose a proper penalty.

The history of what has become known as the fees for no service issue demonstrates, in the clearest possible way, the need for visible public denunciation and punishment in deterring misconduct. So much appears from the following chronology:

- ASIC announced, in April 2015, that it was investigating 'multiple instances' of fees being charged for ongoing advice that had not been provided.<sup>94</sup>
- ASIC published its report on the matter in October 2016.<sup>95</sup>
- In April 2018, a few days before the Commission was first to take evidence about the issues, ASIC accepted EUs from ANZ and CBA (in respect of two of CBA's advice licensees).<sup>96</sup>

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<sup>94</sup> Exhibit 2.1, Witness statement of Peter Kell, 12 April 2018, Exhibit PK-2 [ASIC.0902.0001.0941].

<sup>95</sup> ASIC, Report 499, 27 October 2016.

<sup>96</sup> FSRC, *Interim Report*, vol 1, 124; Enforceable Undertaking, ASIC and ANZ, 29 March 2018, 5 [3.1]; ASIC, Media Release 18-092MR, 6 April 2018; Enforceable Undertaking, ASIC and CFPL and BWFA, 9 April 2018, 9 [3.5.5]; ASIC, Media Release 18-102MR, 13 April 2018.

- In August 2018, the Commission took further evidence on the issues in connection with superannuation.
- In September 2018, ASIC began civil penalty proceedings against MLC Nominees Pty Ltd and NULIS Nominees (Australia) Ltd alleging contraventions of several statutory provisions in connection with the charging of certain advice fees.<sup>97</sup>

Despite ASIC's investigation, the evidence led in the Commission showed that some entities may have continued to charge fees for which no service was provided until the matters were examined publicly by the Commission.<sup>98</sup> And no less importantly, the evidence of protracted negotiations between ASIC and entities about how entities would frame their remediation programs showed their unwillingness to accept that what they had done was wrong. Maintaining that kind of attitude would have been all the harder had a court decided the issue.

The time and cost of litigation can be measured when it ends. But the decision not to litigate also has time and cost implications. Not litigating does not guarantee faster resolution. Nor does it reduce the overall cost to the community if it means that the opportunity to deter further misconduct by litigation that denounces and punishes the original misconduct is not taken.

What then is to be made of the time, cost and risks of litigation?

Time and cost will be much affected by the precision of the case that is sought to be made. But beyond that, time and cost are inevitable features of litigation.

Risk is a different matter. Risk of failing on the facts is an ever-present danger in almost every form of litigation. So much turns on how the evidence is finally presented in court and perceived by the tribunal of fact. But proper preparation of litigation reduces litigation risk.

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<sup>97</sup> *ASIC v MLC Nominees Pty Ltd & Anor* FCA, NSD1654/2018.

<sup>98</sup> See the chapter about financial advice. See also, eg, Transcript, Linda Elkins, 15 August 2018, 4962–3.

Proper preparation requires careful and dispassionate assessment of the questions posed earlier: What conduct is alleged to contravene what law in what respect? And then the relevant questions become: What are the critical facts? How will they be proved? In at least some past cases, there may be grounds to think that insufficient attention was given to these basic questions. If that is right, the solution lies in more precise case formulation and preparation. It does not provide any reason for responding to misconduct by asking ‘How can this be resolved by agreement?’. The relevant question in such a case must always be ‘Why not litigate?’.

### 3.5 Infringement notices

Infringement notices, or penalty notices, are notices authorised by statute that set out the particulars of an alleged contravention and a penalty for that contravention.<sup>99</sup> The recipient of a notice from a Commonwealth regulator may elect to pay the amount stated in the notice. By doing that, the breaches alleged in the notice will be resolved and the issuing authority will be barred from taking further legal action. Alternatively, the recipient may elect not to pay, leaving the regulator to decide whether to commence proceedings in the ordinary way.<sup>100</sup> The usefulness of infringement notices in punishing contraventions is limited.

Historically, infringement notices were applied to minor criminal offences, and did not extend to non-criminal contraventions.<sup>101</sup> The policy rationale for this is that infringement notices expedite the collection of monetary penalties arising from minor offences, and avoid court time and resources from being unduly burdened by minor matters.<sup>102</sup> In essence, infringement notices were designed to provide a system for punishment of an offence proportionate to the seriousness of the conduct.<sup>103</sup>

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<sup>99</sup> ALRC, Report 95, December 2002, 426 [12.4].

<sup>100</sup> ALRC, Report 95, December 2002, 426 [12.4].

<sup>101</sup> ALRC, Report 95, December 2002, 426–7 [12.5].

<sup>102</sup> ALRC, Report 95, December 2002, 426–7 [12.5]–[12.8].

<sup>103</sup> ALRC, Report 95, December 2002, 427 [12.8].

Over time, the types of provisions for which an infringement notice can issue have expanded. The ASIC Enforcement Review Taskforce explained in its December 2017 report that ASIC's powers in respect of infringement notices first started to widen in 2004, when it was given a power to issue an infringement notice for alleged breaches of continuous disclosure obligations.<sup>104</sup> ASIC now has powers to issue infringement notices for certain unconscionable conduct and consumer protection provisions of the *Australian Securities and Investments Commission Act 2001* (the ASIC Act), for strict liability offences and certain civil penalty provisions under the NCCP Act, and for breaches of market integrity rules, derivative transaction rules and derivative trade repository rules under the Corporations Act.<sup>105</sup>

The ASIC Enforcement Review Taskforce recommended that further provisions be made infringement notice provisions.<sup>106</sup> The Bill currently before the Senate that implements the Taskforce's recommendations will, if enacted, have the effect that all strict liability and absolute liability offences in the Corporations Act, and certain civil penalty provisions in the Corporations Act and Insurance Contracts Act, will be subject to an infringement notice regime.<sup>107</sup>

**The availability of infringement notices for non-criminal provisions is relatively new and the range of conduct in respect of which they may be issued has expanded quickly.** The Taskforce's recommendations will increase the number of provisions within the infringement notice regime.

**The use of infringement notices for types of contraventions that involve matters of judgment has been criticised.**<sup>108</sup> In particular, the Australian Law Reform Commission (ALRC) criticised the proposal to introduce an infringement notice regime for contraventions of continuous disclosure provisions, and the Law Council of Australia has described the use of infringement notices for substantive contraventions as 'lazy

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<sup>104</sup> Treasury, *ASIC Enforcement Review Taskforce Report*, 18 December 2017, 80.

<sup>105</sup> Treasury, *ASIC Enforcement Review Taskforce Report*, 18 December 2017, 80–1.

<sup>106</sup> Treasury, *ASIC Enforcement Review Taskforce Report*, 18 December 2017, 81.

<sup>107</sup> Explanatory Memorandum, Treasury Laws Amendment (Strengthening Corporate and Financial Sector Penalties) Bill 2018 (Cth), 12.

<sup>108</sup> ASIC Taskforce Review, Report, 81.

regulation' that does not 'provide guidance to the community as to what conduct should be proscribed or not'.<sup>109</sup> Those criticisms were not accepted by the Enforcement Review.<sup>110</sup>

**Further attention should be given to those criticisms. It cannot be doubted that infringement notices serve as a practical regulatory tool for dealing with non-compliance with some provisions. But I doubt that expanding the infringement notices regime can be shown to have served the public well.**

**Infringement notices give the regulator a course of action (reportable as an 'enforcement action') that is unlikely to have any real deterrent (or punitive) effect.** That was amply borne out by the evidence of Mr Gary Dransfield of AAI in the sixth round of hearings.<sup>111</sup>

Mr Dransfield's evidence was that AAI paid the sum of the four infringement notices issued by ASIC that alleged that representations made about a particular policy were misleading and deceptive, despite maintaining throughout ASIC's investigation that it did not believe the advertising was misleading or deceptive. In Mr Dransfield's words, AAI paid the infringement notices because it 'felt that it was appropriate [to] meet the requirements of [the] regulator'.<sup>112</sup> The sum of the infringement notices AAI paid – \$43,200 – represented 0.01% of the total amount it received in premiums from the policies for the relevant year – \$426 million.<sup>113</sup> When asked whether the reputational effects that flowed from the infringement notice caused AAI to want to defend the allegations put against it, Mr Dransfield's evidence was that, generally, the view was taken that 'we should pay the penalty [and] move on'.<sup>114</sup>

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<sup>109</sup> ASIC Taskforce Review, Report, 81.

<sup>110</sup> See ASIC Taskforce Review, Report, 81–3 Recommendation 44.

<sup>111</sup> Transcript, Gary Dransfield, 20 September 2018, 6305–23, particularly at 6321–2.

<sup>112</sup> Transcript, Gary Dransfield, 20 September 2018, 6321.

<sup>113</sup> Transcript, Gary Dransfield, 20 September 2018, 6321–2.

<sup>114</sup> Transcript, Gary Dransfield, 20 September 2018, 6322.

That is, AAI saw paying the infringement notices as a way of bringing an issue to an end. And no doubt payment of the infringement notices did bring the issue to an end. But with what effect? Issuing the infringement notices may have been ‘convenient and expeditious’ but it achieved neither punishment nor deterrence.

**Infringement notices are a useful way to deal with lax administrative conduct such as failure to file a return on time. But their use beyond purely regulatory matters will rarely be appropriate. And if the provision involves contestable matters of judgment – for example, an alleged breach of the prohibition on false and misleading conduct or the duty of utmost good faith – the issue of an infringement notice will rarely, if ever, be an appropriate regulatory response.**

One risk of the use of infringement notices for a broader range of conduct risks is that it can encourage financial services entities to treat the consequential penalties as a cost of doing business, which is not compatible with the intent to deter further misconduct. That risk is heightened if the recipient of the notice is a large financial institution.

Ultimately, the use of infringement notices is dependent on the enforcement culture of the regulator. An enforcement culture that is properly focused upon effective enforcement of the law will recognise that infringement notices can play only a minor role in that task and, ordinarily, that role will be limited to penalising administrative failings.

I recommend that ASIC’s enforcement policy in respect of infringement notices be redrawn to reflect that:

- infringement notices should principally be used in respect of administrative failings by entities;
- the use of infringement notices for provisions that require an evaluative judgment will rarely, if ever, be appropriate; and
- beyond purely administrative failings, infringement notices will rarely be the appropriate enforcement tool where the infringing party is a large corporation.

### 3.6 Enforceable undertakings

ASIC rightly describes an enforceable undertaking (EU) as a form of administrative settlement that ASIC may accept as an alternative to civil court action or certain other administrative actions.<sup>115</sup> ASIC may accept EUs given by a person, or a responsible entity of a managed investment scheme, in connection with a matter for which ASIC has a function or power under the ASIC Act or related legislation.<sup>116</sup>

In Regulatory Guide 100, ASIC sets out its approach to accepting EUs. The approach has two component parts. It is necessary to say something about each.

The first is that ASIC will not consider an EU unless it has reason to believe there has been a contravention of relevant legislation and it has commenced an investigation or surveillance of the conduct it believes gives rise to the suspected contravention.<sup>117</sup>

These are important conditions. They are important because they identify the essential foundations for ASIC's acceptance of an EU.

The second part of ASIC's stated approach is that it will only use EUs where they result in a 'more effective regulatory outcome'.<sup>118</sup> ASIC says it will generally consider accepting an EU only where:<sup>119</sup>

- it has weighed up the nature of the alleged breach and the effectiveness of the regulatory outcome offered by the EU compared with outcomes offered by other available enforcement remedies; and
- it believes an EU is the most effective and appropriate regulatory outcome given the significance of the issues to the market and the community, the nature and seriousness of the alleged breach and the compliance history of the entity.

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<sup>115</sup> ASIC, Regulatory Guide 100, February 2015, 5–7.

<sup>116</sup> See ASIC Act ss 93AA, 93A.

<sup>117</sup> ASIC, Regulatory Guide 100, February 2015, 8 [100.17].

<sup>118</sup> ASIC, Regulatory Guide 100, February 2015, 9 [100.24]–[100.25].

<sup>119</sup> ASIC, Regulatory Guide 100, February 2015, 9 [100.20].

ASIC says it considers an EU to be an effective regulatory outcome if it does all or any of the following:<sup>120</sup>

- promotes the integrity of, and public confidence in, Australia's financial markets and corporate governance;
- specifically deters the person from future instances of the conduct that gave rise to the undertaking;
- promotes general deterrence by making the business community aware of the conduct and the consequences arising from engaging in that conduct;
- provides an ongoing benefit by way of an improved compliance program.

In the *Interim Report*, I observed that entities often only acknowledge ASIC's 'concerns' when they accept EUs, rather than acknowledge or accept their breach of specific provisions.<sup>121</sup> That is, the facts agreed to in the EU often are not sufficient to establish a breach of the provisions said to have been breached.

EUs are a negotiated outcome between ASIC and the regulated entity. They can be used only if the entity agrees to give the undertaking. It may be assumed that the entity's decision to agree to give the undertaking will be influenced by its willingness to acknowledge ASIC's 'concerns', the strength of the evidence available to support ASIC's concerns, and the availability and nature of other remedies for ASIC to pursue.<sup>122</sup>

Should the Treasury Laws Amendment (Strengthening Corporate and Financial Sector Penalties) Bill 2018 (Cth) be enacted, ASIC will be given disgorgement remedies in civil proceedings and a directions power, which extends to ordering remediation. In these circumstances, it will be more difficult to show that an EU will result in a more effective regulatory outcome than could be achieved by other means. It would follow that ASIC's use of EUs may be expected to be less frequent.

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<sup>120</sup> ASIC, Regulatory Guide 100, February 2015, 9 [100.25].

<sup>121</sup> FSRC, *Interim Report*, vol 1, 271.

<sup>122</sup> See the discussion in the ASIC Taskforce Review, Report, 100.

The flexibility of EUs has undoubted appeal. But that appeal cannot be allowed to distract attention from the fact that EUs ordinarily are given in circumstances where the regulator has formed a view that the law has been breached. That is, they are used in aid of enforcement of the law.

As I have said above, and as ASIC has accepted, the first question to be asked when misconduct has been identified is ‘why not litigate?’. One answer to that question is that a better regulatory outcome can be achieved by the use of an EU. But that view cannot be formed without having first given proper consideration to questions of deterrence, both general and specific. A regulatory response to a breach of law that does not deter, generally and specifically, will rarely be a more effective regulatory outcome.

When an entity fails to acknowledge that it has done wrong the risk is that it considers the promises made in the EU as no more than the cost of doing business or the cost of placating the regulator. And the absence of a judicial determination means that none of the regulator, the entity concerned, or the market more generally, can be sure if the conduct was wrongful. All of those factors will ordinarily point firmly away from accepting an EU.

If, despite all of these considerations, an EU can still be said to be a more effective regulatory outcome, ASIC should adopt a policy that it will generally not agree to an EU in respect of a civil penalty provision without the entity acknowledging that it has breached one or more specific legislative provisions.

## **3.7 Making the change in ASIC’s enforcement culture**

### **3.7.1 Internal review**

ASIC’s first step, which it had taken at the time it made its submissions in response to the *Interim Report*, has been to undertake an Internal Enforcement Review focusing particularly on ‘policies, processes and decision-making procedures’ relevant to ‘whether or not to enforce the law using criminal and civil proceedings or other options’ and ‘the effectiveness and timeliness of the conduct of litigation and of enforcement outcomes’.<sup>123</sup>

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<sup>123</sup> ASIC, Interim Report Submission, 6 [27].

Policies, processes and procedures are important to the proper operation of an organisation like ASIC. There can be no basis for criticising ASIC reviewing its policies, processes and procedures about enforcement. But only time and experience will tell whether altering statements of policies, processes and procedures is effective in achieving their more fundamental purposes.

Time and experience will be necessary because ASIC's statements of enforcement policies, and its processes and procedures as they stood at the time of the events described in the course of the Commission, were not unorthodox. They were statements entirely consistent with the enforcement pyramid model of sanctions of escalating severity.<sup>124</sup> And ASIC's stated policies about enforcement did not preclude it from taking much stronger steps than it did. This is why I have said that the question is one of culture rather than of needing to reformulate policies, processes and procedures. Any resulting restatement of policies, processes or procedures will be important only to the extent that it changes *what* ASIC does, as distinct from *how* it is done.

A related point concerns the structure of the enforcement function as compared with other units within ASIC. Because enforcement is concerned with deciding whether and what legal action is to be taken against an entity, it must, so far as possible, be independent of, and free from continuing relationships with, that entity.

As noted earlier, the risk of regulatory capture is well acknowledged.<sup>125</sup> One means of avoiding regulatory capture affecting enforcement decisions is to have the enforcement arm of ASIC separated from day-to-day dealings with the entities it regulates to the greatest possible extent.

Enforcement staff will have to meet with regulated entities to discuss enforcement decisions. So, for example, enforcement staff will have to negotiate about litigation that is on foot. But those meetings should be conducted through the parties' legal representatives and with appropriate formality. Enforcement staff should not be responsible for the general

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<sup>124</sup> ASIC, Interim Report Submission, 4–5 [18]–[23].

<sup>125</sup> See, eg, James Kwak, 'Cultural Capital and the Financial Crisis' in Daniel Carpenter and David Moss (eds), *Preventing Regulatory Capture* (Cambridge, 2014) 71–98.

relationship between the regulator and the regulated entity.<sup>126</sup>

Their involvement with an entity should be matter-specific.

Within the regulator, enforcement officers must be relied upon for clear and objective advice and action. Those responsible for continuing supervision of an entity may give too much weight to past good conduct, or may – even subconsciously – explain away conduct that would otherwise raise a red flag.

In short, enforcement is radically different from most other functions within a regulator and, to the maximum extent practicable, should be divorced from those other functions. ASIC's Enforcement Review report recommends the establishment of an Office of Enforcement.<sup>127</sup> At a general level – I say nothing as to the proposed role of Commissioners in that office – functional separation of enforcement is consistent with what I have said about the radical difference between enforcement and other regulatory functions.

### **3.7.2 Altering the management structure**

Beyond the essential structure established by the ASIC Act, it is for ASIC to decide what organisational structure will best help it fulfil its remit.

I note the recent changes made in ASIC's management structure by the creation of a group of executive directors (immediately below the Commissioners), who are to manage particular parts of ASIC's activities. I note also that every one of these positions was filled from the existing ranks of senior team leaders without any opportunity for others within or without ASIC to apply for the positions.

One of the chief objectives of the change is said to be to allow Commissioners to deal better with higher-level strategic issues.<sup>128</sup> However, introducing a new level of management must not be permitted to prevent the proper application of the principles I have set out above under the heading 'Litigation' when deciding whether, and what form of, enforcement action will

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<sup>126</sup> Exhibit 7.157, 20 June 2018, Meeting Invitation Re 'AMP Executive Group & ASIC (Reset)'.

<sup>127</sup> Exhibit 7.159, 6 January 2019, Summary of Review of ASIC's Enforcement Policies.

<sup>128</sup> Exhibit 7.6.3, Witness statement of James Shipton, 7 November 2018, 4 [19].

be taken. The longer and more attenuated the chain of responsibility, the harder it is to challenge the views that are expressed along the way. And unless the decision relates to a simple and quasi-administrative requirement (which will either be met or not met), the judgments that are made along the way to making some recommendation about future action may not be explained in ways that give the final decision-maker a real sense of why the recommendation is as it is. No less importantly, the final decision-maker is all too often in a position where he or she cannot be held properly accountable for the decision that is made.

One significant challenge for ASIC's new administrative structure is likely to be the proper determination of enforcement decisions. If ASIC's new management structure operates as intended, it can be expected that many matters of significance will be determined by staff rather than Commissioners. That will require strong operational controls and clear lines of accountability.

But even under the new structure, inevitably some decisions will be reserved to the Commission, or a subset of it. The authors of ASIC's internal Enforcement Review consider that it is in the best interests of the Australian community that enforcement of the Corporations and Consumer Credit legislation be made the principal responsibility of a recognised sub-committee of the Commission comprised of the Deputy Chair and two Commissioners.<sup>129</sup> Close attention will need to be given to both the process by which matters are elevated to the Commissioners (either the proposed sub-committee or the Commissioners as a whole), and the quality of the information presented to the Commissioners. Both may have significant consequences for ASIC's enforcement work. Those observations remain true irrespective of whether an Office of Enforcement is established.

It is for the Commissioners to satisfy themselves that ASIC's processes are designed in a way that assists them to arrive at the correct decisions. I will say no more about that issue, or about ASIC's internal structure.

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<sup>129</sup> Exhibit 7.159, 6 January 2019, Summary of Review of ASIC's Enforcement Policies.

### Recommendation 6.2 – ASIC’s approach to enforcement

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 by entities, will rarely be appropriate for provisions that require an evaluative judgment and, beyond purely administrative failings, will rarely be an appropriate enforcement tool where the infringing party is a large corporation;
- recognises the relevance and importance of general and specific deterrence in deciding whether to accept an enforceable undertaking and the utility in obtaining admissions in enforceable undertakings; and
- separates, as much as possible, enforcement staff from non-enforcement related contact with regulated entities.

## 4 APRA’s remit

APRA is the prudential ‘peak’ of the twin peaks model established following the recommendation of the Wallis Inquiry.<sup>130</sup>

APRA is responsible for administering a wide range of legislation,<sup>131</sup> most relevantly the *Banking Act 1959* (Cth) (the Banking Act), the *Life Insurance Act 1995* (Cth) (the Life Insurance Act), the *Insurance Act 1973* (Cth) (the Insurance Act)<sup>132</sup> and the SIS Act.<sup>133</sup> Under each Act, APRA is responsible for (among other things):

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<sup>130</sup> See Wallis Inquiry, Final Report, 17–24.

<sup>131</sup> See, eg, the legislation listed in the definition of ‘prudential regulation framework law’ in APRA Act s 3(1).

<sup>132</sup> APRA shares administration of the Life Insurance Act with ASIC: see Life Insurance Act s 7.

<sup>133</sup> APRA shares administration of the SIS Act with ASIC and the Commissioner of Taxation: see SIS Act ss 3(1), 6.

- the licensing,<sup>134</sup> authorisation<sup>135</sup> or registration<sup>136</sup> of the relevant entity subject to the Act;
- the suspension,<sup>137</sup> removal,<sup>138</sup> disqualification,<sup>139</sup> revocation<sup>140</sup> or cancellation<sup>141</sup> of that licence (and persons within an entity) issued under the Act;
- giving directions where it believes an entity has failed to comply with the Act;<sup>142</sup>
- conducting investigations where it believes there is a breach of the Act;<sup>143</sup>
- determining prudential standards for conduct relating to prudential matters.<sup>144</sup>

APRA's administration of all of these matters takes a prudential focus. That focus reflects the foundational promises made by institutions to customers. **Authorised deposit-taking institutions** (ADIs) and insurers promise depositors and insureds that they will be paid what they are due when the occasion (and the contract) demands it. APRA's regulatory focus is on ensuring ADIs and insurers do not fail and can therefore meet those promises.

By contrast with the promise of ADIs and insurers, the promise of the superannuation trustee is to manage the member's account in a particular way, in accordance with the covenants provided under

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<sup>134</sup> SIS Act s 29D.

<sup>135</sup> Banking Act s 9; Insurance Act s 12(1).

<sup>136</sup> Life Insurance Act s 21.

<sup>137</sup> SIS Act s 133.

<sup>138</sup> Banking Act s 23; Insurance Act s 27.

<sup>139</sup> Banking Act s 21; Insurance Act s 25A; Life Insurance Act s 245A; SIS Act s 126H.

<sup>140</sup> Insurance Act s 15; Life Insurance Act s 26.

<sup>141</sup> SIS Act s 29G.

<sup>142</sup> Banking Act s 11CA; Insurance Act s 104; Life Insurance Act s 230B; SIS Act s 29EB.

<sup>143</sup> Banking Act s 61; Insurance Act s 52; Life Insurance Act s 137; SIS Act s 263.

<sup>144</sup> Banking Act s 11AF; Insurance Act s 32; Life Insurance Act s 230A; SIS Act s 34C.

the SIS Act. No particular outcome is promised.<sup>145</sup> Instead, the trustee promises (covenants) to exercise powers and perform its duties in the best interests of beneficiaries.

## 5 Co-regulation by APRA and ASIC

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The original conception of APRA from the Wallis Inquiry has shaped how it perceives its role, how it performs its functions and how it exercises its powers. Mr Wayne Byres, APRA's Chair, put the matter plainly:

[W]e don't see ourselves as sometimes a prudential regulator and sometimes a conduct regulator. Our Act, our mandate, our name, the statement of expectations – everything that we have says we are a prudential regulator, but we do have these other things that take us into the conduct territory. But if we're going to be judged as to what we are, we're a prudential regulator.<sup>146</sup>

In the course of the Commission's work, questions have arisen about the scope of APRA's remit and APRA's ability and willingness to exercise its powers. These questions have been raised in circumstances where misconduct has been observed in institutions regulated by APRA and at a time where it is increasingly acknowledged, both domestically and internationally,<sup>147</sup> that the conduct and governance of an institution are relevant to the prudential supervision of that institution.<sup>148</sup>

The Commission's task, directed heavily as it is by the Terms of Reference to misconduct, did not involve an examination of all of APRA's work. Instead the examination of APRA focused largely on two issues: the supervision of the superannuation system and of the BEAR. I deal with each below.

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<sup>145</sup> Except by defined benefit superannuation funds, and they are a small and diminishing number of funds.

<sup>146</sup> Transcript, Wayne Byres, 30 November 2018, 7449–50.

<sup>147</sup> See, eg, FSB, *Guidance on Supervisory Interaction with Financial Institutions on Risk Culture: A Framework for Assessing Risk Culture*, 7 April 2014 <[www.fsb.org/wp-content/uploads/140407.pdf](http://www.fsb.org/wp-content/uploads/140407.pdf)>.

<sup>148</sup> I discuss those developments further in the chapter on culture, governance and remuneration.

## 5.1 Conduct regulation and superannuation

### 5.1.1 The current division

Responsibility for administration of the SIS Act is divided between APRA, ASIC and the Commissioner of Taxation. In general terms, ASIC's role under the SIS Act is limited to matters of disclosure. For example, ASIC has general administration of the covenants imposed on Registrable Superannuation Entity (RSE) licensees under section 52 of the SIS Act, but only to the extent that it relates to, in general terms, any disclosures made by the RSE licensee to members.<sup>149</sup> The Commissioner of Taxation is responsible for those parts of the SIS Act that concern self-managed superannuation funds and revenue matters more generally. It falls to APRA to administer the balance of the Act.

The trustee's covenants set out in the SIS Act have been generally described in the chapter dealing with superannuation. I will not repeat that summary here. For present purposes, it is important to note that many of the Act's covenants both protect the interests of individual members and serve a prudential purpose.

In a document published in 2018, APRA and ASIC set out their respective responsibilities in superannuation. They said that:<sup>150</sup>

Five years after the introduction of the Superannuation Guarantee in 1992, the Wallis Inquiry (1997) made some fundamental recommendations which influenced the way superannuation was regulated. Key recommendations included the establishment of APRA as the prudential regulator and ASIC as the regulator for market conduct and disclosure. *The regulation of the superannuation system involves an adjustment to the twin peaks model* whereby APRA has general oversight of best interest obligations derived from trust law. The model reflects risks arising from the compulsory and market-linked nature of superannuation.

The last two sentences of this paragraph reflect the different nature of the financial promise an RSE licensee makes to members of the

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<sup>149</sup> See SIS Act ss 6(1)(d) and (2).

<sup>150</sup> Exhibit 7.145, Witness statement of Wayne Byres, 27 November 2018, Exhibit WB-1-45 [APRA.0075.0001.0306 at .0306] (emphasis added; footnotes omitted).

fund and the risks inherent in that promise. As I noted above, and in the chapter on superannuation, the promise of the superannuation trustee is to manage the member's account in a particular way, in accordance with the covenants provided under the SIS Act. That differs markedly from the promises made to consumers by ADIs and insurers. Unlike ADIs and insurers, an RSE licensee promises no particular outcome.<sup>151</sup> Instead, the trustee promises (it covenants) to exercise powers and perform its duties in the best interests of beneficiaries. The SIS Act therefore requires the regulator with administration of the Act (in this case, APRA) to have regard not only to the *viability* of each fund but also to the *conduct* of trustees.

### 5.1.2 Enlarging ASIC's role

Allocating responsibilities between prudential and conduct regulation is not always assisted by using the word 'conduct' to describe the type of activity requiring a regulator's attention. Conduct often has both prudential and non-prudential connotations. In its prudential sense, conduct is most directly concerned with the institution in question being administered with appropriate integrity, prudence and professional skill and with action by the institution that, alone or in aggregate, could present a threat to the survival of the institution or the stability of the market. In each case, the focus is on the health of the institution and its ability to meet the promises it has made, and the health of the broader market. In its more common, non-prudential sense, 'conduct' is concerned with consumer protection and market conduct rules. Its essential focus is on the rights and interests of consumers in the context of their participation in the financial services industry.

APRA and ASIC have acknowledged that each has a responsibility for conduct issues concerning RSE licensees. ASIC has a responsibility because RSE licensees are also **Australian financial services licence (AFSL)** holders. However, the current arrangements for the administration of the SIS Act mean that where an RSE licensee's conduct gives rise to harm to a member (other than in respect of disclosure) and is a breach of one or more of the covenants under section 52(2), the prospect of regulatory action is slight. APRA, as the prudential regulator, does not naturally administer those covenants with consumer protection in mind. ASIC, the conduct regulator, has a role limited to disclosure.

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<sup>151</sup> Save for, as noted above, defined benefit superannuation funds.

The Productivity Commission said, in its report on superannuation, that ‘APRA and ASIC’s respective roles need to be more clearly delineated and better aligned with their distinct “regulatory DNA”’.<sup>152</sup>

It might be thought, therefore, that there is a need for a separate regulator for the superannuation sector altogether. For reasons I explain in the chapter on superannuation, I do not consider that is necessary.

The Productivity Commission proposed that ‘APRA should be distinctly focused on prudential health – ensuring high standards of system and fund performance. And ASIC should focus on the behaviour of the system – the conduct of trustees, advisers and the appropriateness of products (including for particular target markets)’.<sup>153</sup>

I agree. In my opinion, the twin peaks should be preserved and reinforced in superannuation. For this reason, I recommend that APRA’s remit in respect of the SIS Act be shared with ASIC in a way that aligns with their traditional roles and strengths. As APRA submitted, an appropriate allocation of responsibility would be as follows:

APRA, as the prudential regulator for superannuation, is responsible for establishing and enforcing Prudential Standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by superannuation entities APRA supervises are met within a stable, efficient and competitive financial system ...

As the conduct and disclosure regulator, ASIC’s role in superannuation primarily concerns the relationship between RSE licensees and individual consumers.<sup>154</sup>

I have reached this conclusion for three broad reasons.

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<sup>152</sup> Productivity Commission, Report 91, *Superannuation: Assessing Efficiency and Competitiveness*, 21 December 2018, 459

<sup>153</sup> Productivity Commission, Report 91, *Superannuation: Assessing Efficiency and Competitiveness*, 21 December 2018, 459.

<sup>154</sup> APRA, Module 5 Policy Submission, 8 [15]–[16].

First, **providing ASIC with the power to protect the interests of members would provide some consistency across the two legislative regimes that apply to RSE licensees**. An RSE licensee holds an AFSL and in holding that licence is subject to the obligations under section 912A of the Corporations Act. Those obligations have some general similarity with obligations imposed under section 52 (and section 52A) of the SIS Act. They are also similar to the obligations imposed on RSE licensees who are authorised to offer a MySuper product under section 29VN(a) (and section 29VO) of the SIS Act. It is evident that the same conduct may give rise to breaches of all of these provisions.

The second reason relates to practical matters. **APRA's skills are geared to prudential regulation**. Its capabilities in respect of enforcement are less developed, and are currently the subject of an internal review.<sup>155</sup> Its enforcement culture is similarly under-developed. Seldom, if ever, has it brought proceedings of the kind it instituted in December 2018 against persons and entities associated with IOOF.

Conversely, **enforcement is a fundamental aspect of ASIC's work**. In enforcing the SIS Act, ASIC would face issues not dissimilar to those it currently faces in enforcing other legislation. For example, the covenants of RSE licensees and their directors under the SIS Act are akin to the duties that ASIC already enforces in respect of responsible entities of managed investment schemes and their officers under the Corporations Act.<sup>156</sup>

**The third reason for wanting to embed the twin peaks model into superannuation is informed by APRA's approach to its core tasks. APRA is predisposed to methods of regulation that rely on 'supervisory suasion'<sup>157</sup> conducted 'behind closed doors', rather than to public deterrence.<sup>158</sup> The prudential regulator may wonder whether public denunciation of an entity might disturb the stability of an entity or the system. But, as I have said, deterrence of misconduct depends upon visible public denunciation and punishment. ASIC's core work is consistent with that objective. APRA's is not.**

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<sup>155</sup> Exhibit 7.145, Witness statement of Wayne Byres, 27 November 2018, 81–3 [325]–[334].

<sup>156</sup> Corporations Act ss 601FC, 601FD; SIS Act ss 52, 52A.

<sup>157</sup> Exhibit 7.145, Witness statement of Wayne Byres, 27 November 2018, 86 [341].

<sup>158</sup> Transcript, Wayne Byres, 30 November 2018, 7451–2.

Because of the nature of its core tasks, APRA is more alive and attentive to threats to the stability and safety of an entity or the financial system as a whole than it is to consumer outcomes. As the Wallis Inquiry noted, where an agency is charged with both consumer protection and prudential regulation, consumer protection tends to become subservient to the prudential objectives.<sup>159</sup> When asked if the ability to commence proceedings for breaches of the SIS Act was in tension with APRA's regulatory approach, Mr Byres answered:

To some extent, yes. There are obvious tensions there. And if we were – if we were taking lots and lots of enforcement action, I would probably have to conclude we were a poor prudential supervisor because ideally we should be trying to head these things off.<sup>160</sup>

### **Recommendation 6.3 – General principles for co-regulation**

The roles of APRA and ASIC in relation to superannuation should be adjusted to accord with the general principles that:

- APRA, as the prudential regulator for superannuation, is responsible for establishing and enforcing Prudential Standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by superannuation entities APRA supervises are met within a stable, efficient and competitive financial system; and
- as the conduct and disclosure regulator, ASIC's role in superannuation primarily concerns the relationship between RSE licensees and individual consumers.

Effect should be given to these principles by taking the steps described in Recommendations 6.4 and 6.5.

<sup>159</sup> Wallis Inquiry, Final Report, 18 March 1997, 244.

<sup>160</sup> Transcript, Wayne Byres, 30 November 2018, 7478.

### 5.1.3 Giving effect to co-regulation

It is necessary then to say something about which provisions ASIC should have the ability to enforce, and how this should be achieved.

ASIC should be given the power to enforce all provisions in the SIS Act that are, or will become, civil penalty provisions or otherwise give rise to a cause of action against an RSE licensee or director for conduct that may harm a consumer. They are provisions that have members' interests and outcomes as their touchstone. At a minimum, this will include sections 52, 52A, 29VN and 29VO, but I do not intend that to be an exhaustive list. That expansion of ASIC's functions and powers will also increase the range of circumstances in which it can cause proceedings to be commenced in the name of beneficiaries to recover loss or damage resulting from a breach of the Act.<sup>161</sup> ASIC is the more appropriate litigant for those proceedings for the reasons I have given.

To be clear, the provisions should not exclude APRA from exercising the same powers. Any decision by APRA to litigate in respect of a provision that is also actionable at the suit of ASIC will be motivated by different concerns. But APRA should retain the ability to have recourse to the provisions in order to achieve the prudential objectives they can serve.

It is also necessary to say something about some responsibilities and powers that APRA should retain, particularly under the SIS Act. Section 6 of the SIS Act sets out the divisions of administrative responsibilities under the Act. In large part these should not change. APRA should retain its current functions, including responsibility for the licensing and supervision of RSE licensees and the powers and functions that come with it. This includes any powers to apply to the court to disqualify a person (section 126H of the SIS Act) and remove that person from being a director of a trustee (section 133); the power to accept an EU (section 262A) and to conduct an investigation under section 263(1), where it appears to APRA that there has been a contravention of the Act. It also includes any power to issue directions that

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<sup>161</sup> SIS Act s 298.

APRA presently has or is to be given.<sup>162</sup> I consider the directions power to be a useful complement to APRA's supervisory toolkit because it can be used to bring pressure to bear on an unco-operative trustee. APRA has itself expressed support for having a broader directions power, which will reflect the scope of directions powers it has for other industries it regulates.<sup>163</sup>

#### **Recommendation 6.4 – ASIC as conduct regulator**

Without limiting any powers APRA currently has under the SIS Act, ASIC should be given the power to enforce all provisions in the SIS Act that are, or will become, civil penalty provisions or otherwise give rise to a cause of action against an RSE licensee or director for conduct that may harm a consumer. There should be co-regulation by APRA and ASIC of these provisions.

#### **Recommendation 6.5 – APRA to retain functions**

APRA should retain its current functions, including responsibility for the licensing and supervision of RSE licensees and the powers and functions that come with it, including any power to issue directions that APRA presently has or is to be given.

## **5.2 The BEAR**

Another overlap between conduct matters and prudential matters arises from the Banking Executive Accountability Regime (BEAR). It will be recalled that the regime came into effect for large ADIs on 1 July 2018

<sup>162</sup> The amendments proposed by the Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No 1) Bill 2017 would give APRA the power to give directions where it has 'prudential concerns' in certain circumstances: see Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No 1) Bill 2017, 56 [6.12]. Under the proposed provisions, APRA would be able to issue a direction if it has reason to believe that the direction is necessary 'in the interests of beneficiaries' or where the failure to issue a direction 'would materially prejudice the interests or reasonable expectations of those beneficiaries': see Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No 1) Bill 2017, 59 [6.29].

<sup>163</sup> Helen Rowell, 'Opening Statement' (Speech delivered at the House of Representatives Standing Committee on Economics, Canberra, 10 October 2017) <[www.apra.gov.au/media-centre/speeches/opening-statement-house-economics-committee-october-2017](http://www.apra.gov.au/media-centre/speeches/opening-statement-house-economics-committee-october-2017)>.

and contains accountability obligations for both ADIs and ‘accountable persons’, as well as other obligations such as those associated with deferred remuneration. ADIs are required to conduct their business with honesty and integrity, and with due skill, care and diligence.<sup>164</sup> Accountable persons have a similar obligation in the way they conduct the responsibilities of their position.<sup>165</sup> But the BEAR also requires ADIs to take reasonable steps to prevent matters from arising that would adversely affect the ADI’s prudential standing or prudential reputation.<sup>166</sup> An equivalent obligation applies to the way accountable persons conduct their responsibilities.<sup>167</sup>

The BEAR, therefore, has both a conduct and prudential outlook. So much is clear from the second reading speech, which emphasised that when community expectations are not met, appropriate consequences should follow for those accountable.<sup>168</sup> This is one reason ASIC should have a role to play in regulating and commencing proceedings in respect of the accountability obligations. Another is that the key accountability obligations reflect the obligations of AFSL holders under section 912A of the Corporations Act. As a practical matter, ASIC must be able to deal with both breaches together.

There should therefore be co-regulation or joint administration of the BEAR by ASIC and APRA. ASIC should be charged with overseeing those parts of Divisions 1, 2 and 3 that concern consumer protection and market conduct matters, and APRA should be charged with the prudential aspects of Part IIAA. That would mean that ASIC would be responsible for bringing any civil penalty proceeding against a contravention of Divisions 1, 2 or 3 to the extent that it related to conduct matters. And APRA would be responsible for bringing any civil penalty proceeding for a contravention of Part IIAA under section 37G to the extent it concerned prudential matters. It would be prudent to enable both ASIC and APRA to seek disqualification of accountable persons if they are satisfied that an accountable person has

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<sup>164</sup> Banking Act s 37C(a).

<sup>165</sup> Banking Act s 37CA(a).

<sup>166</sup> Banking Act s 37C(c).

<sup>167</sup> Banking Act s 37C(c).

<sup>168</sup> Commonwealth, *Parliamentary Debates*, House of Representatives, 19 October 2017, 11270 (Scott Morrison, Treasurer).

breached his or her accountability obligations, although I would expect that the power would ordinarily be exercised by APRA.<sup>169</sup>

Subject to what follows, I do not otherwise consider there to be a need for the obligations in the BEAR to be expanded, although consequential changes may be necessary in light of what I have said above. For example, sections 37C and 37CA should be amended to make clear that both ADIs and accountable persons must deal with ASIC in an open, constructive and co-operative way, as well as with APRA. And practical amendments should be made to provisions such as sections 37K and 37G(1) so that joint administration can be carried out.

Lastly, provisions modelled on the BEAR should be extended to all APRA-regulated financial services institutions. After medium and small ADIs have complied with the BEAR in accordance with the current timetable, the largest RSE licensees should also be required to comply with like provisions. Thereafter, the provisions should be applied to the balance of RSE licensees. After that, they should apply to the largest insurers and, thereafter, the balance of insurers.

These changes cannot and should not be made at once. They must be made sequentially and they will take time. There would be evident advantage in giving notice to all concerned of the general timetable that is proposed but implementation will depend upon how the changes play out and satisfaction that the changes made are proving effective.

#### **Recommendation 6.6 – Joint administration of the BEAR**

ASIC and APRA should jointly administer the BEAR. ASIC should be charged with overseeing those parts of Divisions 1, 2 and 3 of Part IIAA of the Banking Act that concern consumer protection and market conduct matters. APRA should be charged with overseeing the prudential aspects of Part IIAA.

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<sup>169</sup> Banking Act s 37J.

### **Recommendation 6.7 – Statutory amendments**

The obligations in sections 37C and 37CA of the Banking Act should be amended to make clear that an ADI and accountable person must deal with APRA and ASIC (as the case may be) in an open, constructive and co-operative way. Practical amendments should be made to provisions such as sections 37K and 37G(1) so as to facilitate joint administration.

### **Recommendation 6.8 – Extending the BEAR**

Over time, provisions modelled on the BEAR should be extended to all APRA-regulated financial services institutions. APRA and ASIC should jointly administer those new provisions.

## **6 Regulatory co-ordination and information sharing**

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What I have said above about the utility in having ASIC as the principal conduct regulator (including in respect of superannuation) and the need for ASIC and APRA to co-regulate the BEAR, means that the two regulators will have to work more closely than ever across a range of entities and subject matters. Failures to share information, co-ordinate approaches and act with a consistent purpose will result in duplication of effort or, worse, regulatory failings.

### **6.1 History**

There are events in the history of ASIC and APRA's relationship that show the harm that can come from a lack of co-ordination.

In April 2003, the Report of the HIH Royal Commission was published, providing early insight into the relationship between ASIC and APRA. The HIH Commission found failings in the joint relationship. These included deficiencies in information exchange on APRA's part, which

meant that ASIC was less well-informed of issues concerning HIH than it should have been.<sup>170</sup>

Commissioner Owen said:<sup>171</sup>

The evidence indicated there were difficulties in the relationship between ASIC and APRA. Those arose principally from the fact that the two organisations took on overlapping and unclearly delineated roles from June 1998 in relation to financial service providers ... The differences in regulatory approach extended ... to information exchange between the two agencies, which was the subject of regular debate in the ASIC–APRA coordinating committee. [An ASIC employee] said that although there were legislative restrictions on such exchange, APRA was ‘conservative’ in its interpretation of those restrictions.

The Commission concluded that sensible co-ordination of relevant activities and exchange of information of possible interest to the other was required.<sup>172</sup> In particular, the Commission recommended that communications and exchanges should be undertaken in a systematic way (through both formal and informal means) and based on clear protocols.<sup>173</sup>

## 6.2 The need for change

Formalised co-ordination and co-operation between the regulators can no longer be an aspiration. It must become a reality. Co-ordination and co-operation will facilitate quicker detection of misconduct and allow for more timely enforcement action. Co-ordination must go beyond the current memorandum of understanding and informal meetings between representatives of the agencies. The regulators should be required to provide information to each other and to meet at particular intervals. The exchange of critical information should be required, facilitated and protected.

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<sup>170</sup> See HIH Royal Commission, Final Report, vol 3, 466–7 [24.3.4].

<sup>171</sup> HIH Royal Commission, Final Report, vol 3, 466–7 [24.3.4].

<sup>172</sup> HIH Royal Commission, Final Report, vol 3, 466–7 [24.3.4].

<sup>173</sup> See HIH Royal Commission, Final Report, vol 3, 466–7 [24.3.4]. See also Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into the Collapse of Trio Capital*, May 2012. I say no more about that report.

The financial regulators must not be permitted to pursue what they independently perceive to be their own interests in respect of entities or laws in respect of which there is joint responsibility.

While many of the arrangements for inter-regulator collaboration will need to be worked out and agreed between the regulators, the approach should be founded on unambiguous rules for co-operation and information sharing.

### 6.3 Co-operation

To give statutory force to the practical necessity of co-operation, a provision should be inserted into each of the ASIC Act and the *Australian Prudential Regulation Authority Act 1998* (Cth) (the APRA Act) to the effect that, so far as is practicable, each regulator must<sup>174</sup> in performing its functions and exercising its powers inform and co-operate with any other financial regulator with regulatory responsibility for an affected entity.<sup>175</sup>

That provision should be coupled with a requirement that APRA and ASIC prepare and maintain a memorandum setting out how the agencies intend to comply with their statutory duty to co-operate, including how they will co-ordinate their approach in areas of joint responsibility.<sup>176</sup>

Both ASIC and APRA have various memoranda of understanding with each other and other regulators.<sup>177</sup> A joint memorandum was entered into between ASIC and APRA in May 2010 and supplemented by a joint protocol in June 2010. Neither document has since been updated. In the main, both documents use permissive or aspirational language. For example, each agency agrees to ‘endeavour to consult’ with the other about matters relevant to the other’s jurisdiction.<sup>178</sup> **The revised memorandum, which**

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<sup>174</sup> Cf APRA Act s 10A.

<sup>175</sup> See, eg, *Australian Crime Commission Act 2002* (Cth) (the ACC Act) s 17 and *Financial Services and Markets Act 2000* (UK) c 8, s 3D.

<sup>176</sup> See, eg, *Financial Services and Markets Act 2000* (UK) c 8, s 3E.

<sup>177</sup> Exhibit 5.298, Witness statement of Helen Rowell, 14 August 2018, Exhibit HR-1-12 [APRA.007.0005.0007]; Exhibit 5.318, Witness statement of Peter Kell, 13 August 2018, Exhibit PK-6 [ASIC.0800.0012.0146]. See also Exhibit 7.145, Witness statement of Wayne Byres, 27 November 2018, Exhibit WB-1-45 [APRA.0075.0001.0306].

<sup>178</sup> Exhibit 5.318, Witness statement of Peter Kell, 13 August 2018, Exhibit PK-6 [ASIC.0800.0012.0146 at .0148].

**will need to take account of any changes made to implement the recommendations of this Report, should – at least in respect of core obligations – avoid permissive language and instead commit to real obligations.**

**Because the memorandum will be central to the joint relationship, the regulators should be required to review the operation of the memorandum at least every two years.**

Given the importance of the memorandum to the proper administration of the laws that govern large parts of the Australian financial system, the memorandum should be declared to be a legislative instrument and should be laid before each House of Parliament.<sup>179</sup>

APRA and ASIC should each be required to report on the operation of the memorandum and steps taken under it in their annual reports.

## 6.4 Information sharing

The complexities that attend the sharing of information between government agencies are well-acknowledged.<sup>180</sup> There will often be constraints, express or implied, on the use that may be made of documents and information obtained by government agencies by coercive process.<sup>181</sup>

Under the existing statutory arrangements, both ASIC and APRA are permitted to provide certain information to specified parties. Relevantly, ASIC *can* disclose confidential information (including information obtained by exercise of its compulsory powers) to APRA.<sup>182</sup> APRA *may* also provide information to ASIC,<sup>183</sup> but only if APRA is satisfied that the disclosure of the information or the production of the document will assist ASIC to perform its functions or exercise its powers.<sup>184</sup>

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<sup>179</sup> See generally, *Legislation Act 2003* (Cth) ss 6, 38.

<sup>180</sup> Administrative Review Council, *The Coercive Information-gathering Powers of Government Agencies*, May 2008, 65–70.

<sup>181</sup> *Johns v Australian Securities Commission* (1993) 178 CLR 408.

<sup>182</sup> ASIC Act s 127(2A)(c).

<sup>183</sup> ASIC being a ‘financial sector supervisory agency’ within the meaning of the APRA Act: see s 3(1) (definition of ‘financial sector supervisory agency’).

<sup>184</sup> APRA Act s 56(5)(a).

Those provisions, and others found in the ASIC Act and the APRA Act, are of undoubted utility. An inability of financial regulators to share relevant information would lead to duplication of information requests and to agencies acting without all available information. However those provisions, while necessary, are not sufficient. As noted earlier, the changes I have proposed, particularly concerning the SIS Act and the BEAR, will require the regulators to work more closely together than they have before. To make those changes effective the current information-sharing provisions should be changed.

**A new statutory scheme for the sharing of information between APRA and ASIC is required. The detail of the scheme will need to be carefully worked through. But it should be founded on the premise that joint responsibility and co-operation necessitates substantial commonality of information.**

**I favour a model that prefers mandatory, rather than discretionary, sharing of information. ASIC and APRA should, to the greatest extent possible, work from a single body of relevant information.**

Information-sharing arrangements are not novel. A ready example may be found in governing legislation of the Australian Crime Commission (ACC). The ACC is responsible for carrying out operations and investigations of potential relevance to many law enforcement agencies, both state and Federal. Information sharing is therefore critical to its task.

The *Australian Crime Commission Act 2002* (Cth) (the ACC Act) requires the CEO of the ACC to assemble any admissible evidence of an offence against the law of the Commonwealth or of a state or territory and give that evidence to various persons, including the relevant law enforcement agency and any relevant prosecution services.<sup>185</sup> That duty is then coupled with a discretionary power to disclose information to government<sup>186</sup> and private<sup>187</sup> bodies in certain circumstances.

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<sup>185</sup> ACC Act s 12.

<sup>186</sup> ACC Act ss 59AA, 59AAA.

<sup>187</sup> ACC Act s 59AB.

I recommend that each regulator be subject to a requirement to notify the other whenever it forms the belief, based on information available to it, that a breach may occur, or may have occurred, in respect of which the other regulator has enforcement responsibility. I consider that threshold, which does not require the formation of an opinion that a provision has *in fact* been breached, will more naturally result in regular exchanges of information.

But more is required to ensure that as far as possible, information gaps are closed. A change in both mindset and legislation is required. Rather than proceeding from a premise that certain information belongs to APRA or to ASIC, the preferable position is for information to be deemed to be ‘financial regulator information’. The APRA and ASIC Acts should be amended to *require* each entity to share any ‘financial regulator information’ that comes into their possession. Information coming within that description would include, but not be limited to, information concerning entities in respect of which both regulators have regulatory responsibilities and which is relevant to the exercise, or possible exercise, of a power or function of the other regulator. I suspect the most efficient way of storing that information will be in a shared database. But consideration will need to be given to the mechanics of the system, including how each regulator can be best made aware that documents have been uploaded to the database.

That is not to say that *all* documents and information need be shared. The drafting of the statutory definition of ‘financial regulator information’ will need to be given close attention. There will be some documents that should not come within the shared category. But that must be the exception and not the rule.

The mandatory sharing of information should mean that over time a substantial corpus of material will be collected and available – in as close to real time as technology allows – to each regulator. If properly designed and maintained, the shared database of information should become a valuable tool for the shared and individual work of ASIC and APRA.

### **Recommendation 6.9 – Statutory obligation to co-operate**

The law should be amended to oblige each of APRA and ASIC to:

- co-operate with the other;
- share information to the maximum extent practicable; and
- notify the other whenever it forms the belief that a breach in respect of which the other has enforcement responsibility may have occurred.

### **Recommendation 6.10 – Co-operation memorandum**

ASIC and APRA should prepare and maintain a joint memorandum setting out how they intend to comply with their statutory obligation to co-operate.

The memorandum should be reviewed biennially and each of ASIC and APRA should report each year on the operation of and steps taken under it in its annual report.

## **7 Governance of the regulators**

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The Terms of Reference set out in the Letters Patent establishing the Commission require me to inquire into and report on ‘the effectiveness and ability of regulators of financial services entities to identify and address misconduct by those entities’.<sup>188</sup> Consideration of that issue requires me to say something about the internal governance and accountability of both ASIC and APRA.

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<sup>188</sup> *Letters Patent*, 14 December 2017, (g).

## 7.1 Independent non-executive directors?

### 7.1.1 ASIC

ASIC is a body corporate.<sup>189</sup> Its membership comprises at least three and not more than eight members.<sup>190</sup> At least three members must be appointed as full-time members.<sup>191</sup> A Chairperson must be appointed.<sup>192</sup> Up to two Deputy Chairpersons may be appointed.<sup>193</sup>

ASIC's ultimate governing body is now comprised entirely by full-time members. The members of the Commission, the 'Commissioners', are collectively responsible for the achievement of ASIC's objectives.<sup>194</sup> Major strategic decisions are made at bi-monthly Commissioners' meetings.<sup>195</sup>

The Commissioners work together, and with other ASIC officers, on a day-to-day basis. The members have in the past exercised considerable independent authority. In many cases, one or more of the members will have had an active role in items discussed at meetings of the Commissioners.

ASIC has recently taken steps that seek to remove Commissioners from operational decision-making. Until those changes came into effect, the members of ASIC exercised considerable executive power in making operational decisions, as well as exercising governance powers.

It has long been considered good practice for a majority of the directors of a publicly listed corporation to be non-executive and independent.<sup>196</sup>

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<sup>189</sup> ASIC Act s 8(1).

<sup>190</sup> ASIC Act s 9(1).

<sup>191</sup> ASIC Act s 9(3).

<sup>192</sup> ASIC Act s 10(1).

<sup>193</sup> ASIC Act ss 10(2)–(3).

<sup>194</sup> Exhibit 7.63, Witness statement of James Shipton, 7 November 2018, 16 [46].

<sup>195</sup> Exhibit 7.63, Witness statement of James Shipton, 7 November 2018, 16 [47].

<sup>196</sup> ASX Corporate Governance Council, *Corporate Governance Principles and Recommendations 3rd edition*, Australian Securities Exchange Ltd, 2014, Recommendation 2.4, 17.

The United Kingdom's Higgs Review<sup>197</sup> describes non-executive directors as 'custodians of the governance process'.

There may be said to be no obvious reason why ASIC would not benefit in the same ways that listed entities do from the inclusion of non-executive directors on their boards. It may be argued that adding non-executive directors to ASIC may yield three chief benefits.

First, it may be said to improve the scope and quality of internal oversight, by placing independent, disinterested voices within ASIC's highest forum. The non-executive directors would stand apart from operational decision-making and be more distant from the senior executives with operational responsibility. That distance may help to bring different perspectives to important questions.

Second, adding non-executive directors may be said to provide an opportunity to increase – and potentially broaden – the skills and experience of ASIC's ultimate governing body.

Third, non-executive directors may be said to reinforce the independence of the Commission from those it regulates and from the government of the day.<sup>198</sup>

To this point, ASIC has not had non-executive members. But there is nothing novel in the suggestion. In Australia, the RBA and the Payments Systems Board each have non-executive directors. In the United Kingdom the Bank of England (which, through the Prudential Regulation Authority, remains the prudential regulator), the Financial Conduct Authority (FCA), the Competition and Markets Authority and the Payments Systems Regulator all have non-executive directors – in some cases, a majority of non-executive directors. And in Hong Kong the Securities and Futures Commission has a number of non-executive directors.

Even so, I am not persuaded that change of this kind should now be made. To do so would add to the already radical changes upon which ASIC must

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<sup>197</sup> Derek Higgs, *Review of the Role and Effectiveness of Non-Executive Directors*, January 2003, 11 [1.6].

<sup>198</sup> For the Minister's power to direct ASIC, see ASIC Act s 12; but see also s 11(17).

now embark. I recommend that its already large remit be expanded in the ways I have described. ASIC itself recognises that its enforcement culture must change. The membership of the Commission has changed. As is explained further below, I recommend that ASIC, and APRA, should be subject to additional external review and accountability. I think the choice of those who are to perform the role of external review is more urgent and important than appointing non-executive members to ASIC. The essential requirement for both the role of external review and for a non-executive member of the Commission would be the same: deeply experienced, independently minded, people prepared to question what the full-time members of ASIC and the staff of ASIC do. The pool of suitable appointees is not large.

All this being so, I do not favour now recommending the appointment of additional, non-executive, members to ASIC.

### 7.1.2 APRA

In its initial formation, APRA's board was constituted by a full-time chair, a full-time CEO, two representatives of the RBA, a representative of ASIC and four part-time members.<sup>199</sup>

That structure was replaced with a smaller board comprised entirely of full-time members following a recommendation by the HIH Royal Commission.<sup>200</sup> One reason for that change was a concern that the presence of a member of ASIC on the board of APRA resulted in an assumption by staff of both organisations that information exchange was occurring at that level.<sup>201</sup> Another concern may have been that there was an insufficient number of full-time executives on the board.<sup>202</sup>

Those considerations would not speak against the presence of a small number of non-executive directors being appointed to APRA.

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<sup>199</sup> See APRA Act, ss 19 and 27(5) as they stood before Act No 42 of 2003. Those sections were repealed by s 20, *Australian Prudential Regulation Authority Amendment Act 2003* (Cth) (Act No 42 of 2003).

<sup>200</sup> HIH Royal Commission, Final Report, vol 1, lxix [18].

<sup>201</sup> HIH Royal Commission, Final Report, vol 1, 209.

<sup>202</sup> HIH Royal Commission, Final Report, vol 1, 207–9.

But, having said that, APRA's remit is more confined than ASIC's. It also has a considerably smaller board, currently comprising four members, with a statutory maximum of five members.<sup>203</sup>

**While I think that APRA could benefit from the appointment of one or two non-executive directors, I do not recommend making that change. It may be, I do not say it should be, a matter to be revisited as part of the capability review that I recommend below.**

## 7.2 Formalisation of procedure

The APRA Act contains provisions dealing with the times and places of meetings, the quorum required, who is to preside, how voting is to occur and the passing of resolutions without meetings.<sup>204</sup> There are no analogous provisions in the ASIC Act.

While only procedural, the formalisation of the requirements for meetings will serve to reinforce the centrality of collective decision-making. The importance of Commissioner meetings, particularly given ASIC's recent internal changes, necessitates legal and procedural formality.

For that reason, I recommend that provisions substantially similar to those set out in the APRA Act be made in the ASIC Act.

### **Recommendation 6.11 – Formalising meeting procedure**

The ASIC Act should be amended to include provisions substantially similar to those set out in sections 27–32 of the APRA Act – dealing with the times and places of Commissioner meetings, the quorum required, who is to preside, how voting is to occur and the passing of resolutions without meetings.

## 7.3 An accountability regime

The essential thesis that informs the BEAR is that a sound risk culture coupled with effective corporate governance and the imposition of stronger

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<sup>203</sup> APRA Act s 16(1).

<sup>204</sup> APRA Act ss 27–32.

consequences will improve accountability. Improved accountability ultimately translates to improved performance.

APRA has said that the establishment and continuance of a strong risk culture requires:<sup>205</sup>

- a clear, transparent and common understanding within an institution of where accountability lies within the senior executive team for any particular part or aspect of the institution's business;
- a clear, transparent and common understanding within an institution of how a given individual meets his or her obligations as the accountable individual including, for example, by making decisions, serving as a point of review or challenge, or escalating matters as appropriate; and
- for those accountable individuals, direct and proportionate consequences of failure to meet their obligations within their area of accountability, whether it is by inappropriate action or failure to act.

The concept of risk culture is as applicable to a statutory authority as it is to a **financial services entity**. The 2003 Review of Corporate Governance of Statutory Authorities and Office Holders (the Uhrig Report) noted that 'accountability frameworks are an essential part of governance'.<sup>206</sup>

In the United Kingdom, the two regulators with joint responsibility for the Senior Managers Regime have chosen to apply the core elements of the regime to both agencies. The FCA has said:<sup>207</sup>

[The Senior Managers Regime is a] formal expression of the common sense, good governance practice that any organisation should adhere to. It was created against the backdrop of a clear and shared understanding that a culture of personal responsibility must be embedded at the heart of financial services. This is true of firms and regulators alike. We are not formally subject to the regime but we uphold the highest professional

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<sup>205</sup> APRA, *Information Paper: Implementing the Banking Executive Accountability Regime*, 17 October 2018, 6–7.

<sup>206</sup> John Uhrig, *Review of the Corporate Governance of Statutory Authorities and Office Holders*, June 2003, 52.

<sup>207</sup> Exhibit 7.78, Undated, Senior Management Regime, 3.

values and our stakeholders, including Parliament and the Treasury Select Committee rightly expect us to do so. In line with this, we have decided to apply the fundamental principles of the regime to our senior staff.

When asked if ASIC proposed to apply the BEAR principles to its senior staff, Mr Shipton said that he thought it ‘an excellent suggestion’ and that he was ‘minded to apply this form of rigour’ to ASIC. He also said that he thought the preparation of accountability maps ‘was just plain good practice of good governance’.<sup>208</sup>

Mr Shipton also referred to the ‘hypocritical risks of a regulator’ and added, ‘If we expect something of the regulated community, we must be holding that – that standard to ourselves’.<sup>209</sup> I agree.

There are many ways that an accountability regime could be put into force. For example, a specific statutory regime could be designed or parts of the BEAR could be adapted and applied by analogy.

At least as an initial step, I recommend that both APRA and ASIC apply the core tenets of the BEAR to their management structure. The rigour required to produce accountability maps and statements would oblige each regulator to consider its internal arrangements carefully.

The application of the BEAR should be undertaken in consultation with the external oversight body that I recommend below. That role of that body, in so far as the application of the BEAR principles to the regulators is concerned, should be analogous to that of APRA under the current regime. For example, accountability maps should be lodged with the oversight authority and that authority should generally superintend compliance with the BEAR principles.

### **Recommendation 6.12 – Application of the BEAR to regulators**

In a manner agreed with the external oversight body (the establishment of which is the subject of Recommendation 6.14 below) each of APRA and ASIC should internally formulate and apply to its own management accountability principles of the kind established by the BEAR.

<sup>208</sup> Transcript, James Shipton, 23 November 2018, 7016.

<sup>209</sup> Transcript, James Shipton, 23 November 2018, 7016.

## 7.4 Periodic capability reviews

The pace of change in the finance sector must be responded to by its regulators. As the market moves, regulators should consider if their structure and processes remain appropriately adapted to market conditions.

ASIC has recently undergone a capability review. APRA has not. I recommend that a formal capability review be undertaken of APRA, with that review being completed as soon as is reasonably practicable after the publication of this Report.

More generally, capability reviews should be seen as part of the regular review of financial regulators. They present an opportunity to consider the operational abilities and requirements of the regulators. That kind of top to bottom consideration is often neglected due to operational demands.

I recommend that both APRA and ASIC be subjected to at least quadrennial capability reviews. Responsibility for the periodic review should rest with the oversight authority. That is not to say that the oversight authority should conduct the review itself. It may, should it wish, appoint an expert panel to undertake the review. But the review should be undertaken at the instruction of the oversight authority and the resulting report provided to both the regulator in question and the oversight authority.

Undertaking capability reviews with reasonable frequency will assist both the regulator and the Government by identifying resourcing and capability gaps. The importance of the financial regulators to the economy demands that they be fit for purpose. Regular, independent reviews will assist in meeting that goal.

### **Recommendation 6.13 – Regular capability reviews**

APRA and ASIC should each be subject to at least quadrennial capability reviews. A capability review should be undertaken for APRA as soon as is reasonably practicable.

## 8 External oversight

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As I have said, the Terms of Reference direct me to consider ‘the effectiveness and ability of regulators of financial services entities to identify and address misconduct by those entities’. The role and effectiveness of external oversight is relevant to that consideration.

It is necessary to begin by noting the mechanisms that now exist.

### 8.1 Existing mechanisms

#### 8.1.1 Parliamentary oversight

ASIC’s principal external oversight body is the Parliamentary Joint Committee on Corporations and Financial Services.<sup>210</sup>

The Joint Committee consists of 10 members, five from each House of Parliament.<sup>211</sup> Its duties are prescribed by section 243 of the ASIC Act and include inquiring into and reporting to each House on the activities of ASIC,<sup>212</sup> the operation of the corporations legislation<sup>213</sup> and any question connected with the Committee’s duties referred to it by either House.<sup>214</sup>

The Chair of ASIC is required to prepare and give an annual report to the Minister responsible for ASIC.<sup>215</sup> The report must include certain information<sup>216</sup> including information about ASIC’s monitoring and promotion

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<sup>210</sup> The Senate Economics Committee and the House Economics Committee also have responsibilities in respect of referred matters concerning ASIC or any Treasury legislation in so far as it concerns ASIC.

<sup>211</sup> ASIC Act s 241(2).

<sup>212</sup> ASIC Act s 243(a)(i).

<sup>213</sup> ASIC Act s 243(a)(ii).

<sup>214</sup> ASIC Act s 243(c).

<sup>215</sup> See ASIC Act s 9A; *Public Governance, Performance and Accountability Act 2013* (Cth) ss 12(2), 46.

<sup>216</sup> ASIC Act s 136.

of market integrity and consumer protection<sup>217</sup> and ASIC's use of compulsory powers.<sup>218</sup> The Committee is also responsible for reviewing ASIC's annual report.<sup>219</sup>

APRA is also subject to parliamentary and ministerial oversight. APRA's members and senior executives regularly appear before Senate and House of Representatives parliamentary committees, as well as ad hoc parliamentary committees and inquiries.<sup>220</sup> The Treasurer and APRA's members meet at least annually<sup>221</sup> and the Government reviews APRA's annual budget and approves the levies that are imposed on industry each year to fund APRA's operations.<sup>222</sup>

Parliamentary oversight of ASIC and APRA is essential. It is essential because although broadly independent, regulators form part of the executive government and are therefore accountable to the legislature. But parliamentary oversight necessarily has some limitations. Those limitations include the amount of time that can be devoted to a particular entity or topic, the time available to committee members to prepare for the hearings and the training, skill and experience of the members of the committee, who will sometimes need to review and assess complex information on matters of expertise.

Mr Shipton acknowledged that the current arrangements for parliamentary scrutiny of ASIC could be improved. He suggested that ASIC could develop frameworks, metrics and methodologies for review of its performance.<sup>223</sup> The Joint Committee could then review ASIC's performance against the agreed benchmarks.<sup>224</sup>

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<sup>217</sup> ASIC Act s 136(1)(b).

<sup>218</sup> ASIC Act s 136(2A) and ASIC Regulations 2001 (Cth) reg 8AAA.

<sup>219</sup> ASIC Act s 243(b).

<sup>220</sup> Exhibit 7.145, Witness statement of Wayne Byres, 27 November 2018, 25 [112].

<sup>221</sup> APRA, Statement of Expectations (2018), 4 December 2018, <[www.apra.gov.au/statement-expectations-2018](http://www.apra.gov.au/statement-expectations-2018)>.

<sup>222</sup> Exhibit 7.145, Witness statement of Wayne Byres, 27 November 2018, 25 [112].

<sup>223</sup> Transcript, James Shipton, 23 November 2018, 7023.

<sup>224</sup> Exhibit 7.63, Witness statement of James Shipton, 7 November 2018, 19–20 [61].

## 8.1.2 Ministerial responsibility

ASIC and APRA are also both accountable to their relevant ministers. Ministerial accountability takes various forms. Both regulators are subject to direction by the Minister in particular respects.<sup>225</sup> Both are issued with statements of expectations from the Government,<sup>226</sup> which they respond to with a statement of intent.

These, too, are essential means of accountability.

The Uhrig Report identified limitations on the ability of ministers to ensure effective governance of statutory authorities, including:<sup>227</sup>

- limitations on a minister's capacity to direct authorities in terms of the conduct of their operations;
- the presence of a board which does not have full power to act, having the effect of confusing and diluting accountabilities between the Minister, the board and the chief executive;
- the lack of clarity in relationships and responsibilities reduces the capacity of ministers to be satisfied with existing accountability arrangements; and
- the 'hands off' aura surrounding statutory authorities, which arises from the need for operational independence, means that the boundaries of the relationships between statutory authorities, ministers and portfolio departments are not clear to the participants.

Generally speaking, the power of the Minister is to determine some or all of each regulator's policies or priorities. And while ministers may seek information or assurances from a regulator in connection with a funding request or budgetary cycle, it cannot be expected that ministers will comprehensively review the functioning of a regulator on a rolling basis.

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<sup>225</sup> For the Minister's power to direct ASIC see ASIC Act s 12, but note s 11(17). For the Minister's power to direct APRA see APRA Act s 12.

<sup>226</sup> See, eg, Exhibit 7.63, Witness statement of James Shipton, 7 November 2018, Exhibit JS-1 [ASIC.0800.0016.3087].

<sup>227</sup> John Uhrig, *Report of the Corporate Governance of Statutory Authorities and Office Holders*, June 2003, 53.

As with parliamentary accountability, ministerial oversight of regulators is essential but has limitations.

### 8.1.3 Regulator Performance Framework

Each of ASIC and APRA reports annually against the Government's Regulator Performance Framework.<sup>228</sup> That framework, which was released in October 2014, is designed to apply generically to Commonwealth regulators of all kinds.<sup>229</sup>

The Regulator Performance Framework is not intended to serve as an assessment of the overall performance of regulators. It is, by design, more narrow in focus. The framework assesses Commonwealth regulators' performance when interacting with business, the community and individuals against a common set of performance indicators. It is directed to establishing performance measures that encourage regulators to 'minimise their impact on those they regulate while still delivering the vital role they have been asked to perform'.<sup>230</sup>

ASIC and APRA each publish self-assessments of their performance against the framework's six indicators.<sup>231</sup>

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<sup>228</sup> Exhibit 7.145, Witness statement of Wayne Byres, 27 November 2018, 2 [112]; Treasury, Interim Report Submission, 41 [203].

<sup>229</sup> Commonwealth of Australia, *Regulator Performance Framework*, October 2014, i.

<sup>230</sup> Commonwealth of Australia, *Regulator Performance Framework*, October 2014, i.

<sup>231</sup> The indicators are: (1) regulators do not unnecessarily impede the efficient operation of regulated entities; (2) communication with regulated entities is clear, targeted and effective; (3) actions undertaken by regulators are proportionate to the regulatory risk being managed; (4) compliance and monitoring approaches are streamlined and co-ordinated; (5) regulators are open and transparent in their dealings with regulated entities; (6) regulators actively contribute to continuous improvement of regulatory frameworks. (See Commonwealth of Australia, *Regulator Performance Framework*, October 2014, 4.)

### 8.1.4 Other existing forms of oversight

There are some other oversight mechanisms that apply to the regulators.

Both ASIC and APRA submit annual reports that contain certified statements of their performance in accordance with the *Public Governance, Performance and Accountability Act 2013* (Cth). Like other Commonwealth regulators, they are subject to the best practice regulation process administered by the Office of Best Practice Regulation.<sup>232</sup> They also engage with the Treasurer's Financial Sector Advisory Council, which provides a forum for regulated entities to advise Government on financial sector policies and the performance of financial regulators. The Australian National Audit Office also audits ASIC and APRA's annual financial accounts and occasionally undertakes ad hoc reviews of their performance.<sup>233</sup>

## 8.2 Additional oversight required

Each body with an oversight role in respect of APRA or ASIC serves an important, but limited, function. The current framework is heavily focused on governance and financial accountability.<sup>234</sup> None of the existing processes requires regular and systematic review of how well either regulator discharges its statutory functions or exercises its statutory powers.

The Murray Inquiry recommended that a Financial Regulator Assessment Board be established 'to undertake annual ex post reviews of overall regulator performance against their mandates'.<sup>235</sup>

Given the importance and size of ASIC's remit, I have come to the view that a permanent oversight body is now required. Similarly, the significance of APRA's work to the strength of Australia's financial system and the interconnectedness of its work with that of ASIC – which will be significantly amplified if the recommendations I have made are implemented – mean that it too should be subject to more consistent and rigorous assessment.

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<sup>232</sup> Exhibit 7.145, Witness statement of Wayne Byres, 27 November 2018, 25 [112].

<sup>233</sup> Exhibit 7.145, Witness statement of Wayne Byres, 27 November 2018, 26 [112].

<sup>234</sup> See Treasury, Interim Report Submission, 41 [200].

<sup>235</sup> Murray Inquiry, Final Report, 235. See also John Uhrig, *Report of the Corporate Governance of Statutory Authorities and Office Holders*, June 2003, 52–5.

## 9 A new oversight authority

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The need for a permanent oversight body gives rise to the further questions: What oversight is required, and who should undertake that work?

### 9.1 The additional oversight required

The essential role of the oversight body should be to assess:

- the effectiveness of each regulator in discharging its functions and meeting its statutory objects;
- the performance of the leaders and decision-makers within the regulator; and
- how the regulator exercises its statutory powers.

While it may become necessary to develop benchmarks or metrics that serve as a shorthand method to assess performance, formal measures should not be allowed to obscure the fact that the role of each regulator is defined by statute and the tasks entrusted to each regulator by its statute must be the foundation of any assessment. In most cases, that assessment will not be capable of measurement or quantitative expression. For example, the number of proceedings filed, or infringement notices issued, will say little about ASIC's enforcement culture unless the decisions behind those numbers are evaluated.

Over time, the oversight authority should develop a comprehensive list of items against which each agency's performance is evaluated. While the broad contours of the areas of enquiry will be largely obvious (for example, licensing, enforcement, consumer protection, regulatory co-operation and market supervision), as ever, the difficulty will come in designing the detail. An important consideration will be how effective the agencies are in enforcing the laws within their remit. (That will determine whether more radical steps, such as creating a specialist civil enforcement agency, should be reconsidered.)

**There are three specific matters arising from the reforms that I have proposed in this chapter that should be the subject of oversight and assessment.**

**The first concerns inter-regulator co-operation. The centrality of regulatory co-operation necessitates that the oversight body review each entity's compliance with the proposed statutory obligation to co-operate with the other, including fulfilling its information-sharing obligations.**

**The second concerns the proposed memorandum between ASIC and APRA. Because that document will be central to the regulatory arrangements, the oversight authority's mandate should include consideration of the extent to which each entity has complied with the terms of the memorandum and the effectiveness of the operation of the memorandum.** Any recommendations made by the oversight authority could then be considered and, if thought appropriate, taken up in the regular (at least biennial) reviews of that document.

**Third, the oversight authority's remit should extend to assessing ASIC and APRA's adoption of the BEAR. In that regard, the oversight authority should be seen as having a role broadly analogous to that of APRA under the current BEAR arrangements.**

**Beyond that, it will be necessary for the oversight authority to determine how it can assess most effectively the extent to which each entity meets its statutory objects.**

The oversight authority's work should influence and guide ASIC, APRA and the Government. To do so, the authority should be required to prepare a comprehensive assessment of each regulator biennially and provide that report to the responsible minister. The Minister should be required to cause a copy of the report to be laid before each House of the Parliament within 20 sitting days of that House after the report is received by the Minister. The authority should also be permitted to prepare subject-matter-specific reports on an ad hoc basis if the authority considers that necessary.

## **9.2 The appropriate oversight body**

It remains to be determined which entity should assume responsibility for the additional oversight and assessment I have recommended.

Mr Shipton suggested that the Council of Financial Regulators (CFR) – a body constituted by the heads of the financial regulators and chaired by the Governor of the RBA – could be used as the forum for assessing

‘both the effectiveness of financial regulation (in terms of stability and conduct) in Australia, and the effectiveness of individual regulators’.<sup>236</sup>

I am not in favour of the CFR being charged with the second task. The CFR serves as an important, formal occasion for discussion between the financial regulators. It is essentially a forum for co-ordination between the various regulators. I have already emphasised the importance of regulatory co-ordination. Adding an assessment function to the CFR’s remit would mark a radical departure from the current conception of that body. I do not support such a departure.

I consider that a new body is required. Its sole task would be to perform the functions I have described. It should be established by legislation and be independent of Government.

The oversight body should be constituted by three part-time members. Membership of the body should be reserved for people of unquestionable experience in relevant disciplines. Those members should be supported by a permanent staff capable of advancing the work of the authority on a day-to-day basis.

While the staffing arrangements for the new authority are a matter for Government, the appointed members should be supported by a permanent body of staff or secretariat. If the secretariat model was chosen, it could be staffed by, but perform its functions independently from, the Treasury. The permanent office should be led by a head of office capable of directing the daily operations of the authority and advancing the work program determined by the members.

The legislation to establish the oversight body should:

- provide that the authority is independent of Government;
- empower the authority to conduct inspections of either regulator at will;
- empower the authority to issue a notice to either regulator requiring it to produce documents or provide information in any form;
- empower the authority to issue a direction to APRA or ASIC in connection with the adoption and implementation of the BEAR principles;

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<sup>236</sup> Exhibit 7.63, Witness statement of James Shipton, 7 November 2018, 20 [62(a)].

- require the authority to report to the Minister, and through the Minister to Parliament, in respect of each regulator at least biennially;
- authorise the authority to report separately on particular matters if the authority thinks it appropriate and necessary; and
- require the authority to produce or commission quadrennial capability reviews of each entity.

#### **Recommendation 6.14 – A new oversight authority**

A new oversight authority for APRA and ASIC, independent of Government, should be established by legislation to assess the effectiveness of each regulator in discharging its functions and meeting its statutory objects.

The authority should be comprised of three part-time members and staffed by a permanent secretariat.

It should be required to report to the Minister in respect of each regulator at least biennially.

## **Conclusion**

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The twin peaks model of regulation has now operated in Australia for many years. It should be maintained and strengthened. But there should be some adjustments made in respect of the regulation of superannuation and the BEAR.

As I said at the start of this chapter, both ASIC and APRA recognise that their approach to enforcement must change. That change cannot be effected by the passing of legislation. It must come from within the agencies. But it is also important to strengthen the accountability of both – internally, by each separately applying principles modelled on the BEAR, and externally, by both being accountable to a new oversight body.

## 8. Other important steps

### Introduction

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In the previous chapters I have sought to explain the conclusions and recommendations I have reached about many of the issues that have arisen in the course of the Commission's work. For the most part, the issues dealt with in the previous chapters have been seen, at least by some, as controversial. But not all of the issues raised in the course of the Commission's work were of that kind.

Some issues were raised in the *Interim Report* but attracted little or no controversy. Mostly, I have addressed these in the earlier chapters of this Report. Other issues already considered and dealt with by other processes, but not implemented pending the outcome of this inquiry, attracted little or no controversy. One issue not raised in the *Interim Report*, but which was the subject of several submissions, is legal assistance and financial counselling services.

That these matters were not the subject of debate does not mean that they are unimportant. Nor is my leaving them to the last chapter of this Report to be taken as suggesting either that they are not significant matters or that they should not be implemented promptly. Each has its own particular part to play in responding to the conduct recorded in this Report and the *Interim Report*.

The last part of this chapter deals briefly with issues of regulatory complexity and proposes a path for achieving some simplification of what now is, or is in danger of becoming, an unduly complicated regulatory scheme.

# 1 Pending proposals

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## 1.1 A compensation scheme of last resort

The Terms of Reference require me to consider ‘the effectiveness of mechanisms for redress of consumers of financial services who suffer detriment as a result of misconduct by **financial services entities**’.<sup>1</sup> Accordingly, in the *Interim Report*, I asked whether existing dispute resolution mechanisms were satisfactory, and whether a mechanism should be established to provide compensation of last resort.<sup>2</sup>

In 2016–2017, a panel appointed by Government<sup>3</sup> reviewed **external dispute resolution** (EDR) and complaints arrangements in the financial system. The panel delivered a final report in April 2017.<sup>4</sup> In accordance with the panel’s recommendations, a new EDR body, the Australian Financial Complaints Authority (AFCA), was established to take the place of the Financial Ombudsman Service (FOS), the Credit and Investments Ombudsman, and the Superannuation Complaints Tribunal.<sup>5</sup> AFCA commenced operating in November 2018.<sup>6</sup>

AFCA should be permitted to set about its work. I make no recommendation for any change in its operations. Elsewhere in this Report, I have recommended that **Australian financial services licence** (AFSL) holders should be obliged to take reasonable steps to co-operate with AFCA in its resolution of particular disputes including, in particular, by making available to AFCA all relevant documents and records relating to the issues in dispute.

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<sup>1</sup> *Letters Patent*, 14 December 2017, (e).

<sup>2</sup> FSRC, *Interim Report*, vol 1, 344.

<sup>3</sup> Professor Ian Ramsay (Chair), Ms Julie Abramson and Mr Alan Kirkland.

<sup>4</sup> Ramsay Review, Final Report.

<sup>5</sup> Ramsay Review, Final Report, 14, Recommendation 1.

<sup>6</sup> ACFA, ‘Ministerial Authorisation of the Australian Financial Complaints Authority’ (Media Release, 1 May 2018).

In February 2017, the Government had extended the terms of reference of the panel reviewing the EDR and complaints framework to require the panel to make recommendations on the establishment, merits and potential design of a compensation scheme of last resort (CSLR) and to consider the merits and issues involved in providing access to redress for past disputes.<sup>7</sup> In September 2017, the panel delivered a supplementary final report considering these issues.<sup>8</sup>

As the panel noted in its supplementary final report, the *Corporations Act 2001* (Cth) (the Corporations Act) and the *National Consumer Credit Protection Act 2009* (Cth) (the NCCP Act) oblige licensees to have in place arrangements for providing compensation where certain specified losses occur, and, as a result, consumers and small businesses have a reasonable expectation that they will receive compensation in these circumstances.<sup>9</sup> The panel said that there was ‘clear evidence’, however, that not all licensees were meeting their obligations, with the result that some consumers and small businesses were not receiving their EDR awards.<sup>10</sup> Failure to pay compensation was concentrated in the financial advice subsector.<sup>11</sup>

On 21 December 2017 the Government announced that it would defer its consideration of the recommendations made in the supplementary final report until after this Commission had concluded.<sup>12</sup>

In its supplementary final report, the panel made three recommendations for a CSLR:

- A CSLR should be established, but should be limited and carefully targeted at the areas of the financial sector where there is clear evidence of recurrent problems with uncompensated losses.<sup>13</sup>

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<sup>7</sup> Ramsay Review, Supplementary Final Report, 129 [1]–[3].

<sup>8</sup> Ramsay Review, Supplementary Final Report.

<sup>9</sup> Ramsay Review, Supplementary Final Report, 3 [17].

<sup>10</sup> Ramsay Review, Supplementary Final Report, 3 [18].

<sup>11</sup> Ramsay Review, Supplementary Final Report, 4 [23].

<sup>12</sup> The Hon Kelly O’Dwyer, ‘Release of the External Dispute Resolution Framework Supplementary Final Report’ (Media Release, 21 December 2017).

<sup>13</sup> Ramsay Review, Supplementary Final Report, 51, Recommendation 1.

- A CSLR should initially be restricted to financial advice failures where a financial adviser (the ‘relevant provider’ as defined in section 910A of the Corporations Act) has provided personal and/or general advice on ‘relevant **financial products**’ to a consumer or small business. A CSLR should be designed for the future and accordingly be scalable, which means it can be expanded over time to cover other types of financial and credit services, should evidence of significant problems of uncompensated losses emerge.<sup>14</sup>
- A CSLR should have, among others, the following design features.<sup>15</sup>
  - It should apply prospectively (in the sense that it applies only in respect of decisions made after the scheme is established) and be restricted to consumers and small businesses.
  - To access the scheme, claimants should have a decision from AFCA, a court or a tribunal (where the circumstances of that claim would have been eligible for consideration by AFCA) which remains unpaid after reasonable steps have been taken.
  - Applicants will have 12 months to lodge their claim after having completed specified reasonable steps to obtain compensation.
  - Where an uncompensated loss arises from an unpaid EDR determination, AFCA should be required to provide certification that it has completed its processes to enforce the determination and that it does not consider that it will be paid, and then refer the claimant to a CSLR.
  - The CSLR should not independently reassess the merits of claims but must, before paying a claim, be satisfied that the award will not be paid by the financial firm.
  - A compensation cap, aligned to ACFA’s, should apply. The CSLR should set limits on the level and types of legal costs that are recoverable.

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<sup>14</sup> Ramsay Review, Supplementary Final Report, 67, Recommendation 2.

<sup>15</sup> Ramsay Review, Supplementary Final Report, 103–5, Recommendation 3.

- It should have the ability to stand in the shoes of a consumer or small business and pursue the financial firm for the compensation amount, where appropriate.
- The CSLR should be funded by financial firms engaged in the types of financial services it covers (initially, specified types of financial advice). Financial firms should be required to contribute to it from its outset, via an appropriate mechanism developed by Government and industry. Financial firms providing the types of services covered should be required to be members and contribute to the funding of a CSLR as a condition of licensing.
- Governance should be by an independent board with an independent chair and equal numbers of directors with industry and consumer backgrounds.
- The Australian Securities and Investments Commission (ASIC) should have oversight of a CSLR, including a general directions power to allow it to compel a CSLR to meet its regulatory and legislative requirements.

I agree with the panel's recommendations, including those it makes about design principles. The approach proposed by the panel should be followed.

I note that the panel made a fourth recommendation about professional indemnity insurance. It said that '[f]irms that rely on [professional indemnity] insurance to meet their licensing obligations should be required to provide additional data to ASIC, to improve ASIC's ability to undertake market surveillance and targeted regulatory action'.<sup>16</sup> This recommendation was consistent with ASIC's submission to the review panel.<sup>17</sup> Its efficacy will depend on what use ASIC makes of the data. I say no more about it.

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<sup>16</sup> Ramsay Review, Supplementary Final Report, 113, Recommendation 4.

<sup>17</sup> Ramsay Review, Supplementary Final Report, 111 [5.13]–[5.14].

In its supplementary final report, the panel said that, without accurate quantification of the size, scale and nature of the potential claims that would be made if there were access to redress for *past* disputes, it could not ‘assess the merits and issues in this area’.<sup>18</sup> Accordingly, the panel proposed various options for providing access to redress for past disputes and identified the three considerations that it said ‘are important in any mechanism’ designed to provide that access.<sup>19</sup> Those were that the mechanism be ‘simple and accessible’, that it ‘seek to minimise costs for all stakeholders’ and that it provide ‘adequate support for consumers and small businesses’.

As the panel recognised, there is a deal of uncertainty about what kinds of claim are to be considered when looking at whether there should be access to redress for past disputes. The panel concluded that there was ‘merit in considering’ providing access to redress to consumers and small businesses who had ‘a viable claim against a financial firm at the time of the dispute’ where one or more of four criteria were met:<sup>20</sup>

- the firm was no longer operating;
- the firm was not a member of an EDR body;
- the monetary value of the claim exceeded the EDR body’s monetary limit *and* the consumer or small business ‘lacked the resources’ to access the courts or other means of resolution;
- the consumer or small business was not in a position to pursue the dispute with the EDR body ‘due to exceptional circumstances’.

The panel proposed further consideration of the issues and there is evident merit in that being done.

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<sup>18</sup> Ramsay Review, Supplementary Final Report, 164 [8.5].

<sup>19</sup> Ramsay Review, Supplementary Final Report, 184, Observation 5.

<sup>20</sup> Ramsay Review, Supplementary Final Report, 131.

I make only four points about redress for past disputes.

**First, cases in which redress has been directed or ordered but not paid stand apart from all other cases of redress for past disputes.**

Where a claimant has not been paid the amount that an EDR body (or court) found should be paid, the central issue becomes whether Government or industry should now pay what was owing. As the panel said, a necessary first step would be to identify the scale of the problem before deciding how best to approach providing redress in those cases.

Second, the panel accepted, and I agree, that **there would be no merit in allowing further access to redress in any case where the consumer or small business concerned has already resorted to dispute resolution by a court, tribunal or EDR body or has settled the dispute.**

**Third, limiting access to redress to those who ‘had a viable claim’ would be of little practical effect.** The merit of the claim could rarely be determined without detailed examination of the facts and circumstances.

Fourth, **if there is to be any access to redress for past disputes, there must be some time limit imposed.**

#### **Recommendation 7.1 – Compensation scheme of last resort**

The three principal recommendations to establish a compensation scheme of last resort made by the panel appointed by government to review external dispute and complaints arrangements made in its supplementary final report should be carried into effect.

## 1.2 ASIC Enforcement Review Taskforce Government Response

In December 2017, the ASIC Enforcement Review Taskforce provided its report to Government.<sup>21</sup> The report made 50 recommendations with respect to, among other things, breach reporting under the Corporations Act, industry codes, and ASIC's licensing, banning, and directions powers. In April 2018 the Government released its response to the report, agreeing, or agreeing in principle, with all of its recommendations.<sup>22</sup> In its response, the Government announced that it agreed with some recommendations, and that it agreed in principle with other recommendations but would defer implementing them to enable it to take account of any findings arising out of this Commission.

I have dealt with the recommendations of the Taskforce relating to industry codes elsewhere in this report – chiefly in the chapter about banking.

One other set of deferred recommendations relates to self-reporting of contraventions by financial and credit services licensees.<sup>23</sup>

The application to AFSL holders and the enforcement of section 912D have formed an important part of the Commission's work. I support the Taskforce's recommendations about self-reporting, which include the following:

- The significance test should be retained but clarified to ensure that the significance of breaches is determined objectively.
- A self-reporting regime should be introduced for **Australian credit licensees**, equivalent to the regime for AFSL holders under (the amended) section 912D of the Corporations Act.
- The obligation for licensees to report should expressly apply to misconduct by an employee or representative.

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<sup>21</sup> ASIC Taskforce Review, Report.

<sup>22</sup> Australian Government, *Australian Government Response to the ASIC Enforcement Review Taskforce Report*, April 2018.

<sup>23</sup> ASIC Taskforce Review, Report, 2–3.

- Significant breaches (and suspected significant breach investigations that are continuing) must be reported within 30 days.
- The required content of breach reports should be prescribed by ASIC and be lodged electronically.
- Criminal penalties should be increased for failure to report as and when required.
- A civil penalty should be introduced in addition to the criminal offence for failure to report as and when required.
- A co-operative approach should be encouraged where licensees report breaches, suspected or potential breaches or employee or representative misconduct at the earliest opportunity.
- The reporting requirements for responsible entities of managed investment schemes should be streamlined by replacing the requirements in section 601FC(1)(l) of the Corporations Act with an expanded requirement in section 912D.
- ASIC should publish breach report data annually.

I make two additional points.

First, although I have no doubt that a co-operative approach is to be encouraged when licensees report breaches, or suspected breaches, it will always be necessary to recognise that making a proper breach report on time is what the law requires.

Second, **I think it preferable that ASIC publish breach report data annually not only aggregated by breach type but also by individual licensee.** Those who deal with licensees should be able to have access to the reports that the law obliges the licensee to make to the regulator about objectively significant breaches or likely significant breaches of the financial services laws that the licensee has identified.

### **Recommendation 7.2 – Implementation of recommendations**

The recommendations of the ASIC Enforcement Review Taskforce made in December 2017 that relate to self-reporting of contraventions by financial services and credit licensees should be carried into effect.

## 2 Legal assistance and financial counselling services

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The asymmetry of knowledge and power between consumers and financial services entities has been evident throughout the Commission's work. Financial products and services have grown ever more complicated, numerous, and difficult to distinguish. Engagement with the financial services industry, by way of bank accounts, insurance and superannuation, is necessary in order to participate in society. Yet financial literacy among Australians is varied, and research suggests that people struggle with more complex financial dealings such as investments and superannuation. And the laws governing the relationship between customers and entities are frequently opaque. Each of these conditions contributes to the onset of disputes and puts customers at a disadvantage in their resolution.

Aggrieved customers can try to negotiate directly with an entity, they can commence legal proceedings, or they can go to alternative dispute resolution. In each case, the existing asymmetry means that legal assistance is often of critical importance to the customer's position.

The majority of the consumer witnesses before the Commission who gave evidence of having resolved their dispute with an entity did so with the assistance of a legal adviser or financial counsellor. That was true of disputes resolved by direct negotiation, farm debt mediation, and recourse to FOS. That is, access to professional legal advice or counselling services assisted claimants to engage in these alternative dispute resolution mechanisms even though they were designed to improve access to justice and do not depend on claimants having legal representation. Most entities have access to expert legal advice throughout the course of a dispute, and it is unsurprising that customers would benefit from being placed on the same footing. Some consumers may not even know that they have a dispute to resolve until they speak to a financial counsellor or legal adviser.

A number of the consumer witnesses before the Commission received free assistance from the legal assistance sector<sup>24</sup> or free financial counselling services. Often, perhaps in part by force of the situation that gave rise to the dispute, they could not have afforded private financial advice or legal representation. Often, the difference between the result the witness ultimately achieved and the situation that they initially faced before they received legal assistance was very large.

The legal and other assistance available to disadvantaged members of the community in pursuing claims against financial services entities is therefore relevant to the Commission's considerations. It was not a question on which submissions were specifically called for, although a considerable number addressed it. I therefore make limited observations on this point, but I encourage that it be given careful consideration.

The legal assistance sector and financial counselling services perform very valuable work. Their services, like financial services, are a necessity to the community. They add strength to customers who are otherwise disadvantaged in disputes with financial services entities. In that sense, their role in the financial services sector is complementary to the broader recommendations in this Report that are designed to hold entities to account. Reforms to the law, and to practices of regulators and entities, will not eliminate that need though they will properly aim to reduce it. There will always be sources of legitimate dispute, and there will always be vulnerable individuals with a poor understanding of financial services or limited experience or resources who are nonetheless compelled to use these services.

As I have said elsewhere in this chapter, simplification of financial services laws is broadly supported. However, financial services laws will always involve a measure of complexity. Asymmetry of knowledge and power will always be present. Accordingly, there will likely always be a clear need for disadvantaged consumers to be able to access financial and

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<sup>24</sup> Paragraph 52(e) of the National Partnership Agreement on Legal Assistance Services defined this term to include community legal centres, family violence prevention legal services, indigenous legal assistance providers and legal aid commissions: Council of Australian Governments, *National Partnership Agreement on Legal Assistance Services* (Undated) Council of Australian Governments <[www.ag.gov.au/LegalSystem/Legalaidprogrammes/Documents/NationalPartnershipAgreementOnLegalServices.pdf](http://www.ag.gov.au/LegalSystem/Legalaidprogrammes/Documents/NationalPartnershipAgreementOnLegalServices.pdf)>.

legal assistance in order to be able to deal with disputes with financial services entities with some chance of equality of arms.

The legal assistance sector and financial counselling bodies are also recognised by ASIC as playing an important broader role in the financial services sector, for example by bringing issues to the attention of the regulator<sup>25</sup> or providing a balancing consumer voice in policy development.<sup>26</sup>

Information about financial counselling services is published on the websites of each of the four major banks.<sup>27</sup> Information about legal assistance and financial counselling services is also included on the ACFA website.<sup>28</sup>

The legal assistance sector and financial counselling services frequently struggle to meet demand, which is increasing.<sup>29</sup> Some submissions identified areas where the present coverage of such services could be expanded, for example in the provision of consumer advocacy and representation for superannuation consumers.<sup>30</sup> Other areas that were identified were small business assistance<sup>31</sup> and community-led specialist education for Aboriginal and Torres Strait Islander communities regarding funeral insurance and other financial products.<sup>32</sup>

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<sup>25</sup> For example, through the ASIC Consumer Advisory Panel. ASIC, Consumer Advisory Panel (Undated) ASIC <<https://asic.gov.au/about-asic/what-we-do/how-we-operate/external-panels/consumer-advisory-panel/>>.

<sup>26</sup> ASIC, Module 5 Policy Submission, 42–3 [204]–[205].

<sup>27</sup> For example, NAB, *NAB Assist Customer Care Kit* (Undated) NAB <[www.nab.com.au/personal/help-and-guidance/financial-hardship/customer-care-kit](http://www.nab.com.au/personal/help-and-guidance/financial-hardship/customer-care-kit)>.

<sup>28</sup> AFCA, *Other Places to Get Help* (Undated) AFCA <[www.afca.org.au/what-to-expect/other-places-to-get-help/](http://www.afca.org.au/what-to-expect/other-places-to-get-help/)>

<sup>29</sup> CALC, *Submission in Response to Initial Request*, 22 January 2018, 8 [2.30]; National Association of Community Legal Centres and FCA, Interim Report Submission, 5; Financial Rights Legal Centre, *Submission in Response to Initial Request*, 5 February 2018, 2.

<sup>30</sup> CHOICE and Superannuation Consumers' Centre, Module 5 Policy Submission, 6, 31–2; ASIC, Module 5 Policy Submission, 42–3 [204]–[205].

<sup>31</sup> National Association of Community Legal Centres and FCA, Interim Report Submission, 9; CALC, Module 3 Submission, 7 [8.1]–[8.2].

<sup>32</sup> CALC, Module 4 Submission, 9 [32].

Funding for the legal assistance sector and financial counselling services comes from various sources and structures, but is primarily Federal and state government funded, with pro bono and other donations also contributing. A portion of existing funding to some community services is sourced from arrangements such as community benefit payments under **enforceable undertakings** given to ASIC.<sup>33</sup> However, such funding is ‘one-off’ in nature, and reliance on sources of funding that are uncertain presents a longer-term challenge for community-based services to continue to provide services and maintain expertise and scale.

Proposals have been made over time for other models of funding. For example, one submission made to the Commission contained a proposal for an industry levy to fund financial counselling and consumer legal services.<sup>34</sup> The submission stated that this model was operating effectively in the United Kingdom.<sup>35</sup>

**I offer no views about the most appropriate sources, level or mix of funding. However, the desirability of predictable and stable funding for the legal assistance sector and financial counselling services is clear and how this may best be delivered is worthy of careful consideration.** Such consideration should look at all options that may be available to supplement existing funding.

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<sup>33</sup> ASIC, Module 5 Policy Submission, 43 [207].

<sup>34</sup> National Association of Community Legal Centres and FCA, Interim Report Submission, 2 [3]–[5].

<sup>35</sup> National Association of Community Legal Centres and FCA, Interim Report Submission, 2 [5]. The UK has adopted an industry levy model to fund financial counselling and financial literacy services: *Free and Impartial Money Advice, Set Up by Government* (Undated) The Money Advice Service <[www.moneyadviceservice.org.uk/en](http://www.moneyadviceservice.org.uk/en)>.

### 3 Simplification so that the law's intent is met

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Many submissions responding to the *Interim Report* supported simplification of financial services laws.<sup>36</sup> Industry, community groups and regulators agreed the current law is too complex. The effect of legal complexity on each of these groups differs. What would be achieved by simplifying the law?

As is apparent from what is said elsewhere in this Report, the first way to simplify the law, and the first reason for doing it, is to reduce the number of exceptions to otherwise generally applicable norms of conduct. That doing this would simplify the law is self-evident. But doing it will also result in the wider application of the principles that underpin the general rules on which these exceptions have been grafted.

So, eliminating exceptions and qualifications is the first step towards a simpler and more readily understood body of law.

The second step is connected to the first. It is to identify expressly what fundamental norms of behaviour are being pursued when particular and detailed rules are made about a given subject. Hence, to take one example, the detailed rules about conflicts of interest and **conflicted remuneration** should be expressly identified as giving effect to the principle that when a person acts for another, the person must act in the best interests of that other. Obviously, including such a statement of objects is useful in resolving any dispute about how the detailed rules should be construed. And, as I have explained elsewhere, a further consequence of identifying the basic norms to which the detailed rules are intended to give effect, would be that any continued exceptions and carve outs would stand in sharp relief.

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<sup>36</sup> See, eg, ANZ, Interim Report Submission, 34 [172]; CBA, Interim Report Submission, 47 [260(a)]; NAB, Interim Report Submission, 37 [145]; AMP, Interim Report Submission, 6 [27]; ABA, Interim Report Submission, 44; AFIA, Interim Report Submission, Annex 2, 4; ASIC, Interim Report Submission, 21 [88].

Beyond these steps, the task of simplification grows harder and will take much longer. But it is harder, and will take longer, *because* the law is now spread over so many different Acts and is as complex as it is. That is, the very size of the task shows why it must be tackled.

There would inevitably be many questions about legislative design. I deal with only one.

The basic norms of behaviour I have identified are simply stated. They are the fundamental precepts. And statutes have often given legislative expression to fundamental precepts with little textual elaboration. Statutory provisions about misleading or deceptive conduct are the most recent example. But reference could also be made to the sale of goods legislation provisions about fitness for purpose and merchantable quality.

Debate about legislative design may be diverted into disputes about the competing attractions of ‘principles-based’ or ‘outcomes-based’ laws and ‘rules-based’ laws. But debates of that kind will not assist if the debate falls into disputes about definitions.<sup>37</sup>

As Treasury pointed out, ‘[p]rinciples-based regulation requires a commitment from policy-makers to the regulatory architecture.’<sup>38</sup> Legislative schemes have commenced with principles at the fore only to have the full suite of prescriptions such as those described here grafted on over time.<sup>39</sup>

Lobbying for prescription, detail and tailoring has been a significant contributor to the current state of the law.<sup>40</sup> Requests for greater certainty may be justified and often this can be achieved by regulations or other legislative or regulatory instruments rather than amendment to the principal Act. But sometimes the requests for prescription and detail seek to shift responsibility from the regulated to the regulator, by urging the creation

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<sup>37</sup> Julia Black, ‘Principles Based Regulation: Risks, Challenges and Opportunities’ (Speech delivered at The Banco Court, Supreme Court of New South Wales, 27 March 2007) 3, 7–8.

<sup>38</sup> Treasury, Interim Report Submission, 7 [41].

<sup>39</sup> Treasury, Interim Report Submission, 5 [25]. See also ASIC, Interim Report Submission, 22–3 [98].

<sup>40</sup> Treasury, Interim Report Submission, 5 [23]–[25].

of ‘safe-harbour’ provisions that leave the regulated entity with little more than a box-ticking task.

Simplification will not be easy. Like any statutory drafting, **the first requirement will be to settle upon the principle or principles to which the law is to give effect.** Only then can the detailed drafting begin. This drafting must then yield certainty of application and meaning. But often, those aims of certainty of application and meaning will be missed if the drafting seeks to deal with every kind of case imaginable and put each beyond dispute. So many wires are strung between the fence posts that they inevitably overlap, intersect and leave gaps. And, instead of entities meeting the *intent* of the law, they meet the terms in which it is expressed.

Implementing the recommendations I have made in this Report will effect some simplification of the law. Implementing them may provide some opportunities for further simplification. If those opportunities are there, they should be seized. **But the overall task is, I think, much wider. It will require examination of how the existing law fits together and identification of the policies given effect by the law’s various provisions. Only once this detailed work is done can decisions be made about how those policies can be given better and simpler legislative effect.** Implementing the recommendations I have made cannot wait for that larger task to begin, let alone end.

### **Recommendation 7.3 – Exceptions and qualifications**

As far as possible, exceptions and qualifications to generally applicable norms of conduct in legislation governing financial services entities should be eliminated.

### **Recommendation 7.4 – Fundamental norms**

As far as possible, legislation governing financial services entities should identify expressly what fundamental norms of behaviour are being pursued when particular and detailed rules are made about a particular subject matter.