In Whose Best Interests? Regulating Financial Advisers, the Royal Commission and the Dilemma of Reform

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Abstract

Following the Future of Financial Advice reforms, the 'suitability' and 'appropriateness' focus for financial advice has been relocated and supplemented by a 'best interests' focus in s 961B of the *Corporations Act 2001* (Cth). Yet, as the Australian Government's Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry has pointed out, structural issues may often work against best interests being paramount. Further, moves to make the statutory obligation replicate a fiduciary obligation have been resisted in the consultative process that developed s 961B and related obligation sections and any replication is far from clear. Another key issue is the extent to which aspects of the best interests duty are satisfied by a 'tick a box' approach. This aspect of s 961B is said to provide 'safe harbour' for advisers, yet has been criticised by the Royal Commission as more procedural rather than substantive. However, removing the safe harbour altogether may create more problems than it solves. We argue that a catch-all provision in s 961B(2)(g) preserves substantive flexibility, and caution against any reform that leaves no procedural guidance for financial advisers to anchor their behaviour in fulfilling the best interests duty.

I Introduction

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

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

The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry ('*Banking Royal Commission*') has laid bare a number of issues in Australia's multi-billion dollar financial services industry.[2] In an industry covering financial products including savings accounts, mortgages, financial planning and investments, superannuation and insurance, consumers have often turned to financial advisers for assistance in navigating complex products to make informed decisions in clients' best interests.[3] Given the critical role of financial advisers and the contribution of the financial services sector to the economy, Australia has maintained — and tightened, following the Global Financial Crisis ('GFC') — a complex regulatory regime seeking to hold financial advisers accountable.[4] It has been a challenge for Australian legislators and regulators to find an approach that enhances trust and confidence in the financial advice sector and improves the quality of personal advice, while at the same time maintaining reasonably affordable and available advice.[5]

Concerns about investor confidence in financial advisers led the Australian Government to enact the 'best interests' duty and related obligations under the Future of Financial Advice ('FOFA') reforms in 2012. The best interests duty under s 961B(1) of the *Corporations Act 2001 (Cth)* ('*Corporations Act*') specifically requires financial advisers to 'act in the best interests of the client when giving the advice'. Although the concept of 'best interests' is left undefined, s 961B(2), known as the 'safe harbour' provision, provides that financial advisers will satisfy such duty if several steps have been taken. Yet the Banking Royal Commission has questioned the operation of the 'safe harbour' provisions and whether they amount to a tick a box exercise rather than a substantive test.[6] While the aim of these provisions was clearly to improve the quality and reliability of financial advice,[7] questions remain about their operation and effectiveness.

The aim of this article is to appraise the effectiveness of the 'best interests' duty and related provisions, including a review of the latest relevant Federal Court

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1 *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (Final Report, February 2019) vol 1, 2–3 ('*Banking Royal Commission Final Report*').

2 Treasury (Cth), 'The Strength of Australia's Financial Sector', *Backing Australian FinTech* (Web Page) <https://treasury.gov.au/publication/backing-australian-fintech/the-strength-of-australias-financial-sector>.

3 Between 20% to 40% of the Australian adult population use or have used a financial adviser: Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Some Features of the Australian Financial Planning Industry: Background Paper 6 (Part A)* (April 2018) 4 <https://financialservices.royalcommission.gov.au/publications/Documents/features-of-the-australian-financial-planning-industry-paper-6.pdf>.

4 See Dimity Kingsford Smith, 'Regulating Investment Risk: Individuals and the Global Financial Crisis' (2009) 32(2) *University of New South Wales Law Journal* 514.

5 Treasury (Cth), *Key Reforms in the Regulation of Financial Advice: Background Paper 8* (Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry Background Paper, April 2018) 1 <https://financialservices.royalcommission.gov.au/publications/Documents/key-reforms-in-the-regulation-of-financial-advice-background-paper-8.pdf>.

6 *Banking Royal Commission Final Report* (n 1) vol 1, 177.

7 Paul Latimer, 'Protecting the Best Interests of the Client' (2014) 29(1) *Australian Journal of Corporate Law* 8. See also Richard Batten and Gail Pearson, 'Financial Advice in Australia: Principles to Proscription; Managing to Banning' (2013) 87 (2–3) *St. John's Law Review* 511.

of Australia judgments and the *Banking Royal Commission Final Report*. The article has several interrelated objectives. First, to assess whether the government's objective of balancing improvements in the quality of advice and providing certainty in application of the law[8] will be achieved by the best interests duty or whether this focuses too much on process rather than substance, principle and outcome of advice.[9] Second, to assess how the duty of financial advisers to act in the best interests of clients might interact with the safe harbour provisions, which appear to give financial advisers a defence against an allegation of misconduct.[10] Third, to consider whether removing the safe harbour provisions would remove the focus on box ticking or whether this may make financial advisers overtly cautious in the way they provide advice or cause greater confusion in determining what behaviour is required for compliance — a point also made by the Australian Securities and Investments Commission ('ASIC') in its 2012 Regulation Impact Statement.[11] Finally, to consider how the best interests and related obligations provisions might ensure a generally principle-based approach — ensuring that financial advisers focus more on the quality and the independence of their advice.[12]

While favouring some reform to the best interests duty, we do see the need to provide some sort of guidance for financial advisers to anchor their behaviour in fulfilling this duty. In this regard, we see elements of a possible harmonised best interests model in that proposed by the United States ('US') Securities and Exchange Commission ('SEC') (see below Part IVB(2)), albeit modified to take account of differing business and corporate cultures and legislative histories, as providing one possible legal framework for Australia's future reform in this regard. We also note that the recently released Financial Adviser Standards and Ethics Authority ('FASEA') code of ethics has taken a principle-based approach by setting out key standards.

Part II of this article maps the developments leading up to the enactment of the best interests duty and outlining other major FOFA provisions. This is followed in Part III by a critical assessment of the best interests duty through the lens of a number of judgments in three recent Federal Court of Australia proceedings. The related obligations that we have referred to will also be briefly considered. Finally, in Part IV we assess some of the policy and regulatory enforcement issues flowing from the contents of *Banking Royal Commission Final Report*, as well as briefly considering best interests in other contexts.

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8 Chris Bowen (Minister for Financial Services, Superannuation and Corporate Law), 'Overhaul of Financial Advice' (Media Release, 26 April 2010) <https://ministers.treasury.gov.au/ministers/chris-bowen-2009/media-releases/overhaul-financial-advice>.

9 As to process, see Revised Explanatory Memorandum, Corporations Amendment (Further Future of Financial Advice) Bill 2011 (Cth), [1.22], [1.23], [1.24], [1.57].

10 For the view of the Australian Securities and Investments Commission ('ASIC'), see ASIC, *Future of Financial Advice: Best Interests Duty and Related Obligations* (Regulation Impact Statement, December 2012) 6–7 [20], 14 [61]–[67], 15 [69], 24–5 [135].

11 ASIC (n 10) 10 [36].

12 Ibid 10 [38].

II What are the 'Best Interests' Duty and Related Obligations?

The best interests duty and related obligations are contained in pt 7.7A of ch 7 of the *Corporations Act*, which regulates financial services and financial markets overall. Chapter 7 includes in s 912A the general obligation to provide financial services efficiently, honestly and fairly. Part 7.7 (ss 940A–953C) focuses upon disclosure requirements for licensed financial advisers to retail clients and pt 7.7A (ss 960–68) expands on this with best interests duty and related obligations. Previously, the conduct of financial advisers was regulated by the 'suitability rule' under the former s 945A of the *Corporations Act*, as analysed below in Part IIA. Knowing how the suitability rule operated is part of the context of understanding the aims and purposes of the legislature in enacting the best interests duty under s 961 and related obligations under ss 961G, 961H, 961J and 961L of the *Corporations Act*. Those related obligations require financial advisers to give appropriate advice (s 961G), warn clients if the advice is incomplete or inaccurate (s 961H), and prioritise clients' interests over their own in the event of a conflict (s 961J). Finally, s 961L imposes an overall requirement that the holder of an Australian Financial Service Licence ('AFSL') to 'take reasonable steps' to ensure their representatives comply with the relevant statutory duties.

It should be noted that both the best interests duty and related obligations, and the suitability rule that preceded it, do not appear to be intended to impose a statutory fiduciary duty on financial advisers[13] — though the Banking Royal Commission noted that, '[d]epending on the nature of a client's interaction with a financial adviser, a general law duty of care may also arise, as may a fiduciary duty.'[14]

A *Regulating Financial Advisers in the Pre-FOFA Era*

First introduced by s 191 of the *Companies and Securities Legislation (Miscellaneous Amendments) Act 1985 (Cth)*, the suitability rule, otherwise known as the 'know your client' or 'appropriate advice' rule, had been the touchstone governing financial advisers in Australia.[15] AFSL holders or their authorised representatives — referred to as 'providing entities' — were required to comply with the rule in giving personal advice to retail clients. The purpose of the suitability rule, per the judgment of Edelman J in a landmark pre-FOFA Federal Court case

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13 Stephen Corones and Thomas Galloway, 'The Effectiveness of the Best Interests Duty — Enhancing Consumer Protection?' (2013) 41(1) *Australian Business Law Review* 5, 19; Kevin Lindgren, 'Fiduciary Duty and the Ripoll Report' (2010) 28(7) *Company and Securities Law Journal* 435, 437.

14 *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (Interim Report, September 2018) vol 1, 100 [2.7] ('*Banking Royal Commission Interim Report*'). See also Pamela Hanrahan, *Legal Framework for the Provision of Financial Advice and Sale of Financial Products to Australian Households: Background Paper 7* (Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry Background Paper, April 2018) 29–37 <https://financialservices.royalcommission.gov.au/publications/Documents/legal-framework-for-the-provision-of-financial-advice-background-paper-7.pdf>.

15 For a detailed account of the background, Andrew J Serpell, 'Re-Evaluating the Appropriate Advice Rule in light of the Global Financial Crisis' (2009) 4(2) *University of New England Law Journal* 33.

Australian Securities and Investments Commission v Cassimatis (No 8), was to ensure financial advice was suitable for the client and had a reasonable basis.[16]

The suitability rule imposed three separate, but interrelated, obligations on financial services licence holders (not individual advisers). First, there was an obligation under s 945A(1)(a) of the *Corporations Act* to assess the client's relevant personal circumstances before giving advice. Second, there was an obligation under s 945A(1)(b) to consider and investigate the subject matter of the advice. Third, there was an obligation under s 945A(1)(c) to ensure that the advice is appropriate to the client having regard to that consideration and investigation.

Cassimatis shed further light on the interpretation of s 945A — in particular, on the financial adviser's obligations to consider and investigate the subject matter of the advice under s 945A(1)(b) and to provide appropriate advice under s 945A(1)(c).[17] The case related to the collapse of Storm Financial Limited ('Storm') — a financial advice company whose directors were Mr Cassimatis and his wife. ASIC launched legal proceedings against them in the Federal Court, alleging that they breached their duty of care and diligence under s 180(1) of the *Corporations Act* by causing Storm to provide advice through the so-called 'Storm model', which was inconsistent with s 945A(1) among others.

Edelman J held that Mr and Mrs Cassimatis 'should have been reasonably aware that the application of the Storm model would be likely to (and did) cause contraventions of s 945A(1)(b) and s 945A(1)(c)'.[18] A breach of s 945A(1)(b) occurred, as Storm did not give such consideration or conduct such investigation into the subject matter of the advice as was 'reasonable in the circumstances'.[19] In particular, Edelman J took a broad interpretation of 'the subject matter', rejecting the directors' argument that it was limited to the particular product that was the subject of advice.[20]

As for s 945A(1)(c), Edelman J found that the financial advice provided was 'not appropriate to the investors having regard to the consideration and investigation of the subject matter of the advice that ought to have been undertaken'.[21] Despite the requirements to consider personal circumstances, Storm gave the same advice, regardless of each client's circumstances.[22] The interpretation given to the suitability rule by the Federal Court indicates that s 945A imposed a high standard of care in relation to the suitability and appropriateness of advice. Nevertheless, as will be seen, there was still concern in some quarters that the section did not go far enough and was inadequate, with the *Ripoll Report* opining there was no justification for the

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16 (2016) 336 ALR 209, 316–18 [550], [551], [557] ('*Cassimatis*'). See also Explanatory Memorandum, *Companies and Securities Legislation (Miscellaneous Amendments) Bill 1985* (Cth), 20, 191–3.

17 *Cassimatis* (n 16) 315–16 [549], 323–4 [592], 348 [729], 368 [818].

18 Ibid 221 [23].

19 Ibid.

20 Ibid 326 [607].

21 Ibid 221 [23]. See also 328 [619].

22 Evidence to Parliamentary Joint Committee ('PJC') on Corporations and Financial Services, Parliament of Australia, Melbourne, 26 August 2009, 62 (Michael Davison, CPA Australia Ltd), quoted in PJC on Corporations and Financial Services, Parliament of Australia, *Inquiry into Financial Products and Services in Australia* (Report, November 2009) 27 [3.33] ('*Ripoll Report*').

current arrangement where advisers could 'provide advice not in their clients' best interests, yet comply with section 945A of the *Corporations Act*'.[23]

In other words, advice could be 'suitable', but still not in the client's best interests, the latter connoting a different and arguably higher standard. Thus, the suitability rule in s 945A would eventually be replaced by the best interests duty in the subsequent reforms, as noted further below.[24]

B *The Best Interests Duty and Related Obligations*

Following the GFC, the Parliamentary Joint Committee ('PJC') on Corporations and Financial Services convened to inquire into the 'issues associated with recent financial product and services provider collapse', such as Storm and Opes Prime.[25] Chaired by Labor MP Bernie Ripoll, the Committee released its report in November 2009.[26] The *Ripoll Report* identified the need to, among other things:

(i) improve the standard of advice to increase consumers' confidence, be it 'through enhanced legislative requirements about the standard of advice required or enhanced enforcement of existing standards, or both';
(ii) 'better inform customers about the products signed up for' so that consumers would only buy products that 'entail a comfortable level of risk'; and
(iii) 'ensure that advisers are better informed about the products being sold'.[27]

At the PJC Inquiry, ASIC submitted that there is

> a mismatch between the client's expectation that the adviser is providing a 'professional' service (e.g. advice that is in their best interests) and the obligations of the adviser under the *Corporations Act* (that the adviser provides advice that is appropriate to the client and manages conflicts).[28]

ASIC suggested that investors may see advisers as similar to lawyers and accountants in terms of duties and professionalism. On the other hand, industry groups cautioned against imposing an undue legal and administrative burden on financial advisers. Professional Investment Service, for instance, expressed the view that:

> Almost every industry has its bad eggs. In my time in the industry, the majority of advisers put their clients' interests first at all times ... Whilst it is important for the committee to focus on the terrible issues at hand, I would encourage them not to use a sledgehammer to crack a pea … without quality advice to consumers, they would be left to their own accord and make many, many more costly mistakes.[29]

The *Ripoll Report* recommended the creation of a statutory fiduciary duty for financial advisers, requiring they put the interests of their clients ahead of their own.[30] Acting on the Report, the then Labor Government's first response in April

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[23] Ibid 110 [6.28].
[24] See, generally, Hanrahan (n 14) 64–5.
[25] *Ripoll Report* (n 22) vii.
[26] Ibid.
[27] Ibid 30 [3.44].
[28] Ibid 86 [5.69].
[29] Ibid 95 [5.109]–[5.110].
[30] Ibid 150 [7.10] (Recommendation 1).

2010 was to foreshadow a statutory fiduciary requirement for advisers to act in the best interests of their clients, placing their interests ahead of their own.[31] However, key stakeholder groups such as the Australian Financial Markets Association ('AFMA') raised concerns with the proposed provision.[32] The then opposition Coalition responded that 'any reform in this area need[s] to strike the right balance between appropriate levels of consumer protection and ensuring the availability, accessibility and affordability of high quality financial advice'.[33]

In 2012, the FOFA legislation was passed with a statutory best interests duty and related obligations. Before discussing the best interests duty, a brief discussion of the related obligations is useful. Among these is s 961G, which requires advisers to 'only provide the advice ... if it would be reasonable to conclude that the advice is appropriate to the client'. According to the Explanatory Memorandum, s 961G mimics the requirement for advice to be appropriate to the client under the suitability rule, and the process-related elements forming this requirement have been included in the steps of the new best interests duty found in s 961B(2).[34]

Additionally, under s 961H financial advisers are required to warn their clients about the appropriateness of the advice if 'it is reasonably apparent that information relating to the objectives, financial situation and needs of the client on which the advice is based is incomplete or inaccurate'. Section 961J also imposes a 'priority' duty on financial advisers to prioritise their client's interests above their own in cases of conflict of interests. The FOFA reforms also contains a ban on conflicted remuneration and opt-in arrangements under which advice providers must renew their clients' agreement to ongoing fees every two years. Also, while the pre-FOFA suitability rule applies to the 'providing entity', the FOFA reforms expand the best interests and related obligations to cover advice providers.[35]

Section 961B(1) requires an adviser to 'act in the best interests of the client in relation to the advice'. Without defining the concept of 'best interests', s 961B(2) goes on to state that advice providers may satisfy this duty if they have met the safe harbour conditions, which can be summarised as:

- identifying the client's objectives, financial situation and needs (s 961B(2)(a)–(b));
- making reasonable inquiries to obtain complete and accurate information (s 961B(2)(c));

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[31] Bowen (n 8).

[32] The AFMA contended the best interests duty is about the process and '[a]t no point was it inferred or agreed that the outcome of a client following the advice would be an element of the test of whether the advice provider has acted in the client's best interests.': AFMA, Submission to ASIC on *Consultation Paper 182: Future of Financial Advice — Best Interests Duty and Related Obligations* (5 October 2012) <https://afma.com.au/afmawr/_assets/main/lib90055/o54-12%20asic%20cp%20182%20%20best%20interests%20duty.pdf>.

[33] Mathias Cormann, 'The Way Forward on Financial Advice Laws', (Media Release, Treasury (Cth), 20 June 2014) <https://ministers.treasury.gov.au/ministers/mathias-cormann-2014/media-releases/way-forward-financial-advice-laws>.

[34] Explanatory Memorandum, *Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011*, 16–17.

[35] *Corporations Amendment (Further Future of Financial Advice Measures) Act 2012* (Cth) sch 1 item 23.

- assessing whether it has the required expertise to advise on the subject matter (s 961B(2)(d));
- conducting a reasonable investigation into the relevant financial products (s 961B(2)(e));
- basing all judgments on the client's relevant circumstances (s 961B(2)(f)); and
- taking 'any other step that … would reasonably be regarded as being in the best interests of the client' (s 961B(2)(g)).

Such qualifications to the best interests duty have been criticised by some commentators, who argue that the safe harbour clause provides an incentive for financial advisers to focus on the process over the substance or principles of their advice.[36]

On the other hand, the 'catch-all' provision in s 961B(2)(g) has been subject to questions about its necessity and lack of defined meaning. For example, the Law Council of Australia opined that this clause will likely create uncertainty as to the norms of behaviour required by the law.[37]

In response, the Australian Government Treasury indicated that s 961B(2)(g) was designed to discourage the 'tick-a-box' attitude that may otherwise be fostered by the safe harbour clause, and that the new law must balance competing interests.[38]

Similarly, ASIC argued for the inclusion of s 961(2)(g) in order to meet the policy objective to improve the quality of advice, stating:

> The stark choice I am drawing is whether or not you want a tick-a-box approach, which you really get very close to if the provision in (g) is removed, or whether you want to transform this into a profession and have people exercising particular judgment in particular cases as other professionals do.[39]

Another issue arising from the introduction of the best interests duty was whether it was equivalent to a fiduciary obligation. Although the *Ripoll Report* recommended the introduction of a fiduciary-like duty, the Law Council of Australia suggested that as currently worded, the best interests duty is 'more akin to the adviser's duty of care at general law rather than to their fiduciary duties'.[40]

The preceding discussion indicates that the best interests duty had a somewhat controversial law-making history, in which issues regarding additional compliance burden and interpretive uncertainty were raised. Given this, the Federal

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[36] Gerard Craddock, 'The Ripoll Committee Recommendation for a Fiduciary Duty in the Broader Regulatory Context' (2012) 30(4) *Company and Securities Law Journal* 216.

[37] PJC on Corporations and Financial Services, Parliament of Australia, 'Corporations Amendment (Future of Financial Advice) Bill 2011 and Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011' (Report, February 2012) 49 [4.23], quoting Law Council of Australia Submission <https://www.aph.gov.au/Parliamentary_Business/Committees/Joint/Corporations_and_Financial_Services/Completed_inquiries/2010-13/future_fin_advice/report/c04>.

[38] PJC on Corporations and Financial Services (n 37) 49–50 [4.26].

[39] Ibid 50 [4.28] (Mr John Price (Senior Executive Leader, Strategy and Policy, ASIC), from Committee Hansard 24 January 2012).

[40] Department of Parliamentary Services (Cth), 'Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011' (Bills Digest No 96 2011–12, 7 February 2012) 6 <https://www.aph.gov.au/Parliamentary_Business/Bills_Legislation/bd/bd1112a/12bd096>.

Court of Australia's first decisions on the best interests duty were highly anticipated. These are examined in the next section.

III Judicial Consideration of the Best Interests Duty

While compliance with the FOFA provisions has been mandatory since 2013, the best interests duty and related obligations had not been tested until cases brought by ASIC in June 2016. In what follows, we examine the Federal Court's interpretation of these duties in three related cases. We focus on how the Court interpreted the safe harbour and catch-all provisions, and consider whether the decisions provide more certainty for financial advisers while protecting consumers from poor quality advice.

A *NSG Services Pty Ltd Proceedings*

NSG Services Pty Ltd ('NSG') held an Australian Financial Services Licence ('AFSL') that permitted it to 'advise retail clients about and deal in life risk insurance and superannuation products'.[41] From time to time, this company employed and engaged persons to offer financial services on its behalf, including Messrs El-Helou, Chenh, Heneric, Trinh and Ozak (collectively 'NSG Representatives'). The former three were each contractors of NSG (defined in s 961A of eth *Corporations Act* as 'authorised representatives'); the latter two were NSG's employees.[42]

According to the 'Agreed Statement of Facts', NSG's clientele predominantly consisted of retail clients who received personal financial advice.[43] In advising these clients, NSG Representatives: recommended a superannuation fund for which the client was not eligible; failed to disclose fees properly; rolled over a client's superannuation to other firms without permission; and failed to provide a statement of advice.[44]

Moshinsky J concluded that the NSG Representatives had contravened ss 961B (best interests) and 961G (advisers may only offer advice 'if it would be reasonable to conclude that the advice is appropriate to the client, had the provider satisfied the duty under section 961B to act in the best interests of the client'),[45] with NSG 'automatically' liable under s 961K(2)(b) for such violations by its employee representatives Trinh and Ozak.[46] NSG also breached s 961L for failing to take reasonable steps to ensure its representatives complied with these provisions.[47] The Court accordingly ordered Golden Financial Group Pty Ltd (formerly NSG) to pay penalties of $250,000 and $750,000 in respect of contraventions of ss 961K (2) and 961L.[48]

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[41] *Australian Securities and Investments Commission v NSG Services Pty Ltd* (2017) 122 ACSR 47 ('*ASIC v NSG (No 1)*') 48 [1].
[42] Ibid 54 [23].
[43] Ibid 67 (Appendix [18]).
[44] Ibid 80 [112], 85 [142].
[45] Ibid 48 [6]. See also admissions of contraventions at 67ff (Appendix).
[46] Ibid 55 [32].
[47] Ibid 60–2 [75]–[76]. See also admissions of contraventions at 67ff (Appendix).
[48] *Australian Securities and Investments Commission v Golden Financial Group Pty Ltd (formerly NSG Services Pty Ltd) (No 2)* [2017] FCA 1267 (*ASIC v GFG (No 2)*') [9], [35].

B *The Wealth & Risk Management Proceedings*

In March 2017, ASIC launched a proceeding against Wealth & Risk Management Pty Ltd ('WRM'), JECA Holdings Pty Ltd ('JECA') and Yes FP Pty Ltd ('Yes FP'), alleging that they operated a cash rebate scheme that breached various provisions of the *Corporations Act* and the *Australian Securities and Investments Commission Act 2001* (Cth) ('*ASIC Act*'). WRM held an AFSL allowing it to advise retail clients on, and deal in, life risk insurance and superannuation products. WRM engaged its related company, Yes FP, as a corporate authorised representative, who in turn hired WRM authorised representatives to provide personal financial advice to retail clients. An unlicensed entity, JECA, was a marketing/advertising arm of WRM. Mr Fuoco, who directly or indirectly owned these firms and was a director of each of them, was added as the fourth defendant.

The complex cash rebate scheme operated generally as follows: JECA attracted customers with poor credit histories by advertising that it would provide 'fast cash', 'cash now', and 'debt management advice'.[49] To obtain cash payments and/or advice, applicants were required to submit forms detailing salary and superannuation information to JECA, which in turn referred them to WRM authorised representatives. WRM authorised representatives would then provide quotes for insurance (that is, life, total and permanent disability, and income protection insurance). Mr Fuoco would use the quotes to give WRM authorised representatives the indicative amount for a cash rebate and the advice fee.

JECA would then return to the applicant with recommendations that 'it may be appropriate for the applicant to alter their superannuation and insurance (after future consultation with a financial advisor employed by WRM) so as to obtain access to a cash payment' with fees for the financial advice and insurance premiums paid from their superannuation.[50] Meanwhile, JECA would obtain more details about the applicant (for example, financial goals, investment risk profile, superannuation details) and WRM authorised representatives would issue a 'limited statement of advice' typically recommending rearrangement of existing superannuation and insurance to be implemented by Yes FP.[51]

WRM received advice fees, a trailing commission and an upfront commission from the insurance provider for recommending the policies that WRM paid to JECA. JECA then made the cash payment to the client. The average payment from these commissions as 'rebates' totalled approximately $3,623, with approximately $5,707 in profit from each client, plus $517 in ongoing commissions if the insurance policies were maintained.[52]

Moshinsky J found that this scheme incentivised WRM advisers to not act in the best interests of their clients, to give advice that was not appropriate and to not

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[49] *Australian Securities and Investments Commission v Wealth & Risk Management Pty Ltd (No 2)* (2018) 124 ACSR 351 361–2 [32]–[37] ('*ASIC v WRM (No 2)*').

[50] *ASIC v WRM (No 2)* (n 49) 361 [36].

[51] Ibid 362 [40].

[52] *Australian Securities and Investments Commission v Wealth & Risk Management Pty Ltd* [2017] FCA 477, [27] ('*ASIC v WRM (No 1)*').

prioritise their clients' interests.[53] Thus, commissions and fees drove their advice, rather than the best interests of the clients. Furthermore, none of the advertisements stated that applicants were required to change their current insurance and/or superannuation arrangements.

Clients' superannuation balances were reduced by between $2,750 and $15,663, equating to $8,085.50 on average.[54]. WRM contravened s 961L for failing to take reasonable steps to ensure that its authorised representatives complied with ss 961B, 961G, and 961 J of the Act.[55] On the same facts, WRM also breached s 912A of the *Corporations Act* and s 12CB of the *ASIC Act*, while JECA, Yes FP, and Mr Fuoco violated other relevant provisions.[56]

In the first judgment, Moshinsky J granted an interim injunction to restrain WRM, JECA, and Yes FP from carrying on such activities[57] with the second judgment confirming the breaches. WRM, JECA, and Yes FP were each subject to an 18-year ban restraining them from providing financial services; Mr Fuoco was also subject to an order restraining him from providing financial services for a period of ten years; all defendants ordered to pay penalties: WRM $2.8 million; JECA, $2.55 million; Yes FP $1.8 million; Mr Fuoco $650,000.[58]

C *The Financial Circle Proceedings*

Australian Securities and Investments Commission v Financial Circle Pty Ltd was a 'sequel' to the WRM proceedings.[59] After the interim injunction was granted, evidence showed that Mr Fuoco and other individuals established three new companies, which then acquired Financial Circle Pty Ltd ('*Financial Circle*').[60] As a holder of an AFSL and an Australian Credit Licence, Financial Circle adopted a business model similar to that of the defendants in the WRM proceedings (WRM, JECA and Yes FP).[61] However, rather than a cash rebate scheme, it provided loans of between $2,000 and $5,000, in conjunction with offering financial advice. Loans were provided on the condition that the applicant: (i) engage its adviser to provide financial advice; (ii) implement such advice, which typically required rearrangements of existing superannuation and insurance; (iii) pay a financial advice

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53 *ASIC v WRM (No 2)* (n 49) 366 [63], 379 [150].

54 *ASIC v WRM (No 1)* (n 52) [42].

55 *ASIC v WRM (No 2)* (n 49) 377 [138]. Section 961L of the *Corporations Act* requires that '[a] financial services licensee must 'take reasonable steps to ensure that representatives of the licensee comply with sections 961B, 961G, 961H and 961J'.

56 JECA violated s 911A of the *Corporations Act* for carrying on financial services without holding an AFSL: *ASIC v WRM (No 2)* (n 49) 367 [67]. JECA also breached s 1041H of the *Corporations Act*, as well as ss 12DA and 12DB of the *Australian Securities and Investments Commission Act 2001* (Cth) ('*ASIC Act*') for making various misleading representations: *ASIC v WRM (No 2)* (n 49) 369 [80]–[81], 370 [85], 371 [99]. JECA, along with WRM and Yes FP, also contravened s 12CB of the *ASIC Act*: *ASIC v WRM (No 2)* (n 49) 373 [118]. Mr Fuoco was found to be knowingly involved in the various contraventions: *ASIC v WRM (No 2)* (n 49) 375 [128].

57 *ASIC v WRM (No 1)* (n 52) [8]–[9], [64], [69].

58 *ASIC v WRM (No 2)* (n 49) 356–7 [8], 381 [161], 383 [175].

59 (2018) 353 ALR 137, 138 [2] ('*ASIC v Financial Circle (No 1)*'). See also (2018) 131 ACSR 484 ('*ASIC v Financial Circle (No 2)*').

60 *ASIC v Financial Circle (No 1)* (n 59) 138 [2].

61 Ibid.

fee from $3,000–$5,500; and (iv) commit to pay annual insurance premiums from their superannuation.[62] None of this information was adequately disclosed to applicants for loans.[63]

The advice fee was a substantial portion of the superannuation of the client.[64] Clients serviced by Financial Circle were, by and large, worse off: superannuation balances of twelve clients, for instance, were 'immediately reduced by between 5% to 30%, and by between $5,000 and $10,000', with such reductions 'likely to be an average of $11,500' over five years.[65]

Based on the relevant facts, Moshinsky J granted an interim injunction restraining Financial Circle from engaging in the relevant businesses.[66] In the final hearing, O'Callaghan J confirmed that Financial Circle's advice on insurance and superannuation failed to give priority to the clients' interests, but otherwise enabled itself and/or its employees to receive commissions and advice fees. The company had therefore contravened its duties to take reasonable steps to ensure its representatives complied with ss 961B, 961G, and 961J, as s 961L requires.[67] O'Callaghan J also granted an order permanently disqualifying Financial Circle from carrying on financial services, and imposed a fine of $1 million.[68]

D *Lessons from the Decisions*

ASIC has become more active than ever in dealing with non-compliance with the best interests duty and related obligations in recent years. The Federal Court accepted many of ASIC's submissions, though several issues remained unresolved.

1 *How Did the Court Interpret the 'Best Interests' Duty?*

In considering s 961B in *ASIC v NSG (No 1)*, Moshinsky J began by pointing out that the term 'best interests' is undefined.[69] Yet, His Honour expressed the view that sub-s (2) operates as a defence for advisers, adding that '[i]f the provider can prove that he or she has done each of the seven things in s 961B(2), he or she will have satisfied the best interests duty.'[70] The two parties placed a different emphasis on the relationship between the two provisions. NSG submitted that the duty in s 961B (1) could be satisfied, even if the advice provider did not satisfy the elements in the safe harbour.[71] ASIC accepted this, but contended that

> [i]n a 'real world' practical sense, s 961B(2) was likely to cover all the ways of showing that a person had complied with s 961B(1) and, in this way, a

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62 *ASIC v Financial Circle (No 2)* (n 59) 488 [9].
63 Ibid 490 [22], 492 [33].
64 Ibid 505 [107].
65 *ASIC v Financial Circle (No 2)* (n 59) 517 [173].
66 *ASIC v Financial Circle (No 1)* (n 59) 139 [4]–[5] 159 [99].
67 *ASIC v Financial Circle (No 2)* (n 59) 508–9 [122]–[135].
68 Ibid 527 [236], 529–30 [236].
69 *ASIC v NSG (No 1)* (n 41) 52 [17].
70 Ibid.
71 Ibid 52–3 [18].

> failure to satisfy one or more of the limbs of s 961B(2) is highly relevant to the Court's assessment of compliance with the best interests duty.[72]

Moshinsky J noted this difference in emphasis in the relationship between ss 961B(1) and (2), but concluded that it did not appear to be significant.[73]

The Federal Court was largely silent on this issue in the subsequent two cases, though O'Callaghan J reiterated the defence role of s 961B(2) in *ASIC v Financial Circle*.[74] Nevertheless, both cases followed *ASIC v NSG (No 1)*, using the factors of s 961B(2) as a proxy to assess the compliance of s 961B(1). In *ASIC v Financial Circle*, for instance, the Court accepted the expert's report that the various facts (for example, failure to identify the objectives and failure to make reasonable enquiries) indicated the defendant had contravened the best interests duty.[75] What is clear from the above is that while s 961B(1) is the primary obligation, its interpretation can, in practice, be informed by the enumerated factors of s 961B(2). Using s 961B(2) can be, in other words, the primary means of assessing compliance with the primary duty. Thus, it is actually fairly crucial for an AFSL holder to tick these boxes, in order to benefit from the safe harbour.

Intriguingly, however, the safe harbour clause arguably cannot eliminate the legal risk of non-compliance because of the open-ended nature of s 961B(2)(g) requiring 'any other steps that, at the time the advice is provided, would reasonably be regarded as being in the best interests of the client ... given the client's relevant circumstances'. If this imposes additional duties, what would they be? How can financial advisers meet this requirement? If, on the other hand, the other six steps are sufficient to ensure compliance with the best interests duty, should this catch-all clause be removed altogether, for the sake of certainty?[76] These issues remain somewhat unresolved. In *ASIC v WRM (No 2)*, evidence was given of such a failure to 'take any other step' as part of a body of expert evidence of failures to satisfy the multiple limbs of the s 961B(2) safe harbour provisions.[77] This body of evidence was noted as supporting the expert's conclusion that there was a failure to act in clients' best interests. The Court did not, however, examine the 'catch all' specifically, so it remains unclear how broadly the Court will interpret the catch-all provision.

On a broad interpretation of s 961B(2)(g), the catch-all clause means that, even if an adviser satisfies the other six steps, its actions could still be found

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[72] Ibid 53 [18].

[73] Ibid 52 [18].

[74] *ASIC v Financial Circle (No 2)* (n 59) 509 [130].

[75] Ibid 496 [52], 498 [67]. See also *ASIC v WRM (No 2)* (n 49) 365 [60]–[61], 373 [113].

[76] On 19 March 2014, the Australian Government introduced the Corporations Amendment (Streamlining of Future Financial Advice) Bill 2014 into Parliament. One of the proposed changes was to remove the catch-all clause of the safe harbour provision. Shortly after, this change was implemented by regulation instead — though the Regulation was then disallowed by the Senate on 19 November 2014. Parts of the Regulation were reinstated by the *Corporations Amendment (Revising Future of Financial Advice) Regulation 2014*, commencing 16 December 2014. On 2 March 2016, a revised Bill was passed as the *Corporations Amendment (Financial Advice Measures) Act 2016* (Cth). That Act did not remove the catch-all: see ASIC, 'FOFA — Background and Implementation' (Web Page) <https://asic.gov.au/regulatory-resources/financial-services/regulatory-reforms/future-of-financial-advice-fofa-reforms/>.

[77] *ASIC v WRM (No 2)* (n 49) 366 [62].

inconsistent with the best interests duty. Arguably, the clause could be read as broadly as requiring advisers to show that they exercised sound professional judgment in giving the advice.

Simply put, s 961B(2)(g) seems to operate as a moving target, and thus advisers would be ill-advised to consider their compliance with the best interests duty as simply a box-checking exercise. The open-endedness of the best interests duty, as we see it, demands advisers at least tailor the process undertaken, and the advice given, to fit the particular circumstances of each client. This interpretation is consistent with other scholars' arguments that the 'open-endedness' of the best interests duty test in s 961B(2)(g) 'removes a static and inflexible advice model (box ticking) that may fail to take full account [of] all of the client's relevant circumstances'.[78]

In the *Banking Royal Commission Final Report*, Commissioner Hayne has noted, in relation to the best interests duty, that the current law does not require financial advisers to explain that they are not independent, and that 'the present safe harbour model does not prevent interest from trumping duty'.[79] The Report presented the options of removing or amending the safe harbour provision to prevent the possibility of the advisers' interests trumping their duty to act in the best interests of clients.[80] We will return to this in Part IVC(2) below.

2 *The Focus of ss 961B and 961G: Process or Substance?*

Another issue that has emerged concerning the s 961B best interests duty is the focus on the process rather than the substance, principle or outcome in giving the relevant advice. Moshinsky J noted in *ASIC v NSG (No 1)* that while the text of s 961B did not appear 'at first blush' to be about process or procedure, it was accepted by both parties that s 961B is concerned with 'the process or procedure involved in providing advice', while s 961G is concerned with 'the content or substance of that advice'.[81] Without reaching a concluded view, Moshinsky J found support for this formulation of s 961B in that section's context, including 'the language of s 961G, the legislative history, and the legislative materials'.[82] Moshinsky J's observations are consistent with the legislative intent revealed in the Explanatory Memorandum[83] and with

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[78] Latimer (n 7) 20. See also Sean Graham, 'It's an Uncertain Path to Safe Harbour on Best Interests' *Professional Planner* (online, 8 January 2018) <www.professionalplanner.com.au/2018/01/its-an-uncertain-path-to-safe-harbour-on-best-interests/>. For the same reason, this catch-all provision was criticised in the Dissenting Report by Coalition Members of the PJC, see Recommendation 6 and associated commentary in: PJC on Corporations and Financial Services, Parliament of Australia, *Dissenting Report by Coalition Members of the Committee* <www.aph.gov.au/Parliamentary_Business/Committees/Joint/Corporations_and_Financial_Services/Completed_inquiries/2010-13/future_fin_advice/report/d01>.

[79] *Banking Royal Commission Final Report* (n 1) vol 1, 177 [3.2.4].

[80] Ibid.

[81] *ASIC v NSG (No 1)* (n 41) 53 [21].

[82] Ibid 54 [21].

[83] The working assumption of the best interests duty is that 'good processes will improve the quality of the advice that is provided. The provision is not about justifying the quality of the advice by retrospective testing against financial outcomes'. Replacement Explanatory Memorandum, *Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011* (Cth) 10 [1.23].

ASIC's stated practice and intentions.[84] The Court again adopted this view in *ASIC v WRM* and *ASIC v Financial Circle*.

In *ASIC v WRM*, for instance, Moshinsky J noted the opinion of ASIC's expert who suggested the need for a compliance framework, including appropriate policies and procedures.[85] His Honour also considered the procedural deficiencies under s 961B.[86] In other words, the Court considered evidence of the adviser's conduct importing the 'process' the adviser followed. In *ASIC v Financial Circle*, the Court noted the expert's opinion condemning process deficiencies and non-compliance with reasonable industry practice,[87] and noted separately both lack of policies and processes and the substantive failure to comply with s 961B and the ss 961G and s 961J obligations.[88]

It is interesting that ASIC's stated view is that ss 961B (best interests), 961G (appropriate advice) and 961J (priority to client's interests) are separate obligations that operate alongside each other and apply every time personal advice is given.[89]

Our analysis of these cases and issues raises a related question: how clear is the distinction between 'process' and 'substance' ('substance' is sometimes also discussed as 'principle' or 'outcome')? While it is, in theory, possible to draw a line between the process of giving advice and the substance or outcome of the advice,[90] it can be problematic in practice. Though it is true that s 961B is more concerned with process, its wording nevertheless incorporates elements that have a direct bearing on the quality of advice. Providers must show that their advice identified the 'objectives, financial situation and needs of the client that were disclosed to the provider' (under s 961B(2)(a)) and that 'all judgments in advising the client' were based on their relevant circumstances (under s 961(2)(f)). Taken together, it appears that advice should be tailored to the needs of the particular client. It is thus likely that advisers who neglect to judge whether the advice given is appropriate, by mechanically treating s 961B as a checklist of process, may find it difficult to prove their compliance with the best interests duty in s 961B, much less the appropriateness duty in s 961G.

In *ASIC v WRM*, Moshinsky J agreed with the expert's opinion, which stated that 34 clients of WRM had received advice that was inappropriate and not in their best interests.[91] His Honour's approach might suggest that the quality of the process undertaken and the quality of advice — two separate focuses in theory — can inform each other in practice. In its Interim Report, the Banking Royal Commission echoed this view. It noted Westpac's acknowledgment that the advice given by its subsidiary's financial adviser was poor, inappropriate and involved a failure to

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[84] ASIC, *Licensing: Financial Product Advisers-Conduct and Disclosure* (Regulatory Guide 175, 14 November 2017) [175.234]–[175.236], [175.252]–[175.254] ('*ASIC RG 175*').

[85] *ASIC v WRM (No 2)* (n 49) 372 [111].

[86] Ibid 365–6 [62]–[63], [126].

[87] *ASIC v Financial Circle (No 2)* (n 59) 494–5 [45]–[46], 509 [131].

[88] Ibid 508 [122].

[89] *ASIC RG 175* (n 84) [175.235].

[90] Note that the reference to 'outcome' may be somewhat problematic as it may connote a temporal issue and resultant hindsight bias in relation to investments that later prove to be poor performers.

[91] *ASIC v WRM (No 1)* (n 52) [49].

explain that their clients' financial strategies were not viable and not in their best interests (which also involved a failure of process).[92] It is submitted, in short, that while process and substance/principle seem to be different notions, the evidence establishing these two matters can be mutually reinforcing.

3 *Compliance, Systemic Risk, and Corporate Culture under the Spotlight*

The NSG, WRM and Financial Circle judgments in relation to s 961B signalled to the financial sector that it must take its obligations more seriously. The Federal Court of Australia's interpretation of s 961L may also have an effect on financial services providers, and will be examined below.

Although ss 961B and 961G are generally applicable to individual advisers, any breaches of them may lead to an AFSL holder's breach of s 961L. Section 961L imposes an obligation on AFSL holders to 'take reasonable steps' to ensure their representatives comply with ss 961B, 961G, 961H or 961J. These provisions have now received detailed judicial consideration in these three cases.

In *ASIC v NSG (No 1)*, Moshinsky J began by noting that s 961L mirrors s 912A(1)(ca), which requires an AFSL holder to take reasonable steps to ensure its representatives comply with financial services laws.[93] His Honour then dealt with a disputed threshold issue.[94] ASIC, in its written submissions, read three tests into s 961L: NSG representatives' breaches of ss 961B and 961G; NSG's failure to take reasonable steps to prevent such breaches; and a causal link between the two.[95] By contrast, NSG argued that s 961L warrants consideration only of the 'reasonableness of the conduct' (that is, the steps taken by NSG), and that it was not necessary to show a contravention of ss 961B or 961G.[96] However, ASIC later submitted it was not necessary for the Court to reach a concluded view on this issue, as ASIC's higher threshold view was met in this case.[97] ASIC further submitted it did not hold a firm position on this point since, 'as a matter of practicality, some form of causal nexus was likely to exist in most cases'.[98] Moshinsky J found it unnecessary to decide and stated that the agreed facts not only 'establish the underlying contraventions of ss 961B and 961G' by NSG representatives, but show 'a causal relationship between the failure by NSG to take reasonable steps and the contraventions of ss 961B and 961G' by the NSG Representatives'.[99] O'Callaghan J, in *ASIC v Financial Circle (No 2)*, elaborated on this issue:

> [T]here is nothing in the language of s 961L ... that make[s] actual (or proven) contraventions of the anterior provisions a precondition to a finding of contravention of s 961L in itself. In other words, there can be a failure to take

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[92] *Banking Royal Commission Interim Report* (n 14) vol 2, 179 [3.3.1] (and as to process see 177–8 [3.2.3]).
[93] *ASIC v NSG (No 1)* (n 41) 55 [31].
[94] Ibid 56 [36]–[39].
[95] Ibid 56 [36]
[96] Ibid 56 [37].
[97] Ibid.
[98] Ibid 56 [38].
[99] Ibid 56 [39].

> reasonable steps to procure compliance, even without proof that that failure led to an actual contravention of other provisions.[100]

His Honour's observation suggests that, as a matter of statutory construction, establishing a breach of a s 961L duty is not conditional on a breach of another FOFA provision. Yet, while this could help remove hurdles for ASIC, it raises the next question: what are some of the key factual matters that the Court considered in making the orders?

In *ASIC v NSG (No 1)*, Moshinsky J considered the following factors: the new client advice process, training, monitoring, external auditing, compliance policy, and remuneration.[101] Salient examples of NSG's failures in these areas were that its system for advising new clients 'was designed to be completed quickly'[102] with 'little or no time' for them to reflect upon the advice;[103] inadequate training of representatives about compliance with the best interests and related duties;[104] no internal audits of some of NSG's representatives during the relevant period;[105] failure to act on the pitfalls identified by external review;[106] compliance policies that were 'inadequate and, in many cases, not followed or enforced';[107] certain conflicts-of-interest related policies not updated to reflect the FOFA reform;[108] and remuneration structures directing employees to focus on sales, rather than compliance.[109]

The Court in *ASIC v WRM* and *ASIC v Financial Circle* exhibit similar reasoning. The judgments in both cases referred to the report of an expert, Mr Graham, who stated that 'reasonable steps' to ensure effective compliance with ss 961B, 961G and 961J depended on 'the nature, scale and complexity' of each business.[110] The report then identified that a licensee's compliance framework should at least include guidance on policies addressing relevant FOFA duties, 'a definition of, and commitment to, best interests, client priority and appropriateness', peer-review and escalating procedures, regular and targeted-based supervision, effective ongoing training, effective record-keeping, and training on managing conflicts of interest.[111]

While the decision in *ASIC v NSG (No 1)* rested on the Agreed Statement of Facts to identify various aspects of NSG's non-compliance,[112] the decisions in *ASIC v WRM* and *ASIC v Financial Circle* seemed to focus more on the expert reports. Mr Graham set out guidelines based on 'appropriate industry practice' drawn from his

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[100] *ASIC v Financial Circle (No 2)* (n 59) 508 [123].
[101] *ASIC v NSG (No 1)* (n 41) 56–60 [41]–[74].
[102] Ibid 57 [45].
[103] Ibid 57 [46].
[104] Ibid 58 [51].
[105] Ibid 58 [53]–[54].
[106] Ibid 58–9 [58].
[107] Ibid 59 [62].
[108] Ibid 59 [65].
[109] Ibid 60 [73].
[110] *ASIC v WRM (No 2)* (n 49) 372 [110]; *ASIC v Financial Circle (No 2)* (n 59) 508 [125].
[111] *ASIC v WRM (No 2)* (n 49) 372 [111]; *ASIC v Financial Circle (No 2)* (n 59) 508 [126].
[112] *ASIC v NSG (No 1)* (n 41) 48–9 [8].

professional experience.[113] It remains to be seen, though, how much weight such expert evidence on guidelines will have with the Court in similar cases going forward.

One message is clear: an AFSL holder is expected and required to take legal compliance with the FOFA legislation more seriously, by way of clear instructions, effective training and monitoring, and perhaps more importantly, by avoiding any misaligned incentives and interests. As Moshinsky J highlighted, WRM's cash rebate scheme created 'incentives for advisors to not act in the best interests of their clients, to give advice that is not appropriate and to not prioritise their clients' interests',[114] while NSG's commission-based salary structures created a 'culture in which the best interests and appropriate advice duties were more likely to be overlooked'.[115]

The Federal Court's determination of penalties also reflects its concern about the systemic risks of non-compliance. The Court imposed significant penalties in all three cases. In relation to *ASIC v NSG (No 1)*, it ordered a penalty of $250,000 for contraventions of s 961K(2) and $750,000 for contraventions of s 961L.[116] In both *ASIC v WRM* and *ASIC v Financial Circle*, the Court ordered the maximum pecuniary penalty of $1 million for a breach of s 961L.[117] In all three cases, the Court commented that it regarded the contraventions as 'very serious in nature'.[118] While *ASIC v NSG* involved only breaches of the FOFA provisions, and *ASIC v WRM* and *ASIC v Financial Circle* included breaches of other provisions, the Court's consideration for the penalties followed the same principles.[119]

Moshinsky J considered the following facts and circumstances, among others, when imposing the penalty in *ASIC v WRM*:

(1) the contraventions were very serious in nature, deliberate, and persisted despite ASIC's involvement;
(2) the reasonably high likelihood defendants would engage in similar conduct if not prevented from doing so by the Court;
(3) the failure of defendants to demonstrate good character for the purposes of mitigation and:
(4) the prevalent and systematic culture of non-compliance.[120]

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113 *ASIC v WRM (No 2)* (n 49) 372 [111]. Mr Graham was a financial services compliance consultant at Assured Support in Sydney. He has also underscored, in another context, the problematic nature of the catch-all provision: see Graham (n 78).
114 *ASIC v WRM (No 2)* (n 49) 379 [150].
115 *ASIC v NSG (No 1)* (n 41) 60 [73].
116 *ASIC v GFG (No 2)* (n 48) [9], [35]
117 *ASIC v WRM (No 2)* (n 49) 356–7 [8]–[10], 383 [175]; *ASIC v Financial Circle (No 2)* (n 59) 527 [236].
118 *ASIC v WRM (No 2)* (n 49) 381 [163]; *ASIC v Financial Circle (No 2)* (n 59) 520 [190]; *ASIC v GFG* (No 2) (n 48) [27].
119 The Court largely followed the principles set out in *Australian Securities and Investments Commission v Adler* (2002) 42 ACSR 80 and *Trade Practices Commission v CSR Limited* (1991) ATPR 41-076, along with established principles of pecuniary penalties laid out in the Australian common law: *ASIC v WRM (No 2)* (n 49) 380–1 [153]–[156]; *ASIC v Financial Circle (No 2)* (n 59) 517 [177]–[179]; *ASIC v GFG* (No 2) (n 48) [18].
120 *ASIC v WRM (No 2)* (n 49) 381–2 [163]–[171].

These same considerations were discussed in *ASIC v Financial Circle*, with O'Callaghan J commenting that the contraventions were substantially worse and warranted higher penalties than in the NSG proceedings.[121]

In the NSG proceedings, mitigating factors were present: NSG's conduct was not suggested to involve dishonesty, there was cooperation with ASIC and contrition and NSG's senior management had been substantially impaired due to a family bereavement in the 12 months leading up to the compulsory implementation of the FOFA provisions.[122]

In considering the defendant's character as a key factor in determining the appropriate penalty, Moshinsky J in *ASIC v WRM* opined that the cash rebate 'is not only non-compliant ... but involves the targeting and exploitation of financially disadvantaged and desperate people'.[123] His Honour noted the advice fee and insurance premiums were drawn entirely from customers' superannuation funds, and the 'substantial harm' to customers from the rebate scheme.[124] Moshinsky J found 'a systemic culture of non-compliance' in each corporate defendant, condemning WRM, in particular, for its 'disrespect for the financial services law',[125] and concluded that WRM's 'systemic failures'[126] under s 961L 'were not merely technical matters; they went to the heart of its business model'.[127] While it is still too early to predict how the Australian Government and society will react to all aspects and ramifications of the Banking Royal Commission, these decisions nevertheless mark a crucial step towards reversing prevailing practices too often driven only by self-interest.[128]

IV Rethinking Regulatory Strategies in the Post Banking Royal Commission Era

In the *Banking Royal Commission Final Report,* Commissioner Hayne identified six principles for the effective application and enforcement of the law. These were:

- 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.[129]

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121 *ASIC v Financial Circle (No 2)* (n 59) 520 [190]–[203], 525 [229].

122 *ASIC v GFG* (No 2) (n 48) [30]-[34] [48]–[51]. See also *ASIC v Financial Circle (No 2)* (n 59) 525 [229].

123 *ASIC v WRM (No 2)* (n 49) 381 [166].

124 Ibid 381–2 [167]–[168].

125 Ibid 382 [171].

126 Ibid 382 [172].

127 Ibid.

128 *Banking Royal Commission Interim Report* (n 14) vol 1, 91 [2.1].

129 *Banking Royal Commission Final Report* (n 1) vol 1, 8–9 [1.5.1]. The recent decision of the Full Federal Court in *Australian Securities and Investment Commission v Westpac Securities Administration Ltd* (2019) 373 ALR 455 has been highlighted by some commentators as giving a dominant role to the fairness criterion and in a sense converging Commissioner Hayne's six principles to one predominant legal obligation of fairness: see Michael Pelly, 'Hayne's Six Rules for

These principles led to the recommendation that 'exceptions and carve outs' be reduced as '[t]he more complicated the law, the harder it is to see unifying and informing principles and purposes.'[130]

The sections that follow will examine some of the recommendations of the Banking Royal Commission. We shall reflect on implications that could flow from suggestions to review and possibly abolish the safe harbour clause in s 961B, from the perspectives of both consumer protection and financial advisers. We argue that while removing the safe harbour clause may reduce the complexity of the law and make financial advisers more cautious about their duties towards clients, it may not necessarily lead to an optimal outcome. Imposing a best interests duty without any guiding principles may, as a matter of practice, make it problematic to set the expected behaviour norms for financial advisers. This could arguably defeat the Royal Commission's intention that such legislation should, 'as far as possible … identify expressly what fundamental norms of behaviour are being pursued when particular and detailed rules are made about a particular subject matter'.[131]

Working on the Royal Commission's call for reform, we map and assess several possible interpretations of a best interests duty if the safe harbour clause was abolished altogether. We also draw lessons from the US by discussing the practicability of replicating the SEC's action to impose a 'best interests' duty on broker-dealers when giving recommendations to retail clients. To address the best interests duty more holistically, it is crucial to also consider the role of the regulator by taking into account the Banking Royal Commission's recommendations on ASIC enforcement culture and relevant developments in this area.

A *The Implications of the Banking Royal Commission Recommendation on the Best Interests Duty*

The *Banking Royal Commission Final Report* recommended that the Government should, no later than 31 December 2022 and in consultation with ASIC, review the effectiveness of the measures implemented to improve the quality of financial advice.[132] The review should consider, inter alia, the necessity of retaining the 'safe harbour' clause in s 961B(2), with the Royal Commission recommending repeal unless there is a clear justification.[133]

An immediate question arises: why should the safe harbour clause be removed? While some would see the provision as a box-ticking exercise that can undermine the whole purpose of the best interests duty, the potential value in the 'catch-all' provision under s 961B(2)(g) should not be overlooked. As seen in the three recent proceedings discussed in Part III above, the Court has left the reading of this clause open and thus subject to judicial interpretation. Considering that this

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Business Become One Legal Obligation: Be Fair', *The Australian Financial Review* (Melbourne, 1 November 2019) 1.

[130] *Banking Royal Commission Final Report* (n 1) vol 1, 44 [4.1].

[131] Ibid. See also vol 1, 42 (Recommendation 7.4).

[132] Ibid vol 1, 26 ('Recommendation 2.3 – Review of measures to improve the quality of advice').

[133] Ibid.

could arguably make financial service advisers vigilant in advising their clients, one wonders if abolishing the safe harbour provision altogether is an overreaction.

If the recommendation to remove the safe harbour provision is to be adopted, it is also not clear how the Federal Court will interpret the 'best interests' duty. Rather than defining the 'best interests' duty head-on, the Court in the three recent proceedings used the safe harbour provision as a proxy to determine (non)compliance with this obligation. Absent s 961B(2) of the *Corporations Act*, it might be suggested that there would be less context and fewer obvious statutory parameters to aid the Court in its interpretation of acting 'in the best interests of the client'.

If the safe harbour provisions were removed, interpretations of the meaning of the best interests duty based upon the three cases discussed above may become problematic. This is because in those cases the judges' analyses rested to a degree on the safe harbour clause.

Absent the safe harbour clause and its influence on the prior decisions, courts may then need to look elsewhere to discover the object and purpose of the surviving bests interest duty. One approach may involve reference to other contexts. For instance, one might draw an analogy with directors' duty to act in the best interests of the company. A key issue here is whether the Court would apply a subjective or objective standard to the adviser's conduct and meeting of the standard in determining the best interests of the client. In the context of directors' duty, courts generally defer somewhat to the directors' judgment in determining what is in the best interests of the company given the circumstances.[134] Directors are typically given a fair amount of latitude in terms of business decisions and may also have access to the safe harbour defence in the business judgment rule.[135]

It is submitted that this should not be replicated here, as the goal in engaging a financial adviser — to be better off financially — is arguably simpler or narrower than for a director to act in the best interests of the company in running that company. Thus, this subjective standard for directors to act in the best interests of the company is not sufficient to inform the best interests duty under s 961B(1). Instead, a more objective approach should be adopted; whether the decision is one that a reasonable adviser would consider to be in the best interests of a client. This standard could arguably promote accountability, as advisers must consider the best interests of individual clients, make an assessment of the client's financial position and, if necessary, demonstrate measures that have been taken to achieve this end. This approach may moderate Commissioner Hayne's criticism in the *Banking Royal Commission Final Report* that advisers are required to make little or no independent inquiry into products.[136]

Another possibility is to align the reading of the best interests duty with the general law fiduciary obligation. Removing the safe harbour clause may remove the box-ticking exercise for financial advisers; instead, they have to look elsewhere to

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[134] There is debate as to how far an objective element should be incorporated into this subjective test. See *Hutton v West Cork Railway Co* (1883) 23 ChD 654, 671; *Bell Group Ltd (in liq) v Westpac Banking Corporation* (No 9) (2008) 70 ACSR 1, 282 [4608].

[135] *Corporations Act* s 180(2).

[136] *Banking Royal Commission Final Report* (n 1) vol 1, 177 [3.2.4].

anchor the way they advise their clients to discharge such duty. One such anchor is s 961J, which requires financial advisers to place the interests of the clients ahead of their own. By abolishing the safe harbour clause and reading the best interests duty in conjunction with the priority duty, the best interests duty may arguably be made more proscriptive. This might open the door for the court to interpret s 961B(1) similarly to the general law fiduciary duty.

Against this approach, however, are several arguments. First and foremost, it is inconsistent with the FOFA legislative history. Despite the *Ripoll Report* recommending a fiduciary duty, the Government did not use the word 'fiduciary' in the subsequent draft legislation and s 961B imposes prescriptive rather than proscriptive obligations on providers of financial advice.[137] In Australian law, a fiduciary obligation is proscriptive rather than prescriptive,[138] whereas the focus of FOFA legislation was not on prohibitions in the adviser-and-client relationship, but on prescribing a level of quality of financial advice. Fiduciary duty, according to Lindgren, is not 'directly concerned with the quality of advice', though the quality will be affected in such a relationship.[139]

Second, in contrasting the overall structure of the FOFA legislation with the general law fiduciary duty, we are reminded that these are two parallel duties. While not all advice-givers are fiduciaries, case law reveals that in certain situations where financial advice is held out, given, and relied upon by a client, financial advisers may be considered as fiduciaries.[140] Such a fiduciary duty is, as indicated by Rares J in *Wingecarribee Shire Council v Lehman Brothers Australia Ltd (in liq)*, subject to the terms of the contract of provision of services.[141] Indeed fiduciary duties as created in equity are fact specific — arising from a finding of fact as to the nature and incidents of the relationship and not otherwise.[142] In this sense, it may be that a statutory fiduciary duty goes against the grain of authority, with it being suggested that it is not a desirable course as it does not grapple with the underlying problems[143] (as well as standing principle 'on its head').[144]

This however, is not the case in relation to the best interests duty under s 961B. While the general law fiduciary duty may be discharged if a fiduciary makes full disclosure of the interests and obtains consent,[145] disclosure requirements

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137 *Exposure Draft* (Tranche 1), Corporations Amendment (Future of Financial Advice) Bill 2011 (Cth) s 961C. See also Corones and Galloway (n 13) 19.

138 Batten and Pearson (n 7) 520.

139 Lindgren (n 13) 437. See also Simone Degeling and Jessica Hudson, 'Fiduciary Obligations, Financial Advisers and FOFA' (2014) 32(8) *Company and Securities Law Journal* 527, 536.

140 *Ali v Hartley Poynton Ltd* (2002) 20 ACLC 1006, 1050; *Aequitas Ltd v Sparad No 100 Ltd* (2001) 19 ACLC 1006, 1062–66 [306]–[325]; *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 160 FCR 35, 77–9 [282]–[292].

141 *Wingecarribee Shire Council v Lehman Brothers Australia Ltd (in liq)* (2012) 301 ALR 1, 323–4 [1235]–[1240] ('*Wingecarribee*'). Rares J concluded that the adviser's fiduciary obligations were attenuated by contractual terms, but those terms did not extinguish the fiduciary obligations the adviser owed to the clients: at 209 [776], 211 [783].

142 Craddock (n 36) 222, citing RP Meagher, JD Heydon and MJ Leeming, *Meagher, Gummow & Lehane's Equity: Doctrines and Remedies* (LexisNexis Butterworths, 4th ed, 2002) [5-195].

143 Lindgren (n 13) 436, 442.

144 *Breen v Williams* (1996) 186 CLR 71, 137.

145 *Wingecarribee* (n 141) 323–4 [1235]–[1240].

applied to financial advisers through the product disclosure statements and financial services guides,[146] do not discharge the statutory best interests duty. The remedies for breach of the best interests duty and the general law fiduciary duty are also different. There is no evidence in the Report that the best interests duty should be interpreted as aligned with fiduciary duty. That is not to say that the two may not be close in many ways and may not intersect in their practical application.

While it is true that removing the safe harbour clause can moderate criticisms against the box-ticking exercise, it is equally true that it will affect the understanding of the best interests duty going forward. There are questions as to what exactly constitutes the best interests duty. As a matter of practice, the lack of clarity can be rather problematic for financial advisers. It is perhaps due to the complex nature of these issues that the Banking Royal Commission added a qualification to its recommendation: there is no need to abolish the safe harbour clause at this stage, with such removal or amendment dependent in part on 'how effective … other changes have been in improving the quality of advice given by financial advisers'.[147] These remarks lead us to reflect on the next question: can the best interests duty be reshaped to improve the quality of advice? We discuss this below.

B *How Far Have We Come and Where Are We Going?*

Although it may be too early to predict the exact future of the best interests duty, some broader points can be made here. First, it is useful to consider how far we have come from the pre-FOFA suitability rule to the best interests duty.

The pre-FOFA suitability rule required the adviser to reasonably assess the client's relevant personal circumstances, give consideration to and investigate the subject matter of the advice and then ensure that the advice is appropriate to the client. The best interest duty also incorporated 'reasonableness' under s 961B(2)(g) by requiring the adviser must have 'taken any other step that ...would reasonably be regarded as being in the best interests of the client, given the client's relevant circumstances.' Section 961B(2)(g) is arguably more onerous in that it captures all steps that would reasonably be considered as being in the best interests of the client.

Arguably, if we revisit the *Cassimatis* proceedings through the lens of FOFA legislation, Mr and Mrs Cassimatis — if they were financial advisers — may still be caught by the best interests duty since they may not be able to show, at a minimum, that they did what was required under s 961B(2)(g). That is: adequately determine the objectives of the advice;[148] conduct an adequate sensitivity analysis evaluating other factors such as the ramifications for the clients;[149] and give reasonable consideration to the income and expenditure of the clients.[150]

This analysis may be even more interesting if the Banking Royal Commission's recommendation to abolish the safe harbour clause is adopted.

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[146] *Corporations Act 2001* (Cth) pt 7.9.
[147] *Banking Royal Commission Final Report* (n 1) vol 1, 177 [3.2.4].
[148] *Cassimatis* (n 16) 260–61 [261].
[149] Ibid 263 [274].
[150] Ibid 265 [285].

Arguably, this will make the process and outcome/substance divide much less clear. In an ideal theoretical world it might be that such divide can be conceptually explained by suggesting that the best interests duty focuses on the process, while the appropriate advice duty is concerned about the substance or principles behind the advice. In practice, however, such a distinction is not necessarily so clear. In particular, it is unclear how the Court will interpret the best interests duty without guidance on the standard of care required. It might be argued that, absent the safe harbour provision, the best interests duty could be interpreted similarly to the suitability rule in the pre-FOFA era. However, a clearer exposition of the elements of best interests may need to be legislated in order for such interpretation to be possible. This route may also make the appropriate advice duty under s 961G redundant.

1 *Best Interests Duty in Superannuation*

The best interests duty has also been incorporated into s 52 of the *Superannuation Industry (Supervision) Act 1993* (Cth),[151] which applies to trustees of superannuation funds. It is accepted that the statutory provision reflects the general law duties of trustees.[152] Notably, there is no equivalent safe harbour clause for superannuation trustees. Although the application of the best interests duty may vary from that applicable to financial advisers, the interpretation of the provision may nevertheless offer some guidance. In the context of superannuation, the best interests duty is not only concerned with the process of decision-making, but the substance or principles of the decision itself.[153] With respect to a trustee's power to invest, in the seminal English case of *Cowan v Scargill* Megarry V-C noted:

> When the purpose of the trust is to provide financial benefits for the beneficiaries, as is usually the case, the best interests of the beneficiaries are normally their best financial interests. In the case of a power of investment, as in the present case, the power must be exercised so as to yield the best return for the beneficiaries, judged in relation to the risks of the investments in question; and the prospects of the yield of income and capital appreciation both have to be considered in judging the return from the investment.[154]

As noted, it appears that the best interests duty as applied to superannuation trustees is focused on both process and content. This may be different from the approach taken by the FOFA, under which the best interests duty and the appropriate advice duty govern process and content respectively. Thus, it may be open for debate as to whether there can be any future alignment of the best interests duty under the FOFA legislation with that applying to superannuation trustees.

A more crucial issue after the Banking Royal Commission is how to rebalance competing interests when undergoing reform. While removing the safe harbour provision could arguably make financial advisers more cautious about the

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[151] As repealed and substituted by *Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Act 2012* (Cth) sch 1 item 12.

[152] Justice Mark Moshinsky, 'The Continuing Evolution of the 'Best Interests' Duty for Superannuation Trustees from *Cowan v Scargill* to the Current Regulatory Framework' (Conference Paper, 2018 Superannuation Conference: Order in the House, 9 March 2018) 16.

[153] Ibid 18.

[154] *Cowan v Scargill* [1985] Ch 270, 287.

way they provide advice, it is equally true that they may find it difficult to anchor their behaviour against the undefined best interests duty. One option is to rethink the use of a rule-based and principle-based approach. The safe harbour clause appears to be a rule-based approach — though ASIC's 2012 Regulation Impact Statement indicated otherwise.[155]

Such a prescriptive strategy was rejected by the Royal Commission, which specifically ruled out the option to 'amend the provision to be more prescriptive about how an adviser must pursue the client's best interests'.[156] According to the Banking Royal Commission, adopting a more prescriptive approach (for example, requiring advisers to make explicit in the statement of advice the comparisons they have made between products) would be unlikely to work as it only expands on the safe harbour model and that model does not prevent interests from trumping duty.[157]

The question arises: how to design a principle-based regulation to give financial advisers high-level instructions without overly detailed elements?

2 *Best Interests in the United States*

In the US, investment advisers have long been subject to fiduciary duties with broker-dealers subject to a less rigorous standard of suitability — a distinction said to be rooted in history, even though both may often perform similar functions.[158] In relation to the latter, the SEC in June 2019 adopted the *Regulation Best Interest: The Broker-Dealer Standard of Conduct* establishing a new standard of conduct for broker-dealers in relation to their recommendations to retail customers on a securities transaction or investment strategy.[159] Like the Australian approach, the US does not define the term 'best interests'. Unlike Australia's detailed, step-by-step safe harbour provision however, the US uses a more principle-based approach by underscoring several key points.[160] A broker-dealer would comply with this duty by

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155 ASIC (n 10) 10 [34].

156 *Banking Royal Commission Final Report* (n 1) vol 1, 177 [3.2.4].

157 Ibid.

158 Arthur B Laby, 'Selling Advice and Creating Expectations: Why Brokers should be Fiduciaries' (2012) 87(3) *Washington Law Review* 707.

159 *Securities Exchange Act of 1934* § 240.15l-1, 17 USC (2019). By way of context, broker-dealers in the US are required to fulfil what is called a 'suitability obligation' considering the clients' personal circumstances, though less onerous than the fiduciary duty imposed on an investment adviser. Investment adviser's fiduciary duty was first read into the *Investment Advisers Act of 1940* 17 USC §275 (1940) by the US Supreme Court in *Securities and Exchange Commission v Capital Gains Research Bureau Inc*, 375 US 180 (1963). The SEC clarifies that the fiduciary duty includes a duty of care and duty of loyalty. The duty of care includes 'the duty to act and to provide advice that is in the best interest of the client' and 'the duty to seek best execution' of a client's transactions, and the 'duty to provide advice and monitoring over the course of the relationship'. See generally US SEC, *Commission Interpretation Regarding Standard of Conduct for Investment Advisers* (Release No IA-5248, 5 June 2019) <https://www.sec.gov/rules/interp/2019/ia-5248.pdf>. For criticism of different treatments between these two categories, see Christine Lazaro, 'The Future of Financial Advice: Eliminating the False Distinction between Brokers and Investment Advisers' (2013) 87 (2-3) *St. Johns' Law Review* 381.

160 Jay Clayton, 'Statement at the Open Meeting on Commission Actions to Enhance and Clarify the Obligations Financial Professionals Owe to our Main Street Investors' (Public Statement, US SEC, 5 June 2019) <https://www.sec.gov/news/public-statement/statement-clayton-060519-iabd>.

meeting four specified component obligations: the disclosure obligation, the care obligation, the conflict of interest obligation, and the compliance obligation.[161]

Under the US approach, the care obligation compels the broker-dealer to not act negligently while disclosure and conflict of interest obligations intend to tackle conflicts of interest issues. In particular, the care duty has also adopted an objective approach that a broker-dealer exercises reasonable diligence, care, skill and prudence, and has a reasonable basis to believe that each transaction is in the customer's best interests. Such an approach might, on the one hand, provide some practical anchors for financial advisers and, on the other, moderate the concerns about a mechanical, box-ticking exercise.

The conflict aspect means that the US approach essentially regulates broker-dealers through something like a fiduciary relationship. While the US model seems to offer some promising guidance, it does not square entirely with the rationale underlying the Australian best interests duty, which interacts with, but does not amount to, a general law fiduciary duty.

3 *Ethics Code*

The newly released ethics code may be of practical assistance to financial advisers in fulfilling the best interests duty. Following the earlier *Corporations Amendment (Professional Standards of Financial Advisers) Act 2017* (Cth), the Financial Adviser Standards and Ethics Authority released its legislative instrument for the code of ethics standard, namely, the *Financial Planners and Advisers Code of Ethics* ('*Ethics Code*'), effective from January 2020.[162]

By taking a principle-based approach, among other things, the *Ethics Code* requires financial advisers to 'act with integrity and in the best interests' of clients and 'must not advise, refer or act in any other manner where you have a conflict of interest or duty'.[163] In accordance with recommendations in the *Banking Royal Commission Final Report*,[164] the Code therefore intends to eliminate conflicts of interests, instead of reducing them. However, some have argued that this is impractical, considering that conflicts are prevalent and that advisers manage such conflicts.[165] Arguably, this imposes more onerous duties than the best interests duty under s 961B(1). It is not clear that breach of the relevant standards under the *Ethics Code* can, by itself, also result in contravention of the best interests duty (and relevant obligations), though the *Ethics Code* would serve as some sort of yardstick

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161 US SEC, *Regulation Best Interest: The Broker-Dealer Standard of Conduct* (Release No 34-86031, 5 June 2019) 13–16, 129–360 <https://www.sec.gov/rules/final/2019/34-86031.pdf>.

162 *Financial Planners and Advisers Code of Ethics 2019* ('*Ethics Code*'). The Authority is a statutory body established pursuant to s 921X *Corporations Act* to 'set the education, training and ethical standards of licensed financial advisers in Australia'. See FASEA Standards Authority, 'Financial Adviser Standards and Ethics Authority' (Web Page) <https://www.fasea.gov.au/>.

163 *Ethics Code* (n 162) Standard 2.

164 *Banking Royal Commission Final Report* (n 1) vol 1, 20 [3.1] (Recommendations 1.2, 1.3).

165 Tahn Sharpe, 'Code of Ethics 'Impossible to Manage': AFA', *Professional Planner* (online, 5 June 2019) <https://www.professionalplanner.com.au/2019/06/code-of-ethics-impossible-to-manage-afa/> quoting Phil Anderson, Head of Policy and Professionalism, Association of Financial Advisers ('AFA').

for financial advisers. The manner in which the standards will be interpreted and enforced is yet to be seen.

C *Changing Enforcement Culture and New Developments*

The profit-driven culture of financial companies and the sometimes cavalier attitudes of certain financial advisers toward the best interests duty, even several years after the FOFA reforms, indicates that bad corporate culture has persisted.[166] The problems are not confined to regulatory inadequacy, but may also extend to enforcement issues. Clearly law, by itself, is not sufficient to compel advisers to act in the best interests of the client. Something more has to be done to restore the public's trust in the system of financial advice, as suggested by the results of an April 2017 poll that found two-thirds of Australian voters favoured the establishment of a Banking Royal Commission.[167]

While we have discussed the Royal Commission's recommendations to this effect in relation to the best interests duty and related obligations, we now turn to further issues regarding regulatory culture. We then discuss recent government initiatives to hold financial advisers accountable.

First, putting aside issues with the current regulatory design, the lack of optimal enforcement, which undercuts the effectiveness of the law, has been a key theme in the Royal Commission reports. Over the past decade, the improvements made to the law — from the suitability rule to the best interests duties — indicate that financial service providers are already subject to increasingly extensive regulation. As seen in the aforementioned cases and Royal Commission findings, misconduct stemming from corporate culture remains a recurring problem in the Australian financial industry. The Banking Royal Commission supports this view by underscoring the entrenched sales-driven culture, and the confusion of different roles of relevant parties, despite the reforms:

> [I]n 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.[168]

As the Banking Royal Commission suggested, although there are already mechanisms addressing conflicts of interest, 'experience shows that conflicts between duty and interest can seldom be managed; self-interest will almost always trump duty'.[169] The evidence indicated 'how those who were acting for a client too often resolved conflicts… in favour of the interests of the entity, adviser or

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[166] Gail Pearson, 'Commission Culture: A Critical Analysis of Commission Regulation in Financial Services' (2017) 36(1) *University of Queensland Law Journal* 155.

[167] Katharine Murphy, 'Most Australian Want Banking Royal Commission — Guardian Essential Poll', *The Guardian* (online, 28 November 2017) <https://www.theguardian.com/australia-news/2017/nov/27/most-australians-want-banking-royal-commission-guardian-essential-poll>.

[168] *Banking Royal Commission Final Report* (n 1) vol 1, 1–2 [1.1].

[169] Ibid vol 1, 3 [1.1].

intermediary and against the interests of the client'.[170] Such problems go hand-in-hand with the misaligned interests between financial service providers and customers. According to the Royal Commission, the industry has designed its incentive scheme to measure 'sales and profits', rather than 'compliance with the law and proper standards'.[171] Rewards are paid 'regardless of whether the person rewarded *should* have done what they did'.[172] In addition, many financial institutions are so vertically integrated that financial advisers have a tendency to recommend their in-house products.[173]

Further issues beyond regulatory design lie in the role of ASIC as a watchdog to enforce the law effectively. In the *Banking Royal Commission Final Report*, the Commissioner reaffirmed the view that 'the law has not been obeyed, and has not been enforced effectively'.[174] Although agreeing with ASIC that the role of a regulator is 'to oversee advisers' compliance with the law and not to supervise or monitor their work',[175] the Final Report identifies a 'robust approach to enforcement' as a critical element of the disciplinary system.[176] The Final Report underscored, specifically, that despite the existence of various provisions, the breach of which would attract civil penalties (including those addressed herein: ss 961B, 961G, 961H, and 961J), 'these civil penalty provisions have seldom been invoked'.[177]

As ASIC explained to the Banking Royal Commission, 'civil penalty proceedings generally … "are time-consuming and resource intensive for ASIC"'.[178] Moreover, their outcomes are 'not proximate to the time of the misconduct', while the 'deterrent effect is limited by the (currently modest) size of the available penalty'.[179] While a banning order has thus served as one of the major regulatory tools to govern financial advisers over the past few years,[180] the Commissioner noted that these too are time-consuming and thus focused only on the 'most obviously serious cases'.[181] Further, 'a regulator's choice of regulatory steps should not be treated as requiring exercise of only one form of power'.[182]

While court proceedings might be expensive, as per the Commissioner, 'chosen wisely, cases pursuing civil penalty may be prosecuted to conclusions that lead to a public denunciation of [unlawful] conduct' and such denunciation is a 'deterrent and educative tool that is important to … proper regulation'.[183] In a similar vein, the Commissioner warned of the role of enforceable undertakings as an

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170 Ibid.
171 Ibid vol 1, 2 [1.1].
172 Ibid (emphasis in original).
173 ASIC, *Financial Advice: Vertically Integrated Institutions and Conflicts of Interest* (Report 562, 24 January 2018).
174 *Banking Royal Commission Final Report* (n 1) vol 1, 12 [1.5.2].
175 Ibid vol 1, 206 [4.1.2].
176 Ibid.
177 Ibid vol 1, 207 [4.1.2].
178 Ibid, quoting Louise Macaulay (Senior Executive Leader of ASIC's Financial Advisers Team).
179 Ibid.
180 Ibid, citing Louise Macaulay.
181 Ibid vol 1, 216 [4.2.2].
182 Ibid vol 1, 208 [4.1.2].
183 Ibid.

alternative governance tool, as 'entities often only acknowledge ASIC's "concerns" when they accept EUs [enforceable undertakings], rather than acknowledge or accept their breach of specific provisions'.[184] An enforceable undertaking can thus risk being considered 'no more than the cost of doing business or the cost of placating the regulator'.[185]

The above observations, made by the Royal Commission, point to a matrix of issues about the choice of regulatory tools and their effectiveness for deterrence, which in turn raises a question about ASIC's capacity and enforcement culture in overseeing the financial service industry appropriately. The Royal Commission has set forward recommendations in this regard. Among these is a 'why not litigate' approach to enforcement strategy: ASIC should consider 'whether a court should determine the consequences of a contravention' while recognising 'the relevance and importance of general and specific deterrence' in deciding whether to use enforceable undertakings.[186] The Royal Commission also called for the creation of a new oversight body for ASIC and its sister agency, the Australian Prudential Regulation Authority ('APRA').[187]

While enforcement can always be improved, particularly in relation to big industry players, it is unwise, in our opinion, to consider the litigation approach as a complete panacea. Litigation costs must also be considered, given that external counsel/barristers are usually required and cases can take up to several years.[188] It has since been suggested that a flood of prosecutions will follow the Banking Royal Commission,[189] marking the end of conciliatory financial regulatory culture and the beginning of 'litigate first' in Australia.[190] The Australian Financial Complaints Authority ('AFCA') has also seen an increase in complaints recently, with the body itself noting that the Royal Commission has brought issues to the

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184 Ibid vol 1, 441 [3.6].

185 Ibid vol 1, 442 [3.6].

186 Ibid vol 1, 37–8 [3.6], 446 (Recommendation 6.2).

187 Ibid vol 1, 480 (Recommendation 6.14).

188 Clinton Free, Dimity Kingsford Smith and Hannah Harris, 'In Defence of ASIC: There's More to Regulation than Prosecution', *The Conversation* (online, 15 November 2018) <https://theconversation.com/in-defence-of-asic-theres-more-to-regulation-than-prosecution-106239> (arguing that '[n]egotiated settlements avoid this extremely expensive and time-consuming use of ASIC's resources'); Claire Bickers, 'The One Big Problem with the New War on Banks', *Daily Mercury* (online, 16 January 2019) <https://www.dailymercury.com.au/news/banking-royal-commission-asic-calls-in-legal-help-/3623271/> (noting potential external counsel costs $1,000 an hour or so if there was a protracted legal fight).

189 See, eg, Andrew Tillett, 'Banking Royal Commission Final Report: Government to Extend Federal Court's Jurisdiction', *Australian Financial Review* (online, 4 February 2019) <www.afr.com/business/banking-and-finance/banking-royal-commission-final-report-government-to-extend-federal-courts-jurisdiction-20190204-h1ausi>.

190 Mark Wilks, 'A US State of Mind: The End of Conciliatory Financial Regulation in Australia', *Corrs Chambers Westgarth* (Web Page, 1 May 2019) <https://corrs.com.au/insights/a-us-state-of-mind-the-end-of-conciliatory-financial-regulation-in-australia>. See also Andrew Lacey, 'ASIC Takes Strong Stance to "Litigate First" following the Financial Services Royal Commission', *Mccabe Curwood* (Article, 29 January 2019) <https://mccabecurwood.com.au/asic-takes-strong-stance-litigate-first-following-financial-services-royal-commission/>.

surface and 'made the Australian public more aware of when things weren't right with their financial firm'.[191]

Having said that, we note that limited resources can inhibit ASIC's ability to conduct contested litigation actions though there is evidence that resourcing has been increased since the Royal Commission.[192] Moreover, litigation is just one among several regulatory tools for deterrence, and there must be room for the regulator to determine the optimal strategy in each context. Ultimately, what really matters is not just how to reshape the statutory best interests duty, but how to enhance the role of ASIC to secure compliance without overly deterring profitability in the banking and financial markets. In terms of law reform, history tells us that reforming the law to introduce anything approaching a statutory fiduciary duty has been politically sensitive, raising political concerns about overregulation and broader ramifications for the financial industry and the nation's economy as a whole.[193]

To date there has been no reform proposal from the Government dealing with the best interests duty of financial advisers. There has been legislative action on a best interests requirement for mortgage brokers,[194] while at the same time, resistance to a fee-for-service proposal for such brokers.[195] This may illustrate the political difficulties of reform in this general area.

Finally, two other recent developments should be mentioned. The *Banking Executive Accountability Regime* ('*BEAR*'), in addition to providing for prudential improvements, has imposed obligations on senior banking executives, including non-executive directors, to conduct business with honesty and integrity and with due skill, care and diligence.[196] This extends to ensuring that each of its accountable

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191 Lewis Panther, 'AFCA Sees Complaints Soar after Royal Commission', *InFinance* (online) 18 February 2019 <https://finsia.com/insights/news/news-article/2019/02/18/afca-sees-complaints-soar-after-royal-commission>, quoting David Locke (AFCA Chief Ombudsman and CEO). See also AFCA, *Six Month Report* (1 November 2018 to 30 April 2019) <https://www.afca.org.au/news/statistics/six-month-report>.

192 ASIC, 'Budget Estimates, Opening Statement by ASIC Chair James Shipton' (10 April 2019) <https://asic.gov.au/about-asic/news-centre/speeches/budget-estimates-opening-statement-asic-chair-james-shipton-10-april-2019>. See also Katharine Murphy, 'Budget Will Pump $550m into Bank Regulators in Response to Royal Commission', *The Guardian* (online, 23 March 2019) <https://www.theguardian.com/australia-news/2019/mar/23/budget-will-pump-550m-into-bank-regulators-in-response-to-royal-commission>.

193 See for instance: Bevan Shields, 'Scott Morrison Warns against Rash Response to Banking Royal Commission', *The Sydney Morning Herald* (online, 31 January 2019) <www.smh.com.au/politics/federal/scott-morrison-warns-against-rash-response-to-banking-royal-commission-20190130-p50uo1.html>. See also 'Abbott Confirms Coalition Roll-back of FoFA', *Riskinfo* (online, 13 November 2012) <https://riskinfo.com.au/news/2012/11/13/abbot-confirms-coalition-rollback-of-fofa/>.

194 See *National Consumer Credit Protection Act 2009* (Cth) pt 3-5A div 2 inserted by the *Financial Sector Reform (Hayne Royal Commission Response—Protecting Consumers (2019 Measures)) Act 2020* (Cth) sch 3 pt 1 with effect from 18 February 2020.

195 The Banking Royal Commission recommended that the mortgage broker charge the borrower a fee instead of receiving commissions from lenders: *Banking Royal Commission Final Report* (n 1) vol 1, 20 [3.1] (Recommendation 3). The Government backed away from this recommendation in March 2019: Sarah Danckert, 'Government Ditches Hayne Recommendation on Mortgage Broker Pay', *The Sydney Morning Herald* (online, 12 March 2019) <https://www.smh.com.au/business/banking-and-finance/government-ditches-hayne-recommendation-on-mortgage-broker-pay-20190312-p513lp.html>.

196 The regime is set out in pt IIAA of the *Banking Act 1959* (Cth) ('*Banking Act*').

persons meets his or her accountability obligations and that each of its subsidiaries that is not an Authorised Deposit-Taking Institution ('ADI') complies as if it were an ADI.[197]

Further, reforms to the *Corporations Act* in 2012 introduced measures to raise the education, training and ethical standards of financial advisers providing personal advice to clients on more complex financial products.[198] In 2018, in the midst of the Banking Royal Commission, the Australian Banking Association, the industry self-regulatory body, also issued a new *Banking Code* that provided greater protections for all bank customers including to 'take extra care when providing banking services to customers who are experiencing vulnerability'.[199]

V Conclusion

The objective of ensuring that retail clients enjoy a high standard of financial advice from financial services providers has been a preoccupation of Australian legislators and regulators in recent times. The introduction of the best interests duty and related obligations was intended to achieve that end, while providing financial advisers with standards that are clear to assist compliance. However, our analysis of case law and Commissioner Hayne's *Banking Royal Commission Final Report* has shown that the current best interests duty and the related obligations are complex, with numerous exceptions and qualifications. Due to its complexity, the current law may, in our view, fail to expressly identify the fundamental norms of behaviour that are expected of financial advisers.

Turning our attention to the Final Report's recommendation to review and possibly abolish the safe harbour clause, we first note from the recent judgments that

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[197] Australian Prudential Regulation Authority ('APRA'), *Implementing the Banking Executive Accountability Regime* (Information Paper, 17 October 2018) 8. The *BEAR* came into effect from 1 July 2018. According to the Explanatory Memorandum, the objective of the *BEAR* is to 'improve the operating culture of ADIs and increase transparency and accountability across the banking sector': Explanatory Memorandum, Treasury Laws Amendment (Banking Executive Accountability and Related Measures) Bill 2017 (Cth) 17 [1.44]. By setting out accountability obligations in the *Banking Act*, APRA may impose penalties of up to 1 million penalty units on the ADI and may apply to the Federal Court to have a director, senior manager or auditor disqualified from being or acting in that position: Explanatory Memorandum, Treasury Laws Amendment (Banking Executive Accountability and Related Measures) Bill 2017 (Cth) 12. More recently, the Treasury proposed to extend the BEAR regime to adopt the 'Financial Accountability Regime' to apply to all other APRA-regulated entities, including all general and life insurance licensees, all private health insurance licensees, all Registrable Superannuation Entity licensees, and licensed non-operating holding companies: Treasury (Cth), *Implementing Royal Commission Recommendations 3.9, 4.12, 6.6, 6.7 and 6.8 Financial Accountability Regime* (Proposal Paper, 22 January 2020) <https://treasury.gov.au/sites/default/files/2020-01/c2020-24974.pdf>.

[198] The *Corporations Amendment (Professional Standards of Financial Advisers) Act 2017* (Cth) provides that financial advisers must have a relevant bachelor or higher degree, pass an exam, meet continuing professional development requirements each year, complete a year of work and training and comply with the Ethics Code. From 1 January 2019, only financial advisers who meet the new standards can call themselves a 'financial adviser' or 'financial planner': ASIC, 'Professional Standards for Financial Advisers' (Web Page) <https://asic.gov.au/for-finance-professionals/afs-licensees/professional-standards-for-financial-advisers/>.

[199] Australian Banking Association, 'New Banking Code' <https://www.ausbanking.org.au/campaigns/new-banking-code/>.

the open-ended nature of the catch-all provision in s 961B(2)(g) may help to moderate the concerns of the box-ticking exercise. Moreover, we caution that abolishing the safe harbour provision may create more uncertainties in interpretation. Such an outcome might be counterproductive. There is much to be said for the Royal Commission's suggestion of the need to simplify the law and in this article we have contended that the best interests duty should be mainly principle-based. In this regard, we point to the US SEC's proposed approach to setting the norms of conduct expected from broker-dealers to fulfil their obligation to act in the best interests of their retail clients when giving recommendations. Yet, while the US model seems promising in that it provides principle-based guidance to financial advisers, it is also apparent that Australia's FOFA legislation has already taken a somewhat different path. The US approach does not neatly square with our current system in that the latter might be seen as being less analogous with fiduciary principles. Another approach is to utilise the FASEA *Ethics Code* as a supplement for financial advisers to anchor their behaviour. Arguably, though, the scope of the *Ethics Code* is broader than s 961B and related provisions, with such interactions yet to be tested and clarified.

Clearly, improving public confidence in the financial industry requires regulators to pursue optimal enforcement of the law. Although there has been criticism of ASIC and of APRA by the Royal Commission and in some popular media, we advocate for a holistic review of regulatory provisions and enforcement strategies by considering the institutional capacities and resources, rather than blaming either of these regulators. We note, in particular, that the Government has already taken a multifaceted approach through measures like *BEAR* and the *Ethics Code*. Along with continuing judicial exposition and clarification of the duties, together, these efforts will hopefully help improve the quality of financial advice and regain the public's trust in our financial services industry.