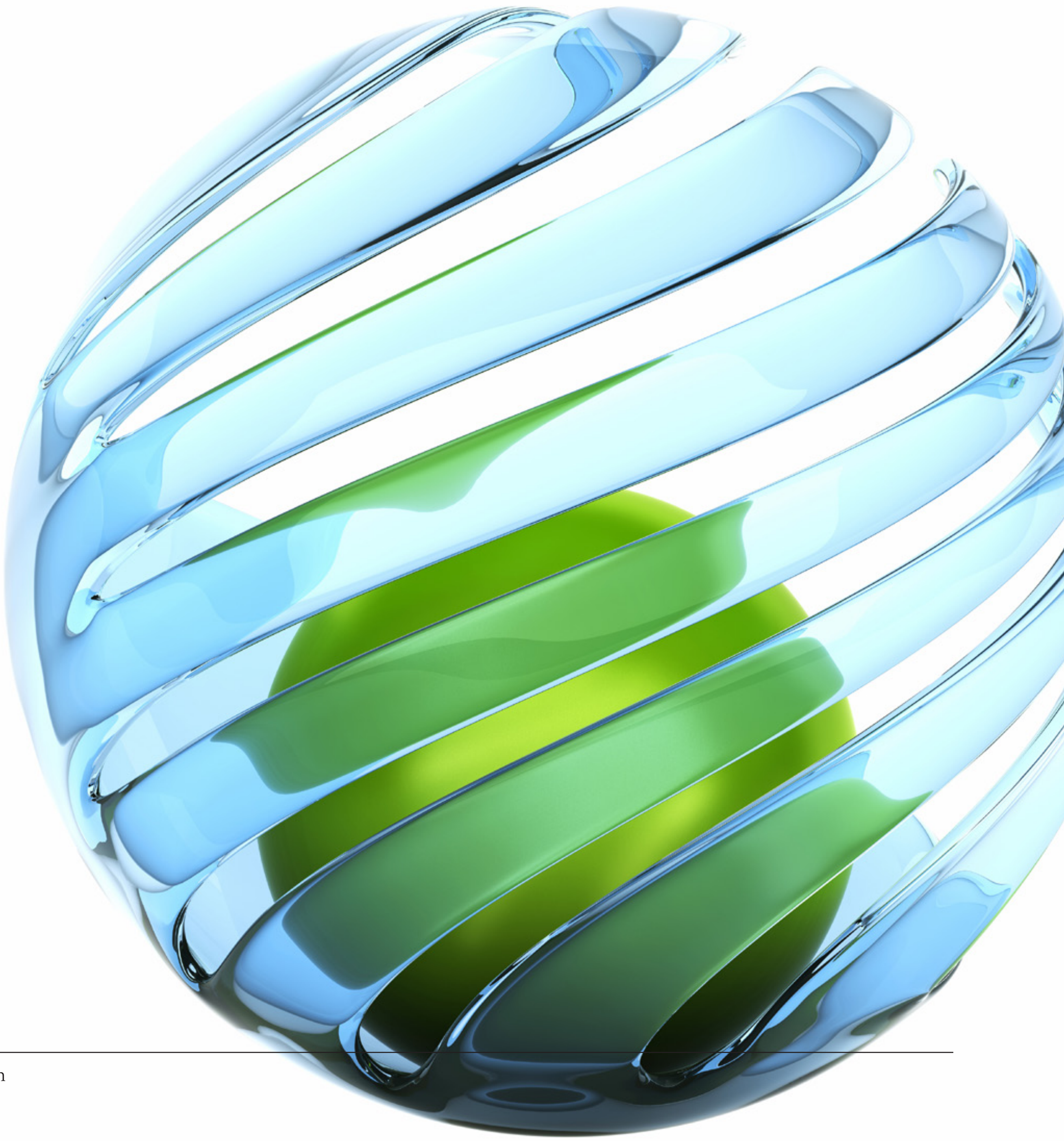
ALLEN & OVERY

Australian Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry: Key Themes in the Interim Report



Introduction

The Australian Royal Commission into Misconduct in the Banking Superannuation and Financial Services Industry published its interim report on 28 September 2018 (**Initial Report**). It provides no formal recommendations but highlights key issues identified during the Commission's 11 months of public hearings and evidence gathering.

Such issues include the prevalence of conflicts of interest in the delivery of financial advice and consumer lending; the detrimental effects of remuneration practices and policies; concerns around the culture and governance of firms, and the scope and effect of the Banking Executive Accountability Regime.

The Interim Report is particularly critical of the effectiveness of the Australian financial regulatory system and use of regulatory power. Many may well expect an increase in the regulators' rigor in their enforcement and supervisory activities in light of the report. We also expect many other financial services regulators will be reviewing the report and considering the relevance of the Commission's findings to their home jurisdiction.

A further round of public hearings will take place in November 2018 to address the questions raised in the Interim Report and responses to it. A final report from the Commission is scheduled for February 2019.

Timeline

December 2017	Royal Commission established.
January 2018	Select entities provided responses to the Commission addressing all instances of 'misconduct'.
February 2018	Initial public hearings conducted. Select entities required to provide supplementary responses to January requests.
March - September 2018	Six rounds of public hearings conducted.
September 2018	Interim report tabled 28 September 2018.
October 2018	Interim report published.
November 2018	Seventh round of hearings scheduled to address policy questions arising from first six rounds fo hearings.
February 2019	Final Report due by 1 February 2019

Conflicts of interest and duty

Financial licensees have an obligation to put in place adequate arrangements for the management of conflicts of interest that may arise. Providers of financial advice to retail clients are also subject to a duty to act in the best interests of the client in relation to the advice. The Australian Securities and Investments Commission's (**ASIC**) regulatory guide titled "Licensing: Managing conflicts of interest" sets out (i) ASIC's general approach to compliance with the statutory obligation to manage conflicts of interest and (ii) guidance for licensees generally on controlling, disclosing and avoiding conflicts of interest.

The Commission found that notwithstanding these obligations, financial services entities had put their own reward before their customers' interests and that the best interests and fair treatment of customers were undermined. In particular, the Commission highlighted the following practices:

– *"licensees or advisers charging fees to customers for financial advice that was not provided";* [1]

– *"financial advice that does not comply with the 'best interests' obligation and related obligations in Part 7.7A of the Corporations Act 2001 or advice that does not take proper account of a client's circumstances"; and*

– *"improper conduct by financial advisers, which included falsifyng documents, misappropriating customer funds and engaging in misleading or deceptive conduct."*

The Interim Report strongly criticises financial services entities for a sales-above-all-else ethos. In the Commission's words:

– *"Charging for doing what you do not do is dishonest.*

– *Giving advice that does not serve the customer's interests but profits the adviser is equally dishonest.*

– *No matter whether the motive is called 'greed', 'avarice' or 'pursuit of profit', the conduct ignores basic standards of honesty.*

– *Its prevalence and persistence require consideration of the issues of culture, regulation and structure."*

Accordingly, *"…advice that benefits the adviser 'commonly' does not advance the interests of the client and [the Commission found] in a significant number of cases does actual harm to the client"*.

In light of such findings there is extensive discussion in the Interim Report with regard to the existence of conflicts and how they should be managed: *"Although spoken of as a conflict of 'interests', the conflict may be better seen as a conflict between the financial interests of the adviser or licensee and the duty that each owes to the client."* Such conflicts *"(whether of interests or between duty and interests) should not be 'managed' in a way that aligns with the adviser's interests"*.

The theme of conflicts of interest and duty are also associated with structural considerations, in particular, vertical integration, whereby an entity manufactures and sells financial products while, at the same time, advising clients which products to use or buy. ASIC undertook a review of the quality of financial advice which resulted in the report "Financial Advice: Vertically Integrated Institutions and Conflicts of Interests, January 2018" which revealed that more than two-thirds by value of investments made by clients were made in in-house products rather than in those manufactured by third parties. The Interim Report acknowledges that result is not surprising (advisers may be expected to know more about products manufactured by their licensee) but such investments made a direct and immediate benefit to the adviser in the form of commission and bonuses.

The Interim Report goes on to note that confusion around roles and responsibilities is an integral issue when considering and managing conflicts.

1 – The Commission noted that financial services entities had charged fees for personal financial advice that had not been provided. In particular, clients had made an 'ongoing service agreement' for the provision of personal advice and had been allocated advisers but that the advisers had not provided the ongoing service while fees had been deducted automatically. "What exactly was, or is, to be provided in an 'annual review'? What is meant when it is said that the client may 'have access' to the adviser? Was (or is) the only promise made to 'offer' an annual review?"

The apparent confusion of the role played by intermediaries is discussed in the context of consumer lending. The Interim Report poses the (rhetorical) question *"For whom does the intermediary act?"*. While intermediaries undeniably have the responsibility to help fulfil an entity's responsible lending obligations (both contractually stipulated and non-delegable statutory obligations), entities have given *"conflicting messages about whether intermediaries represent entities, themselves, or the customer"*. The Commission observed that both entities and customers appear to be confused about the roles of intermediaries. Without clarity in the intermediaries' role, issues arise about *"how entities can communicate with customers to create realistic expectations of products"*, one of the most fundamental questions when obligations are required to be fulfilled or suspected misconduct has to be resolved.

Customer disclosure

The licensing regime for holders of Australian financial services licences imposes statutory requirements as to disclosures, in particular with respect to fees. Before financial advice is rendered, a client must be provided with a Financial Services Guide, containing prescribed information, including the remuneration the adviser will receive from any ensuing transactions, and information about for whom the financial services licensee acts when providing the relevant services. The Commission reported that multiple licensed entities had acknowledged breaches with respect to their disclosure obligations but the Interim Report stopped short from identifying major issues with respect to the disclosure requirements.

Suitability

Suitability has been a major thematic development in regulatory frameworks across jurisdictions and the suitability of products sold will continue to be a major focus of regulators concerned with consumer protection.

The Interim Report is no exception. It stresses the concept of suitability (in the context of lending) and highlights the need for a holistic assessment. The Commission recognises that *"a contract will be unsuitable for the consumer if, at the time of the assessment, it is likely that the consumer will be unable to comply with the consumer's financial obligations under the contract, or could only comply with substantial hardship."* However, *"credit licensees too often have focused, and too often continue to focus, only on 'serviceability' (which is to say credit risk) rather than making the inquiries and verification required by law."* Further, *"lending was treated as not unsuitable if the customer was unlikely to default. But that is not what the responsible lending provisions required. Contrary to those provisions, the banks made no inquiry about the customer's circumstances, requirements or objectives."*

Remuneration structures

In the Commission's view, conflicts of interest come hand in hand with remuneration structures which in turn influences conduct and culture (see below). Conflict is exacerbated by value-based remunerations (e.g. sales incentives and commissions): *"value- and volume-based remuneration …has been an important contributor to misconduct and conduct falling short of community standards and expectations and poor customer outcomes"*.

The legitimacy of sales incentives are challenged by the Commission when examining the conflicted remuneration of financial advisers. This leads the Commission to question the justification for existing grandfathering of conflicted remuneration under relevant legislation. *"If the premise for the conflicted remuneration provisions is accepted (and no one suggested that it should not be) how can the grandfathering provisions be justified today?" "[A]ny exception to the ban on conflicted remuneration, by definition, has the ability to create misaligned incentives, which can lead to inappropriate advice"*.

In short "… *misaligned incentives can lead to inappropriate advice"*.

Conduct, culture and governance

The Interim Report emphasises the overwhelming influence of remuneration practices on conduct and culture. It attributes the remuneration practices and policies of banks as a key driver of the culture and conduct of the financial services entities. *"Almost every piece of conduct identified and criticised in this report can be connected directly to the relevant actor gaining some monetary benefit from engaging in the conduct."* It characterises the culture of financial services entities as one in which employees *"learned to treat sales, or revenue and profit, as the measure of their success"*. The culture and conduct of the entities further entrenched misconduct and did not provide grounds for proper risk management practices to take root.

The force which sculpted current remuneration practices and policies was management by measurement. Remuneration is treated as the universal tool to manage each member of an organisation. When an employee's value to the organisation is directly tied to his remuneration (which the Commission identified as short-term incentive payments in most cases), *"how the goal is pursued is treated as a matter of lesser importance."*

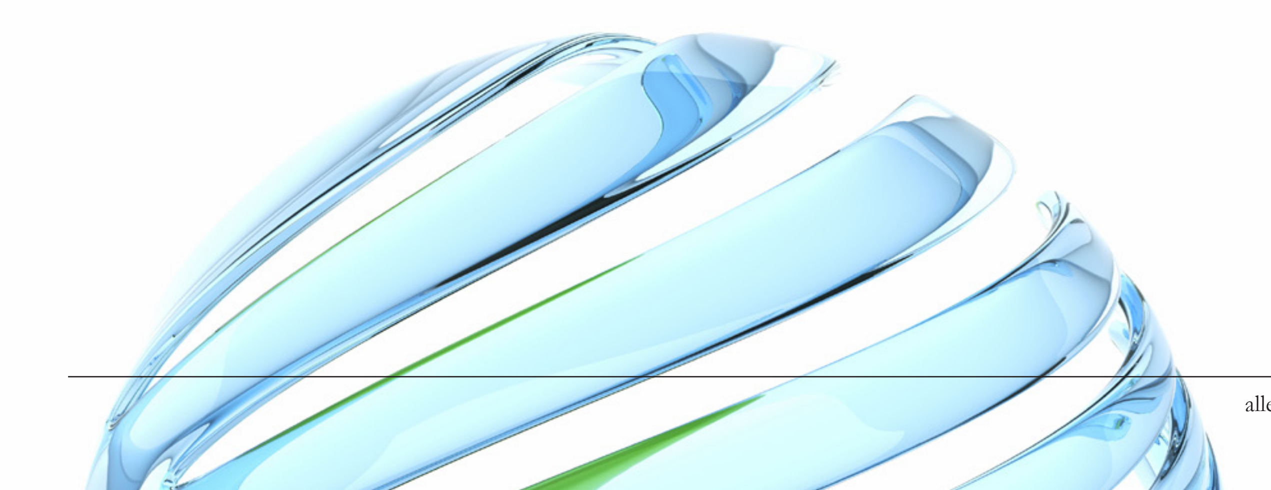
On the subject of governance, the Interim Report notes that *"every piece of conduct that has been contrary to law is a case where the existing governance structures and practices of the entity and its risk management practices have not prevented that unlawful conduct"*.

The Commission observed that licensed entities had dealt with regulatory compliance piecemeal rather than comprehensively. Licensed entities too saw particular events as isolated departures from an assumed norm caused only by individuals, while deeper causes and connections remained unconsidered and unidentified. Approaching compliance piecemeal does not permit the identification of underlying causes.

In the case of fees for services that were not provided, the Interim Report notes that financial services entities had neither the systems nor the processes to know whether their authorised representatives were delivering what had been promised. The failure to provide services could not be detected and the answers as to how and why the events occurred did not come to light sooner.

The Commission observed that licensees almost never reported their concerns about advisers to industry associations or self-regulatory bodies. Industry bodies similarly did not share disciplinary information. As a result, members of the public are generally unaware of the existence of the industry associations or self-regulatory bodies, taking their complaints to a dispute resolution body rather than reporting to the industry bodies. Consequently, industry bodies have little basis on which to play any effective disciplinary role.

In discussing how to change this culture, the Commission is clearly of the view that legislation is not sufficient. *"Good culture and proper governance cannot be implemented by passing a law. Culture and governance are affected by rules, systems and practices but in the end they depend upon people applying the right standards and doing their jobs properly."* The aim is the prevention of improper conduct, which begins with education and training. Preventing improper conduct and promoting desirable conduct are central tasks of management at every level in an entity and raises for consideration the appropriateness of internal structures: *"Criticisms of conduct direct attention to questions about structure of financial services entities."*



The BEAR

The Banking Executive Accountability Regime (**BEAR**) came into force on 1 July 2018 and is aimed at enhancing accountability in the banking industry. It requires Authorised Deposit-Taking Institutions (**ADIs**) to identify 'accountable persons', ie those in director and senior executive roles, who must comply with certain obligations including a registration requirement. Under the regime, ADIs must also have accountability statements for each 'accountable person', must draft and maintain an accountability map detailing the governance arrangements of the ADI's group and (importantly in light of the Commission's focus on remuneration), defer a minimum percentage of a senior executive's variable remuneration where a senior executive has not met his or her obligations under the BEAR.

The Interim Report considered the efficacy of the BEAR in the context of how 'enhanced accountability' will affect the culture of banks, particularly in relation to remuneration beyond that of senior executives. It also asks if the BEAR should be changed and/or whether its application should be extended.

Regulation and the Regulators

The Interim Report examines in some detail financial regulators' ability to adequately identify and address misconduct. The report identifies numerous examples of *"systematic cover up by management and inadequate offers of compensation to complaining customers"* and other misconduct which in the Commission's view the regulators failed to address appropriately. Regulatory complexity is seen as an increasing pressure on the regulators' resources and may have allowed entities to develop cultures and practices that are unfavourable to compliance.

ASIC

The Interim Report criticises ASIC's response to misconduct, describing ASIC as having a *"deeply entrenched culture of negotiating outcomes rather than insisting upon public denunciation of and punishment for wrongdoing"*.

It notes that ASIC rarely invoked the full extent of its powers, civil penalty proceedings were seldom brought and ASIC preferred to bring criminal prosecutions against individuals rather than against licensed entities.[2] *"When deciding what to do in response to misconduct, ASIC's starting point appears to have been: How can this be resolved by agreement?"* The Commission also noted that *"when the misconduct was revealed, little happened beyond an apology from the entity"*; hence *"the entity either went unpunished or the consequences did not meet the seriousness of what had been done"*.

The Interim Report also questions the effectiveness of enforceable undertakings and infringement notices as a primary regulatory response to misconduct and cites examples where, in the Commission's view, ASIC required disproportionately low penalties as compared to the severity of the breach.

ASIC's Enforcement Review Taskforce (established in October 2016) made recommendations to expand ASIC's powers. However, the final adoption has been said to be dependent upon the Commission's recommendations in the final report. As to this, the Interim Report notes *"…that the effect of making those changes depends entirely upon the way in which the provisions are implemented. In particular, increased penalties for misconduct will have only limited deterrent (or punitive) effect unless there is greater willingness to seek their application."*

2 – In the Commission's view, there may be lively debate between ASIC and an entity about the breadth and operation of applicable provisions but if there is, it may be all the more important to commence litigation than attempt to settle it. If there is doubt about the reach of particular provisions, it will often be better that the doubt is resolved once for all than allowed to linger, while a court judgment provides public denunciation of the conduct as wrong and meriting punishment.

Against this background, the Interim Report poses six key questions with respect to the future of ASIC's operation, including: whether the size of ASIC's remit is too big; whether the regulatory regime is too complex; whether ASIC's enforcement practices are satisfactory (or should be changed) and whether ASIC's enforcement priorities should change.

APRA

The perspective of the Australian Prudential Regulation Authority (**APRA**) as regards issues of governance and risk culture is that of financial stability. The Interim Report notes that as a result APRA's lack of action in response to misconduct is more understandable. Nevertheless, the Interim Report questions whether APRA's regulatory and enforcement practices are satisfactory or should be changed, whether its prudential standards on governance need reconsidering and whether steps already taken by APRA in its inquiry into the governance, culture and accountability of one of Australia's largest financial services entities should be deployed in other such entities.

Lack of information sharing among stakeholders

The Interim Report highlights the lack of information sharing between regulators, disciplinary bodies, and market participants. Licensees either failed to report, or reported late, their concerns about an adviser's conduct. This impeded ASIC's ability to enforce disciplinary sanctions on those that breached the law.

Conclusion – for now

The Interim Report stopped short of providing any initial recommendations; however it hinted that the root cause of the problems identified lies with the structure of the financial system and past regulatory approach to misconduct.

That said, adding *"an extra layer of legal complexity to an already complex regulatory regime"* is, the Commission suggests, not the answer. The current Australian regulatory regime is *"labyrinthine and overly detailed"*. Rather than adding new layers of laws or regulations, the Commission suggests that a more principles, rather than rules, based regulatory regime may be preferable in order to simplify the regime.

We expect that the final report will make both specific findings in relation to the misconduct of entities that have appeared before the Commission, as well as recommendations as to how the regulators should be monitoring and addressing misconduct across the industry moving forward. Remuneration practices and policies, an emphasis on transparency, honesty, and fair treatment of consumers and conflicts of interest will be a key focus of the final report and the regulatory regime.

As the Interim Report clearly notes *"conflicts cannot be 'managed' by saying 'Be good. Do the right thing"*.

With such sharpened criticism of the current regulatory regime and practice in Australia, an increase in the regulators' rigor in their enforcement and supervisory activities is expected. We also expect many other financial services regulators will be reviewing the report and considering the relevance of the Commission's findings to their own home jurisdictions.

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