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LOOKING AHEAD TO POSSIBLE REFORMS

Identifying themes or trends arising from the second round of the Royal Commission

Vince Battaglia

Possible law reforms are on the agenda following the conclusion of the second round of hearings of the Financial Services Royal Commission. We identify the trends arising from the Royal Commission and look at them in the context of other current law reform proposals in the financial services industry.

Key points

- The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry ('Royal Commission') recently concluded Round 2 hearings into the financial advice industry.
- We have identified themes or trends arising from these hearings that indicate areas that may come under parliamentary and regulatory scrutiny, as well as being subject to formal recommendations from the Royal Commissioner.
- We expect that, as a result of the Royal Commission, there will be law reform to deal with actual or perceived deficiencies with respect to the operation of the legislative framework set out in Parts 7.6 and 7.7A, and related provisions, of the Corporations Act 2001 (Cth) ('Corporations Act').
- Such possible reforms are also to be considered in the context of the reforms recommended by the ASIC Enforcement Review, to which the Government has agreed or agreed in principle, as well as the proposed ASIC product intervention power and the product design and distribution obligations.

Background

The second round of public hearings considered the conduct of financial services entities that provide financial advice to consumers, including the treatment of consumers, compliance with the law and community standards and expectations, and the sufficiency of the current legal and regulatory structure.

Some of the major themes that arose during the second round of hearings were considered in our earlier article. In this update, we examine some specific areas of Parts 7.6 and 7.7A of the Corporations Act, dealing respectively with the financial services licensing regime and the conflicted remuneration provisions, to identify themes that indicate areas that may come under parliamentary and regulatory

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scrutiny, as well as being subject to formal recommendations from the Royal Commissioner.

These observations are based on the tenor of the hearings, as well as from written submissions by ASIC and Treasury to the Royal Commission at the end of the Round 2 hearings.

Themes arising from the second round

As at the date of this update, we consider that the following general themes arise.

'Gaming' of grandfathered provisions

A lot of attention has focused on the ability of financial advice firms to continue to receive what would otherwise be conflicted remuneration on the basis of 'grandfathered' (or pre-existing) remuneration arrangements.

A strong theme is whether financial services firms have 'gamed' these grandfathering provisions by relying on broad interpretations of what constitutes an 'arrangement' that was in existence before the introduction of the 'Future of Financial Advice' (or 'FOFA') regime, and whether such firms have taken the view that changed remuneration arrangements still continue to enjoy the grandfathering benefits.

Therefore, one key issue is whether the grandfathering exemption from the FOFA regime should be abolished, with or without a transition period.

In its written submissions to the Royal Commission, ASIC believes that the grandfathering of commissions should cease as soon as reasonably practicable and to the maximum possible extent, although it accepts that consideration may need to be given to a short transition period to allow licensees and advisers to adjust their businesses. Further, in ASIC's view, grandfathered platform fees or rebates paid by fund managers should be passed onto clients as such fees or rebates are effectively paid by such clients in price mark-ups by the fund manager.

Regulating the basis for permissible remuneration

At the heart of the conflicted remuneration provisions under the FOFA regime is the removal of, or setting controls around, remuneration structures that incentivise the remuneration of an adviser in preference to the provision of quality advice by that adviser.

Round 2 hearings have raised questions about whether:

a. all adviser fees should be charged on a fee-for-service basis (regardless of whether a client has consented to the payment of commissions);
b. all adviser fees should be capped to avoid excessive fees being charged (again, regardless of whether a client has consented to the payment of commissions); and
c. whether all adviser fees determined on a percentage of funds under management should be replaced with a flat fee or a fee that reflects the cost of the provision of such services.

In relation to conflicted remuneration being payable on account of a client's consent, ASIC stated it is concerned that clients are paying for ongoing advice but may not receive benefits from that advice commensurate with its cost to them, and in any event clients should be separately invoiced for advice in the interests of transparency and ensuring that the client's consent is fully informed.

Managing conflicts of interest

Another key theme is whether the current conflicts management provisions under the current regulatory regime are achieving their desired ends, or are otherwise effective, so that clients' interests are preferred where they are in conflict with the interests of advisers.

The Royal Commission has heard evidence to the effect that, despite arrangements satisfying or being permitted under legal requirements, such arrangements may give rise to conflicts of interest and in such circumstances platform operators may have given preference to their own interests (e.g. by continuing to receive grandfathered fees because it results in increased funds under management) at the expense of the interests of underlying investors (for example, because the products on the platform were not suitable for the investors or had above-market fees or other uncompetitive features).

Conflicts arising from vertical integration

The Royal Commission has also explored whether there are inherent conflicts of interest in the structures of financial services firms, and indeed across the whole financial services industry.

In particular, the issue is whether there are inherent conflicts of interest in product manufacturers having ownership (or other control of) product distributors (i.e. dealer groups and platforms), and whether platform operators should own dealer groups that advise clients to invest on such platforms, such that this 'vertical integration' is inherently not in the best interests of clients.

Perhaps surprisingly, ASIC is not currently favouring a disintegration of vertically aligned groups as it considers that conflicts can be adequately managed. Rather, ASIC has submitted that, where a vertically integrated firm both provides financial product advice and manufactures financial products, this business model can provide benefits to consumers such as consumer convenience in dealing with a single institution across a range of financial matters, or having a large institution 'standing behind' the adviser if remediation is required for poor advice.

Treasury in its written submissions to the Royal Commission also stopped short of recommending that there be disintegration of vertically aligned structures; rather, it only raised a number of factors for the Royal Commission and regulators to consider.

Shared responsibility by all persons involved

Of interest to all firms in the financial services industry – both those receiving remuneration and those paying it – is whether there is a shared responsibility for (and therefore a shared liability for) compliance with the FOFA regime.

In particular, an important issue is whether the current legal regime obliges fee payers (i.e. product manufacturers) to monitor the conduct of fee recipients to ensure that fee recipients perform their obligations under law (for example, the giving of fee disclosure statements by advisers and advisers ceasing to receive payments where clients have not opted-into the on-going fee arrangement). Further, if such obligations arise, whether they arise only where in respect of vertically integrated dealer groups where, it is argued, there can be a greater and more meaningful level of control of all persons involved in the advice-giving chain.

In its written submissions, ASIC states that it is to be expected that all persons involved in processes that have the advice fees deducted from their investments should take all reasonable steps available to them to ensure that the client has properly authorised that deduction. Further, ASIC submits that platform operators should be expected to have controls in place to ensure that fee recipients are legally entitled to the funds removed from client funds.

Re-thinking financial product advice

Another issue arising under the Royal Commission is whether the current or traditional 'professional adviser' model of financial planning and advice works from a client's perspective, particularly in the light of the increasing complexity of financial products and the widespread failure of advisers to meet expected standards.

ASIC, in its written submissions, considers that it is not enough to have further regulation of the 'personal professional adviser' model; rather, consideration should be given to other mechanisms that will promote and secure the financial well-being of Australian consumers who are not able to access personal professional advice through that model, such as by:

a. facilitating the provision of basic, more commoditised, personal or general advice offerings to a large proportion of the population;
b. simplifying financial products or mandating some basic, simple financial products that are suitable for Australian consumers (on the basis that consumers are less likely to require access to financial advice where safer and less complex products are readily available);
c. restricting access to more complex, riskier products (which are more likely to require access to financial advice);
d. allowing for basic advice services to be provided at low cost, subsidised by industry or Government; and
e. in the longer term, seeking to minimise the impact that changes to superannuation, tax and social welfare regulation have on the complexity of financial decision-making faced by consumers with limited access to professional, personalised financial advice.

In its written submissions, Treasury was less specific than ASIC on the above points.

Both ASIC and Treasury see the merits of, but caution against, the proposal raised by Counsel Assisting the Royal Commission about a dual-licensing regime where both the entity and the individual adviser would require an AFS licence.

Conflicts with directors' duties

An interesting, and far-reaching, theme is whether the current laws are conflicted such that it makes it difficult, if not impossible, for directors of financial services firms to comply with both their directors' duties to shareholders and their (actual or expected) obligations to clients.

That is, financial services firms have expressed a conflict regarding the stakeholders that its directors must take into account in their deliberations regarding the management of such companies. In particular, the Royal Commission has highlighted that the needs of shareholders may have been preferred to those of the company's customers; however, directors and senior managers of such companies have given evidence to the effect that the corporations laws require directors to consider only the interests of shareholders and that they are not legally permitted under the law of directors' duties to a company to consider the interests of clients.

This is an area requiring further consideration of directors' duties generally and whether the current FOFA regime (and any reforms to it) should expressly permit directors to take into account (and perhaps prefer) the interests of the customers of companies of which they are a director to the interests of the shareholders.

Corporate culture

A common theme that has arisen centres on the 'corporate culture' of financial services firms, and whether a failure in culture is at the root of legal and regulatory failure. An interesting sub-issue cutting across this theme and other governance themes is the extent to which directors and senior managers should meet 'community expectations' (whatever that may mean), and whether the standard of behaviour should be judged according to such (changing) standards.

In particular, there has been evidence to the effect that some financial services firms have not complied with legal and regulatory requirements on account of a failure of good governance across the firms, in that there has been a failure to have a good governance 'culture'.

The 'corporate culture' of financial services firms is a theme of particular ongoing interest to ASIC. Treasury for its part states in its written submissions that 'the hearings so far have made clear that poor institutional culture and misaligned incentives are a key cause of the misconduct issues identified and of failures to meet community standards'.

Treasury also suggests that one option to improve the clarity of responsibilities and internal governance and controls is to extend features of the Banking Executive Accountability Regime (or 'BEAR') beyond the prudentially regulated sector to all financial services businesses, but also notes that the BEAR was not designed for such businesses and the ASIC Enforcement Review Taskforce did not consider that such a regime was merited.

Outsourcing reviews to independent reviewers

Allied to good governance is the manner by which a financial services firm seeks an independent review of its current practices. While few would challenge the notion of a regulated entity seeking a review of its current practices to determine whether it complies with its regulatory and legal obligations, the issue that arose during the hearings is the purported passing off of the 'independence' of such a review.

The message from the Round 2 hearings appears to be that, where a financial services firm seeks an independent report on its adviser remuneration arrangements, such a report should be truly independent of the commissioning financial services firm meaning that, for example:

- a law firm may be constrained from meeting the requisite level of independence because of the legal and ethical requirements for legal practitioners to act on the instructions of their clients; and
- the commissioned reviewer should not be given instructions as to what should be their findings in their report.

Compensation scheme

In its written submissions to the Royal Commission, in ASIC's view, given that some level of non-compliant advice leading to client loss is inevitable, consumer protection would be enhanced by the creation of a last resort compensation scheme.

Breach reporting

Another persistent theme arising from the second round of hearings is whether financial services licensees are complying with their obligations to report significant breaches of relevant financial services laws to ASIC.

In particular, ASIC and others consider that licensees are taking too long to report significant breaches of relevant financial services laws under section 912D of the Corporations Act, and that many licensees are failing to comply with the time period of 10 business days to report breaches to ASIC.

In this regard, we note that the ASIC Enforcement Review Taskforce recommended (before any of the hearings of the Royal Commission) a number of significant reforms to the breach reporting regime, including recommending that significant breaches (and suspected breach investigations that are ongoing) must be reported within 30 days, criminal penalties should be increased for failure to report as and when required, and a civil penalty should be introduced in addition to the criminal offence for failure to report as and when required. In its response to Taskforce's report, the Government agreed in principle with these recommendations and deferred the implementation of these recommendations to take into account the findings of the Royal Commission.

Other concurrent reforms

Reforms contemplated or suggested by or as a result of the Royal Commission are also to be considered in the context of the reforms recommended by the ASIC Enforcement Review, to which the Government has agreed or agreed in principle. Apart from breach reporting (described above), there are a number of recommendations regarding the strengthening of ASIC's licensing powers, giving ASIC the power to ban individuals in the financial services sector and expanding the range of penalty provisions, and increasing maximum civil penalty amounts in the Corporations Act and National Consumer Credit Protection Act 2009 (Cth).

Further, the recommendations of the Financial System Inquiry (FSI) of 2015 are also to be kept in mind. In particular, the Government accepted the FSI's recommendations to introduce:

a. design and distribution obligations for financial products to ensure that products are targeted at the right people (FSI recommendation 21); and
b. a temporary product intervention power for ASIC when there is a risk of significant consumer detriment (FSI recommendation 22).

Earlier this year, Treasury consulted on an exposure draft of the Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2017, which sought to implement these measures. Interestingly, Treasury in its written submissions to the Royal Commission states that the proposed ASIC product intervention power would empower ASIC to ban aspects of remuneration practices where there is a direct link between remuneration and distribution of the product. **FS**