



**SUBMISSION IN RESPONSE TO THE
INTERIM REPORT OF THE ROYAL
COMMISSION INTO MISCONDUCT IN
THE BANKING, SUPERANNUATION
AND FINANCIAL SERVICES INDUSTRY**

Centre for Law Markets and Regulation

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THE CENTRE FOR LAW MARKETS AND REGULATION

The Centre for Law, Markets and Regulation (CLMR) is a research centre created by a partnership between UNSW Law and the UNSW Business School. It is Australia's premier research centre for the study of the dynamics of market regulation. The CLMR conducts research on the legal, regulatory and contextual aspects of markets, corporations, finance and business transactions. CLMR members produce high quality research to deepen understanding, influence opinion and support action with real-world impact. The CLMR's work is distinctive in the range of market institutions it studies, and its focus on understanding the nature and effects of regulation. The work is also distinctive because while in a commercial context, the CLMR's research often has social justice aspects.

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INTRODUCTION

The researchers from the Centre for Law Markets and Regulation are pleased to present this submission for the policy phase of the Banking Royal Commission's work.

Some parts of this submission respond to specific questions raised by the Commissioner. The sections on conflicted remuneration and future regulatory structure, do this. Other parts either respond to background questions (such as ethics and professionalism in financial services) or to questions raised by counsel assisting in final submissions (for example the question of what is 'fair' in financial services provision). One responds to what we see as the 'elephant in the court-room': the capability and vulnerability of financial consumers, which has been well in evidence during the Commission's hearings.

Our submission is made with the intent of sharing both our own research and that of other academics. Much regulation is conducted, and opinion about regulation arrived at, by 'arm-chair speculation' and conjecture. We have included empirical research, comparative research and have supported our responses to the Interim Report with careful reasoning.

Above all, our submissions enjoy the privilege of independence that a University research centre gives us, to say what we really think, based on the research evidence we have collected. In particular, we have included what might be considered a counter-case to the views expressed in the Interim Report about enforcement. We have conducted and include by reference and a hyper-link, the report of a small pilot study into the deterrent effects of enforceable undertakings. That report collects the perceptions of financial services and credit providers that enforceable undertakings do have deterrent effects and observes the mechanisms by which that deterrence is delivered. We believe it to be the first study of its kind.

It is not easy to get funding for regulatory research, especially of the type which asks questions of powerful institutions the answers to which may unsettle comfortable ways of doing things. This is so for example, with executive remuneration. We would like to take this chance to suggest to the Commissioner that one of his recommendations is the establishment of a Foundation for Banking and Financial Services Research.

In the Netherlands there is such a Foundation, funding research into improving audit practice – a primary support of the disclosure ubiquitous in financial markets. The Foundation for Auditing Research (FAR), was established in Amsterdam on 20 October 2015. It aims to inform the auditing profession in its continuous development and the improvement of audit quality: <http://foundationforauditingresearch.org/governance-and-organization/> Although privately funded by audit firms, the creation and funding of the Foundation was encouraged by the Netherlands Government to address community demands and expectations. We think the moment is right in Australia for such an initiative in the banking and financial services sector.

We look forward to the Commissioner's Final Report.

FINANCIAL CONSUMERS, FAIRNESS AND COMMUNITY STANDARDS

Dimity Kingsford Smith

INTRODUCTION

Unlike most of our submission this part is not elicited by questions raised by the Commissioner directly in Chapter 10 of the Interim Report. Instead it addresses questions raised with various levels of directness throughout the Report and by counsel assisting in closing addresses in the Commission's proceedings. Although the terms of reference of the Commissioner do not expressly limit his inquiry to 'consumers of financial services' this term is used. Conduct of hearings has placed financial consumers at the centre of the Commissioner's inquiries. This submission responds to these settings by providing a short account of recent academic research on two issues, relevant to the ways financial consumers participate in financial markets.

The first issue is the capability of financial consumers. Until recently the Wallis Committee's reliance on disclosure for the confident decision-making and protection of financial consumers was paramount. The disclosure approach was and remains central to ASIC's remit and powers in enabling and vindicating the rights of financial consumers. However, over the last 30 years consumer behavioural research has shown that financial regulation has placed too much weight on disclosure as a regulatory tool in retail or consumer markets. There are now two main bodies of research supporting this view: research into the decision-making capability of consumers from behavioural psychology and research into the financial literacy of consumers in retail financial markets.

Discussing remuneration and a Treasury submission which asked 'whether better disclosure of remuneration arrangements would make a difference'¹ the Commissioner concluded that further disclosure is unlikely to better the position of consumers.² This conclusion is well supported by research, and is part of the reason for a world-wide turn to relying more on other approaches in the regulation of retail financial markets and less on disclosure. Disclosure is however, likely to remain a core technique in financial market regulation. Accordingly, this part of our submission sets out briefly what is known about financial consumer capability and behaviour and its central regulatory implications.

¹ Commonwealth, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report* (2018) vol 1, 318 [6.2] ('*Interim Report*').

² *Ibid* 290.

The second issue has been expressly referred to regularly at the Commission and has prompted many questions by counsel assisting. It is the issue of fairness and how it might best be made to operate in financial regulation and consumer dealings. The Commissioner suggests that rather than adding new laws, that simple core principles might be introduced one of which is 'be fair'.³ Behind the suggestion like many good ideas, lurk many questions. What, in the unfamiliar terrain of financial markets, does 'fairness' mean? How should 'fairness' which is usually thought of as a relational concept between individuals, be delivered at scale in mass financial consumer markets? What do we know about the meaning of 'fairness' where it already appears in Australian financial legislation?⁴ We suggest that getting the idea of 'fairness' right, will help with vindicating community standards and restoring trust.⁵

FINANCIAL CONSUMER CAPABILITY AND BEHAVIOUR

Financial Literacy: 'Financial literacy is generally the ability to understand how money works, how a person can earn money or make it more. It specifically refers to the set of skills and knowledge that allows people to make informed and effective decisions with all of their financial resources.'⁶ The most consistent findings are of low capability in all countries researched, and how consistent the variations are across age groups, gender, education levels and prior experience.⁷

Two-thirds of adults worldwide are financially illiterate.⁸ There is significant variation between the most financially literate countries (71% literacy) and the least literate (13% literacy).⁹ But even across the developed world, on average, only 55% of adults are financially literate.¹⁰ In this study 160,000 adults in 140 economies were asked four questions of universal application to debt and investing activity covering risk diversification, inflation, numeracy (interest) and compound interest. If they gave 3 correct answers they were considered literate.¹¹ Regardless of country lower literacy is associated with being female, poor, less educated and aged.¹² Most observers accept that it is more difficult for financial consumers to make decisions about investments,¹³ and that their capacity with credit contracts is likely to be greater. However, even in the most literate countries there are still large segments of the population where capacity with credit is low, often associated with other sources of vulnerability and comes at a tangible cost as shown by the following discussion.

Lusardi and Tufano¹⁴ studied 'debt literacy' in populations in the US. They identified low debt literacy with paying 'a sizeable share of credit card charges and fees' and concluded that 'Perhaps as much as one-third of the charges and fees paid by the less knowledgeable are related to a lack of financial knowledge versus other observable demographic factors.'¹⁵ They also found a connection between debt illiteracy and 'over-indebtedness'.¹⁶ In the US particular segments of the population, the elderly, the very young, minority groups and the separated and divorced are particularly vulnerable in dealing with debt, because of debt

³ Ibid 290 [3.1].

⁴ *Corporations Act 2001* (Cth) s 912A.

⁵ Dimity Kingsford Smith, 'The Fairness Rationale for Customer Advocacy in the Financial Sector' 2017 35 *Companies and Securities Law Journal* 444-463.

⁶ Gail Pearson, Philip N Stoop and Michelle Kelly-Louw, 'Balancing Responsibilities – Financial Literacy' (2017) 20 *Potschefstroom Electronic Law Journal* 1.

⁷ Commonwealth, above n 1.

⁸ Leora Klapper, Anna Maria Lusardi and Peter van Oedheusden, 'Financial Literacy Around the World: Insights from the Standard & Poor's Global Financial Literacy Survey' (Global Financial Literacy Excellence Centre, 2016) <http://gflec.org/wp-content/uploads/2015/11/3313-Finlit_Report_FINAL-5.11.16.pdf?x87657> 7.

⁹ Ibid 6.

¹⁰ Ibid 8.

¹¹ Ibid 7.

¹² Ibid 10–14.

¹³ Only 35% of adults worldwide could accurately answer a question about asset diversification: Ibid 10

¹⁴ Annamaria Lusardi and Peter Tufano 'Debt Literacy, Financial Experience and Over-indebtedness' (2015) 14 *Pension Economics and Finance* 332.

¹⁵ Ibid 334, 358–9.

¹⁶ Ibid.

illiteracy.¹⁷ Low debt literacy is ‘also associated with finding financial services ‘complicated or confusing’’.¹⁸ Gathergood et al find similar results in the UK.¹⁹ Along with financial literacy capability at maths is emerging in the research as an important determinant of mortgage defaults²⁰ and paying above average costs and charges on borrowings.²¹

In related research Bateman and co-researchers²² used three of the four questions employed in the world-wide literacy survey discussed above,²³ to study the financial literacy of a group reflecting the general Australian adult population. They too find that respondents do least well on the risk diversification question, though Australian respondents were overall in line with the highest levels of financial literacy worldwide on questions of interest and inflation.²⁴ Following other studies they show that ‘financial illiteracy is more prevalent among certain demographic groups. These groups are younger individuals, women, those with less education and those who are not employed or not in the labour force.’²⁵ In the worst cases financial providers have used the asymmetry between their own and consumers’ position to ‘design and sell products that benefit from consumers not overcoming mistakes, or at times, exacerbating mistakes.’²⁶ Instances of this have been evidenced in Commission hearings.

Behavioural short-cuts and biases leading to poor financial decisions: As with financial literacy the research findings of behavioural influences on financial decision-making are well established. Regulators have accepted them as an explanation for much sub-optimal financial consumer decision-making.²⁷

In financial decision-making, heuristics or short-cuts are routinely employed, because financial decisions often involve a cluster of factors to understand and weigh. Customers are limited by over-load or absence of information, their own understanding and analytic abilities and time.²⁸ These short-cuts ‘...sometimes yield reasonable judgments and sometimes lead to severe and systematic errors.’²⁹ Researchers have identified many, many heuristics,³⁰ but the three most influential are those of Tversky and Kahneman³¹ first exposed in 1974. Similarly, behavioural biases may influence individuals to make irrational choices that

¹⁷ Ibid 339–40.

¹⁸ Ibid 359.

¹⁹ Richard Disney and John Gathergood ‘Financial Literacy and Consumer Credit Portfolios’ (2013) 37 *Journal of Banking and Finance* 2246; John Gathergood, ‘Self-control, Financial Literacy and Consumer Over-Indebtedness’ (2012) 33 *Journal of Economic Psychology* 590.

²⁰ Klapper, Lusardi and van Oedheusden, above n 8, 14; Kristopher Gerardi, Lorenz Goette and Stephn Meier ‘Numerical Ability Predicts Mortgage Default’ (2013) 110 *Proceedings of the National Academy of Sciences* 11267.

²¹ Sumit Argawal and Bhashkar Mazumder ‘Cognitive Abilities and Household Financial Decision-making’ (2013) 5 *American Economic Journal: Applied Economics* 193.

²² Julie Agnew, Hazel Bateman and Susan Thorp ‘Financial Literacy and Retirement Planning in Australia’ (2012) 6(2) *Numeracy* 1; see also Hazel Bateman et al, ‘Financial Competence and Expectations Formation: Evidence from Australia’ (2012) 88(280) *Economic Record* 39; Australian Securities and Investments Commission, ‘National Financial Literacy Strategy Annual Highlight Report 2015–16 (Report No 510, 16February 2017) <<https://www.moneysmart.gov.au/media/560313/nfls-annual-highlights-report-2016-web-version.pdf>>; National Bank of Australia, ‘Financial Resilience Report 2015’ (2016) <<https://www.nab.com.au/content/dam/nabrwd/About-Us/corporate-responsibility/docs/nab>> (which indicates that only 31% of Australian population could withstand a shock which affected their income.

²³ Klapper, Lusardi and van Oedheusden, above n 8,.

²⁴ Agnew, Bateman and Thorp, above n 22, 5–7.

²⁵ Ibid 9.

²⁶ Kristin Erta et al, ‘Applying Behavioural Economics at the Financial Conduct Authority’ (Paper No 1, Financial Conduct Authority April 2013) <<https://www.fca.org.uk/publication/occasional-papers/occasional-paper-1.pdf>> 21.

²⁷ Department of Finance and Deregulation, *Influencing Consumer Behaviour: Improving Regulatory Design* (Paper, 2010); Kristin Erta et al, above note 26.

²⁸ See Herbet Simon, ‘Theories of Bounded Rationality’ in C B McGuire and Roy Radner (eds), *Decision and Organization* (University of Minnesota, 1972) 161.

²⁹ Amos Tversky and Daniel Kahneman, ‘Judgment under Uncertainty: Heuristics and Biases’ (1973) 185 (4157) *Science* 1124.
³⁰ For a survey of the literature, see David Hirshleifer, ‘Investor Psychology and Asset Pricing’ (2001) 56 *Journal of Finance* 1533.

³¹ Tversky and Kahneman, above n 29, 1124.

reduce financial well-being.³² Again, there are many biases affecting behavior and only the most significant and well-studied are covered below.

'Short-cuts' and heuristics: Starting with short-cuts the 'availability heuristic' suggests that financial consumers will assess the likelihood of something happening according to the '... ease with which instances or associations come to mind.'³³ A recent or cataclysmic event may be estimated as more salient and likely to occur than those in the past that are harder to bring to mind. Even if they understand all relevant information, the availability shortcut leads consumers to make decisions by prioritizing the causative effects of salient or recent information, in preference to other information which is, statistically, more likely to influence outcomes.³⁴

Similarly, the 'representativeness heuristic' describes the tendency of the consumer to over-weight probability judgments based on what is familiar or stereotypical.³⁵ Research on advertising,³⁶ labelling³⁷ and past financial returns show this effect.³⁸ Accordingly a financial consumer may be over-pessimistic or the reverse, and give weight (or under-weight) to the wrong factors in decision-making.³⁹ The third heuristic is consumers' tendency to use the 'anchoring and adjustment' short-cut to make estimates. This might be a generalization in common circulation or a personal belief, that is used as an 'anchor'⁴⁰ to interpret information that they have available,⁴¹ although as is often the case with short-cuts, they may be insufficient.⁴² The classic example of this heuristic in financial markets is the 'disposition effect'.⁴³ This is the well documented tendency of investors to hold an asset for too long, believing it will reach, or return to, a certain price, when they have become personally attached to it, rather than on the basis of objective performance.⁴⁴

Behavioural biases: Behavioural biases may also influence consumers to make choices that are not objective or beneficial.⁴⁵ As with short-cuts there are many influences, and only a few of the most telling are used to illustrate. The overconfidence bias captures the idea that consumers will often overestimate how high their returns will be⁴⁶ and also the degree to which success is due to their own talent or prowess.⁴⁷ This is a universal bias,⁴⁸ though men are more predisposed to it than women,⁴⁹ and with overtrading it has

³² See, eg, Sarah Brown et al, 'Debt and Financial Expectations: An Individual and Household Level Analysis' (2005) 41 *Economic Enquiry* 100; Neil Weinstein, 'Unrealistic Optimism About Future Life Events' (1980) 39 *Journal of Personality and Social Psychology* 806.

³³ Ibid.

³⁴ Tversky and Kahneman, above n 29, 1127.

³⁵ Richard Taffler, 'The Representativeness Heuristic' in H Kent Baker and John R Nofsinger (eds), *Behavioral Finance: Investors, Corporations and Markets* (John Wiley & Sons, 2010) 259.

³⁶ Prem C Jain and Joanna Shuang Wu, 'Truth in Mutual Fund Advertising: Evidence on Future Performance and Fund Flows' (2000) 55 *Journal of Finance* 937.

³⁷ Michael M Cooper, Huseyin Gulen and P Raghavendra Rau, 'Changing Names with Style: Mutual Fund Name Changes and their Effects on Fund Flows' (2005) 60 *Journal of Finance* 2825.

³⁸ Robert Bloomfield and Jeffrey Hales, 'Predicting the Next Step of a Random Walk: Experimental Evidence of Regime-Shifting Beliefs' (2002) 65 *Journal of Financial Economics* 397.

³⁹ Tversky and Kahneman, above n 29, 1128.

⁴⁰ Gretchen B Chapman and Eric J Johnson, 'The Limits of Anchoring' (1994) 7 *Journal of Behavioral Decision Making* 223.

⁴¹ Tversky and Kahneman, above n 29, 1128.

⁴² G A Quattrone et al, 'Explorations in Anchoring: The Effects of Prior Range, Anchor Extremity and Suggestive Hints' (Working Paper, Stanford University, 1984).

⁴³ Hersh Shefrin and Meir Statman, 'The Disposition to Sell Winners Too Early and Ride Losers too Long: Theory and Evidence' (1985) 40 *The Journal of Finance* 777.

⁴⁴ Karen E Jacowitz and Daniel Kahneman, 'Measures of Anchoring in Estimation Tasks' (1995) 21 *Personality and Social Psychology Bulletin* 1161.

⁴⁵ See, eg, Sarah Brown et al, 'Debt and Financial Expectations: An Individual and Household Level Analysis' (2005) 41 *Economic Enquiry* 100.

⁴⁶ Brad M Barber and Terrance Odean, 'Trading is Hazardous to your Wealth: The Common Stock Investment Performance of Individual Investors' (2000) 55 *Journal of Finance* 773.

⁴⁷ See generally Michael Pompain, *Behavioural Finance and Wealth Management: How to Build Investment Strategies that Account for Investor Bias* (Wiley, 2011).

⁴⁸ Simon Gervais and Terrance Odean, (2001), 'Learning to Be Overconfident' (2001) 14 *Review of Financial Studies* 1.

⁴⁹ Mary A Lundeberg, Paul W Fox and Judith Puncocar, 'Highly Confident but Wrong: Gender Differences and Similarities in Confidence Judgment, (1994) 86 *Journal of Educational Psychology* 114; Brad M Barber and Terrance Odean, 'Boys Will be Boys: Gender Overconfidence, and Common Stock Investment' (2001) 116 *Quarterly Journal of Economics* 261.

a negative effect on returns.⁵⁰ Social factors are also potent, but not always rational, influences on financial decision-making.

As with variations in financial literacy, research has shown systematic effects on rationality in decision-making attached to demographics, including gender, age, marital status, educational level and income level. For example, greater age leads to more conservatism about risk, and higher income increases riskiness of decisions.⁵¹ Social relationships also affect investment decisions.⁵² Influence of family and friends is well-documented⁵³ and likewise the media⁵⁴ with the latter particularly understood to influence large groups of investors to imitate each other in what has been called 'herding' behavior.⁵⁵ This bias is shown to be exacerbated by internet-based trading.⁵⁶ Finally, the effect of the 'framing' bias is seen when alternative ways of explaining or 'framing' identical objective information (eg statistics or past returns) results in significantly different decisions.

FAIRNESS IN RETAIL FINANCIAL MARKET REGULATION AND CONSUMER TREATMENT

The Idea of Fairness

Fairness is a big, slippery notion. In essence, fairness is the capacity to recognize the circumstances, perceptions or values of another.⁵⁷ It has many meanings from the everyday and prosaic, to overarching norms which reflect humanity in its finest aspirations. So, fairness has been the foundation of theories of justice which argue for keeping in mind the least well off, and adjusting economy and society, consistent with liberty for all, to operate for their benefit.⁵⁸

In financial markets fairness tends to be writ smaller and does not have the redistributive purpose of theories of justice. In line with most modern discussion of fairness, in this submission we are not talking about actual equality or some ideal of perfect fairness. Instead most people think of fairness as an approximate notion, a 'rough' or 'good enough' fairness.⁵⁹ One reason for this 'good enough' or 'approximate' fairness, is that fairness is a complex idea, especially in practice. Fairness is subject to exceptions for lack of intention or variations for merit, skill or hard work. In practice, an important aspect of fairness might be described as equitability: the ability to bring a variety of contextual factors to bear in coming in a practical way to an understanding of fairness that all concerned will accept.⁶⁰

⁵⁰ Barber and Odean, 'Boys will be Boys', above n 49; Mark Grinblatt and Matti Keloharju, 'Sensation Seeking Overconfidence and Trading Activity' (2009) 2 *The Journal of Finance* 549; Barber and Odean, 'Trading is Hazardous', above n 46. .

⁵¹ Richard A Cohen et al, 'Individual Investor Risk Aversion and Investment Portfolio Composition' (1975) 30 *Journal of Finance* 605.

⁵² D T Campbell, 'Social Attitudes and Other Acquired Behavioral Dispositions', in Sigmund Koch (ed.), *Psychology: A Study of Science* (McGraw-Hill, 1963) 94.

⁵³ John R Nofsinger, 'Social Mood and Financial Economics' (2005) 6(3) *The Journal of Behavioural Finance* 144.

⁵⁴ Robert J Shiller, R, *Irrational Exuberance* (2000) 149.

⁵⁵ David Hirshleifer, D. and Siew Hong Teoh, 'Herd Behaviour and Cascading in Capital Markets: A Review and Synthesis' (2003) 9 *European Financial Management* 25.

⁵⁶ Barber and Odean, 'Trading is Hazardous', above n 46; Brad M Barber and Terrance Odean 'The Internet and the Investor' (2001) 15 *Journal of Economic Perspectives* 41.

⁵⁷ Christina Bicchieri, 'The Fragility of Fairness: An Experimental Investigation on the Conditional Status of Pro-Social Norms' in Ernest Sosa and Enrique Villaneuva (eds), *Interdisciplinary Core Philosophy, Philosophical Issues, Vol 18* (2008: Wiley-Blackwell) 232: As Bicchieri puts it:

We do not reason about fairness in general, and we are not especially good at that, but we are quite able to detect, in a host of different situations, what being fair means in any particular case. We observe this collective, shared ability to move from one meaning to another in many experiments in which, when the circumstances of an allocation change, the interpretation of what is fair to do changes in the same direction.

⁵⁸ John Rawls, *A Theory of Justice* (Harvard University Press, 1971).

⁵⁹ James Q Wilson, *The Moral Sense* (Free Press, 1993) 62.

⁶⁰ One of the most obvious instances of this in modern policy and administration, is the shift in the gender pay debate from equal pay to pay equity or equitability of pay. This is partly because of difficulties of comparison and different valuation of work as between the sexes – eg caring professions versus highly technical expertise, both of which are equally valuable in their own settings but virtually impossible to monetise by comparison: Sylvia Fuller '[Job Mobility and Wage Trajectories for Men and Women in the United States](#)' (2008) 73 *American Sociological Review* 158.

Conceptions of Fairness in the Financial Sector

Fairness as Reciprocity or Mutuality: The leading and distinctive idea of fairness underlying individual transactions in financial markets is fairness as reciprocity or mutuality. This is the idea of ‘fairness in exchanges’,⁶¹ and it is not difficult to see basic intuitions towards sociability and recognition of the perspective of another, in reciprocity of commercial relations. This idea of fairness is foundational to rules against fraud and misleading conduct. Whether it is telling deliberate lies or careless disregard for the welfare of the other party, the counterparty does not receive fair or agreed value. ‘The core of the unfairness in both instances is that one party to the bargain is not getting what it has been represented they will get: there has been a failure of reciprocity’.⁶² Our sense of what is due between the parties is offended by seeing ourselves or some-one else made a fool of, in the gap between what was represented or promised and the outcome. The unfairness is a social offence, may be financially damning and undermines trust.

If there are sufficient cases of failure of reciprocity and damage, individuals and corporations may lose their trust more widely. So while fairness is quintessentially a relationship between people, its absence can also have damaging effects on the perceived trustworthiness of institutions or in extreme situations (such as the 1930s depression or moments in the 2008 financial crisis) the financial system as a whole. Dramatic failures of this idea of fairness as reciprocity evidenced in Commission hearings are ‘fees for no service’, ‘car-yard’ life insurance sales and some credit insurance sold to pay-day borrowers.

Fairness as Absence of Bias or Impartiality: The second variation in which fairness appears in financial markets, is the idea of fairness as impartiality, or absence of bias.⁶³ This is most obvious in observing natural justice in dispute resolution. It may appear as ‘consistency’ in treatment of customers as an operating principle in remediation schemes.⁶⁴ Absence of bias (especially when hidden) is also a conception of fairness which can explain the principles inherent in conflicts of interest and conflicts of duty. These conflicts and their potential for bias are ubiquitous in financial markets and especially intense in vertically integrated financial conglomerates as shown in Commission hearings. In mass financial markets, it is practically impossible for retail investors to resist agreeing (or apparently agreeing) to contractual disclosures or exclusions permitting conflicts of interest and conflicts of duty. There are legal limits,⁶⁵ but generally mass market or standard form contracts are offered on a ‘take it, or leave it’ basis.

Fair Equality of Opportunity: Occasionally, fairness as equality or more commonly, as fair equality of opportunity,⁶⁶ is found in the financial sector. Fair equality of opportunity may accommodate lack of equality of initial endowments or starting position. For example, equal access to securities information is an accepted principle of financial regulation,⁶⁷ without any guarantee of equality in how accurately a recipient might interpret it or their expertise in using it. This conception of fairness generally concentrates on formal equality and not the substantive equality that customers often expect. The equality of opportunity standard is one of equality in what goes in, not what comes out.

Fairness and Regulation in Mass Financial Consumer Markets

Institutions and doing fairness ‘at scale’ in mass markets: As mentioned, fairness is a relational idea, that we understand best when observed between two individuals. Fairness may be compromised when the uniform treatment and relentless subjection of customers to ‘process’ does not make a financial institution alive to individual cases such as those with low financial literacy, vulnerable or disabled customers or those

⁶¹ Wilson, above n 62, 65.

⁶² Kingsford Smith, above n5, 449

⁶³ Wilson, above n 59, 69.

⁶⁴ Australian Securities and Investments Commission, ‘Regulatory Guide No 256: Client Review and Remediation’ (at September 2016) 28.

⁶⁵ *Australian Securities and Investments Act 2001* (Cth) ss 12BF, 12BG.

⁶⁶ Quentin Skinner, *Political Philosophy* (Polity Press, 2001) 20–6.

⁶⁷ Regulation Fair Disclosure [17 CFR 243.100-243.103](#) (adopted in August 2000) in the US is probably the clearest example along with continuing disclosure requirements of regulators and stock exchanges in a growing number of countries.

suffering hardship. One of the leading challenges of regulating in financial consumer mass markets, is how to be fair at scale.

Existing Concepts of Fairness in the law and regulation of the financial sector: In Australian financial law and regulation the concept of fairness is applied widely in policy⁶⁸ and legislation: it is a statutory obligation of all Australian financial services and credit licensees.⁶⁹ Accordingly fairness is an important value in the work of ASIC in guidance to licensees about their obligations, in surveillance, investigation and enforcement.

By contrast fairness is argued infrequently and used with restraint in court decisions. Case law finding a departure from 'fairness' includes selling products when unlicensed,⁷⁰ acting outside contractual authority in making investment directions,⁷¹ misleading clients to maximise commissions against client interests,⁷² inconsistent decision-making in a financial dispute resolution scheme⁷³ and lapse of exercise of sound ethical values and judgment in matters relevant to a client's affairs.⁷⁴ It may also be unfair to breach a conflicts obligation as a financial adviser⁷⁵ and it is clear that the obligation to act fairly may change in response to changes in commercial morality.⁷⁶

Fairness is also central and has had wide practical application in the determinations of the Financial Ombudsman Scheme and this is likely to persist at the new Australian Financial Complaints Authority. Disputes must be resolved in a 'cooperative, efficient, timely and fair manner' and having regard to what is 'fair in all the circumstances.'⁷⁷

CONCLUSION

Most of these applications of fairness are more fragmented than explanatory. The task now is to materialize wider conceptions of fairness such as those discussed above, in law and regulation. This is necessary because fairness is not self-executing. Looping back to the Commissioner's suggestion that a simple principle of 'be fair' is adopted, we agree. Leaping forward to the discussion of legal complexity later in this submission, we think implementation should be considered at greater length than is possible here, in the phase after the release of the Final Report Commission.

⁶⁸ Financial System Inquiry, 'Financial System Inquiry Final Report (November 2014) 3–8.

⁶⁹ *Corporations Act 2001* (Cth) s 912A(1)(a) and its predecessors.

⁷⁰ *Bathurst Regional Council v Local Government Financial Services Pty Ltd (No 5)* [2012] FCA 1200 (5 November 2012) paras [2947-50].

⁷¹ *In re MF Global Australia Ltd (in liq)* [2012] NSWSC 994 (29 August 2012).

⁷² *Australian Securities and Investments Commission v Camelot Derivatives Pty Limited (In Liquidation); In the Matter of Camelot Derivatives Pty Limited (In Liquidation)* [2012] FCA 414 (23 April 2012) [69-74].

⁷³ *Australian Timeshare and Holiday Ownership Council Limited and Australian Securities and Investments Commission* [2008] AATA 62 (23 January 2008) [214].

⁷⁴ *Re Hres and Australian Securities and Investments Commission* (2008) 105 ALD 124, [237]; *Story v National Companies and Securities Commission* (1988) 13 NSWLR 661, 672.

⁷⁵ *Daly v Sydney Stock Exchange Ltd*; (1986) 160 CLR 371.

⁷⁶ *Story v National Companies and Securities Commission* (1988) 13 NSWLR 661, 672; *R J Elrington Nominees Pty Ltd v Corporate Affairs Commission (SA)* (1989) 1 ACSR 93, 110.

⁷⁷ Financial Ombudsman Scheme, *Terms of Reference*, paragraphs 1.2 and 8.2 at: <https://www.fos.org.au/about-us/terms-of-reference/> (last visited 4 October 2017).

REMUNERATION AND MOTIVATIONS FOR MISCONDUCT: EXTENDING THE BAN ON CONFLICTED REMUNERATION

Clinton Free
Hannah Harris

INTRODUCTION

This section addresses the role of variable remuneration in driving misconduct, answering the following questions raised in the *Interim Report*.¹

1. Should any 'customer facing employee' be paid variable remuneration?
2. If more junior employees should not be remunerated in this way, why should their managers and senior executives?
3. Should intermediaries be subject to rules generally similar to the conflicted remuneration prohibitions applying to the provision of financial advice?
4. Should other changes be made to the remuneration practices of banks? What would they be, and how could change be required?

In answering these questions, we provide an overview of relevant academic research, catalogue recent regulatory activity internationally, and offer some recommendations for the future of remuneration policy and practice in Australia's financial service sector.

Remuneration issues lie at the heart of the *Interim Report*. As the Commissioner puts it, 'all of the conduct identified and criticised in this report was conduct that provided a financial benefit to the individuals and entities concerned'.² Numerous cases in the public hearings have underscored the nexus between certain forms of variable remuneration payments, conflicts of interest, poor sales practices, and unsuitable products. Notable examples include the NAB Introducer Program,³ the CBA Mortgage broking case, and the Aussie Home loan conduct. In Phase Two, a range of cases demonstrated how sales culture and remuneration practices impacted the quality of financial advice. Emphatic examples from later phases of

¹ Commonwealth, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report* (2018) vol 1 ('*Interim Report*').

² *Ibid* 301.

³ See National Australia Bank ('NAB'), Submission (Introducer Case Study) to Commonwealth, *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*, 3 April 2018, 5 [19].

the commission include the Aboriginal Community Benefit Fund issues discussed in Phase Four⁴ and the Freedom Insurance and ClearView case studies in Phase Six.⁵ These cases highlight that variable remuneration linked to sales can drive intermediaries and employees to provide unsuitable financial products, cross-sell unnecessary products, inflate product cost, and provide inferior products. All of these outcomes negatively impact the customer. In some cases, sales culture resulted in fraud and customers unknowingly ‘buying’ useless products. Several reports investigating a range of financial products provide further evidence of adverse customer outcomes driven by ill-conceived variable remuneration arrangements. An ASIC study of life insurance advice found that 96% of the bad advice was given by those who received upfront commissions. Similarly, loans arranged by mortgage brokers tend to be larger, more expensive and more likely to go into arrears than those provided directly by lenders.⁶

Based on the research and expertise set out below, we submit the following key recommendations:

KEY RECOMMENDATIONS

1. Customer facing employees should have access to variable remuneration, but the statutory ban on conflicted remuneration should be extended to all customer facing employees without limitation. Other carve outs and limitations to this regime should be substantially reduced.
2. The same conflicted remuneration provisions should apply to managers and executives in banks.
3. Intermediaries should be subject to a ban on conflicted remuneration, in the same way as FSLs and bank staff.
4. Banks should consider extension of malus and clawbacks for staff who continue to receive variable remuneration, as a mechanism to incentivise long-term outcomes and customer wellbeing.
5. Banks should continue to build on their application of the Sedgewick Report and develop more complete incentive schemes and remuneration practices to support sound risk-taking behaviour and customer outcomes. They should be encouraged to adopt regular reviews of their systems and structures, to assess and enhance the practical impact on institutional culture at all levels.

SPECIFIC RECOMMENDATIONS

Should any ‘customer facing employee’ be paid variable remuneration?

Variable remuneration is difficult to critique in principle. The idea of rewarding employees for high-quality performance is backed by several psychological and economic theories.⁷ However, variable remuneration comes in many shapes and flavours (gain sharing, lump-sum bonuses, and sales commissions). Rather than considering variable remuneration as a blanket term, it is more useful to focus attention on specific components of variable remuneration. There is good reason to scrutinise certain classes of volume- and value-based commissions and bonuses, which are characterised by conflicts of interest.

⁴ The Aboriginal Community Benefit Fund case study explored during Phase Four is discussed in the *Interim Report*: at vol 2, 449.

⁵ Council Assisting, Ms Orr, noted on day 59 of the public hearings that: ‘The remuneration and incentive structures that ClearView had in place encouraged its sales agents to make as many sales as possible, frequently to the detriment of customers’ best interests’: Transcript of Proceedings, *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (21 September 2018) 6463.

⁶ Gail Pearson, ‘Commission Culture: A Critical Analysis of Commission Regulation in Financial Services’ (2017) 36 *University of Queensland Law Journal* 155, 166.

⁷ For example, agency theory: see Linda K Stroh et al, ‘Agency Theory and Variable Pay Compensation Strategies’ (1996) 39 *Academy of Management Journal* 751; expectancy theory: see Victor H Vroom, *Work and Motivation* (Wiley, 1964); goal-setting theory: see Edwin A Locke and Gary P Latham, ‘Building a Practically Useful Theory of Goal Setting and Task Motivation: A 35-year Odyssey’ (2002) 57 *American Psychologist* 705; reinforcement theory: see Barry Gerhart and Sara L Rynes, *Compensation: Theory, Evidence, and Strategic Implications* (Sage Publications, 2003). Proponents of variable pay-for-performance most commonly refer to the premise in agency theory that by rewarding executives for performance their interests become aligned with those of the company’s shareholders, thus bridging the principal-agent gap. Angeli and Shahzad note that the primary purpose of variable remuneration is to incentivise performance, noting additional benefits and justifications relating to flexibility of costs, staff retention, and demands of employees: see Marilena Angeli and Gitay Shahzad, ‘Bonus Regulation: Aligning Reward with Risk in the Banking Sector’ [2015] (Q4) *Bank of England Quarterly Bulletin* 322.

There is a large body of academic research that highlights how variable remuneration can drive risk-taking behaviour, and in some circumstances, misconduct. Research has consistently found that incentive-based variable remuneration is associated with short termism, excessive (and sometimes illegal) risk-taking,⁸ earnings management,⁹ and financial misreporting.¹⁰ Performance-based remuneration has been associated with instrumental ethical climates, which are more prone to unethical and illegal conduct.¹¹ Research and commentary about banker remuneration has been largely restricted to executive remuneration (and stock option grants). However, the cases at the Royal Commission provide ample evidence that variable remuneration tied to sales (primarily in the form of commissions and volume and value-based bonuses) provide unacceptable incentives to customer facing employees, driving sale and churn of inappropriate products and creating conflicts of interest between the firm and customers.

In Australia, after a web of inquiries and reports have pointed the finger at remuneration, we have been left with a confusing potpourri of regulatory interventions. These include disclosure across all financial service sectors, caps on variable remuneration in the insurance context, and partial banning of conflicted remuneration in financial advice and some insurance products. These interventions are summarised in Table 1 and further elaborated below.

Table 1: Regulation of Variable Remuneration in Financial Services in Australia

Intervention	Current Application in Australia	Relevant Legislation
Disclosure	<ul style="list-style-type: none"> • Financial Service Licensees (Financial Advice and Insurance) • Credit 	<p><i>Corporations Act 2001</i> (Cth) p ss 923A, 942B–942E, 947B–947E, 949A–949B, 1013A–1013M, 1015A–1015E</p> <p><i>Corporations Regulations 2001</i> (Cth) regs 7.7.03–7.7.07, 7.7.08A, 7.7A.11</p> <p><i>National Consumer Credit Protection Act 2009</i> (Cth) ss 113, 121, 136, 144, 158, 160</p>

⁸ A growing body of research reveals that compensation directly impacts executive risk-taking behaviours. Rajgopal and Shevlin find that executive stock options ('ESOs') provide managers with incentives to invest in risky projects: Shivaram Rajgopal and Terry Shevlin, 'Empirical Evidence on the Relation between Stock Option Compensation and Risk Taking' (2002) 33 *Journal of Accounting and Economics* 145. Sanders and Hambrick find that CEO stock options engender high levels of investment outlays and bring about extreme corporate performance (big gains and big losses), suggesting that stock options prompt CEOs to make high-variance bets, not simply larger bets: W M Gerard Sanders and Donald C Hambrick, 'Swinging for the Fences: The Effects of CEO Stock Options on Company Risk Taking and Performance' (2007) 50 *Academy of Management Journal* 1055. Similarly, Hagendorff and Vallascas analyse how the structure of executive compensation affects the risk choices made by bank CEOs and find that executive compensation encourages CEOs to undertake risk-increasing investment choices: Jens Hagendorff and Francesco Vallascas, 'CEO Pay Incentives and Risk-taking: Evidence from Bank Acquisitions' (2011) 17 *Journal of Corporate Finance* 1078. Research has also shown that executive compensation played a strong role in risk-taking in the lead up to the Global Financial Crisis. Using firm-level data in 2005 to explain risk-taking by large United States bank holding companies ('BHCs') in 2006, Fortin, Goldberg and Roth find that BHCs whose CEOs were granted more stock options and higher bonuses in 2005 exhibited greater risk in 2006, while BHCs whose CEOs received higher base salaries experienced less risk: Rich Fortin, Gerson M Goldberg and Greg Roth, 'Bank Risk Taking at the Onset of the Current Banking Crisis' (2010) 45 *Financial Review* 891. Guo, Jalal and Khaksari find that bank risk (as measured by Z-score) and stock return volatility increases with both the percentages of short-term and long-term incentive compensation before and during the Financial Crisis: Lin Guo, Abu Jalal and Shahriah Khaksari, 'Bank Executive Compensation Structure, Risk Taking and the Financial Crisis' (2015) 45 *Review of Quantitative Finance and Accounting* 609.

⁹ For example, Bergstresser and Philippon provide evidence of the higher use of discretionary accruals to manipulate reported earnings is more pronounced at firms where the CEO's potential total compensation comprises higher levels of stock options: Daniel Bergstresser and Thomas Philippon, 'CEO Incentives and Earnings Management' (2006) 80 *Journal of Financial Economics* 511.

¹⁰ For example, Burns and Kedia find that the sensitivity of the CEO's option portfolio to stock price is significantly positively related to the propensity to misreport: Natasha Burns and Simi Kedia 'The Impact of Performance-based Compensation on Misreporting' (2006) 79 *Journal of Financial Economics* 35.

¹¹ See Murphy and Free who discuss instrumental climate in the context of fraud and demonstrate its relationship with profit-based incentives, among other things. This research highlights that an instrumental climate that may trigger misconduct in the context of consumer outcomes. See Pamela R Murphy and Clinton Free, 'Broadening the Fraud Triangle: Instrumental Climate and Fraud' (2015) 28(1) *Behavioral Research in Accounting* 41.

		<i>National Consumer Credit Protection Regulations 2010</i> (Cth) regs 26–28H <i>National Consumer Credit Protection Act 2009</i> (Cth) sch 1 (National Credit Code), ss 16–17
Caps	<ul style="list-style-type: none"> Insurance 	<i>Corporations Act 2001</i> (Cth) s 963A <i>ASIC Corporations (Life Insurance Commissions) Instrument 2017/510</i>
Bans	<ul style="list-style-type: none"> Financial Advice 	<i>Corporations Act 2001</i> (Cth) ss 963E–965

Disclosure

In Australia, disclosure requirements exist in both the *Corporations Act 2001* (Cth) and the *National Consumer Credit Protection Act 2009* (Cth). The framework is quite comprehensive, illustrating the historical weight placed by government and regulators on a disclosure model for consumer protection. Disclosure rules are also prominent in other jurisdictions. For example, in Europe, MiFID II¹² (which has applied from January 2018), clearly sets out disclosure requirements for investment firms in relation to their clients, under art 23. In the United States, investment advisors are subject to disclosure requirements under the *Investment Advisers Act of 1940*, 15 USC § 80b (2010). In 2014, the United Kingdom expanded its disclosure rules for credit providers.

Disclosure has a long history of use in professions where conflicts of interest may occur, including medicine, law and finance. However, research shows that consumers are ill equipped to deal with disclosure information and thus often deal with it inappropriately.¹³ Disclosure requirements place the burden on the customer to fully understand what is being disclosed. Low levels of financial literacy are particularly concerning in this context:¹⁴ ‘Most clients do not read the disclosure and solely rely on the adviser’.¹⁵ Furthermore, several studies have shown that disclosure does not impede the provision of poor and biased advice.¹⁶

Certainly, disclosure is a valuable tool in an educated customer’s arsenal. In some circumstances, disclosure rules may motivate actors to avoid potential conflicts, so that they have nothing to disclose.¹⁷ While avoiding conflicts is obviously the most desirable outcome, for this option to be available, alternative actions must be possible. The current framework for financial services in Australia, with its heavy reliance on commissions and entrenched sales culture, make it nearly impossible for actors to avoid conflicts of interests. Thus, despite the popularity of the disclosure model, research has clearly demonstrated the limitations and potentially harmful effects of this approach.¹⁸ Field and laboratory experiments demonstrate

¹² *Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on Markets in Financial Instruments Amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC* [2004] OJ L 145/1 (‘MiFID’).

¹³ Sunita Sah and George Loewenstein, ‘Nothing to Declare: Mandatory and Voluntary Disclosure Leads Advisors to Avoid Conflicts of Interest’ (2014) 25 *Psychological Science* 575, 575.

¹⁴ Annamaria Lusardi and Olivia S Mitchell, ‘Financial Literacy around the World: An Overview’ (2011) 10 *Journal of Pension Economics and Finance* 497.

¹⁵ Eyal Carmel et al, ‘Facing a Biased Adviser while Choosing a Retirement Plan: The Impact of Financial Literacy and Fair Disclosure’ (2015) 49 *Journal of Consumer Affairs* 576, 578.

¹⁶ Daylian M Cain, George Loewenstein and Don A Moore, ‘When Sunlight Fails to Disinfect: Understanding the Perverse Effects of Disclosing Conflicts of Interest’ (2011) 37 *Journal of Consumer Research* 836.

¹⁷ Sah and Loewenstein, above n 13, 582.

¹⁸ There is a large line of research that shows that many kinds of disclosures don’t work, including simplified disclosures. See, e.g. Omri Ben-Shahar and Carl C Schnieder, *More Than You Wanted to Know* (Princeton University Press, 2010); George Loewenstein Friedman et al, ‘Consumers’ Misunderstanding of Health Insurance’ (2013) 32 *Journal of Health Economics* 850; James J. Choi, David Laibson and Brigitte C Madrian, ‘Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds’ (2010) 23 *Review of Financial Studies* 1405. See also Daniel E Ho, ‘Fudging the Nudge: Information Disclosure and Restaurant Grading’ (2012) 22 *Yale Law Journal* 574; Florencia Marotta-Wurgler, ‘Does Contract Disclosure Matter?’ (2012) 168 *Journal of Institutional and Theoretical Economics* 94.

that disclosures do not improve portfolio investment decisions, choices regarding payday loans, or other important financial decisions.¹⁹ In *More Than You Wanted to Know: The Failure of Mandated Disclosure*, Omri Ben-Shahar and Carl Schneider systematically critique of disclosure as a mode of regulation, including the latest innovations such as ‘smart’, ‘personalised’ and ‘just in time’ disclosure. They conclude that disclosure simply depends on the simultaneous success of too many factors for it to work. In short, meaningful disclosure regulation depends on the right information being disclosed, read, understood, and used in a way that allows individuals to make the right decision.²⁰ As Florencia Marotta-Wurgler puts it, ‘people don’t read (and don’t want to read), don’t want to make decisions (so why bother reading), and couldn’t read even if they wanted to because there are too many disclosures and they are written in language too complex for most readers to grasp’. Certainly, the conduct exposed by the Royal Commission suggest that a disclosure model is not a satisfactory solution.

Capping

Caps refer to statutory limits on commissions. Following the reviews into retail life insurance advice, the *Corporations Act 2001* (Cth) was amended to bring life insurance within the remit of the conflicted remuneration provisions.²¹ However, this extension was limited. The *ASIC Corporations (Life Insurance Commissions) Instrument 2017/510* allows for commissions to be paid for life insurance products, provided they meet cap and clawback requirements. The instrument commenced on 1 January 2018 and will continue to reduce the size of allowable commissions down to 60% of the premium in the first year of the policy, by January 2020.

Caps are blunt instruments for curtailing misaligned incentives. In the context of executive remuneration, research on bonus caps in Europe and the United Kingdom suggests a ‘questionable’ impact on risk-taking.²² While caps limit the quantum of variable pay, they do not address the underlying behaviour being incentivised. Plainly put, it is this underlying behaviour, namely the preference of profit over customer financial outcomes, that is the cause of misconduct. There exists no empirical evidence to support particular limits, making the selection of a cap largely arbitrary. If caps are to be pursued further as a regulatory tool, empirical research is necessary to address their impact on misconduct.

Banning

Bans refer to legislative prohibitions on certain forms of variable remuneration. In the Australian context, a patchwork of regulatory changes has resulted in the banning of certain commissions for certain products. Perhaps the most notable example is the banning of ‘conflicted remuneration’, a key feature of the Future of Financial Advice (‘FOFA’) reforms.²³ FOFA reforms have materially changed remuneration in the advice industry, although it is clear that not all providers and their representatives have complied.

A host of products are excluded from the current ban on conflicted remuneration for financial advice.²⁴ Grandfathered commissions were excluded and attempts to continue these historical arrangements were a significant feature of early case studies during the Royal Commission hearings. The conflicted remuneration provisions also contain carve outs for certain classes of employees and benefits. Exceptions and exclusions were driven in large part by industry resistance to reform. The result is considerable

¹⁹ Florencia Marotta-Wurgler, ‘Even More Than You Wanted to Know about the Failures of Disclosure’ (2014) 11 *Jerusalem Review of Legal Studies* 63.

²⁰ Ben-Shahar and Schneider, above n 18.

²¹ Australian Securities and Investments Commission, ‘Review of Retail Life Insurance Advice’ (Report No 413, October 2014); and 2) John Trowbridge ‘Review of Retail Life Insurance Advice’ (Report, Life Insurance and Advice Working Group, 26 March 2016).

²² Stefano Colonnello, Michael Koetter and Konstantin Wagner, ‘Effectiveness and (In)efficiencies of Compensation Regulation: Evidence from the EU Banker Bonus Cap’ (Discussion Paper No 7/2018, Halle Institute for Economic Research, April 2018). Capping of variable remuneration for executives has also resulted in an increase in fixed pay and a reduction in the quantum available for deferral, reduction or clawbacks. This is not a desirably outcome, as deferral of variable remuneration can help to align the interests of providers with those of consumers and signal to customer facing employees that their employer values customer relationships and outcomes over the long term.

²³ *Corporations Act 2001* (Cth) pt 7.7A, div 4.

²⁴ These include general insurance and life insurance outside superannuation: *Corporations Regulations 2001* (Cth) reg 7.7A.12G.

complexity in an environment that is already bewildering for many customers. Complex regulation has also rightly been raised by the Commission as a limit on effective enforcement. Complexity also raises compliance costs for the industry.

We submit that the current ban on conflicted remuneration under the *Corporations Act 2001* (Cth) should be extended across the financial services industry and across all products. Any sales- or volume-based component of variable remuneration given to customer facing staff within banks should be captured by the presumption of conflicted remuneration under s 963L. This would be an extension of the existing framework. Under s 963D, employees of authorised deposit-taking institutions are exempt when providing advice about basic banking, general insurance, and consumer credit insurance.

An extension of the conflicted remuneration ban is supported by the limitations of a disclosure model, the lack of empirical evidence to support the effectiveness of caps, and the obvious conflicts of interest that arise from sales-based variable remuneration within the banking sector. This position extends, but is supported by, the recommendations of the Sedgwick Report, which stated that incentives should no longer be paid to any in-scope retail staff based *directly or solely* on sales performance.²⁵ We suggest that the Royal Commission has clearly demonstrated the need for this stronger position.

Banning conflicted remuneration across the entire financial service industry, including within banks, would be in line with international moves to address the impact of incentives on conduct risk. The Financial Stability Board ('FSB') this year published supplementary guidance to the FSB Principles and Standards on Sound Compensation Practices stating that 'firms should embed compensation tools in wider risk management and governance frameworks in order to support effective prevention and accountability for misconduct'.²⁶ The supplementary guidance further states that compensation systems should be designed 'to promote ethical behaviour and compliance with laws, regulations, and internal conduct standards'.²⁷ In 2013, the Financial Services Authority produced a report which stated that customers were likely to lose out if 'firms reward staff through material incentive schemes based on sales volumes, fee income or similar measures'.²⁸ MiFID II also has express requirements for member states to ensure firms address remuneration that may drive poor customer outcomes.²⁹ Even in the US, discussion has turned to the need to deal with misaligned incentives and harmful outcomes across the banking sector, not only for executives, but for all levels of employees and management.³⁰

Recommendation 1: Customer facing employees should have access to variable remuneration, but the statutory ban on conflicted remuneration should be extended to all customer facing employees without limitation. Other carve outs and limitations to this regime should be substantially reduced.

If more junior employees should not be remunerated in this way, why should their managers and senior executives?

There is strong evidence that remuneration structures at managerial and executive levels influence the culture of an institution. Remuneration practices are an important visible artefact of corporate culture.³¹ As stated in *Australian Securities and Investments Commission v NSG Services Pty Ltd*, 'commission-based salary structures created an incentive for representatives to emphasise sales imperatives over compliance requirements and a culture in which the best interests and appropriate advice duties were more likely to be

²⁵ Stephen Sedgwick, 'Retail Banking Remuneration Review Report' (19 April 2017).

²⁶ Financial Stability Board, 'Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices: The Use of Compensation Tools to Address Misconduct Risk' (9 March 2018).

²⁷ Ibid 6.

²⁸ Financial Services Authority, 'Final Guidance: Risks to Customers from Financial Incentives' (January 2013) 13.

²⁹ MiFID II arts 23–4. Under MiFID II art 24(10), a firm 'shall not make any arrangement by way of remuneration, sales targets or otherwise that could provide an incentive to its staff to recommend a particular financial instrument to a retail client when the investment firm could offer a different financial instrument which would better meet that client's needs'.

³⁰ John Heltman, 'Eliminate Incentives that Encourage Bad Behavior: NY Fed's Dudley' (2018) 183(59) *American Banker* 1.

³¹ See Edgar H Schein, *Organizational Culture and Leadership: A Dynamic View* (Jossey-Bass, 1985).

overlooked'.³² Accordingly, the banning of conflicted remuneration for customer facing employees of banks should also be considered for their managers and for senior executives. The underlying rationale for the ban is that no bank employee should be incentivised to put personal profit above customer interests.

It should be noted that, within the current conflicted remuneration regime, the presumption of conflicted remuneration in the case of volume-based benefits can be rebutted, based on whether it can be reasonably expected to influence advice.³³ This opportunity for rebuttal allows some flexibility for managerial and executive level staff to continue to receive remuneration based on enhancing the profitability of the bank, provided they are sufficiently removed from influencing customer choice and outcome.

Recent research suggests that profit-based incentives may not be necessary to motivate profit generating behaviour, although they certainly contribute to risk culture.³⁴ Further research in this area is warranted, and outcomes will impact the continued viability of traditional agency-based arguments for remuneration at all levels.

Recommendation 2: The same conflicted remuneration provisions should apply to managers and executives in banks.

Should intermediaries be subject to rules generally similar to the conflicted remuneration prohibitions applying to the provision of financial advice?

We submit that the ban on conflicted remuneration should also be extended to intermediaries. The Royal Commission hearings have produced clear evidence of conflicts in the case of intermediaries. Furthermore, in the case of mortgage broking, the industry has acknowledged the importance of moving away from volume- and value-based incentives.³⁵ Incentives are powerful motivators and misaligned incentives result in negative customer outcomes. This argument is clearly supported by the research and analysis documented above. We see no valid reason why intermediaries should remain outside of the ambit of the conflicted remuneration provisions. Inclusion of intermediaries will also simplify the regulatory approach, reduce compliance burden, and send a clear message to the industry: Australia requires customer interest to be placed above pure profit.

Recommendation 3: Intermediaries should be subject to a ban on conflicted remuneration, in the same way as FSLs and bank staff.

Should other changes be made to the remuneration practices of banks? What would they be, and how could change be required?

Much of the misconduct uncovered during the Royal Commission is linked to sales culture. On this basis, we submit that additional steps should be taken by the industry to ingrain a service-based approach over a profit-based approach. This goes beyond basic compliance with a ban on conflicted remuneration and commissions. In fact, this ban will help to stimulate creative rethinking of incentives and objectives for the industry. Banks will be encouraged to continue to build on the Sedgwick Report and develop an internal culture that values customer outcomes over sales. There is strong evidence that Banks have already taken steps in this direction. Expanding conflicted remuneration to all bank employees and removing carve outs and caveats across the industry will further encourage continued action and adaptation.

³² [2017] FCA 345, [73] (Moshinsky J).

³³ *Corporations Act 2001* (Cth) s 963A.

³⁴ Elizabeth Sheedy, Le Zhang and Kenny Chi Ho Tam, 'Are Profit-based Incentives Compatible with a Risk Culture?' (Experimental Research Report, Macquarie University Applied Finance Centre and Financial Services Institute of Australasia, August 2017).

³⁵ Combined Industry Forum, 'Improving Customer Outcomes: The Combined Industry Forum Response to ASIC Report 516: Review of Mortgage Broker Remuneration' (Report, 2017).

Ensuring that bank employees are incentivised to do the right thing will be an ongoing challenge.³⁶ Incentivising good conduct is a key reason to allow the continuation of some form of variable compensation, provided it does not result in conflicts of interest.

One method for tying incentives to longer-term objectives and good customer outcomes would be to expand deferral, malus and clawbacks. Deferral of variable compensation is considered a principal mechanism in mitigating short-termism and ensuring the reflection of longer-term risk horizons. By extending the payment (or vesting) of a proportion of an employee's variable remuneration over a prescribed period, deferral enables banks to reassess the outcome of risks taken and accordingly reduce variable compensation in appropriate circumstances. This process of 'ex-post risk adjustment' that attaches to the deferral of remuneration is known as 'malus'. By requiring part of an employee's variable remuneration to be paid out or vested over an extended period, deferral allows for 'malus' to be applied in relevant circumstances and any variable remuneration not already paid or vested will be forfeited. Clawback refers to the process whereby part or all variable remuneration that has already been paid or vested must be returned to the employer. It typically applies where performance ends up worse than originally reported, or where previous misconduct is subsequently uncovered. Clawback arrangements therefore supplement the application of malus to deferred remuneration by serving as an additional mechanism for ex-post risk adjustment. Malus and clawback arrangements were introduced under 'BEAR'³⁷ and their application should be considered more generally, from the perspective of misconduct as well as prudential risk. Further research should also be conducted to explore opportunities to directly reward and incentivise good conduct beyond bare minimum compliance.

Recommendation 4: Banks should consider extension of malus and clawbacks for those staff who continue to receive variable remuneration, as a mechanism to incentivise long-term outcomes and customer wellbeing.

Another method for ensuring long-term cultural change within the industry would be enhancing review of policies and culture within institutions. Sheedy and Griffin, among others, have shown a significant disconnect between management and lower levels of business regarding culture and the values of the firm. Sheedy and Griffin use an empirical survey methodology to demonstrate the disconnect between risk governance measures and risk culture. They emphasise that 'structures are interpreted through the lens of culture'³⁸ and highlight the way incentive schemes and avoidance behaviour by management can drive culture that is incompatible with effective risk management.³⁹ Banks should be encouraged to reflect on and evaluate their culture, taking a proactive and preventive approach to managing misconduct risk. To do this, they could draw on survey designs such as those of Sheedy and Griffin.⁴⁰

Further research on sound methods for evaluating culture and its impact on misconduct risk should be considered. The goal of continual internal monitoring should be to identify shortfalls before they become problematic. If banks fail to embrace this idea, regulators could actively encourage internal review.

Recommendation 5: Banks should continue to build on their application of the Sedgewick Report and develop more complete incentive schemes and remuneration practices to support sound risk-taking behaviour and customer outcomes. They should be encouraged to adopt regular reviews of their systems and structures, to assess and enhance the practical impact on institutional culture at all levels.

³⁶ Further research on the effectiveness of implementing 'gateway' compliance requirements to participate in variable remuneration versus actually rewarding compliance behaviour directly is needed to understand that best way to incorporate compliance metrics into remuneration frameworks.

³⁷ *Treasury Laws Amendment (Banking Executive Accountability and Related Measures) Act 2018* (Cth).

³⁸ Elizabeth Sheedy and Barbara Griffin, 'Risk Governance, Structures, Culture, and Behaviour: A View from the Inside' (2018) 26 *Corporate Governance* 4, 20.

³⁹ Avoidance behaviour is defined as 'the perception among staff that risk issues and policy breaches are ignored, downplayed, or excused': *ibid* 5.

⁴⁰ *Ibid* 20.

CONCLUSION

The Royal Commission has provided ample evidence to suggest the variable remuneration linked to sales value or volume can result in conflicts of interest and customer detriment. As Pearson notes: 'Arguments that commissions are good for consumers because without them they would not be sold life insurance or would not have assistance to choose a mortgage, reflect the culture, belief systems and habits of product providers'.⁴¹ It is time to reshape this culture. Extending the application of conflicted remuneration across the financial service industry, removing carve outs and exceptions, is the most effective means of reducing misconduct risk and regulatory complexity related to remuneration. This move is appropriate in a banking system characterised by mandatory citizen participation and information asymmetry. Banning conflicted remuneration for some products or services (advice) but allowing others is illogical and creates confusion in the marketplace. Simplifying the application of the conflicted remuneration provisions through extension to all bank staff and intermediaries will assist in restoring public confidence: 'Instead of competing on the amount of a commission, firms could compete on the quality of the product and help to consumers.'⁴² This is the most desirable outcome. Extension of conflicted remuneration should be combined with regulatory action and meaningful efforts by industry to evaluate and reform culture. We submit that these steps will result in a financial service sector that is robust, effective, and responsive to customer needs.

⁴¹ Pearson, above n 6, 174.

⁴² Ibid 175.

BRING ETHICS, INTEGRITY AND PROFESSIONALISM TO FINANCIAL GOVERNANCE

Hugh Breakey
Charles Sampford

PROFESSIONS & PROFESSIONALISM

With the series of scandals and ethical failures in banking and the financial services industry worldwide, there have been continuing calls for professionalisation of the sector as a method of improving standards. Legislative efforts have provided force for such reforms, at least in terms of the financial advice industry, with the Corporations Amendment (Professional Standards of Financial Advisers) Act 2017 (Cth), and the resulting *Financial Adviser's Standards and Ethics Authority* ('[FASEA](#)').

This section looks at the promise of professionalism and integrity approaches to improving ethical standards.

What is a profession?

Many groups with a claimed expertise for sale have sought to be recognised as 'professions' – with the prestige, autonomy, power and ability to charge higher fees. The great learned professions of medicine and law were joined by dentists, architects, accountants and engineers in the nineteenth century and 'allied health professions' in the twentieth.

A profession traditionally involves a public good delivered by a self-regulating group of experts through application of a body of knowledge and conformity to an ethical code.

Public good: The public good is the social benefit delivered by the profession to society at large, and to their individual clients. For example, lawyers recognise a duty to law and the system of justice. Some put it that the duty to the court is always prior to the duty to the client, or that their duty to the court and justice is via the representation of their client in ways that advance justice rather than impede it.

The dedication to the public good does not make professions into charities or government agencies. Professionals can charge fees for the service they render, and those who serve best may earn particularly high fees, in line with the service they do and the public good they promote.

Body of knowledge: Each profession possesses a body of expert knowledge used to advance its public good. Traditionally passed down in guilds through lengthy apprenticeships, entrance-level education is now provided at universities, sometimes accompanied by professional exams. Ongoing refinement, growth and updating occurs through lifelong learning and continuing professional development schemes.¹ The best professions have multiple

¹ Hugh Breakey and Charles Sampford, "National Exams as a Tool for Improving Standards: Can Australian Financial Advisers Take a Leaf from the Professionals' Book?," *University of New South Wales Law Journal* 40, no. 1 (2017).

means for challenging its body of knowledge – through public contestation in the academy, in professional bodies and, in law, through the structure of adversarial court processes.

Code of ethics: Clients, patients, third-parties and public institutions are all vulnerable to professional malfeasance.² Because professions deal with fundamental needs (health, security, legal representation, safety), individuals and societies have little choice except to engage with them. Yet the stakes of low-standards advice or treatment can be devastating, issuing in enormous life-costs. These vulnerabilities are exacerbated by the professional's special expertise. Because expertise involves years of study and the capacity to judge subtly amid conflicting signals, ordinary clients and third-parties are ill-equipped to accurately evaluate professional standards. It can take years before a layperson acquires definitive evidence of poor-standards professional behaviour. A final vulnerability occurs because the professional service itself involves clients exposing their personal history, records, future plans and even physical body.

To respond to these vulnerabilities, and ensure clients and the public can trust professionals, professions have developed and inculcated a code of ethics in which the public good comes first, the client comes second, and the professional comes third.³ Typical principles responding to core areas of vulnerability include those of confidentiality, prior consent, fiduciary obligation, integrity, collegiality and the avoidance of conflicts of interest. Empirical studies show that the code's ubiquity and efficacy depend upon: a) the process of codification; b) the code's clarity and comprehensiveness; c) communication and education about the code; and, d) embedding the code in processes and practices.⁴

Self-regulation: Admission, promotion and exclusion from the profession is performed through professional organisations on the basis of code compliance and educational requirements. Self-regulation is only ever partial, as government involvement routinely covers several critical dimensions: protecting professional title and function; setting disciplinary measures; and laying down formal regulation and criminal laws.

If a member acts in breach of the code they can be sanctioned by the professional organisation, and if necessary removed. Yet the most esteemed professions are not those who merely prohibit unacceptable behaviour. Codes of ethics include aspirational goals and strong ethical principles, and professional organisations can work actively to raise standards to these levels.

Professionalism: Financial Advisers

The scandals in the financial services industry since the GFC have led to pushes to professionalise various groups within the industry. One key part of the financial services industry appeared to have the necessary ingredients for professionalisation: financial advisers/planners.

With the growth in complexity of financial products and related areas of law, proficient financial advisers came to acquire an expert body of knowledge, at the same time as that complexity made their clients increasingly vulnerable to exploitation. Building on these existing attributes, the government legislated the *Corporations Amendment (Professional Standards of Financial Advisers) Act 2017* (Cth), and the resulting FASEA. While FASEA is not strictly a professional organisation in terms of being self-regulatory, it nevertheless possesses sufficient expertise and independence to play this role, in particular by developing educational standards (including a continuing professional development regime and a national exam) and a code of conduct. With the concurrent development of monitoring bodies (including existing professional organisations) to scrutinise each professional's conformity to the code, the key ingredients for a profession are effectively in place.

² Hugh Breakey, "Supply and Demand in the Development of Professional Ethics," *Research in Ethical Issues in Organizations* 15 (2016): 7-9.

³ *ibid.*; Rosamond Rhodes, "Understanding the Trusted Doctor and Constructing a Theory of Bioethics," *Theoretical Medicine* 22 (2001).

⁴ Muel Kaptein and Johan Wempe, "Twelve Gordian Knots When Developing an Organizational Code of Ethics," *Journal of Business Ethics* 17 (1998); Muel Kaptein, "Toward Effective Codes: Testing the Relationship with Unethical Behavior " *ibid.* 99 (2011).

There are, however, some gaps remaining. The current public draft of the FASEA [Code of Ethics](#)⁵ rightly imposes standards of integrity, independence and advice to be given in the ‘best interests’ of the client: Standards 2, 3 and 5. However, the current FASEA Draft Code falls short of professionalism insofar as it does not prohibit advisers from possessing a conflict of interest. (As was described above in the section on Conflicted Remuneration, and noted by the Commission itself,⁶ current regulations on conflicted remuneration fall far short of a blanket ban on conflicts of interest, and duties of disclosure provide a poor substitute for such a ban.) In the existing financial industry, such a requirement may be challenging for individual advisers to secure and maintain. Yet without a prohibition on conflicts of interest that aligns substantively with that observed by other professions – such as doctors, lawyers and accountants – there will be a consistent and powerful incentive for providing conflicted advice. Worse, a breach of professional standards will be more difficult for code-monitoring bodies to police and prove (it being harder, and necessarily retrospective, to demonstrate the existence of self-interested advice as compared with the mere presence of a conflict of interest). This gap provides a critical opportunity for the Royal Commission to require banks and other financial platform/product-developers to work with the nascent profession in order to fully professionalise.

Recommendation 1: Banks and financial organisations should be required to work with FASEA to the point where the FASEA Code can include a direct, standalone Standard prohibiting conflicts of interest. This Standard can be subsequently specified through FASEA’s Additional Guidance on the Code.

Professionalism: bankers

Banks as employers of professionals

Before considering whether banking is, or could ever become, a profession, it warrants emphasis that banks are *major employers of professionals*. This is true of established professionals like accountants, auditors and lawyers. It has historically been true of the now developing profession of financial advisers. While some major banks are divesting themselves of their financial advising practices, they will retain substantial links to the profession – if only through their supply of financial products and platforms that will be the subject of financial adviser’s guidance and management.

One critical part of reforming banking behaviour will be to help raise and empower the standards of professionals it employs, or for whom it develops products. There are several ways banks can do this. First, the independent professional code of conduct must be officially recognised and prioritised in all workplace codes (of ethics, conduct, practice or risk-management). Professionals are employed *as professionals*, and can only undertake their dedicated functions when protected and guided by their professional codes of ethics.⁷ Second, employed accountants and lawyers may be encouraged to provide ‘whole of business’ advice, whether under an explicitly ethical banner or a risk-management practice.⁸ Finally, in terms of conflicted remuneration, internal processes must not reward, incentivise or pressure employed professionals into neglecting their professional duties, and (as noted above), banks will need to work with FASEA and the financial advice profession to minimise, mitigate or remove potential conflicts of interest. Just as the public would not accept drug companies providing cash kickbacks to prescribing doctors, so too banks must be prohibited from incentivising the breach of financial advisers’ ethical duties of integrity, independence and fiduciary obligation to their clients (all part of the existing FASEA Draft Code).

Recommendation 2: All industry and bank codes that apply to employed professionals (including codes of ethics, practice, conduct and risk-management) must accord with the standards of the independent

⁵ Financial Adviser Standards and Ethics Authority, ‘Code of Ethics for Financial Advisers’ (Exposure Report for Proposed Standard, 20 March 2018) ‘FASEA Draft Code’.

⁶ Commonwealth, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report* (2018) vol 1, 301.

⁷ Hugh Breakey and Charles Sampford, “Employed Professionals’ Ethical Responsibilities in Public Service and Private Enterprise: Dilemma, Priority and Synthesis,” *University of New South Wales Law Journal* 40, no. 1 (2017).

⁸ Charles Sampford and Sophie Blencowe, “Educating Lawyers to Be Ethical Advisors,” in *The Ethical Challenge for Legal Education*, ed. K. Economides (Hart Publishing, 1998); Elaine M. Doyle, Jane Frecknall Hughes, and Keith W. Glaister, “Linking Ethics and Risk Management in Taxation: Evidence from an Exploratory Study in Ireland and the UK,” *Journal of Business Ethics* 86 (2009).

professional code, and should explicitly state that – in any cases of perceived conflict – the professional code must take priority.

Banking as a profession

Banking is not, and has not been for some time, a profession in the proper sense of that word: it is heavily externally regulated (with entities rather than individuals being the subject of regulation); dominated by a profit-seeking mentality, without clear loyalty to a core public good; and increasingly involves proprietary trading rather than providing partnership or advice to clients.⁹ Furthermore, unlike financial advisers, there is not a settled domain of expertise shared across the group. Banking gathers a diverse amalgam of employees and partners of different occupations, expertise and educational qualifications. This can leave little tradition and shared common purpose that transcends profit-making.

Yet there are similarities. The Royal Commission has demonstrated that clients, third-parties and the public are vulnerable to the standards of bankers in all too manifest ways.¹⁰ The recent initiatives with bankers' oaths in Australia and abroad might be suggestive of values and core purposes – though these tend to be client-centred, and can suffer from being ambiguous and overly broad.¹¹ Codes of conduct for banking do occur – yet these are entity- rather than individual-focused, and in employing a stakeholder process, involve levels of flexibility far beyond the discretion afforded in professional codes.¹² Ultimately, different parts of the banking industry seem better fitted towards professionalisation, such as with respect to existing duties of confidentiality, loyalty and fiduciary duties.¹³

However, even if there are areas and aspects of banking where full professionalisation should not be attempted, it nevertheless remains possible that various mechanisms employed by the professions will be useful in improving ethical standards. For the same approach that works for building ethics in the professions, and in other institutions, can apply to banking: the institutional integrity and integrity system approach.

ETHICS & INTEGRITY IN BANKING & FINANCIAL SERVICES

Integrity, institutional integrity & integrity systems

Improved standards can be pursued through institutional integrity, based on the integrity systems approach. This approach starts with the basic ethical question – how are we to live? Answering that question involves asking hard questions about one's values, giving honest and public answers, and trying to live by those answers. Those who do so have personal integrity in the sense that they are true to their values.¹⁴ *Institutional integrity* applies the same approach to institutions. It involves an institution asking hard questions about its value and values, giving honest and public answers and living by them. Doing so for an institution is more complex than for an individual – but it is both possible and necessary.¹⁵ This approach is familiar in the context of the professions. Indeed, the very idea of a 'professional' derives etymologically from 'one who professes': that is, the act of professing what one stands for and living by it.¹⁶

Delivering on ethical standards and institutional integrity requires *integrity systems* made up of legal and institutional supports that gives good external reasons for individuals, firms and institutions to implement their public values. This approach (initially called an 'ethics regime/infrastructure') developed out of the anti-corruption reforms arising from the Fitzgerald Inquiry in Queensland. When Jeremy Pope, the first CEO of *Transparency International* came to Queensland in 1995, he saw that this approach was very different and far superior to then

⁹ Dimity Kingsford-Smith, Thomas Clarke, and Justine Rogers, "Banking and the Limits of Professionalism," *UNSW Law Journal* 40, no. 1 (2017): 412-13, 43-4.

¹⁰ A fact already well-known: *ibid.*, 441-2.

¹¹ *ibid.*, 432-36.

¹² *ibid.*, 436-9.

¹³ *ibid.*, 439.

¹⁴ Noel Preston, Charles Sampford, and Carmel Connors, eds., *Encouraging Ethics and Challenging Corruption: Reforming Governance in Public Institutions* (Annandale: Federation Press, 2002).

¹⁵ Hugh Breakey, Timothy Cadman, and Charles Sampford, "Conceptualizing Personal and Institutional Integrity: The Comprehensive Integrity Framework," *Research in Ethical Issues in Organizations* 14 (2015): 3-4.

¹⁶ Michael Davis, "Professionalism Means Putting Your Profession First," *Georgetown Journal of Legal Ethics* 2, no. 34 (1988): 342.

then fancied Hong Kong model. Pope called it an integrity system.¹⁷ It became a global exemplar and recommended approach to tackling corruption and other governance problems with systemic reform.

This approach required reforming virtually all the institutions of government. Queensland established an independent reform commission which recommended a wide range of mutually reinforcing changes to laws and institutions – including to constitutional law, administrative law, ombudsmen and more.

The integrity systems approach improves on purely regulatory regimes in several ways.¹⁸ First, it is organised around the positive purpose developed by the institution that justifies its existence and activities (similar to the ‘public good’, noted above, that delineates professional codes).¹⁹ Attention is focused on delivering the positive good the institution can do, rather than fixating on the dangers it presents. Second, the goal is to improve ethical standards to raise ‘normal’ behaviour above the low bar of legal compliance. Ethical behaviour falls on a normative continuum from the highest aspirations, to expected standards, to minimum requirements (policed by workplaces and professional organisations), and finally to criminal wrongdoing (policed by the courts). The integrity system aims to reward and facilitate high aspirations and expected standards. Third, the reform process employs a system-wide variety of levers and mechanisms. As well as ethical standard setting, it employs legal regulation, institutional design and economic incentives.²⁰ The latter is critical. While people cannot be bribed to be good, it is vital to avoid creating perverse incentives for wrongdoing through bonuses, performance metrics, promotions, or employment opportunities that effectively reward and promote morally risky or wrongful behaviour.

Integrity in Banking and Finance

The 2017 legislation professionalising financial services provides a good example of an integrity-systems approach. The new regime is built around a developing code of ethics that makes clear the values and goods offered by quality financial advice, and that brings in new education standards. The system for ensuring compliance brings together not only government regulators like ASIC and independent authorities like FASEA, but also a regime of monitoring bodies and the incorporation of accredited educational providers.

However, some institutional gaps remain in the new regime. In a normal professional integrity system, the professional organisation not only polices code compliance, but also provides communication and education that embed professional standards. While initial education on the code will be comprehensively covered by the [FASEA educational pathways](#), it appears that crucial practices like advice-hotlines and whistle-blower support could fall into the gap between FASEA’s remit and that of monitoring bodies.

Recommendation 3: FASEA-accredited monitoring bodies should be required to provide advice-hotlines and whistle-blower support mechanisms, following best practice examples in established professions.

While pursuing professionalism may not be possible for (all parts of) banking, banks can nevertheless be reformed on the integrity-approach. This will require, perhaps building on existing declarations like the bankers’ oaths, banks asking the vital questions that must be asked of any institution or organisation: What is it for? What justifies the organisation to the community in which it operates given that the community generally provides privileges? Asking those questions involves an institutional and collective effort under its own formal and informal constitutional processes (including getting acceptance from relevant outsiders – including shareholders and or relevant regulators). A multi-institutional approach will then be needed to deliver those values and public goods. Each institution contributing to financial integrity (including regulators, prosecutors, industry bodies and, of course, companies engaged in banking and finance), new or reformed, should be assessed not only on the way they do their job but the way they collaborate and interact in raising and enforcing standards.

¹⁷ Jeremy Pope, *Confronting Corruption: The Elements of a National Integrity System* (*‘the Transparency International Source Book’*) (Berlin: Transparency International, 2000).

¹⁸ Charles Sampford, Rodney Smith, and A. J. Brown, "From Greek Temple to Bird’s Nest: Towards a Theory of Coherence and Mutual Accountability for National Integrity Systems," *Australian Journal of Public Administration* 64, no. 2 (2005).

¹⁹ Breakey, Cadman, and Sampford, "Comprehensive Integrity Framework," 22.

²⁰ Sampford, Smith, and Brown, "Greek Temple to Bird’s Nest."; Hugh Breakey, "Dividing to Conquer: Employing the Separation of Powers to Structure Institutional Inter-Relations," *Research in Ethical Issues in Organizations* 12 (2014).

CONCLUSION

If financial corporations are to truly serve the communities in which they operate, they must have a clear vision of the way they add value to those communities and work internally and externally to add that value. If this is achieved, then financial services will possess integrity because they are, and do, what they claim. The best way of achieving this is through an 'integrity system' – a combination of professional and institutional ethical standard setting, legal regulation and economic and institutional reform – with significantly improved inputs from the long-standing professions of law and accounting, as well as the establishment of a high-standards profession of financial advisers.

Integrity systems were first applied to public governance reform in Australia. Australia can take a lead in these developments, contributing to the reform of 'financial integrity systems' at national, regional and global levels. If it does, our finance industry can produce innovations that can be trusted by Australians and foreigners alike to serve investors, communities and economies.

AUSTRALIA'S FINANCIAL REGULATORY FUTURE: STRUCTURE, ENFORCEMENT & LEGAL COMPLEXITY

Hannah Harris

Dimity Kingsford Smith

INTRODUCTION

This section addresses the Royal Commissioner's questions on Australia's regulatory structure, the remit of ASIC, ASIC's regulatory enforcement, and whether the law ASIC administers is too complicated. Specifically, we provide discussion in response to the following questions from the Interim Report:

- Is the regulatory regime too complex?
- Is ASIC's remit too large?
- Who would take over those parts of the remit that are detached?
- Why would detachment be better?
- Are ASIC's enforcement practices satisfactory? If not, how should they be changed?
- Should ASIC enforcement priorities change?
- After the Enforcement Review's recommendations are implemented, will ASIC have enough and appropriate regulatory tools?
- Is the law governing financial services entities and their conduct, too complicated?
- Would a statement of simple principles assist? How?

REGULATORY STRUCTURE

Institutional to Functional Approach: The Twin Peaks Model and the Singular Ideal

Prior to the Wallis Report¹ there were at least 10 financial regulators in Australia, where now there are two.² Numbers alone are often a poor guide and the real regulatory problem the twin peaks model addresses was the multitude of different regulatory standards and approaches, prominently for disclosure, Wallis' key regulatory strategy. Just as bad were the gaps and overlaps between them.

¹ Phil Hanratty, 'The Wallis Report on the Australian Financial System: Summary and Critique' (Research Paper No 16 1996–97, Economic, Commerce and Industrial Relations Group, Parliament of Australia, 23 June 1997).

² Ibid, where this plurality of regulators is discussed: National Securities and Companies Commission (and related state companies registrars and stock and futures exchanges); Insurance and Superannuation Commission; Reserve Bank of Australia.

The Wallis ideal was both functional and singular.³ There were to be regulators addressing different functions: APRA for prudential regulation and ASIC for market misconduct, point of sale conduct and disclosure for retail investors. Instead of various institutional regulators for conduct and disclosure there was to be *one regulator, one license and one rules regime*. Even for credit, after Wallis, ASIC was given an extended definition of ‘financial product’ including credit.⁴ That permitted legislative standards for the sale of credit contracts mirroring those for other financial products and ASIC enforcement powers in relation to them.⁵ Since 2009, the single regulator ideal has been further realised by increasing ASIC’s point of sale credit regulation through new licensing and disclosure powers. At the same time, the new act has meant a practical departure from the single licence,⁶ and the ideal of a single regime. However, the patterns of the earlier licensing regime and legislative standards for other financial products are followed significantly in credit licensing. Likewise, enforcement powers for financial products and credit are aligned and the ASIC Enforcement Taskforce Review Report recommended further harmonisation of enforcement.⁷ This assists ASIC and agencies to which ASIC refers matters, such as the Commonwealth Director of Public Prosecutions (‘CDPP’) and the Australian Federal Police (‘AFP’).

Structure and ‘Meta-Regulation’: Customer Disputes and Codes

One aspect of the Australian twin peaks structure is that ASIC meta-regulates (or supervises) the regulatory work of subordinate bodies related to its functions.⁸ While there are others,⁹ the new Australian Financial Complaints Authority (‘AFCA’) is one of these subordinates.¹⁰ AFCA gives reasons for optimism in addressing complexity and is a boon for ASIC compared to the three external dispute organisations it previously supervised. ASIC has no responsibility for the resolution of individual complaints by AFCA nor its management,¹¹ unless systemic issues arise. It has information gathering powers regarding AFCA external disputes, augmented recently to include internal provider disputes,¹² and it has rule-making powers.¹³ These changes should allow ASIC both greater visibility of provider conduct and consumer wellbeing, and the power to adjust the regulation as the new system matures.

Regulator supervision of codes of conduct is another dimension in which meta-regulation can be observed. The ASIC power to approve codes¹⁴ has been little used. The only code it administers is for e-payments. Codes governing financial advisers have recently been prescribed, and they are supervised by the FASEA,¹⁵ which ASIC meta-regulates. Unlike codes under the remit of the Australian Competition and Consumer Commission (‘ACCC’)¹⁶ ASIC has no powers to investigate or enforce codes as such,¹⁷ and this

³ Andrew Godwin and Ian Ramsay, ‘Twin Peaks – The Legal and Regulatory Anatomy of Australia’s System of Financial Regulation’ (Research Paper No 74/2015, Centre for International Finance and Regulation, August 2015).

⁴ *Australian Securities and Investment Commission Act 2001* (Cth) s 12BAA(7)(b).

⁵ *Ibid* pt 2.D.

⁶ Credit providers are licensed under the *National Consumer Credit Protection Act 2009* (Cth) pt 2–2 and providers of other financial products under the *Corporations Act 2001* (Cth) s 912A.

⁷ Australian Securities and Investments Commission, ‘ASIC Enforcement Review: Taskforce Report’ (18 December 2017) <<https://static.treasury.gov.au/uploads/sites/1/2018/04/ASIC-Enforcement-Review-Report.pdf>>.

⁸ *Treasury Laws Amendment (Putting Consumers First – Establishment of the Australian Financial Complaints Authority) Act 2018* (Cth).

⁹ For example, the Financial Advisor Standards and Ethics Authority (‘FASEA’), the Auditing and Assurance Standards Board (AASB) and Australian Financial Security Authority (‘AFSA’).

¹⁰ AFCA’s relationship with ASIC is considered in Australian Securities and Investment Commission, ‘Oversight of the Australian Financial Complaints Authority’ (Regulatory Guide 267, 20 June 2018) (‘RG 267’).

¹¹ *Treasury Laws Amendment (Putting Consumers First – Establishment of the Australian Financial Complaints Authority) Act 2018* (Cth); ASIC, ‘RG 267’, above n 10,

¹² *Treasury Laws Amendment (Putting Consumers First – Establishment of the Australian Financial Complaints Authority) Act 2018* (Cth); ASIC, ‘RG 267’, above n 10,

¹³ *Treasury Laws Amendment (Putting Consumers First – Establishment of the Australian Financial Complaints Authority) Act 2018* (Cth); ASIC, ‘RG 267’, above n 10,

¹⁴ ASIC has the power to approve codes in the financial services sector: see *Corporations Act 2001* (Cth) s 1101A; Australian Securities and Investment Commission, ‘Approval of Financial Services Sector Codes of Conduct’ (Regulatory Guide 183, March 2013).

¹⁵ See: Financial Adviser Standards <<https://www.fasea.gov.au/>>.

¹⁶ *Competition and Consumer Act 2010* (Cth) pt IVB (‘CCA’).

¹⁷ Under pt IVB of the CCA, the ACCC is given certain powers to enforce industry codes of conduct. Section 51ACB prohibits the contravention, in trade or commerce, of an ‘applicable industry code’ by a corporation. The ACCC has the power to

is mainly left to industry association code bodies. These enjoy none of the powers of investigation, compulsion or banning from the industry.¹⁸ Even if a member is disciplined and expelled they must only leave the association, not the industry.

As with AFCA, ASIC's meta-regulation of bodies involves regulatory 'steering' but not regulatory 'rowing' – 'rowing' is the role of the subordinates. At first glance this multiplication of regulators may seem to add complexity: actually, 'meta-regulation' assists with regulatory co-ordination, builds out sub-functions in an orderly way and allows appropriate private financial support of public regulatory work. Consumer dispute resolution is an essential regulatory function (other subordinate bodies likewise). Meta-regulation which combines a statutory framework with public norms often funded by industry (licensees pay for AFCA disputes not customers), provides a counter-weight to provider market power. Meta-regulation often supplies timely information about provider compliance and emerging risks. Meta-regulation can be adapted to a variety of regulatory purposes as shown by the other 'subordinate' bodies ASIC supervises.¹⁹

A Short Comparative Analysis of Regulatory Structure

The Commissioner has raised the question of regulatory complexity, but by comparison with other countries, Australia's regulatory structure is relatively simple. First, for prudential, conduct and competition regulation, both laws and enforcement are national. We do not comment further on competition regulation, noting in all comparable jurisdictions its primary regulator and regime is separate from financial services. Second, by comparison with the fragmented institutional approach of say the US the twin peaks model involves few regulatory bodies, even with those it 'meta-regulates'. This facilitates focus on regulatory function, inter-agency coordination and reduces regulatory arbitrage (designing product form to disguise financial function and to choose strategically the lightest regulation).²⁰

Third, twin peaks also avoids the short-comings of the 'integrated or unified approach'²¹ which places all regulatory functions in one regulator. An integrated approach concentrating 'on detailed rules and process which all but guaranteed that the big risks would be missed' allowed scandals to grow to 'vast proportions in part because of the slowness and inadequacy'²² of the integrated response. This approach was abandoned in the United Kingdom because it presented a 'single point of regulatory failure'.²³ The integrated approach has been successful in some other countries,²⁴ and while it avoids problems of regulatory co-ordination and arbitrage, it lacks the fail-safe that if one regulatory function fails, the other may not. The integrated United Kingdom Financial Services Authority has been replaced by two regulators dividing prudential and conduct regulation into a twin peaks framework.

Finally, other jurisdictions have found 'meta-regulation' of necessary functions closely related to the objects of the main twin peaks regulators useful. The UK conduct and point of sale regulator, the Financial Conduct

investigate breaches of an industry code, including by compelling production of documents by a business. In response to a breach, the ACCC may issue infringement notices, public warning notices and make orders compensating aggrieved parties. At the extreme end of the scale, the ACCC may demand an enforceable undertaking or commence court proceedings

¹⁸ The disciplinary powers of 'domestic' tribunals are considered in J R S Forbes, *Justice in Tribunals* (Federation Press, 4th edition, 2014)

¹⁹ *Corporations Act 2001* s 920.

²⁰ *Sydney Futures Exchange Ltd v Australian Stock Exchange Ltd* 56 FCR 236.

²¹ Andrew D Schmulow, 'Four Methods of Financial System Regulation: An International Comparative Survey' (2015) 26 *Journal of Banking and Finance Law and Practice* 151, 155, 158–65.

²² Remarks by Professor Geoffrey Wood to the Economic Affairs Committee in Economic Affairs Committee, House of Lords, *Banking Supervision and Regulation* (2009) 29 [97].

²³ Financial Regulatory Systems Working Group, 'The Structure of Financial Supervision: Approaches and Challenges in a Global Marketplace' (Report, Group of Thirty, 2008) 14.

²⁴ Schmulow, above n 21, 155–8.

Authority (FCA),²⁵ meta-regulates the Financial Ombudsman Service²⁶ and the Financial Services Compensation Scheme (FSCS).²⁷

Conclusion

The twin peaks structure regulates according to function, while pursuing the ideal of a single approach within that function. By comparison with overseas jurisdictions this avoids regulatory fragmentation and duplication, as in the US, and the pitfalls of a single point of regulatory failure demonstrated by the FSA in the UK. Before Wallis, there were multiple conduct and disclosure regimes and multiple regulators. Along with the variety of 'laws on the page' there were various approaches to enforcement. In conduct and point of sale regulation a single approach *should* strengthen disclosure and price comparability; likewise, it should simplify provider compliance systems, controls, and training. Consumer complaints and regulatory supervision and enforcement should also be simpler.²⁸ Twin peaks and meta-regulation since Wallis are further steps in the long arc of creating a national Australian market and regulatory system for companies and financial products and services, started in 1961 with the uniform *Companies Act 1961* (Cth).

THE WIDTH OF ASIC'S REMIT

The current remit of ASIC is demonstrated by the following diagram reproduced here from a submission by Commonwealth Treasury to the Commission.

Table 1: Table of Regulator Remit from the Treasury Submission²⁹

Comparison of market conduct regulators' responsibilities	Financial services	Corporate regulation	Consumer credit	Financial education	Supervision of Financial Markets	Insolvency	Company registration	Prudential regulator	Statutory responsibility for competition	Payment Systems
ASIC										
Financial Conduct Authority (United Kingdom)										
Securities and Exchange Commission (United States)										
BaFIN (Germany)										
Authority for Financial Markets (Netherlands)										
Securities and Futures Commission (Hong Kong)										
Monetary Authority (Singapore)										

Another agency performs the role The role is shared

This chart is a visual aid and has been simplified for clarity. Areas of responsibility are based on Australia's regulatory framework and may not precisely align with frameworks adopted in other jurisdictions. The Reserve Bank of Australia has responsibility for payment systems and APRA for prudential regulation. In Australia the ACCC is the primary competition regulator, but ASIC's revised Statement of Expectations requires ASIC to have regard to competition issues.

As argued, there are differences between institutional, integrated and twin peaks regulators. The Treasury diagram is helpful for orientation however, it compares the remit of different regulatory types. A national regulator like ASIC will always be wider, than one sharing remit with state (US) or provincial regulators

²⁵ The *Financial Services and Markets Act 2000* (UK) c 8 (FSMA) sets out the oversight role of the FCA in relation to the Ombudsman.

²⁶ Financial Conduct Authority and Financial Ombudsman Service Limited, 'Memorandum of Understanding' (18 December 2015) <<https://www.financial-ombudsman.org.uk/about/MOU-with-FCA-dec2015.pdf>>.

²⁷ Financial Services Compensation Scheme (FSCS), *Financial Services Compensation Scheme* (2018) <<https://www.fscs.org.uk/>>.

²⁸ Dimity Kingsford Smith, 'Is "Due Diligence" Dead? Financial Services Disclosure under the *Financial Services Reform Act 2001*' (2004) 22 *Company & Securities Law Journal* 128.

²⁹ Commonwealth Treasury, 'Submission on Key Policy Issues' to Commonwealth, *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*, 13 July 2018,24. <<https://financialservices.royalcommission.gov.au/publications/Documents/Treasury-background-paper-24.pdf>>.

(Canada). Likewise, an integrated regulator (like Singapore) will always be wider than a twin peaks regulator, the former remit being designed to cover all functions.

By contrast the remit of an institutional regulator will be narrower because it regulates an historically path-dependent institution or instrument. The Securities Exchange Commission ('SEC') regulates only corporations and 'securities',³⁰ and related financial markets and intermediaries. If they do not involve 'securities', the SEC does not regulate employment related retirement income,³¹ derivatives³² or credit contracts.³³ Accordingly, the best approach is to contrast ASIC's remit with *comparable* overseas regulators, being other twin peaks regulators.

How Is ASIC's Remit Different from Comparable Regulators?

At present, twin peaks regulators are to be found in Australia, the Netherlands, Switzerland, Qatar, the UK, New Zealand and recently, South Africa.³⁴ Following Treasury's lead, we visualise the twin peaks comparison in the following Table 2, focusing on the most comparable regulation.

Table 2: Remit of comparable twin peaks regulators - comparing diversity of subject matter

Market conduct regulator responsibilities	Financial Services	Corporations Regulation	Consumer Credit	Financial Education	Financial Market Supervision	Insolvency	Co Registration	Prudential Regulation	Competition	Payment System
ASIC	Light Blue	Light Blue	Light Blue	Light Blue	Light Blue	Light Blue	Light Blue	White	White	Light Green
Financial Conduct Authority (UK)	Light Blue	Light Blue	Light Blue	Light Blue	Light Blue	White	Light Blue	Light Green	Light Green	Light Green
Financial Sector Conduct Authority (South Africa)	Light Blue	Light Blue	Light Green	Light Blue	Light Blue	White	White	White	Light Green	Light Green
Netherlands Authority for Financial Markets (Netherlands)	Light Blue	White	Light Green	White	Light Blue	White	White	White	White	White
Financial Markets Authority (NZ)	Light Blue	Light Green	White	Light Blue	Light Blue	White	White	White	White	White

This diagram demonstrates that ASIC's remit is similar to other twin peaks conduct regulators. Except for New Zealand all twin peaks conduct regulators supervise both credit and investment. South Africa has left companies regulation with the relevant government department and New Zealand and the Netherlands have done likewise. The UK has done this with corporate insolvency. In UK and South Africa, the conduct regulator has more responsibility than ASIC for prudential and competition matters. Recently ASIC has

³⁰ Republic Act 8799, USC §§ 2(1), 5, 77b(1) (2004).

³¹ *Employee Retirement Income Security Act of 1974*, 29 USC 18 §§1001–1461 (2014) ('ERISA') is a federal law that sets minimum standards for most voluntarily established pension and health plans in private industry to provide protection for individuals in these plans.

³² Derivative are regulated by the Commodities Futures and Trading Commission: see Commodities Futures and Trading Commission <<https://www.cftc.gov>>.

³³ Credit Contracts are regulated by the Consumer Financial Protection Bureau, established in 2009: <<https://www.consumerfinance.gov/>>.

³⁴ Schmulow, above n 21, 165.

shed to the ATO its large corporate registry operation, bringing this element of its remit into line with South Africa, and leaving the UK FCA with the widest twin peaks remit.

Why Would Detachment be Better or Worse? How?

Accordingly, comparative analysis of ASIC's remit does not support partial detachment due to width. Are there other reasons for detachment? The effective management of any regulatory remit depends on adequacy of funding. In its submission, Treasury acknowledges that ASIC's remit has widened significantly while over the last decade the real value of its funding has not increased.³⁵ Recent research by the Library of the Commonwealth Parliament estimates that ASIC's funding has been cumulatively reduced by \$197 million since 2013 and its staff reduced by 20%. On forward estimates ASIC's funding will remain below 2013 levels by \$81 million cumulatively between now and 2022.³⁶ Since the level of ASIC's funding is still constrained by government appropriation reimbursed by a new industry levy,³⁷ there are reasons for concluding that the politics of ASIC's funding have not shifted. Detachment is one response, but detachment would only release more funding for remaining functions in the short-term. This would not reduce overall cost, since detached functions would also need funding.

Would detachment address complexity? We think there are two sources of complexity: institutions and rules. We have already shown that a twin peaks approach with a single regime for conduct and point of sale regulation, provides the best trade-off between *institutional complexity* and the consequences of single-point regulatory failure. Unless functions were transferred to an existing regulator, detachment would likely increase institutional complexity and co-ordination costs. This is exemplified by the additional referring agencies the CDPP and investigative agencies would have to manage if the priority given to prosecution by the *Interim Report* is accompanied by detachment. By international comparison, Australia's institutional arrangements for financial regulation at the simpler end. We argue below that instead it is the politics of regulation creating a proliferation of be-spoke rules *on the same subject matter* for financial sub-sectors that needs addressing. This *rules complexity* would not be addressed by detachment.

Conclusion

ASIC's remit is not overly wide, for a twin peaks regulator. Because Australian financial regulation is national and because the Wallis architecture removed a host of institutional regulators, Australia's regulatory structure is relatively simple internationally. Detachments from ASIC's remit would damage the regulatory design of the twin peaks model: it would add co-ordination costs and would not provide savings. Detachment would also surrender any possibility of realising the single regulator, single licence and single rules regime for conduct regulation envisaged as central to the twin peaks approach. Instead since 1997 there has been sectoral multiplicity in conduct rules, a potent source of complexity which we consider below. Detachment would also sacrifice the possibility of institutional co-ordination in rule-making between the twin conduct and prudential regulators adopted in South Africa, and as we propose below.

ASIC AND REGULATORY ENFORCEMENT

As Schmulow points out, regulatory effectiveness does not end with structure and subject matter remit.³⁸ It also depends on enforcement, in terms of both formal powers and enforcement priorities or 'style'. As Table 3 indicates, in formal terms ASIC is furnished with regulatory powers comparable with (or greater than) other twin peaks regulators. Further, if the Government implements the recommendations of the ASIC

³⁵ Commonwealth Treasury, above n 29, [117].

³⁶ Andrew Tillett, 'Coalition budget cuts nobbling ASIC, Labor's Clare O'Neil says', *Australian Financial Review* (Sydney), 24 October 2018, 5. <<https://www.afr.com/news/coalition-budget-cuts-nobbling-asic-labors-clare-oneil-says-20181022-h16z2z>>.).

³⁷ Australian Securities and Investment Commission, 'ASIC Cost Recovery Arrangements: 2017–18' (Regulatory Guide 535, 14 July 2017) *passim*.

³⁸ Schmulow, above n 21.

Enforcement Taskforce Review Report, ASIC’s investigation powers as well as its enforcement powers and sanctions will be significantly rationalised and brought up to date.³⁹

Table 3: Comparable twin peaks regulators – comparison of enforcement powers

Market conduct regulator enforcement powers	Negotiate / Educate / Persuade / Facilitate	Warning Letters	Infringement Notices	Enforceable Undertakings	Civil Penalty Actions	Summary Criminal Prosecution	Indictable Criminal Prosecution	Licence Suspension or removal	Product Intervention Powers
ASIC									*40
Financial Conduct Authority (UK)									
Financial Sector Conduct Authority (South Africa)									
Netherlands Authority for Financial Markets (Netherlands)									
Financial Markets Authority (NZ)									

What is ‘Enforcement’?

The Commissioner has suggested in his *Interim Report*, that ASIC should use more formal prosecution and civil penalty actions. He even goes as far as to argue that ‘if a case can be made, and there is no public interest for not prosecuting, charges [should be] laid’.⁴¹ This suggests a view that the only enforcement deserving of the name, is of the more formal kind. Further it indicates a heavy weight being placed on deterrence from public denunciation and imposition of sanctions.

No regulator does only enforcement, and in undertaking registration, licensing, regulatory guidance, information gathering and publishing reports on emerging risks ASIC is no exception. Mostly because of its difficulty and expense empirical evidence from regulatory scholarship shows that enforcement is ‘spread around thinly and weakly’.⁴² Thus other approaches are both valuable to educate, persuade and negotiate with the regulated to comply and financially necessary.

A substantial body of research illustrates the benefits of a multiple and responsive approach to enforcement, over an overly formal and adversarial one.⁴³ The responsive approach is visualised in

³⁹ Australian Securities and Investments Commission Enforcement Review Taskforce, ‘ASIC Enforcement Review Taskforce Report’ (December 2017), above n 7.

⁴⁰ Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2018 (Cth) sch 2 pt 1.

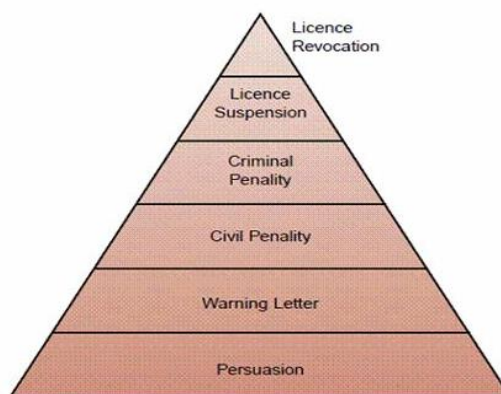
⁴¹ Commonwealth, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report* (2018) vol 1, 272 277 (‘*Interim Report*’). 276–7.

⁴² John Braithwaite, ‘Responsive Regulation and Developing Economies’ (2006) 35 *World Development* 884, 888.

⁴³ Braithwaite *Corporate Crime in the Pharmaceutical Industry* (Routledge & Kegan Paul, 1984); J Braithwaite, Toni Makkai and V Braithwaite *Regulating Aged Care* (Edward Elgar 2007);

Braithwaite's enforcement pyramid.⁴⁴ This enforcement is understood as a broad mix of progressively more formal, curial and punitive sanctions: the pyramid and its escalating elements are reproduced below. Unless conduct is really serious (eg fraud or damage is wide-spread) enforcement starts at lower levels and escalates if compliance is not achieved. Compliance is sought by a combination of lower level approaches and the latent threat of action by the 'benign big gun' regulator at the top of the pyramid.⁴⁵ For responsiveness to be credible escalation must be determined and relatively quick, if compliance is not forthcoming at lower levels.

Figure 1: The Regulatory Pyramid



The benefits of this approach include using proportionate approaches to secure provider buy-in, internalisation of a culture of compliance, enhanced collaboration and learning between the regulator and the regulated, as well as enabling flexibility and adaption in responding to new problems.⁴⁶ Avoiding adversarialism in enforcement lower in the pyramid is important because 'dialogue, with an active, well-informed, critically thinking, and public-minded regulatory presence, has the affirmative power to change perspectives and even the rules of the game'.⁴⁷ Instead, the regulator should seek to engage more broadly with multiple stakeholders, more actively with the regulated, and more critically in response to arguments presented by industry.⁴⁸ With these goals in mind, it is essential to arm regulators with the independence to withstand political pressure and funding to pursue their diverse efforts.⁴⁹

This is also true of other similar approaches.⁵⁰ All advocate being targeted and using a variety of enforcement techniques in ways which vary according to the approach: for example, adopting risk priorities or choosing a 'big problem' and fixing it. All seek compliance but are also driven by the practical benefits of

R Baldwin & J Black 'Really Responsive Regulation' LSE Law, Society and Economy Working Papers 15/2007 at www.lse.ac.uk/collections/law/wps/wps.htm; Parker & Nielsen, *Explaining Compliance - Business Responses to Regulation* (Edward Elgar, 2011).

⁴⁴ Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford University Press, 1st ed, 1992).

⁴⁵ *Ibid* 19–30.

⁴⁶ Cristie Ford, 'Macro- and Micro-level Effects on Responsive Financial Regulation' (2011) 44 *University of British Columbia Law Review* 589, 598; Cameron Holley, 'Facilitating Monitoring, Subverting Self-Interest and Limiting Discretion: Learning from "New" Forms of Accountability in Practice' (2010) 35 *Columbia Journal of Environmental Law* 127; David Hess and Christie L Ford, above n 30 'Corporate Corruption and Reform Undertakings: A New Approach to an Old Problem' (2008) 41 *Cornell International Law Journal* 307.

⁴⁷ Ford, above n 46, 623.

⁴⁸ John Braithwaite, 'The Essence of Responsive Regulation' (2011) 44 *University of British Columbia Law Review* 475.

⁴⁹ Ford, above n 46. The author notes the benefits of a flexible regulatory approach, while also discussing ways to strengthen this framework against the risks of political and industry influence and implementation challenges.

⁵⁰ Malcolm K Sparrow, *The Regulatory Craft*; risk based regulation Schmulow 2015?: *Controlling Risks, Solving Problems, and Managing Compliance* (Brookings Institutions Press, 2000).

the *relative* cheapness, speed and certainty of using a variety of enforcement techniques over starting with formal, curial enforcement.

While transparency and openness is key to such regulatory approaches, so is regulatory capacity and regulator credibility.⁵¹ Credibility is important for any regulator and ‘responsive regulation has fared well because of its emphasis on maintaining a robust regulatory and enforcement presence’.⁵² However, it is probable that a regulator under continuing financial stress will find action at the top of the pyramid to maintain credibility, the most difficult of all techniques to sustain. The ‘benign big gun’ at the top of the pyramid must be utilised,⁵³ and used strategically. It should not be overused because that reduces the opportunities for appropriate co-operation at lower levels. The focus should be on improving aim, rather than firing sooner and more often. Improving aim will require an increased emphasis on ensuring adequate funding, fierce independence (from industry and politics), and appropriate personnel.⁵⁴ ‘[B]uilding a credible enforcement pyramid requires that regulators possess independent-mindedness and adequate resources’.⁵⁵

Responding to the Commissioner’s Interim Report also involves considering public denunciation and the role of general deterrence. Is the effective response to system wide misconduct to suggest that more aggressive enforcement (starting towards the top of the regulatory pyramid rather than strategically escalating) will result in stronger deterrence? The research on corporate criminal deterrence does not demonstrate this relationship. In fact, a review of over 50 studies on corporate deterrence shows that using a mix of regulatory approaches has significant deterrent impact, compared with use of punitive sanctions alone.⁵⁶ This literature is discussed further in the section of this submission titled ‘Enforceable Undertakings’. A direct link to the report is provided [here](#).

There is strong research evidence for maintaining a flexible and responsive approach to enforcement, from the base to peak of the regulatory pyramid.⁵⁷ That evidence shows turning the pyramid on its head will likely result in an unproductive increase in adversarialism between regulator and regulated. The corporate deterrence research likewise gives no significant support for reversing the pyramid. Non-strategic increase in prosecutions will likely lead to ineffective increases in expense, delay and uncertainty. It would of course raise the numbers of cases prosecuted or enforced: but we think numbers alone are a poor indicator of regulatory effectiveness. Rather, *strategic use* of the upper levels of the pyramid is *crucial* to the credibility of the entire approach.

What sort of regulator is ASIC?

Related to the question ‘what is enforcement’ is ‘what sort of regulator is ASIC’? At the time of its creation commentators remarked that the ASC (as ASIC then was) was an enforcement regulator.⁵⁸ The inaugural Commission chairman intended its regulatory approach to include ‘preservation, recovery and prosecution’.⁵⁹ In 1992 an agreement was concluded with the DPP for it to conduct major prosecutions referred by ASIC.

⁵¹ Ford, above n 46, 605.

⁵² Ford, above n 46, 624.

⁵³ Ayres and Braithwaite, above n 44, 19–30.

⁵⁴ For an in-depth discussion of the importance of personnel in the context of ASIC, see Kingsford Smith, above n 3028.

⁵⁵ Ford, above n 46, 624.

⁵⁶ Natalie Schell-Busey et al, ‘What Works? A Systematic Review of Corporate Crime Deterrence’ (2016) 15 *Criminology & Public Policy* 387, 388–9.

⁵⁷ See, eg, David .Hess and Christie L Ford, ‘Corporate Corruption and Reform Undertakings: A New Approach to an Old Problem’ (2008) 41 *Cornell International Law Journal* 307.above n 46. The authors emphasise that deterrence is limited in its ability to effect corporate culture change. See also Dimity Kingsford Smith, ‘A Harder Nut to Crack? Responsive Regulation in the Financial Services Sector’ (2011) 44 *University of British Columbia Law Review* 695. In this paper, the importance of productive regulatory relationships and the need for appropriate personnel to secure them is emphasised as essential to the success of a responsive regulatory approach.

⁵⁸ Michael Bersten, ‘Managerial and Major Crime in Australia’ (1990) 13 (1) *UNSWUniversity of New South Wales Law Journal* 42, 55.

⁵⁹ *Ibid*, 56.

In 1996 the ASC was moved from the Commonwealth Attorney General as responsible Minister, to the Treasury.⁶⁰ Very significant reductions in expenditure and staff were made and when the Wallis Inquiry reported in 1997, ASIC's remit was greatly increased.⁶¹ Variability in funding and extension of its remit, seem to have dogged ASIC ever since.⁶² There now seems a general acknowledgment that ASIC has long been under-funded, cuts have been recent and continue.⁶³

The current Commissioners agree that ASIC is an enforcement regulator,⁶⁴ and this is reflected in the fact that ASIC spends 70% of its budget on surveillance, investigation and enforcement.⁶⁵ It has extensive investigation and enforcement powers. However, debates since ASIC's inception and the variability of its funding, have raised questions about what sort of regulator ASIC should be. The Royal Commissioner favours more formal enforcement and retrenchment from administrative or negotiated outcomes by ASIC.⁶⁶

This contrasts with the views of ASIC's external stakeholders, the majority of whom consider ASIC does too much enforcement, and 39% of whom think ASIC has the balance right.⁶⁷ This group also thinks ASIC does too much litigation making it appear reactive and unwilling to act more collaboratively to solve regulatory problems.⁶⁸ If they were asked, the general public would likely want compensation to be part of enforcement: this has been an enforcement purpose since ASIC's inception, in pursuit of which ASIC has been very successful. Most of this compensation has been won by ASIC for consumers through activity low in the enforcement pyramid, since prosecution and civil penalty action do not provide for compensation or limit its nature and extent.

Our view is that ASIC is and should remain an enforcement regulator: an enforcer that is enabled politically, financially and legislatively to use a wide range of techniques strategically and credibly. We think, since ASIC is an enforcement regulator and needs to work closely with the CDPP, that there is merit in considering the return of ASIC to the Department of the Attorney-General. We think this would assist with the rule complexity we discuss below. Finally, the exercise of ASIC's enforcement discretion in responding to any case or class of cases should be left to the Commission and its expert staff.

How do ASIC's enforcement outcomes compare with those of other Australian regulators?

A report produced by the Australia Institute in 2016 documents ASIC's enforcement efforts as part of a broader analysis of corporate malfeasance in Australia. It also includes statistics for the ATO and ACCC. These provide a comparison and which contextualises ASIC's work.⁶⁹ To summarise, from July 2011 to December 2015 ASIC successfully concluded 3,115 cases against corporations.⁷⁰ The Commissioner's Interim Report notes that '[w]hen the Small Business Team outcomes are excluded, ASIC's enforcement results are very different.'⁷¹ Excluding small businesses, ASIC succeeded in 184 criminal actions, 134 civil actions, 460 administrative remedies, and 186 enforceable undertakings or similar negotiated outcomes over the five-year period.⁷² By comparison, the average prosecution rate for the ATO during the same

⁶⁰ Bernard Mees and Ian Ramsay, 'Corporate regulators in Australia (1961–2000): From companies' registrars to ASIC' (2008) 22 *Australian Journal of Corporate Law* 212 at, 250.

⁶¹ Ibid.

⁶² Productivity Commission, *ASIC Commonwealth, 'Fit for the Future: A Capability Review of the Australian Securities and Investments Commission* (Report 2016, x and , December 2015) 72- (Cut in last budget ARF Saturday 20/10).

⁶³ Productivity Commission, *ASIC Capability Report* 2016, x and 76. Ibid 76.

⁶⁴ Productivity Commission, *ASIC Capability Report* 2016, 26. Ibid 26.

⁶⁵ Productivity Commission, *ASIC Capability Report* 2016, 26. Ibid 26.

⁶⁶ *Interim Report*.

⁶⁷ Productivity Commission, *ASIC Capability Report* 2016, 26-27. Commonwealth, above n 63, 26–7.

⁶⁸ Productivity Commission, *ASIC Capability Report* 2016, 69. Ibid 69.

⁶⁹ Matt Grundhoff et al, 'Corporate Malfeasance in Australia' (Discussion Paper, The Australia Institute, April 2016).

⁷⁰ Ibid 10.

⁷¹ Commonwealth, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Interim Report* (2018) vol 1, 272 ('Interim Report')..

⁷² Calculated from Grundhoff et al, above n 70, 67 with small business statistics excluded.

period was 426 companies a year.⁷³ Regardless, the ATO settles most of its disputes out of court, reaching more than \$7.5billion in settlements between 2011 and 2015.⁷⁴

The ACCC is also often used as a comparator for ASIC. Like ASIC the ACCC may bring both civil and criminal proceedings for breaches of the Australian Consumer Law (ACL).⁷⁵ The ACL is enforced on a 'one law, multiple regulators model',⁷⁶ in which the ACL may be enforced by any of the ACCC and designated state regulators. Each may decide differently whether and how to pursue a breach of the ACL.⁷⁷ Given its federated nature it is difficult to accurately compare the national enforcement by ASIC with the more variable and fragmented enforcement of the ACL. Concentrating just on those actions brought by the ACCC between 2011–12 and 2015–16, 137 litigation proceedings were commenced cases were litigated. Comparatively, it accepted 116 undertakings and 191 infringement notice payments.⁷⁸ These statistics show that even the ACCC, which has been considered a 'strong' enforcement regulator, uses negotiation significantly more often than litigation.

Further, we provide more recent statistics in the table below, including a comparison with the UK twin peaks regulator the FCA. The comparison with the FCA shows that ASIC actively uses enforcement from the top of the pyramid as does its foreign counterpart, and the ACCC. Expanding this analysis across all comparable twin peaks jurisdictions would be valuable.

Table 4: Enforcement Actions 2016-2017⁷⁹

Entity	Criminal Enforcement (in house)	Criminal Enforcement (referred)	Civil Actions Commenced	Civil Penalties	Regulated Population
ASIC	397	10	81	\$5.2m	2.24 million Business 908 Individual Financial Service and Credit Licensees 3,925 Auditors 666 Liquidators 18 Licensed Markets 121 Market Participants 800 Securities Dealers ⁸⁰

⁷³ *Interim Report*, 14.

⁷⁴ *Ibid*, 15.

⁷⁵ In its competition law jurisdiction the ACCC has not until recently undertaken criminal prosecutions having recently received powers to refer cartel crimes to the CDDP: Brenda Marshall, 'Criminalisation of Cartel Conduct: Compelling Compliance with Anti-Collusion Laws' (2010) 3 *Journal of the Australasian Law Teachers Association* 11.

⁷⁶ S Coronos and P Clarke, *Australian Consumer Law* (Thomson Reuters 5th edition 2015) 857.

⁷⁷ *Ibid* 855 for a good account of the intricacies of this federated system, which looks very much like what corporations and securities regulation was like before the creation of what is now ASIC, in 1989.

⁷⁸ Australian Competition and Consumer Commission and Australian Energy Regulator, 'Annual Report 2011–12' (16 October 2012) apps 9–10; Australian Competition and Consumer Commission and Australian Energy Regulator, 'Annual Report 2012–13' (28 August 2013), 179, app 9; Australian Competition and Consumer Commission and Australian Energy Regulator, 'Annual Report 2013–14' (28 August 2014) apps 8–9; Australian Competition and Consumer Commission and Australian Energy Regulator, 'Annual Report 2014–15' (2 October 2015) apps 8–9; Australian Competition and Consumer Commission and Australian Energy Regulator, 'Annual Report 2015–16' (29 August 2016) apps 8–9. See also Grudnoff, above n 31, 7.

⁷⁹ The figures in this table have been collected from annual reports produced by the relevant agencies, unless otherwise stated.

⁸⁰ This number includes actively trading businesses (ABNs), all individuals registered in the following classes: Financial Service Licensees (235), Credit Licensees (673), Auditors (3925) and Liquidators (666); plus an additional 18 licensed markets, 7 licenced clearing and settlement facilities, 2 derivative trade repositories, 7 credit agencies, 121 market

ATO	1,952	29	0	0	~ 16 million taxpayers ⁸¹
ACCC	0	1	29	\$48.53m	2.24 million ⁸²
FCA (UK)	11	unavailable	198	£181m	58,000 ⁸³

Conclusion

The above analysis shows the clear trend across all Australian regulators to use a flexible enforcement framework involving both formal proceedings and negotiated outcomes. This is in line with what research shows is most effective: it is also sustainable in terms of regulator funding. A comparison of ASIC's prosecution and civil penalty statistics with those of other market regulators in Australia demonstrates ASIC's willingness to escalate action, despite funding short-falls and loss of staff. If funding is a proxy for political will, then guaranteeing funding in the forward estimates sufficient for ASIC to be credible in its enforcement work over the coming decade, will be the best signal that the politics of regulation have changed and that systematic non-compliance in the financial sector is no longer acceptable.

IS FINANCIAL SERVICES LAW TOO COMPLICATED?

Is the law governing financial services entities and their conduct, too complicated?

We have already argued that there are two types of regulatory complexity: *institutional* and *rules* complexity. We have discussed institutional complexity above and concentrate on rules complexity here. Before proceeding it is important to ask which regulatory purposes and which regulatory participants will be affected by complexity. Put another way, is financial regulation too complicated for what? For risk management processes and assurance? For compliance? For enforcement? For consumers to understand? Is financial regulation too complicated for whom? Licensees? Regulators? Consumers? Dispute resolvers?

Our overall view is that rules complexity has been an unfortunate outcome of the politics of regulation that was not anticipated by the twin-peaks designers. The substance of regulation is complex, because sub-sectors have successfully argued for divergent rules. For example, intermediary remuneration is regulated using prohibition (financial advice), disclosure (mortgage broking) and caps (insurance).⁸⁴ This makes difficult all of: consumer comparison of disclosed terms and price, consumer understanding of incentives, compliance, remediation, regulation and enforcement. It is challenging to identify the public interest in this burden on consumers, dispute resolvers and regulators which the 'twin-peaks' designers never intended.

Rule divergence can also encourage the arbitrage between rules that twin-peaks was designed to avoid. The product design and distribution obligations being enacted by the Parliament in 2018 apply to a broad

participants, and 800 securities dealers. Data on the individuals registered was taken from <https://data.gov.au/organization/australian-securities-and-investments-commission-asic> and mined to remove all business actors. Data on the number of licenced markets and related actors is taken from the Australian Securities and Investments Commission, 'Annual Report 2016-2017, at-17' (5 October 2017) 20.

⁸¹ Australian Taxation Office, *2015-16 Stats Released* (27 April 2018) <<https://www.ato.gov.au/Media-centre/Media-releases/2015-16-Tax-Stats-released/>>.

⁸² This is the total number of actively trading business (ABNs) based on recent date from the Australian Bureau of Statistics: , *Business Counts Up 3.1% in the Year to June 2017* (20 February 2018)<<http://www.abs.gov.au/ausstats/abs@.nsf/Latestproducts/8165.0Media%20Release1Jun%202013%20to%20Jun%202017?opendocument&tabname=Summary&prodno=8165.0&issue=Jun%202013%20to%20Jun%202017&num=&view=>>.

⁸³ Financial Conduct Authority, *About the FCA* (21 April 2016) <<https://www.fca.org.uk/about/the-fca>>.

⁸⁴ Free and Harris, this submission, 16-18.

swathe of products in the consumer interest.⁸⁵ Although Australian consumers deal with credit products more than any other financial interest, credit products have been, with no evident policy reason, exempted from this obligation.⁸⁶ This may lead to interests other than credit, being designed to look like credit, when they are not, to avoid design and distribution obligations. This leads to rule complexity: complexity in application for regulators and dispute resolvers; complexity in product understanding, terms and pricing for consumers. Again, the public interest in permitting potential for this rule complexity and its consequences is not obvious.

Another source of rule complexity is also derived from the politics of regulation. Complexity derives from rules which are very obscure or have little or no legal meaning, and consequently are difficult to comply with and enforce. The best interests duty for financial advisers exemplifies this problem.⁸⁷ Legally this duty bears no resemblance to a 'best interests' duty in general law. The process of its negotiation began with the purpose of enacting a statutory best interests duty for advisors – an uncertain enterprise at best, since even in trust law this duty really only requires a trustee to be at their superlative best in discharging their other duties. By the time it had been negotiated for months and enacted, the duty had become a legal chimera: called a best interests duty but in fact part negligence,⁸⁸ part financial advising process and part exceptions. ASIC has made the best of it with the publication of guidance,⁸⁹ but how the duty will be enforced as a civil penalty provision,⁹⁰ is not obvious. Here the complexity impacts provider compliance, consumer disputes and remediation, and most of all regulator enforcement.

Finally, rule complexity has also derived from the historical sequencing of enactment of rules over time. The ASIC Enforcement Taskforce encountered instances where ASIC had differing powers in relation to its investment mandate by comparison with its credit remit. The Taskforce Report makes recommendations generally to harmonise and rationalise such variations particularly in investigation and enforcement powers, reducing rule complexity.

Would a statement of simple principles assist? How?

If the simple principles were legislated as paramount interpretive principles, they may be of assistance. Whether principles-based regulation is effective, is mostly dependent on how the principles are used legally.⁹¹ We suggest further consideration of the technical aspects of how these principles might best be deployed is one for legal experts to consider in the implementation phase of the Royal Commission's recommendations.

Conclusion

We conclude (admittedly from limited examples here, but our working experience is much wider) that financial regulation in Australia suffers from rules complexity. We think this has arisen over a long time from a variety of factors. As we have noted, all participants are affected by some instances and in some ways. We think much of the difficulty arises from the politics of regulation in the process of creation.

One approach the Commissioner might consider which would retain the existing institutions and might address rule complexity, is adopted in South Africa. There the twin-peaks legislation specifies three pillars of regulatory authority shared between the twin prudential and conduct regulators. Each regulator is

Treasury Laws Amendment Act (Design and Distribution Obligations and Product Intervention Powers) Bill 2018 at: https://www.aph.gov.au/Parliamentary_Business/Bills_Legislation/Bills_Search_Results/Result?bld=r6184; See also Kingsford Smith and Marina Nehme, 'Product Intervention Powers: A Legal Comparative and Policy Analysis' (Report, 2015) at: <https://download.asic.gov.au/media/3251548/product-intervention-powers-a-legal-comparative-and-policy-analysis.pdf>.

⁸⁶ They are still subject to ASIC product intervention powers, *ibid*.

⁸⁷ S961B *Corporations Act 2001* (Cth). In 2017, ASIC secured a civil penalty order *by consent* in the case of *ASIC v NGS Services Pty Ltd* FCA [2017] 354.

⁸⁸ The 'safe-harbour' provision in S961B *Corporations Act 2001* s 961B(2) is couched in the language of 'reasonableness'.

⁸⁹ Australian Securities and Investment Commission, 'Licensing: Financial Product Advisers' (Regulatory Guide 175, 14 November 2017), 60-66–6.

⁹⁰ *Corporations Act 2001* (Cth) ss 961K(1)–(2), s1317E.

⁹¹ Julia Black, *Rules and Regulation*, (Oxford University Press, 1997).

empowered to make standards separately in relation to matters core to their distinctive regulatory functions. The third pillar is shared. There the enabling legislation nominates subject matter areas where each of the twins (ASIC and APRA in Australia) can produce standards covering the same subject matters or act jointly, as agreed between them. This institutionalises regulatory co-ordination and should confirm the ‘twin-peaks’ choice while reducing rule complexity.⁹²

Another approach to be considered is an independent expert body to advise on law and regulatory reform when changes to financial regulation are suggested. This could be established in the Commonwealth Attorney General’s Department. Until 2014, when it was disbanded the Corporations and Markets Advisory Committee (CAMAC) did some of this work. We think the rules complexity we have identified could be addressed if there were independent experts advising on the creation of new laws or the review of long-standing ones.

OVERALL CONCLUSION AND RECOMMENDATIONS

We have indicated our answers to the Commissioner’s questions as we have concluded each section of this submission. We now set out recommendations for the Commissioner’s consideration which flow from those arguments and conclusions.

Subject	Recommendation
Funding	ASIC’s funding and recruitment should be reviewed and forward estimates for the Commission’s work made for the next 10 years to ensure it has resources to discharge its mandate. Funding for the CDPP will also need to increase to deal with additional prosecutions in its Commercial, Financial and Corruption Practice Group.
Minister responsible	Since ASIC is an enforcement regulator, which is substantially a legal concern even low in the enforcement pyramid, it should be accountable to a Minister with legal responsibilities. Accordingly, we recommend that ASIC return to the Attorney General as Minister responsible. Department Co-ordination with the CDPP and with the Courts (especially the Federal Court) is a high priority.
Enforcement	ASIC should stay with a mix of enforcement approaches broadly understood. It should extend its activities at the top of the enforcement pyramid as is strategic for delivery on its remit. It should be appropriately funded to do this work.
Law Reform	A standing expert regulatory law reform advisory body should be formed in the AG’s Department, to advise on changes to regulation. Rule complexity, which is not in the public interest, would be better addressed by the development of rules (including simple principles if so agreed) understood to work well, from prior regulatory or other legal experience.
Regulatory Structure	Australia should continue with the ‘twin-peaks’ regulatory structure constituted by ASIC and APRA. The Commissioner should consider the benefits of greater regulatory co-ordination to be gained from legislating to provide that the two regulators may make rules governing the same subject matters in their overlapping remits. This improvement to ‘twin-peaks’ has been adopted in South Africa.
ASIC’s Remit	As a ‘twin-peaks’ regulator, ASIC’s remit is not too wide, and there is no need for detachment of part of its mandate.

⁹² Ernst and Young, ‘Financial Sector Regulation Act –: Implementing Twin Peaks and the Impact on the Industry (2018) 6.

DETERRENT EFFECT OF ENFORCEABLE UNDERTAKINGS

Marina Nehme

This section provides a brief summary of a recently published report produced for ASIC by this author and other CLMR members Prof Dimity Kingsford Smith, Dr Olivia Dixon and Ms Jessica Anderson ('The Report').¹ It sets out the results of a pilot study on the general deterrent effect of Enforceable Undertakings ('EUs'). The pilot involved 32 qualitative interviewees with a range of stakeholders including peer providers, professional advisers, ASIC's officers and consumer advocates. Most peer providers interviewed (11 out of 15 respondents) perceived that EUs entered by peer providers may have some deterrence effect on the way they conduct their business.² Further, 13 out of the 15 of peer providers who took part in the study stated that an EU is intended to change compliance standards within an organisation.³

The Report emphasises the value of EUs, particularly in the context of the findings of misconduct made in the Royal Commission's Interim Report. It also contains a short review of the research on corporate deterrence more broadly than EUs and the highly contextual settings in which corporate deterrence has been found. The Report can be viewed in full here: <https://download.asic.gov.au/media/4916053/18-325mr-deterrence-effects-of-enforceable-undertakings-on-financial-services-and-credit-providers.pdf>.

An enforceable undertaking ('EU') is a sanction available to a range of regulators at both federal and state levels.⁴ This sanction is a promise enforceable in court. When the regulator suspects that a party is breaching the law, either the regulator or the party may propose entering into an undertaking. The undertaking reflects a compromise reached by the two parties.⁵ In it, the alleged offender (the promisor) will promise to do or not to do certain things. As an administrative sanction, the key purposes of the

¹ Marina Nehme, Dimity Kingsford Smith, Olivia Dixon & Jessica Anderson 'The General Deterrence Effects of Enforceable Undertakings on Financial Services and Credit Providers' (Report, 2018) <https://download.asic.gov.au/media/4916053/18-325mr-deterrence-effects-of-enforceable-undertakings-on-financial-services-and-credit-providers.pdf>

² Report 2018, above n1, 16.

³ Ibid.

⁴ Some of the regulators that have this sanction at their disposal include: ASIC, Australian Competition and Consumer Commission ('ACCC'); Australian Communications and Media Authority ('ACMA'); Australian Transaction Reports and Analysis Centre ('AUSTRAC'); Australian Prudential Regulation Authority ('APRA'); Civil Aviation Safety Authority ('CASA'); Comcare; Therapeutic Goods Administration ('TGA'); Fair Work Ombudsman ('FWO'); Australian Charities and Not-for-Profits Commission ('ACNC'); Consumer Affairs Victoria ('CAV'); Office of Fair Trading (NSW) ('OFT NSW'); Office of Fair Trading (Qld) ('OFT Qld'); Environmental Protection Authority (NSW) ('EPA NSW'); Environmental Protection Authority Victoria ('EPA Vic'); Access Canberra; WorkCover Qld (including the Electrical Safety Office Queensland ('ESO Qld')); WorkSafe Tasmania; WorkSafe Victoria.

⁵ See, eg, *Australian Securities and Investments Commission Act 2001* (Cth), ss 93AA, 93A.

undertaking will centre on the protection of the public, the prevention of similar conduct in the future and corrective action.⁶

ASIC has noted that the objectives of an EU are the following:⁷

- 1) Promotes the integrity of, and public confidence in, our financial markets and corporate governance;
- 2) Specifically deters the person from future instances of the conduct which gave rise to the undertaking;
- 3) promotes general deterrence in making the business community aware of the conduct and the consequences arising from engaging in that conduct; or
- 4) provides an ongoing benefit by way of improved compliance programs.

These are outcomes that have been adopted by other regulators with some agencies going further than this and noting an EU must go beyond requirements under the law⁸ and must benefit the community.⁹

Ascertaining deterrence, especially general deterrence, can be difficult but the Report illustrates that EUs do have deterrent power. This benefit is in addition to those of enforceability, transparency, cultural impact, and restorative justice.

Enforceability and Transparency

All regulatory tools should be viewed in the context of other available mechanisms for compliance. The use of an EU is more advantageous than reliance on informal settlements as ASIC's EUs are all available to the public and are enforceable in court.¹⁰

The availability of EUs to the public provides this sanction with a level of transparency and accountability that informal settlements do not. It increases the chances of an EU achieving general deterrence. As the deterrence literature has demonstrated, general deterrence is predicated on the intended audience (peer providers, professional advisers and consumer advocates in ASIC's case) being *aware* of conduct that the regulator deems as unacceptable and the consequences attached to such behaviour.¹¹ The perceived certainty of sanctions is heightened if people know that the sanction is relied on by regulators to deal with misconduct.¹² For instance, it has been found that individuals in a corporation modify their behaviour when they are made aware of misconduct via the media, even if the misconduct is not directly related to their industry.¹³

EUs are generally well disseminated by ASIC and there is a high awareness of the EUs entered within relevant industries.¹⁴ Further, dissemination of information about EUs may allow consumer advocates to

⁶ Australian Law Reform Commission Report, 'ALRC, *Compliance with the Trade Practices Act 1974*' (1974, Report No 68, 1994) 38.

⁷ Australian Securities and Investment Commission, 'Enforceable Undertakings' (Regulatory Guide 100, 19 February 2015) [RG 100.25] ('*RG 100*'). ASIC RG100, [RG100.25].

⁸ See, eg, WorkCover QLD (including ESO Qld): Office of Industrial Relations, 'Guidelines for the Acceptance of an Enforceable Undertaking: Work Health and Safety Act 2011, Electrical Safety Act 2002, Safety Recreational Water Activities Act 2011' (22 November 2017) <https://www.worksafe.qld.gov.au/__data/assets/pdf_file/0003/95313/guidelines-acceptance-EU.pdf>.

⁹ See, eg, EPA NSW: Environmental Protection Authority (NSW) *Guidelines on Enforceable Undertakings* (2017), 4.

¹⁰ The enforceability of EUs in court was one of the reasons why this sanction was introduced to the ACCC in 1993. See, eg: Marina Nehme, 'Enforceable Undertakings in Australia and Beyond' (2005) 18 *Australian Journal of Corporate Law* 68, *passim*.

¹¹ Kelli D Tomlinson, 'An Examination of Deterrence Theory: Where Do We Stand?' (2016) 80(3) *Federal Probation* 33, 33–8.

¹² Joseph C Ugrin and J Michael Pearson, 'The Effects of Sanctions and Stigmas on Cyberloafing' (2013) 29 *Computers in Human Behaviour* 812, 812.

¹³ See, eg, David C Cicero and Mi Shen, 'Do Executives Behave Better When Dishonesty is More Salient?' (2016) *Social Science Research Network (SSRN)* <<http://ssrn.com/abstract=2748258>>.

¹⁴ Nehme et al, above n 7, 34.

obtain a better outcome for consumers.¹⁵ Some professional advisers have noted that class action may follow an EU, as it signals a problem within the institution that may have affected a range of consumers.¹⁶

The Report notes the public availability of EUs to peer providers has a range of benefits:¹⁷

- clarified acceptable practices;
- reinforced existing compliant practices;
- reassured the organisation that it is compliant;
- encouraged continuing improvement of existing practices and legitimised internal arguments for improvement; and
- resulted in the departure of incapable providers from the industry in some instances.

As such, EUs have wide ranging benefits and the potential to play a role in the education of peer providers in promoting good practices within industries. Below we extend the discussion from general deterrence to operation of EUs when agreed between ASIC and a non-complying provider.

Culture and Restorative Justice

One of the key strengths of an EU is the fact that, if used properly, outcomes can go beyond mere compliance with the requirements of law, change the culture of an organisation, and support restorative justice.

Culture

Changing culture in an organisation is difficult. Successful change will require the alignment of a range of factors including the good will of many people within an organisation.¹⁸ An EU has the potential to achieve such a change because promisors usually undertake to implement changes to their policies and compliance system. This could be in fact a distinctive characteristic of an EU that allows the undertaking to go beyond the mere requirement of the law.

However, the implementation of new policies and compliance programs does not always have an impact on the culture of an organisation. There are a range of factors which may limit the effect of EUs. Addressing these factors will be essential so that EUs may make an effective contribution as part of ASIC's enforcement tool-kit and to financial services regulation. The following factors must be addressed:

- *The investment of the leadership and middle management in the EU:* The lack of real investment from senior management may mean that the changes occurring as part of the EU are superficial and unlikely to lead to a greater change within the organisation.¹⁹

To remedy this issue, EU negotiation needs to be perceived as fair, to ensure that no resentment is created.²⁰ This reality emphasises the importance of regulators using a flexible approach and working up the enforcement pyramid, as discussed in the preceding submission on 'Australia's Financial Regulatory Future'. More importantly, someone from senior management must champion the EU. If it is seen that senior executives are embracing the EU a change of culture may be more readily accepted by employees. Accordingly, it is recommended that senior executives become signatories of the EU to signify compliance of the organisation with the terms of the EU.

¹⁵ Ibid 21.

¹⁶ Ibid 20.

¹⁷ Ibid 24.

¹⁸ See, eg, Martin Smith, 'Changing an Organisation's Culture: Correlates of Success and Failure' (2003) 24 *Leadership and Organization Development Journal* 249.

¹⁹ Ibid.

²⁰ Marina Nehme, 'Enforceable Undertakings: Are they Procedurally Fair' (2010) 32 *Sydney Law Review* 471.

- *Broader terms of EUs*: In certain instances, the alleged breach can be a symptom of larger issues within the organisation.²¹ Consequently, it may be necessary for ASIC to make sure that the root-cause of the problem (which may be broader institutional culture) as well as the symptoms, are dealt with and considered within the terms of the undertaking.
- *Monitoring of EUs*: The presence of a sound monitoring system for EUs plays a key part in ensuring the effectiveness of the sanction. If the monitoring regime is weak or non-existent, promisors may decide to ignore the terms of the EU or comply with only part, if at all.²² As such, it is important for ASIC to actively monitor the compliance of entities with the EU.

A quick review of ASIC's regulatory practices highlights improvements in these areas:

- Since the second half of 2015, ASIC has been issuing updated reports on compliance with the terms of the EU, on the EU register. This sends a message to the industry that ASIC is monitoring the terms of the EU and the promisor is complying with them. Accountability is in place. Attaching a media release to these updates would further enhance the impact, highlighting how the organisation is complying with the terms of the EU.
- The use of independent experts to ensure the implementation of an EU has always been fraught practice, resulting from the inherent conflicts of interest between EU party and expert. On one hand, the independent experts are hired and are accountable to the promisor. On the other hand, they advise ASIC on the level of compliance of the promisor with the terms of the EU. ASIC has managed this conflict by requiring that the appointment and removal of independent experts be approved by them. Ideally, ASIC would have its own team of experts assessing compliance. This would increase costs for the regulator and would require consistent and substantial funding. The need to back up political will with financial resources was also addressed in the preceding submission.

Restorative Justice

One of the key advantages of an EU is that it can be restorative in nature. This is something other regulators such as the EPA NSW, Access Canberra and WorkSafe Victoria have embraced. ASIC has achieved this in certain EUs, through the inclusion of undertakings requiring redress to affected parties and community benefits.²³

Redress to affected parties is a good start to publicise the conduct of the promisor (to extend general deterrence) and compensate parties who may have suffered a loss. The drawback is that there is little consultation between ASIC and the affected parties regarding the way the conduct of the promisor has affected them. One way to make the EU more effective and transparent is by ensuring that affected parties are consulted during the negotiation of the EU so their voice is heard. This will also enhance transparency and accountability of the process of an EU.

Community benefits are also used by ASIC. Here the promisor delivers benefits to the affected communities. One issue behind community benefits is that they have to be restorative in nature. If such a promise is used with the purpose of punishment, then the promise itself cannot be enforceable in court in case of non-compliance of the promisor with this term. This should not be viewed as a limitation, but rather as the natural result of the nature of EUs as an administrative (not penal) sanction. They may be deterrent, but they are not and should not be punitive. There should be a greater clarity on how the regulator calculates the amount of community benefit that should be paid by an organisation to ensure it is not used for punishment purposes and the sums are not decided arbitrarily.

²¹ Nehme et al, above n 7, 30.

²² Marina Nehme, 'Monitoring Compliance with Enforceable Undertakings' (2009) 23 *Australian Journal of Corporate Law* 76.

²³ Marina Nehme, 'Enforceable Undertaking: A Restorative Sanction?' (2010) 36 *Monash University Law Review* 108.

Admission of Liability

Should a component of EUs be the acknowledgment of specific wrongs?

The answer is no. This requirement may stop organisations from entering an EU. ASIC may then be put in a difficult position of either litigating the matter (which may be more than appropriate) or accepting an informal settlement. The last option may not be desirable as informal settlements or voluntary undertakings are not as transparent as EUs. Observations of interviewees recorded in the Report, highlighted that EUs are more effective than informal settlements in ensuring that terms are complied with in a timely fashion.²⁴ Further, unlike an EU informal settlements are not enforceable in court.

The mere fact that an EU is entered into may also have a significant deterrence effect on peer providers as there is a possibility that a class action may be initiated depending on the conduct the promisor was involved in. As one professional adviser noted, even though an EU may not include an admission of liability, the promisor has to acknowledge that ASIC's concerns are reasonably held. This provides a 'roadmap' for class action lawyers to build their case.²⁵

Concluding Observations

In view of regulatory practices worldwide, negotiated settlements have a key place to play within the regulatory landscape. EUs are by far superior to informal settlement (or what ASIC may refer to as voluntary undertakings). They are transparent, ensure greater accountability through sound monitoring and reporting requirements, set out clear terms, and are enforceable in court.

As highlighted by the Report introduced above, EUs have a certain element of general deterrence. Further, peer providers try to avoid entering into an EU because of the risk of reputational damage, cost, and scrutiny by regulators.²⁶

²⁴ Nehme et al, above n 7, 32.

²⁵ Ibid 20.

²⁶ Ibid 17.