

SUBMISSION TO THE FINANCIAL SERVICES REFORM TASKFORCE

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I. INTRODUCTION

This is a submission in response to the exposure draft of the *National Consumer Credit Protection Amendment (Mortgage Brokers) Bill 2019* (the ‘draft Bill’). In particular, it comments on the obligation that the draft Bill imposes on mortgage brokers to act in the best interests of consumers when providing credit assistance. This new ‘best interests’ duty is driven by Commissioner Hayne’s recommendations in the Final Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (the ‘Final Report’). The duty would be similar to the one for financial advisers in s 961B of the *Corporations Act 2001 (Cth)* (‘CA’), introduced as a result of the Future of Financial Advice (‘FOFA’) reforms in 2012. We recommend that the Government draws lessons from the FOFA legislation to assess the effectiveness of this new ‘best interests’ duty. Our view is that, although a principles-based approach is preferable to protect consumer interests, the Government should provide more guidance as to the content of the duty, and how compliance can be achieved, in order to provide clarity and certainty for the mortgage brokers industry. In what follows, we provide our reasoning.

II. LESSONS FROM THE FOFA

A. *Background of the FOFA Reforms*

Before the FOFA reforms, the conduct of financial advisers was regulated by the ‘suitability rule’ under the former s 945A CA. The suitability rule imposed three specific obligations that are separate but interrelated; financial services licence holders (not individual advisers) were required to assess the client’s relevant personal circumstances before giving advice, investigate the subject matter of the advice, and ensure that the advice was appropriate to the client.

Following the Global Financial Crisis (GFC), in 2009, the Parliamentary Joint Committee (PJC) on Corporations and Financial Services convened to enquire into and report on the ‘issues associated with recent financial product and services provider collapse’.¹ At this inquiry, the Australian Securities and Investment Commission (ASIC) suggested that investors may see advisers as similar to lawyers and accountants in terms of duties and professionalism.² Consequently, there appeared to be a mismatch between the client’s expectations and the obligations of the adviser under the *CA*. On the other hand, industry groups cautioned against imposing an undue legal and administrative burden on financial advisers.

In 2012, the concerns about investor confidence in financial advisors led the Government to enact the FOFA legislation. The legislation imposes an obligation on financial advisers under s 961B *CA* to ‘act in the best interests of the client when giving the advice’, as well as related obligations under ss 961G, 961H, 961J, and 961L.

B. *Operation of the Best Interests Duty and Safe Harbour Provision*

Although the concept of ‘best interests’ in s 961B (1) is left undefined in the legislation, s 961B(2) qualifies the best interests duty. Section 961B (2), known as the ‘safe harbour’ provision, provides that financial advisers will satisfy the best interests duty if several required steps have been taken. Required steps include, among others, identifying the client’s objectives, financial situation and needs; and making reasonable enquiries to obtain complete and accurate information.

In three related Federal Court cases, it appears that while s 961B (1) is the primary obligation, it can, in practice, be informed by the enumerated factors of s 961B (2).³ In other words, the provisions of s 961B (2) can be used as the dominant proxies to assess compliance with the primary obligation. Some commentators have criticised the safe harbour provision as incentivising financial advisers to only focus on the process over the substance or principles of their advice.⁴ Similarly, the Banking Royal Commission also questioned whether the ‘safe harbour’ provisions amount to a ‘box ticking’ exercise rather than a substantive test.⁵

C. *Implications of Abolishing the Safe Harbour Provision*

In the Final Report, Commissioner Hayne recommended that the government should, in three years, review ‘the effectiveness of the measures that have been implemented by the Government, regulators and financial services entities to improve the quality of financial advice’.⁶ The

¹ The Rudd Labor Government convened this inquiry, but was met with opposition from the industry against both the Ripoll Committee and some of its recommendations. The Opposition Coalition opposed the eventual FOFA amendments to the Corporations Act and repealed a portion of the amendments once they returned to Government. See <futureofadvice.treasury.gov.au/Content/Content.aspx?doc=home.htm>. The Ripoll Report’s findings foreshadowed the Banking Royal Commission.

² Ibid 86.

³ *Australian Securities and Investments Commission, in the matter of NSG Services Pty Ltd v NSG Services Pty Ltd* [2017] FCA 345; *Australian Securities and Investments Commission v Wealth & Risk Management Pty Ltd (No 2)* [2018] FCA 59; *Australian Securities and Investments Commission v Financial Circle Pty Ltd* [2018] FCA 2; *Australian Securities and Investments Commission v Financial Circle Pty Ltd* [2018] FCA 1644.

⁴ Gerard Craddock, ‘The Ripoll Committee recommendation for a fiduciary duty in the broader regulatory context’ (2012) 30(4) *Company and Securities Law Journal* 216.

⁵ *Royal Commission into the Banking, Superannuation and Financial Services industry* (Final Report, February 2019) vol 1 (n 1) 177 (*Banking Royal Commission Final Report*).

⁶ See Recommendation 2.3 - Review of measures to improve the quality of advice. Ibid 26.

Commissioner also suggested that unless there is a clear justification for the retention of the ‘safe harbour’ clause in s 961B (2), the provision should be repealed.⁷

While removing safe harbour clause may reduce the complexity of the law and make financial advisers more cautious about their duties towards clients, it may not necessarily lead to an optimal outcome. Judicial interpretations of the provision have not directly defined the ‘best interests’ duty, but rather, used the safe harbour provision as a proxy to determine (non)compliance with this obligation. Our view is that if the safe harbour provision in s 961B (2) is abolished, it is not clear how the court will interpret the ‘best interests’ duty. There is also no guidance on the standard of care required. Furthermore, the best interests obligation, as revealed in legislative history, is not a statutory fiduciary duty, hence absent the safe harbour provision, it is unclear how the duty will be interpreted.

One possibility is that it might be interpreted similarly to the suitability rule in the pre-FOFA era. Another possibility is using existing case law, however, this may be difficult as the interpretation of the duty currently rests upon the safe harbour provisions. Searching for the ordinary meaning of the expression ‘to act in the best interests’ of somebody may be an alternative approach. A last possibility (as noted above) would be to align the best interests duty with the general law fiduciary obligation. This last approach seems least likely given that the proposal of imposing a statutory fiduciary duty was rejected (as revealed in the FOFA legislative history) and that the best interests duty as it is today under s 961B operates in parallel with the general law fiduciary duty.

In summary, it would appear that removing the safe harbour clause may affect the understanding of the best interests duty itself. As a matter of judicial interpretation, it would require a re-evaluation of the content and operation of the duty. As a matter of practice, this uncertainty will be problematic for mortgage brokers in terms of how compliance can be achieved.

D. *Adopting a Principle-Based Approach: Reflecting on the Best Interests Duty on Mortgage Brokers*

As mentioned above, the safe harbour provision was criticised in part because it appears to be a rather descriptive, rule-based approach that is concerned with the process or procedure involved in providing advice, rather than the principle or outcome in giving the relevant advice.⁸

Indeed, the draft Bill’s exposure draft explanatory memorandum stated that the best interests duty for mortgage brokers is a principle-based standard of conduct. Instead of prescribing conduct that will be taken to satisfy the duty, it holds mortgage brokers responsible for ensuring that their conduct meets the standard of ‘acting in the best interests of consumers’. This will arguably make mortgage brokers more cautious about the way they provide credit assistance and enhance protection for consumers. However, if the approach that is ultimately adopted is too general and vague, mortgage brokers may find it difficult to anchor their behaviour against the undefined term ‘best interests duty’.

For financial planners and advisers, it has been recognised by the Commonwealth Parliament that their standards of education, training and ethics must be raised in order to promote enhanced consumer trust and confidence.⁹ A Code of Ethics was established for the profession with mandatory compliance from 1 January 2020. The Code contains a set of principles and core values

⁷ Ibid.

⁸ Gerard Craddock, ‘The Ripoll Committee recommendation for a fiduciary duty in the broader regulatory context’ (2012) 30(4) *Company and Securities Law Journal* 216.

⁹ Explanatory Statement, *Financial Planners and Advisers Code of Ethics 2019*.

including trustworthiness, competence, honesty, fairness, and diligence.¹⁰ There are also standards in relation to ethical behaviour, client care, quality process, and professional commitment.¹¹ While the safe harbour provision of the best interests duty may be removed, this Code will at least exist to inform and provide guidance to financial advisers about their professional standards. There is currently no equivalent Code that applies to mortgage brokers, and hence, the removal of the safe harbour provisions may have an adverse impact for this profession. Imposing such a duty without any guiding principles may, as a matter of practice, make it problematic to set the expected behaviour norms for mortgage brokers. It would lead to interpretive uncertainty in the application of the law and impose a heavy compliance burden on mortgage brokers. Arguably, such an increase in the compliance cost may in turn be passed onto consumers.

In our view, designing a principle-based regulation that can give mortgage brokers high-level instructions without overly detailed elements is a daunting task for policymakers. From a comparative law perspective, the recent developments in the United States (US) may be informative. Similar to the Australian approach, the US model does not define the term ‘best interests’. Unlike Australia’s detailed, step-by-step safe harbour provision, however, a broker-dealer in the US would comply with this duty by meeting three specific obligations, namely, the disclosure obligation, the care obligation, and the conflict of interest obligation.¹² Under the US approach, the care obligation compels the broker-dealer to not act negligently while disclosure and conflict of interest obligations intend to tackle conflicts of interest issues. In particular, the care duty has also adopted an objective approach that a broker-dealer exercises reasonable diligence, care, skill and prudence, and has a reasonable basis to believe that the transaction(s) is in customers’ best interests. Such an approach might, on the one hand, provide some practical anchors for financial advisers, and on the other, moderate the concerns about a mechanical, box-ticking exercise. The conflict aspect means that the US approach essentially regulates broker-dealers through something like a fiduciary relationship, which proposition was rejected by the FOFA reform. Admittedly, while the US approach—reflecting a different business environment and legal culture—may not neatly square with the rationale underlying the best interests obligation under the FOFA reforms, this approach sheds light on how to offer some practical guidance while adopting a principle-based approach in a dynamic and complex setting.

III. RECOMMENDATIONS AND CONCLUSION

We are of the view that the Government should consider the key lessons from the FOFA reforms in evaluating the effectiveness of the ‘best interests’ obligation for mortgage brokers. The FOFA reforms demonstrate the importance of striking an appropriate balance between the need to protect consumers and the need to provide the consumer lending industry with guidance as to what fundamental norms of behaviour are being pursued. While a principle-based approach seems a promising option, we recommend that the Government provides some guidelines for mortgage brokers to comply with the ‘best interests’ duty.

¹⁰ Ibid.

¹¹ Ibid.

¹² Disclosure obligation: disclose to the retail customer the key facts about the relationship, including material conflicts of interest.

Care obligation: exercise reasonable diligence, care, skill, and prudence, to (i) understand the product; (ii) have a reasonable basis to believe that the product is in the retail customer’s best interest; and (iii) have a reasonable basis to believe that a series of transactions is in the retail customer’s best interest.

Conflict of interest obligation: establish, maintain and enforce policies and procedures reasonably designed to identify and then at a minimum to disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives; other material conflicts of interest must be at least disclosed.

U.S. Securities and Exchange Commission, ‘SEC Proposes to Enhance Protections and Preserve Choice for Retail Investors in Their Relationships with Investment Professionals’ (Press Release 2018-86, 18 April 2018).