The Financial Services Royal Commission: Quo vadis, Financial Services Industry? Part 1 — Superannuation (and vertical integration)

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Background

Readers will be familiar with the genesis, progress and conclusion (at least in a formal sense) of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

Commissioner Kenneth Hayne submitted an interim report to the Governor-General on 28 September 2018, with the report being tabled in parliament on the same date. The interim report provided some indication as to as to the direction the final report might take and the thinking of the Royal Commission on a range of topics canvassed before it.

On 1 February 2019, the Commissioner submitted that final report (Report) to the Governor-General.[1] The Report was tabled in Parliament on 4 February 2019. The government and the opposition each issued supportive responses to the Report.

Purpose

The purpose of this article is to discuss some of the implications of the Report for the financial services industry and the potential challenges it presents. With some 76 recommendations, it is not possible to analyse in minute detail the recommendations. Indeed, I will not focus on recommendations which are specific to the banking and general insurance industries. Rather, my purpose is to draw out some undercurrents in the Report with a view to commenting on where indeed the financial services industry is going and what we can expect to see in terms of legislative and administrative change. For one analysis of the possible themes which are discernible in the Report, and their implications, I refer readers to "The Financial Services Royal Commission: emerging themes and lessons for all" by Michael Vrisakis and Steven Rice. This part of this article focuses principally on superannuation matters dealt with in the Report.[2]

Despite some criticisms of the Report for "not going far enough", in my view there are some potentially wide-ranging implications of the Report. I will note these in this article where appropriate.

Underlying principles — the six norms

The starting point of this analysis is the underlying principles identified by Commissioner Hayne.

> At their most basic, the underlying principles reflect the six norms of conduct I identified in the *Interim Report:*
> - obey the law;
> - do not mislead or deceive;
> - act fairly;
> - provide services that are fit for purpose;
> - deliver services with reasonable care and skill; and
> - when acting for another, act in the best interests of that other.
>
> These norms of conduct are fundamental precepts. Each is well-established, widely accepted, and easily understood.
> …
> The six norms of conduct I have identified are all reflected in existing law. But the reflection is piecemeal.[3]

These norms provide the bedrock for the Report and each of the recommendations should be considered against this backdrop.

Structure of this article

Given the breadth of the Report, it has been necessary to present this in parts. The first part is this article and will deal with superannuation matters. The next instalment will be published in the next issue of the *Financial Services Newsletter*, being Vol 18 No 3, and will deal with the remainder of the financial services topics dealt with by the Commission.

A note of caution at this juncture — the final political and legislative outcomes of the Report are unclear. At the time of writing, the parliament has limited sitting days in the current session available. There appears to have been some divergence by the government, in the sense explained below, from some of the recommendations and the implementation timetable proposed by the government and the opposition differ, and there are also are some differences in the accepted substantive content of the proposed reforms. With a Budget and election looming, the Report reform process is a beast of many movable parts.[4]

Superannuation

Recommendation	Government response	Observations
Recommendation 3.1 — No other role or office: Following evidence during the superannuation hearings, the Commissioner recommended that in order to avoid conflicts that arise in the industry, registrable superannuation entity (RSE) licensees should be prohibited from acting in any other capacity and should be solely focused on the performance of their duties as a superannuation fund trustee. This conflict was seen to arise commonly in the case of "dual-regulated entities" ie, an entity will act in two capacities, first as an RSE Licensee (regulated primarily by the Australian Prudential Regulation Authority (APRA)) and second as Responsible Entity (RE) of a managed investment scheme (regulated primarily by the Australian Securities and Investments Commission (ASIC)).	The government agreed to address the risks associated with dual regulated entities by prohibiting trustees of an RSE assuming obligations other than those arising from, or in the course of, its performance of the duties of a trustee of a superannuation fund.	Evidence before the Commission found that dual-regulated trustee entities created conflict issues and difficulties to which the trustees and regulators need to give close and continuing attention. The Commissioner, in making this recommendation, necessarily, was not convinced that none of the general law, APRA Prudential Standards on conflicts and the Superannuation Industry (Supervision) Act 1993 (SIS Act) covenants relating to conflicts (and the priority to be afforded to the interests of beneficiaries) were sufficiently robust to prevent conflicted decision-making and actions. It is perhaps ironic that, as a number of commentators have noted, until recently, it commonly was the case that APRA's standard RSE licence conditions reflected the substance of this recommended prohibition. The Corporations Act 2001 (Cth) of course contemplates the existence of dual-regulated entities. This change, apart from the many capital, systems, process and other business implications, will require amendment and revision of ASIC Regulatory Guides and Class Orders. There may also be duty and revenue implications of a "demerger" of dual-regulated entities which will require considerations (although hopefully, this will be treated as a change of trustee having little or no adverse implications). What is not entirely clear is whether a *director in a group* may act both as a director of the trustee entity of the RSE and the (separate) RE of a managed fund. On the face of it, the recommendations seem to apply to trustee entities only. Nevertheless, the view expressed above has emerged. Clarity on this point would be useful.

		This is one area where legislation will be required, despite the Commissioner's sentiment that further legislation is not always the answer. The timing of this change is not certain.
Recommendation 3.2 — No deducting advice fees from MySuper accounts: Deduction of any advice fee (other than for intra-fund advice) from a MySuper account should be prohibited.	The government agreed to prohibit the deduction of any advice fees from a MySuper account (other than for intra-fund advice).	The question of fees and fees for service (or no service) was one which gave rise to considerable controversy during the Commission. The recommendation is consistent with the policy objectives for MySuper accounts where, generally, trustees are responsible for moneys which have been placed in default superannuation arrangements. The policy of the 2011 Stronger Super reforms in respect of MySuper was to introduce a new default system using low fees and costs and "simpler" superannuation products. How this prohibition interacts with the concept of "stapling" a member to one default fund and the Productivity Commission's proposal for "best in show" proposal for default funds (assuming that proposal remains viable) need to be played out.
Recommendation 3.3 – Limitations on deducting advice fees from choice accounts: Deduction of any advice fee (other than for intra-fund advice) from superannuation accounts other than MySuper accounts should be prohibited unless there is satisfaction of the proposed requirements in connection with ongoing fee arrangements (about annual renewal, prior written record of services to be provided and provision of the client's express written authority as set out in recommendation 2.1).	The government agreed to limit deductions of advice fees levied on non-MySuper superannuation accounts consistent with the government's response to recommendation 2.1, which will require ongoing fee arrangements to be renewed annually in writing by the client, and prevent fees being deducted from the client's account without the client's express written authority.	Again, this appears to be an outflow of the various fees issues put in evidence at the Commission (including the fees for no service issues). As can be seen from recommendation 3.2, there is no similar exception or carve out for the prohibition of deduction of advice fees for MySuper accounts (other than for intra-fund advice). It is also useful to note here that the Commission, echoing a long-held APRA view, thought that fees for advice concerning wealth management generally, ought not to be deducted from member balances. The advice must relate to the "member's interest in the fund" on this analysis. Practically, this may well be a difficult limitation to satisfy.

		Accordingly, fees for advice concerning consolidation of accounts, asset allocations and fund selection, where appropriate, to be deducted from accounts.[5] The practical outcome of this recommendation is that both advisers and trustees will need to enhance existing due diligence and operational processes concerning both requests for advice and deductions in payment of adviser fees for that advice. Indeed, it might be thought that advisers will need to consider carefully whether they can satisfy their professional, fiduciary and statutory obligations in providing advice within such limited parameters. As a separate matter, there may be the potential issues of fund selection, ie, consumers may be steered toward choice products purely so they can deduct advice (albeit within the limited constraints mentioned).
Recommendation 3.4 — No hawking: There should be a prohibition on the unsolicited offer or sale of superannuation products. Hawking of superannuation products should be prohibited. That is, the unsolicited offer or sale of superannuation should be prohibited except to those who are not retail clients and except for offers made under an eligible employee share scheme. The law should be amended to make clear that contact with a person during which one kind of product is offered is unsolicited unless the person attended the meeting, made or received the telephone call or initiated the contact for the express purpose of inquiring about, discussing or entering into negotiations in relation to the offer of that kind of product.	The government agreed that hawking of superannuation products should be prohibited, and the definition of hawking should be clarified to include selling of a financial product during a meeting, call or other contact initiated to discuss an unrelated financial product.	Here, most certainly, the devil will be in the detail. As a matter of general principle, the policy behind the recommendation is to be commended. This particular recommendation follows from evidence given at the Commission, that some consumers were being sold superannuation products following unsolicited approaches. An outcome of such approaches is that some members may have been acquired superannuation products and became members of funds which were not appropriate for them or which were not in the best interests of the member. However, expressing the circumstances where the problem should and might apply gives rise to some degree of difficulty and uncertainty. Currently, the major issue which the superannuation industry has faced in this context is the distinction between general and personal advice.[6] The focus now may well shift to appropriate or acceptable methods of marketing to existing and potential clients and the scope and application of any new anti-hawking provision.

		In due course, ASIC's *Regulatory Guide 38: The Hawking Provisions*[7] will require review. Another potential layer of complexity here is the proposed new design and distribution obligations and product intervention powers. At the time of writing, the relevant Bill had not finally progressed through the parliament. It is to be hoped that ASIC will consult fully on the many issues which potentially arise here and the interplay of the various provisions.
Recommendation 3.5 — One default account: A person should have only one default account. To that end, machinery should be developed for "stapling" a person to a single default account.	The government agrees that a person should only have one default account.	This also responds to the Productivity Commission's report *Superannuation: Assessing Efficiency and Competitiveness*[8] (Report 91) which was released in January 2019. This recommended members without an account only be defaulted once. This builds on the action the government has taken to address the stock of unintended multiple accounts through the Protecting Your Superannuation Package, which includes the automatic consolidation of low balance inactive accounts, capping fees for low balance accounts and preventing inappropriate account erosion by ensuring members receive insurance policies that are suitable for them and represent value for money. The mechanism how such stapling might work requires consideration and consultation.
Recommendation 3.6 — No treating of employers: The SIS Act should be amended to prohibit the trustees of a regulated superannuation fund, and associates of a trustee, doing any of the acts specified in s 68A(1)(a), (b) or (c) especially where the act may reasonably be understood by the recipient to have a substantial purpose of having the recipient nominate the fund as a default fund. The provision should be a civil penalty provision.	The government agreed to amend SIS Act to facilitate this recommendation.	The policy and effect of this recommendation appear to be to prevent funds entertaining (or "treating") employers who are responsible for nominating the default fund for their employees. If legislated, civil penalties will apply to trustees and associates of superannuation funds who "treat employers" as a means of inducing employers to nominate the particular fund for their business. Considered in isolation, this recommendation may have far-reaching consequences for both employers and

		trustees, as well as any agents such as administrators. The prohibition is extremely widely expressed and the number of what otherwise might be thought to be innocuous "marketing" activities potentially caught. The final legislative outcome of the recommendation needs to be considered carefully as does the enforcement approach of the regulators. We do know that the ASIC view is that in the context of enforcement, the first question, it must consider in the post-Commission world, is "why not litigate?" Hopefully, there will be clear statutory and administrative guidance in this area and that the guidance is developed in consultation with all of industry.
Recommendation 3.7 — Civil penalties for breach of covenants and like obligations: Breach of the following covenants should have civil penalty consequences under the SIS Act: • trustee's covenants in ss 52 or 29VN • director's covenants in ss 52A or 29VO	The government agreed that trustees and directors should be subject to civil penalties for "breaches of their best interests obligations".	The government previously introduced the Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No 1) Bill 2017 (Cth) into parliament to establish civil penalties for directors for breaches of the best interests duty and amendments have been made to this Bill to extend civil penalties to trustees. At the time of writing, this Bill has been passed by the Senate and awaits consideration in the House of Representatives. Unfortunately, the ambit of the government response is unclear. The government response to this recommendation appears to be limited to the SIS Act "best interests" covenants. However, the Commissioner's recommendation referred to all of the relevant SIS Act covenants.
Recommendations 3.8 (and 6.3) — adjustment of APRA and ASIC's roles: The roles of APRA and ASIC with respect to superannuation should be adjusted as follows: • APRA is responsible for establishing and enforcing Prudential Standards for superannuation funds. • ASIC's role is the conduct and disclosure regulator in superannuation concerning the relationship between RSE licensees and individual consumers.	The government agrees that the roles of APRA and ASIC in superannuation should be aligned to the twin peaks model.	As the Royal Commission hearings demonstrated, in a practical sense, there appeared to be ambiguity over the respective roles of the twin peaks regulators. However, the recommendation gives clarity to the role of each regulator in the superannuation industry: APRA is the prudential regulator and responsible for system and fund performance, and ASIC is the conduct and disclosure regulator.

		This also responds to the Productivity Commission's Report 91 which recommended clarifying the regulators' roles and powers, including their respective areas of focus.
Recommendations 3.9 (and 6.8) — accountability regime: The Commissioner recommended that the existing Banking Executive Accountability Regime (BEAR) (which clarifies standards of accountability and governance in the banking sector) be extended to apply to *all RSE Licensees*. Further, the BEAR should be jointly administered by APRA and ASIC, with ASIC taking responsibility for the consumer protection and market conduct aspects of the BEAR.	The government agreed with the recommendations and indicated that it would extend BEAR to *all APRA-regulated* entities, including insurers and superannuation RSEs. Further, the government has extended the recommendations and indicated that a similar regime will apply to all Australian financial services licensees, Australian credit licensees, market operators and clearing settlement facilities.	The outcome of the recommendation and the government comments is that BEAR becomes *FEAR* — Finance Executive Accountability Regime. This represents a new paradigm for the financial services industry. Care will need to be taken in drafting of the legislation to ensure that there are no unintended consequences and that the legislation accommodates the diversity of activity within the sector (just as the current BEAR accommodates differences in size in authorised deposit-taking institutions (ADIs)). There also is a real and significant question as to whether the regulators are appropriately resourced in administering and enforcing the new provisions.

Vertical integration[9]

There was speculation prior to the release of the Report, that limitations would be placed on "vertical integration" or that for-profit trustees would be prohibited. This did not eventuate.

It is interesting to note that the Commission indicated that conflicts which might arise from vertical integration, such as contracting with related entities, or preferring self or a parent's interests over those of members, could be addressed by a trustee simply complying with its existing duties and obligations. The Commission further noted that even if structural separation were to occur, conflicts would remain — members would wish to maximise return on investment and the "for-profit trustee" would seek to increase its profit.[10]

In the result, the Commissioner made these observations:

> Enforced separation of product and advice would be a very large step to take. It would be both costly and disruptive. I cannot say that the benefits of requiring separation would outweigh the costs, and the Productivity Commission concluded that "forced structural separation is not likely to prove an effective regulatory response to competition concerns in the financial system". I observe, however, that the Productivity Commission recommended, and I agree, that commencing in 2019, the Australian Competition and Consumer Commission (the ACCC) "should undertake 5 yearly market studies on the effect of vertical and horizontal integration in the financial system".
> I am not persuaded that it is necessary to mandate structural separation between product and advice.[11]

However, given the clear call to arms by the Commissioner to the regulators for them to robustly enforce the law, it is anticipated that these arrangements and related party transactions will be examined quite closely by the regulators. Trustees and REs prudently should document in some detail the reasoning behind any appointment of a related party service provider. It is envisaged that this would include, for example, comparative analyses of arm's-length providers' costings and services with that of the related party.

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The views expressed in this article are those of the author only. They do not represent the views or opinions of the Financial Services Council or any of its members.

Footnotes

1. Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry *Final Report* (February 2019) https://financialservices.royalcommission.gov.au/Pages/reports.aspx.
2. Together with some brief comments on "vertical integration".
3. Above n 1, Vol 1 at 8–9.

4. This paper addresses the government response only. As indicated, although the opposition has largely accepted the recommendations and in some respects opposition policy "goes further" than that of the government.
5. See for example, above n 1, Vol 1, para 2.3, recommendation 3.2 and para 2.3.3.
6. See *ASIC v Westpac Securities Administration Ltd* [2018] FCA 2078; BC201812686. It is understood that ASIC has lodged an appeal to the Full Federal Court following the decision.
7. ASIC *Regulatory Guide 38: The Hawking Provisions* (May 2005) https://download.asic.gov.au/media/1238114/rg38.pdf.
8. Productivity Commission *Superannuation: Assessing Efficiency and Competitiveness* Inquiry Report No 91 (December 2018) www.pc.gov.au/inquiries/completed/superannuation/assessment/report/superannuation-assessment.pdf.
9. The issue considered by the Commission was "whether there should be a separation between the manufacture or sale of financial products and the provision of financial advice": above n 1, Vol 1 at 192.
10. See discussion in above n 1, Vol 1 para 3.3.2 and references therein.
11. Above n 1, Vol 1 at 196.