Submission to Inquiry: the Corporations Amendment (Streamlining of Future of Financial Advice) Bill 2014

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Protecting the Best Interests of the Client

by

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The new 'best interests' duty in the Future of Financial Advice (FOFA) amendments to the Corporations Act in 2012 builds on the former 'know your client' statutory duty owed by the financial services licensee (the advice provider) to the client. It co-exists with - and has not replaced - the existing common law and equitable duties of advice providers, underpinned in some circumstances by fiduciary duties in equity. The new statutory duty for an advice provider to act in the best interests of the client is fulfilled by satisfying a six-part checklist including identifying the client's objectives, financial situation and needs and conducting a reasonable investigation into all financial products available to the client. In addition, the new best interest duty confirms the potential professionalism of the advice provider when it includes a catchall which requires the advice provider to take 'any other step that …would reasonably be regarded as being in the best interests of the client' in s 961B(2)(g). This catchall has been criticised by some sectors of the financial planning industry as open-ended and allegedly too uncertain because it is said to make the six-part checklist unworkable for advice providers. In the same way that it would not be too uncertain for a medical practitioner to be expected to consider 'any other step' in the treatment of a patient, FOFA has presented those in the financial planning industry with the opportunity to think outside the checklist when offering advice. The industry has come a long way since the days when many advice providers were commission salesman for product manufacturers, and the financial planning industry should embrace the best interests duty and its catchall as an opportunity to take one more step towards professionalising the industry rather turning back the clock by lobbying for and supporting its 'streamlining' (reduction) in 2014.

Integrity of advisers at common law and in equity

The amendments to the Corporations Act 2001 (Cth) by the Future of Financial Advice amendments (FOFA)[1] in force from 2012 present the lower end of the financial planning industry with the chance to step up from being populated with commission salesmen for product manufacturers and instead to become professionals taking all steps in the best interests of the client and in return charging a professional fee for service. The FOFA amendments co-exist with existing principles of contract law (such as implied terms of due care and skill, and the duty to act in good faith) and in some circumstances fiduciary duties in equity. The amendments aim to raise the professional standards of financial planners (advice providers)[2] by requiring them to act in the best interests of the client (s 961B) by reference to a checklist of six enumerated factors in s 961B(2) including the client's objectives, financial situation and needs, and the client's relevant circumstances. The duty of 'best interests' is new in the Corporations Act, but aspects of it build on and raise the standards and the lessons of the former 'know your client rule'.[3] However, the catchall 'any other step' in s 961B(2)(g) which follows the checklist has been opposed by sectors of the financial services industry who have lobbied to return the industry professionalism to the earlier pre-FOFA days of

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[1] Corporations Amendment (Future of Financial Advice) Act 2012 (Cth) and Corporations Amendment (Further Future of Financial Advice) Act 2012 (Cth), in force 1 July 2012 (voluntary); mandatory from 1 July 2013.

[2] Hereafter this article follows ASIC practice and uses 'advice provider' to include, for example, adviser, broker, financial planner and stockbroker. All are required to hold an Australian Financial Services Licence (AFSL) under Corporations Act 2010 (Cth) s 911A, issued by the Australian Securities and Investments Commission (ASIC).

[3] Australia's 'best interests' duty is in line with global experience.

For example, all authorised investment firms and banks in the 28 European Union member states and Iceland, Liechtenstein and Norway operate under local laws passed to give effect to a statutory requirement based on the European Directive to 'act honestly, fairly and professionally in accordance with the best interests of its clients' with no limitations (MiFID, article 19(1): Conduct of business obligations when providing investment services to clients). This article was introduced as part of the EU's Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on Markets in Financial Instruments Directive (MiFID).

Best interests is the standard expected of advice providers in the US at common law: see the authorities in, eg, SEC, *Study on Investment Advisers and Broker-Dealers - As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, Washington DC, 2011. This Securities and Investments Commission (SEC) report opens with 'An investment adviser is a fiduciary whose duty is to serve the best interests of its clients', iii. Section 913 of the Dodd-Frank Act has given the SEC the authority to make a regulation that would require anyone giving retail investment advice to act in the best interests of their clients. Section 731 of the Dodd-Frank Act has added the best interests standard for swap dealers in new s 4s of the Commodity Exchange Act 1936 (USA).

The best interests duty is under consideration for advice providers in Canada: Canadian Securities Administrators Consultation Paper 33-403, *The Standard of Conduct for Advisers and Dealers: Exploring the Appropriateness of Introducing a Statutory Best Interest Duty When Advice is Provided to Retail Clients*, Ontario Securities Commission, 25 October 2012.

In Hong Kong, *the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission* (Hong Kong, 2014) states that a 'licensed or registered person should act in the best interests of its clients' (clause 3.10).

commission salesmen. Some sectors of the industry have evidently also promoted personal interest over the interests of their clients by opposing other FOFA initiatives which would have led to the likely loss of trailing fees following the new opt-in requirements of clients, and removing the annual fee disclosure statement for pre-1 July 2013 clients. As a result, repeal of some of the proposed professional standards of the FOFA amendments has been the subject of intense lobbying since and negotiation by sectors of the financial planning industry since the outset, and are set for repeal in 2014.

The essential 'best interests' duty of integrity is based on fiduciary principles in equity, and expectations of good faith and disclosure at common law . At common law, and under the Corporations Act, a licensee giving personal advice to a retail client must determine the client's personal circumstances and make reasonable inquiries of the client to ensure that the advice is appropriate to the client. However, it is the catchall in s 961B(2)(g) which requires that the advice provider has 'taken any other step .. that would reasonably be regarded as being in the best interests of the client' which is facing repeal in 2014.

The statutory standards of advice providers build on the standard of integrity owed to a client by a broker, set out by Street J over 40 years ago:

> (t)he occupation of sharebroking demands high standards of integrity. In carrying on his occupation a sharebroker acts, not for himself, but for his client. His remuneration is his brokerage, or commission. Clients, some with great, others with little, business acumen and ability to protect themselves, seek and act on his advice and permit him to handle their money and their shares. Those clients are entitled to expect from a broker not only competence, but also integrity and absence of conflicting person interests. His position is one of trust and responsibility. By the recognition and pursuit of the high traditions of their occupation, brokers have aspired to the status of an honourable profession. The price they must pay for this status is that they forswear all compromise of their integrity, and that they repudiate the creation of personal interests which could bring them into conflict with their duty to their clients.[4]

Financial services law (securities regulation in some jurisdictions) aims for inter alia investor confidence, professionalism and high standards, and it recognises and attempts to overcome the usual (but not universal) imbalance of information and power between advice provider and client. Financial services law recognises that the ordinary client cannot or may not be able to understand or protect themselves in the modern world of financial products and financial opportunities, each with their own language, meanings and mathematical finance. The problems of emotional factors affecting economic decision making were succinctly put into context by the Queensland Chief Justice in these words:

> Behavioural economics emphasises that, contrary to the assumptions of neoclassical economists, individuals are not inherently rational in their actions and decision making. As its proponents Thaler and Sunstein note, the contrary would require people to 'think like Einstein, store memory like Big Blue, and exercise willpower like Mahatma Gandhi'.[5]

Justice Street rightly adverted to what is now one of the current issues underlying the FOFA reforms, the payment of the advice provider by brokerage and commission.[6] At common

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[4] Street J in *Bonds & Securities (Trading) Pty Ltd v Glomex Mines NL* [1971] 1 NSWLR 879 at 891.

[5] P de Jersey, 'Developments in Financial Services Laws over the Last 30 years', Banking and Financial Services Law Association 30th Annual Conference, Gold Coast, 30 August 2013, citing R Thaler and C Sunstein, *Nudge: Improving Decisions About Health, Wealth, and Happiness*, Yale University Press, 2008, 7.

[6] Street J was not required to go to the next step and investigate and examine the source of the brokerage and

sense, it would not be possible for an advice provider to provide independent advice if they are being paid by issuers of financial products (such as product manufacturers, financial product developers and the wholesalers of managed funds) to promote and to sell their products to investors.

Justice Street neatly summarised the legal framework, the expectations of the client, and the authority for brokers to control 'other people's money'.[7] Developments since these words were written over 40 years ago now include the requirements of legislation such as the Corporations Act and its administration by the Australian Securities and Investments Commission (ASIC), the soft law of ASIC and stock exchanges (their guides and releases), the common law (such as contract, agency and tort), equitable principles (fiduciaries, if applicable) and in some sectors, industry codes of ethics. Combined, this underlies what in the US is called the Shingle Theory – that when a financial adviser hangs up their shingle to show that they are in business or otherwise advertises their services, that they impliedly represent that they will deal fairly with their clients and in accordance with industry standards, that they will fulfil industry legal and ethical responsibilities and that they will act in the best interests of the client.[8] Unfortunately in the context of generally successful and satisfied investors, some failings in the industry were exposed during the global financial crisis (GFC, 2007-2008) with some high profile failures of financial planners

The quotation by Street J from the 1970s must be widened today to recognise that brokers are no longer the main advice providers in today's financial services market. Until the 1970s, the financial services industry consisted of, at one end, stockbrokers, and at the other end, insurance salesmen (commission salesmen) largely paid by commissions and other bonuses by issuers of financial products. Some financial products and financial services were offered in that market by others who today would need to be licensed by ASIC with an Australian Financial Services Licence (AFSL) such as accountants and lawyers (for example, those then involved in mortgage broking and running informal managed investment schemes from the office for the benefit of their clients). Developments in the financial services sector over recent years have seen some reduction in the numbers of commission salesman and their replacement by new professional advice providers – tertiary graduates, ASIC licensed - who provide independent professional advice, rebate commissions and receive their compensation on a fee for service basis by fees rather than by payment and bonuses from product providers.

Advice providers as fiduciaries

The Corporations Act, including the FOFA amendments, draws on Australia's legal culture when it refines and puts into statutory form many aspects of the common law and some of the principles of equity. The Act does not exclude the common law and equity. It sits alongside, for example, the existing principles of equity including the fiduciary relationship, the relationship which arises from a relationship of ascendancy, confidence, dependence, disadvantage, influence, trust, unequal bargaining power and/or vulnerability between person

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commission – the client or the product issuer - and that the broker may take other incentives such as soft dollars in many forms, and the disclosure thereof.

[7] Louis D Brandeis, *Other People's Money, and How the Bankers Use It* (1914, reprinted 1986).

[8] Eg *Charles Hughes & Co. v. SEC* (1943) 139 F 2d 434. The shingle theory includes standards of conduct such as know your client, priority to clients and disclosure of principal trading. Many of these appear in ASIC's Market Integrity Rules and in the self-regulatory rules of the stock exchanges.

A (the fiduciary) and person B (the client). The relationship gives rise to a fiduciary expectation which parallels and co-exists with the new best interests duty of FOFA:

> A fiduciary is a person who undertakes to act in the interest of another person….The greater the independent authority to be exercised by the fiduciary, the greater the scope of his fiduciary duty.[9]
>
> No part of the jurisdiction of the Court is more useful than that which it exercises in watching and controlling transactions between persons standing in a relationship of confidence with each other.[10]

However worthy, and unlike the FOFO obligations,[11] fiduciary duties owed to clients can be excluded by contract.[12]

Fiduciary duties are an imposed standard of contract, partly based on public policy, and they set a standard which is not applicable to contracts in general, as demonstrated by Finn when he said that:

> My trust in a motor vehicle mechanic may, in fact, greatly exceed my trust in a lawyer yet only the latter is likely to be found a fiduciary.[13]

There may be uncertainties about the scope and definition of 'fiduciary', described by Finn as a 'concept in search of a principle',[14] but there is no doubt that fiduciary duties can and do sit with the new best interests duty of FOFA. As stated almost 150 years ago, and often cited:

> Wherever two persons stand in such a relation that, while it continues, confidence is necessarily reposed by one, and the influence which naturally grows out of that confidence is possessed by the other, and this confidence is abused, or the influence is exerted to obtain an advantage at the expense of the confiding party, the person so availing himself of his position will not be permitted to retain the advantage, although the transaction could not have been impeached if no such confidential relation had existed.[15]

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[9] A W Scott, 'The Fiduciary Principle' (1949) 37 *California Law Review* 539, 540, 541.

[10] *Billage v Southee* (1859) 9 Hare 534, 540; 68 ER 623, cited by F Flannigan, 'The Fiduciary Obligation' (1989) 9 *Oxford Journal of Legal Studies* 285 at 285.

[11] Corporations Act 2001 (Cth) s 960A (no contracting out), discussed below at nn 59, 63.

[12] See, eg, *Chan v Zacharia* [1984] HCA 36 per Deane J at [19] (partnership); *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* [2007] FCA 963 (broker), discussed by, eg, A Tuch, 'The Paradox of Financial Services Regulation: Preserving Client Expectations of Loyalty in an Industry Rife with Conflicts of Interest', in H Tijo (Ed), *The Regulation of Wealth Management*, Singapore Conferences on International Business Law, Centre for Commercial Law Studies, Singapore, vol 10, 2008, 53-85, available on SSRN; P F Hanrahan, 'The Relationship Between Equitable and Statutory "Best Interests" Obligations in Financial Services Law" (2013) 7 *Journal of Equity* 46 at 72; also P F Hanrahan, 'The Fiduciary Idea in Financial Services Law', ch 11 in J O'Brien and G Gilligan (Eds), *Integrity, Risk and Accountability in Capital Markets*, Hart Publishing, Oxford, 2013.

[13] P Finn, 'Contract and the Fiduciary Principle' (1989) 12 *UNSWLJ* 76 at 93.

[14] A F Mason, 'Themes and Prospects' in P D Finn (ed), *Essays in Equity* (Law Book Co, Sydney, 1985) 246, cited by P D Finn, 'Fiduciary Reflections' (2014) 89 *ALJ* 127 at 127.

[15] *Tate v Williamson* (1866) LR 2 Ch App 55 at 61 per Lord Chelmsford , cited by, eg, Finn, above n 13 at 132.

Some classifications put fiduciaries into two categories - status-based fiduciaries and fact-based fiduciaries.[16] Status-based fiduciaries include the relationships of trustee/beneficiary, agent/principal, company director/company, solicitor/client and partner/partner.

The relationship between an advice provider and client is not of itself one of the status-based classes of fiduciaries, and this gives rise to some confusion in the law about whether and when an advice provider is a fiduciary owing fiduciary (and therefore best interests) duties to clients.[17] As a fact-based relationship, the advice provider/client relationship may or may not give rise to fiduciary duties.[18] ASIC gave evidence to the Ripoll inquiry on financial planners that 'the law at the moment is uncertain as to whether the fiduciary duty exists. (ASIC) take(s) the view that it may well exist, but it is unclear'.[19] For example, Glover states correctly that '(o)nly some aspects of the relations between brokers and clients can be fiduciary' and provides as examples the giving of advice upon which the client is reasonably believed to rely, initiating transactions without the client's instructions and receiving money, securities or other property in the course of the retainer on behalf of the client.[20] Certainly not all advice providers are fiduciaries if the provider is not acting for, or on behalf of, or in the interests of, or with the confidence of, another.[21]

There is authority that the relationship between an investment bank and its financial advisory client is fiduciary in character and that this will lead to a duty to avoid conflicts.[22] As SEC Commissioner Ferdinand Pecora put it in the 1930s:

> an (investment) bank was supposed to occupy a fiduciary relationship and to protect its clients, not to lead them into dubious ventures; to offer sound, conservative financial advice, not a salesman's puffing patter.[23]

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[16] See, eg, The Law Commission (UK), *Fiduciary Duties and Regulatory Rules* (London, Consultation Paper No 124, 1992) 27-28 (Who is a fiduciary?).

[17] D Mendoza-Jones, 'Reform of the Financial Advice Industries in Australia and the United States' (2013) 31 C&SLJ 261 at 267.

[18] See, eg, P Latimer, 'Disclosure and Fair Dealing by Stockbrokers' (1989) 18 *Anglo-American Law Review* 335.

[19] Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into Financial Products and Services in Australia* (Ripoll Report) (Commonwealth of Australia, 2009), Official Committee Hansard (transcript of public hearings), evidence of Tony D'Aloisio, Australian Securities and Investments Commission (Canberra, 16 September 2009) at 10, cited in the Ripoll Report at 86, and by Mendoza-Jones, above n 17 at 266.

[20] J Glover, *Commercial Equity – Fiduciary Relationships*, Butterworths, Sydney, 1995, [3.62], [3.63]; J Glover, *Equity, Restitution and Fraud*, LexisNexis Butterworths, Sydney, 2004, [2.37]-[2.40]. This parallels Rares J in *Wingecarribee Shire Council v Lehman Bros Australia Ltd (In Liq)* [2012] FCA 1028 at [733].

[21] P Finn, 'The Fiduciary Principle', ch 1 in Timothy G Youdan (ed), *Equity, Fiduciaries and Trusts*, Carswell,

Toronto, 1989, 2.

[22] See, eg, A Tuch, 'Investment Banks as Fiduciaries: Implications for Conflicts of Interest' (2005) 29 *MULR* 478 at 509; A Tuch, 'Obligations of Financial Advisers in Change-of-Control Transactions: Fiduciary and Other Questions' (2006) 24 *C& SLJ* 488 at 521.

[23] F Pecora, *Wall Street Under Oath: The Story of Our Modern Money Changers* , Cresset Press, London, 1939,

Only if the advice provider is an agent will the provider be a status-based fiduciary. As such, the advice provider will owe a duty of economic loyalty to the principal,[24] including the best execution rule, and disclosure of conflict of interest under the 'no conflict' rule, one of the four sides to the duties of a fiduciary.[25] This is what Pecora called 'elementary fair play … (in the absence of which) the public never had a chance'.[26] Disclosure of conflict of interest arises when the fiduciary is conflicted between self-interest and the best interests of the client. 'No man can serve two masters',[27] and an advice provider cannot in good faith work on two different sides of a contract. It would be a rare and unusual advice provider who would not end up favouring its own interests over those of its client.

The nature of the advice provider/client relationship will indicate whether the relationship is fiduciary. A fiduciary obligation may be called a 'judicial guess' but courts use 'fiduciary' to extract good faith and fair dealing[28] in the context of the best interests of the client. A relationship is more likely to be fiduciary if an investment adviser is 'cultivating … a position of trust and confidence',[29] but it is too strong to say that all advice providers are fiduciaries all the time.[30] Battaglia argues that Australian financial planners acting as investment advisers are in a fiduciary relationship with clients when financial planning advice is given over a period of time.[31] To its credit, the Financial Planning Association of Australia clearly states that its members are fiduciaries.[32]

To conclude:

> The fiduciary nature of the counsellor's (investment adviser's) position is more apparent than that of a broker and its burdens are more exacting. A marked similarity will be seen between this relationship

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reprinted 1973, 89.

[24] See, eg, L S Sealy, 'Fiduciary Relationships' [1962] *CLJ* 69; L S Sealy, 'Some Principles of Fiduciary Obligations' [1963] *CLJ* 119; E J Weinrib, 'The Fiduciary Obligation' (1975) 25 *U Toronto LJ* 1 at 5 (the 'notoriously intractable' problem in identifying fiduciary relationships).

[25] The 'no conflict' rule; the 'no profit rule'; the 'undivided loyalty rule' and the duty of confidentiality: see, eg, The Law Commission (UK), above n 16, 32.

[26] Pecora, above n 23, 100, 102.

[27] Matthew 6:24.

[28] D De Mott, 'Beyond Metaphor; An Analysis of Fiduciary Obligation' [1988] *Duke Law Journal* 879 at 880.

[29] See, eg, *Arleen W Hughes*, Securities Exchange Act of 1934 Release No 4048, 20 February 1948 at 12, cited in 'Disclosure Requirements in Over-the-counter Trading' (1948) 57 *Yale Law Journal* 1316 at 1319 (unnamed author).

[30] *Daly v Sydney Stock Exchange Ltd* [1986] HCA 25: 'Normally, the relation between a stockbroker and his client will be one of a fiduciary nature' (but not always) per Gibbs CJ at [6]. Daly's case is cited by A Tuch, 'Investment Banks as Fiduciaries: Implications for Conflicts of Interest' (2005) 29 *Melbourne University Law Review* 478 at 491.

[31] V Battaglia, 'Dealing with Conflicts: The Equitable and Statutory Obligations of Financial Services Licensees' (2008) 26 *C&SLJ* 483 at 485, cited by Mendoza-Jones, above n 17 at 267.

[32] Financial Planning Association of Australia, *Code of Professional Practice, The Pillars of Our Profession*, 23, 24, July 2013, at < http://www.fpa.asn.au/media/FPA/FPA%20Standards/FPA_CodeofPractice_July2013.pdf> (accessed 5 March 2014).

and that of attorney and client.[33]

Statutory 'best interests' of the client

One of the consequences of the GFC (2007-2008) in Australia were corporate collapses of some providers of financial products and financial services - including Storm,[34] Trio[35] and Westpoint[36] - which resulted in the loss of investors' savings including sometimes some high-profile losses of investors' life savings.

This motivated the then Commonwealth government to 'do something', which included setting up in 2009 an inquiry into the causes of these collapses through the Parliamentary Joint Committee on Corporations and Financial Services to report on and to make recommendations for the future.[37] One focus of the inquiry was to include the role of the financial planning industry in providing advice for investors especially in the non-superannuation area. The committee's report, known after its chair as the Ripoll Report, made recommendations for changes to the law to inter alia raise the professional standards of the industry. The recommendations included providing for better outcomes and protections for consumers of financial products and services by restoring trust and confidence in the financial services sector. The recommendations became the FOFA amendments to the Corporations Act 2011 (Cth) in 2012. Ideally, one result of FOFA will be to accelerate the replacement of the commission salesman by the development of the financial advice industry into a profession providing conflict-free independent professional advice, with its members paid as a professional by fee for service, and not dependent on commissions and bonuses paid by product wholesalers and product manufacturers (conflicted remuneration).

The new FOFA best interests amendments to the Corporations Act build on Australia's many years of experience with the former statutory know your client duty[38] in line with international know your client standards. The best interests duty is intended to lead to the provision of a higher quality advice than the former know your client duty, with the result that a client would be in a better position if they in fact did follow the advice.[39] The

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[33] R H Lee, 'The Financial House and its Customers' (1935) 15 *Boston University Law Review* 234 at 237.

[34] See, eg, <https://storm.asic.gov.au> (accessed 5 March 2014).

[35] See, eg, <http://www.asic.gov.au/asic/asic.nsf/byheadline/Grant+of+financial+assistance+-+Trio+and+Astarra+investors?openDocument> (accessed 5 March 2014).

[36] See, eg, <http://www.asic.gov.au/asic/asic.nsf/byheadline/Westpoint+bulletin?openDocument> (accessed 5 March 2014).

[37] Ripoll Report, above n 19. See, eg, M Ap, 'The Future of Financial Advice Reforms: Restoring Public Trust and Confidence in Financial Advisers - An Unfinished Puzzle' [2011] *CanLawRw* 36; (2011) 10(3) *Canberra Law Review* 188.

[38] Corporations Act 2001 (Cth) Chapter 7, Part 7.7, Div 3, Subdiv B, inserted into the Corporations Act by the Financial Services Reform Act 2001 (Cth) (now repealed).

[39] Second reading speech to the Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011, quoted in ASIC, 'Future of Financial Advice: Best Interests Duty and Related Obligations—Update to RG 175', CP 182, August 2012 at 35.

statutory duty of advice providers under the former know your client duty applied to personal advice (not general advice) given by the holder of an AFSL or representative to a retail client (s 944A(b)). The advice provider was required to determine the client's relevant personal circumstances, make reasonable inquiries and provide advice which would be appropriate to the client (former s 945A(1)). The know your client duty was backed up with a duty to warn a client if advice was based on incomplete or inaccurate information (s 945B).[40]

One of the consequences of the FOFA reforms was to confirm the former statutory know your client duties of advice providers in former ss 945A and 945B,[41] with the addition of the new statutory duty of the advice provider to act in the 'best interests' of the client.[42] In the words of the then Minister for Financial Services and Superannuation, '(t)he best interests duty is a legislative requirement to ensure the processes and motivations of financial advisers are focused on what is best for their clients'.[43] One aim was to lead to a more client-focused advice, better availability of advice and more adviser engagement with clients.

Section 961B(1) of the Corporations Act 2011 (Cth) now provides a simple statement of professionalism with a new duty for advice providers when it states that the 'provider must act in the best interests of the client in relation to the advice'. The FOFA best interests amendments coexist with the existing relevant principles at common law and in equity.

Section s 961B(2) then attempts to clarify the best interests duty by providing a safe harbour checklist (conduct steps) of what the advice provider has to have done to show that it has acted in the 'best interests' of the client. This is based on the former know your client rule. The checklist moves the focus from the motivation of the advice provider to the conduct of the advice provider (what the provider 'has done'). ASIC has stated that there is no absolute requirement for an advice provider to comply with all the steps, that whether or not they are required to so comply will vary depending on the surrounding circumstances.[44] On one interpretation, this best interests duty set out in s 961B(1) stands alone, and is not affected by

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[40] The know your client duty was enforceable administratively (by, eg, ASIC suspending, cancelling or banning an AFSL), by civil action (damages, civil penalties) or by criminal penalties (s 1311(1) and schedule 3). Further civil action was available, eg, for misleading or deceptive conduct and/or for false representations.

[41] Ripoll Report, above n 19 at 150 (recommendation, then described as a 'fiduciary duty').

[42] Corporations Act 2001 (Cth), Part 7.7A (Best interests obligations and remuneration), based on Ripoll Report, above n 19, Recommendation 1 – that there be a statutory fiduciary duty for financial advisers - at para 6.29-6.34, at <http://www.aph.gov.au/binaries/senate/committee/corporations_ctte/fps/report/report.pdf> (accessed 16 January 2014).

'Best interests' is also in Corporations Act 2001 (Cth) s 601FC(1)(c) (duties of responsible entity) and Superannuation Industry (Supervision) Act 1993 (Cth) s 52(2)(c) (Covenants required of trustees of superannuation funds): see, eg, M Stone, 'The Superannuation Trustee: Are Fiduciary Obligations and Standards Appropriate?' (2007) 1 *Journal of Equity* 167 at 180 and D Mendoza-Jones, 'Superannuation Trustees: Governance, Best Interests, Conflicts of Interest and the Proposed Reforms' (2012) 30 *C&SLJ* 297, both cited in Mendoza-Jones, above n 17 at 267. Case law on the best interests of trustees requires trustees to exercise their powers in the best interests of present and future beneficiaries of the trust: *Cowan v Scargill* [1985] Ch 270 at 287 per Megarry V-C.

[43] ASIC, 'Future of Financial Advice ... Update to RG175', above n 39 at 35.

[44] ASIC, 'Licensing: Financial Product Advisers—Conduct and Disclosure', ASIC RG175, October 2013 at RG 175.336, 175.337.

any of the checklist which follows and is set out in s 961B(2). However, if s 961B(2) is not intended to be an 'exhaustive and mechanical checklist', some argue that the steps in s 961B(2) remain open-ended and cloud their original purpose of providing clarity.[45] As always argued when new legislation is passed, there is further argument that s 961B(2)(g) will cause difficulties in interpretation and that its application will lead to uncertainty and unpredictability.

In fact the best interests duty imposed by s 961B(2) both parallels - and is additional to - the duty owed by an advice provider in situations where the advice provider is in a fiduciary relationship (no profit, no conflict of interest, disclosure) and at common law (implied terms, contractual duty of good faith, potential liability in tort). The result is that advice providers are now regulated by various and slightly different legal best interest duties by statute, at common law and in equity.

The best interests duty is not a true fiduciary duty[46] as recommended by the Ripoll Report.[47]

It is one aspect of a fiduciary duty but it is not as far reaching as a fiduciary duty. Instead, the best interests duty is a duty of suitability, which has been described as 'statutory',[48] 'fiduciary-like' or 'duty of care-like',[49] 'fiduciary-type',[50] but not 'fiduciary'.[51] Further, it

can be argued that the best interests duty in s 961B confuses the duty of loyalty with a duty of care when it sets out a duty of loyalty with standards used to define a duty of care. These two duties should not be confused because it is the duty of loyalty that underpins fiduciary duties and this is the duty that the advice provider should meet.

The checklist (conduct steps) in s 961B(2) states that the advice provider has satisfied the 'best interests' test if, firstly, the advice provider has identified the 'objectives, financial situation and needs' of the client.[52] As Serpell has pointed out, there are limitations on the operation of the best interests duty because 'an adviser can recommend a financial product to

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[45] S Corones and T Galloway, 'The Effectiveness of the Best Interests Duty – Enhancing Consumer Protection? (2013) 41 *ABLR* 5 at 26.

[46] See, eg, M S Donald, 'Regulating for Fiduciary Qualities of Conduct' (2013) 7 *Journal of Equity* 142 at 146. A fiduciary duty is a principle based on undivided loyalty and trust to act in good faith and in the best interests of a client

[47] Ripoll Report, above n 19,t Recommendation 1 at 6.29:
'The Committee recommends that the Corporations Act be amended to explicitly include a fiduciary duty for financial advisers operating under an AFSL, requiring them to place their clients' interests ahead of their own.'

[48] L Gray and J Ireland, 'Future of Financial Advice Reforms' (2011) 49(11) *Law Society Journal* 66.

[49] S Corones, 'Submission on Financial Planning Consultation Paper, QUT, Brisbane, 2013, 1, at <http://eprints.qut.edu.au/56692/1/FPA_Consultation_Paper_Submission_%282%29.pdf> (accessed 5 March 2014).

[50] D Mendoza-Jones, above n 17 at 267.

[51] K Lindgren, 'Fiduciary duty and the Ripoll Report' (2010) 28 *C&SLJ* 435.

[52] Corporations Act 2001 (Cth) s 961B(2)(a). This is the definition of 'personal advice' in s 766B(3)(a).

a client (provided it is 'appropriate') even if the adviser is aware of other financial products which would or may be 'better' for the client.'[53]

The section provides a safe harbour, as with the former know your client rule, if it is reasonably apparent that the information from the client is 'incomplete or inaccurate' and that the adviser has made inquiries to obtain the information.[54] If the provider lacks the relevant expertise, it should decline to provide the advice.[55] The provider is to conduct reasonable investigation into the financial products that might achieve the objectives of the client.[56] The advice is to be based on the client's 'relevant circumstances'.

As mentioned above, the advice provider is not a status-based fiduciary (the first class of fiduciaries) as he or she does not have the capacity to directly and immediately affect the interests of the retail client. Instead, an advice provider is a fact-based fiduciary (the second class of fiduciaries), and as a result, in the view of Lindgren, 'the language of "best interests" sits awkwardly with those who merely provide advice'.[57]

The best interests duty is actionable under the Corporations Act,[58] but this does not mean that every poor outcome for the client (such as loss of capital or income) is the result of a breach of the best interests duty.

In addition, to improve transparency for consumers, the FOFA amendments to the Corporations Act now ban conflicted remuneration including commissions (s 963E) to overcome the temptation of conflict of interest where an adviser may be motivated to put its own interests (commission) ahead of the interests of the client. The resulting advice must be appropriate to the client (s 961G). Priority must be given to the interests of the client in the event of conflict between the interests of the client and the interests of the advice provider (s 961J; a new duty which builds on centuries of fiduciary law). Section 960A now prevents an advice provider contracting out of these duties (s 961B(2)(g)) or limiting the steps they need to take by disclosing that they will not take those steps.[59]

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[53] A Serpell, 'The Future of Financial Advice Reforms' (2012) 30 *C&SLJ* 240 at 252. Similar limitations in the reasonable basis test were identified by the Industry Super Network in its Submission 380 at 17, quoted in the Ripoll Report, above n 19 at 86.

[54] Corporations Act 2001 (Cth) s 961B(2)(c).

[55] Corporations Act 2001 (Cth) s 961B(2)(d).

[56] Corporations Act 2001 (Cth) s 961B(2)(e).

[57] K Lindgren, 'Administrative Law in the Superannuation Context' (2013) 87 *ALJ* 688 at 692.

[58] Section 961M of the Corporations Act provides for civil action against a financial adviser for loss or damage if there has been breach of the division. Breach is not a criminal offence – as was the case with the former know your client rule – but it may lead to the imposition of a civil penalty (ss 961K and 961Q).

[59] See, eg, see ASIC, RG175, above n 44 at RG 175.209.

Critics predictably argue that because of the non-exhaustive checklist (conduct steps), the best interests duty will lead to increases in advisers' professional indemnity insurance premiums. They argue that professional indemnity insurers will be cautious for the years it may take for the new best interests duty to be tested in the courts.

The catchall to the best interests of the client in s 961B(2)(g) - that the advice provider has taken 'any other steps … in the best interests of the client'

The duty to act in the best interests of the client comes with the catchall in s 961B(2)(g) that the provider has

> taken any other step that, at the time the advice is provided, would reasonably be regarded as being in the best interests of the client, given the client's relevant circumstances.

This catchall follows and is additional to the six preceding steps set out in s 961B(2)(a) to (f). It moves the focus from the six steps in the checklist as it requires professionalism of advisers (advice providers) when it requires them to exercise their own judgment. ASIC has said that it would expect advice providers to exercise their judgment in considering whether any of these additional steps need to be taken to satisfy s 961B(2)(g),[60] and that fulfilling the requirements of s 961B(2)(g) will vary depending on the surrounding circumstances. ASIC would expect the advice provider to:[61]

> (a) explain clearly to the client the advice service that *is* and *is not* being provided ..;
>
> (b) if the advice includes a product recommendation, provide related strategic recommendations that benefit the client;
>
> (c) depending on the subject matter of the advice, specify in the advice that the client should review any decision made about financial products on the basis of the advice provided:
>
> > (i) once after a period of time;
> >
> > (ii) regularly (eg every one or two years); or
> >
> > (iii) if the client's circumstances change ... and
>
> (d) offer to provide advice (or refer the client to someone who can provide advice) on any other key issues identified by the advice provider within the subject matter of the advice ..

This is well-intentioned and confirms the current practice of the upper end of the financial planning industry. ASIC has pointed out that the words 'at the time the advice is provided' in s 961A(2)(g) mean that fulfilling the best interests duty takes place when the advice is provided and that it does not require the advice provider to consider what in hindsight may have been in the client's best interests.[62]

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[60] See ASIC, RG 175, above n 44 at RG 175.338.

[61] See ASIC RG 175, above n 44 at RG 175.336 (edited); draft in ASIC, 'Future of Financial Advice … Update to RG 175', above n 39 at RG175.A111; ASIC, Report 319, 'Response to Submissions on CP 182 on the Best Interests Duty and Related Obligations and CP 183 on Scaled Advice', December 2012, 17.

[62] See ASIC, RG 175, above n 44 at RG 175.335; revised after ASIC, CP 182, above n 39; House of Representatives, *Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011, Replacement Explanatory Memorandum*, 1.43.

Many or most of the better advice providers do and continue to operate in a professional manner, working on fee for service and rejecting conflicted remuneration by inter alia rebating commissions or by not accepting soft dollars and/or kickbacks such as bonuses, all-expenses paid ‘seminars’, laptops and more. As with, for example, a medical practitioner, an advice provider professional would not consider the options for their professional advice to be limited only to a checklist and they would naturally explore all options, including possible referral for specialist advice. In other words, a medical practitioner would naturally take and would be expected to take ‘any other step’ for the better treatment of a medical patient.

FOFA has presented the financial services industry with an opportunity to take one more step towards the professionalising of the industry. It should be cause for concern that some in the financial services industry have attacked the ‘catch-all’ duty in s 961B(2)(g) before and now after its commencement on the grounds that it makes the best interests checklist in s 961B uncertain. They argue that the catchall will make it difficult for advice providers to fulfil the best interests test, and that it will be impossible for them to design efficient processes for compliance and for providing advice (ie to tick the box). This is compounded by s 960A which prevents an advice provider from contracting out of s 961B(2)(g) or otherwise limiting the steps they need to take by disclosing that they will not take those steps.[63]

Compliance with the checklist in s 961B(2) by box ticking potentially takes away the responsibility of advice providers to exercise their own judgment, with the danger that s 961B(2) could be seen as no more than a safe harbour for formal compliance by box ticking. This highlights the importance of the catchall in s 961(2)(g) to keep the box open for professional and independent judgment. As Craddock has rightly pointed out, the Explanatory Memorandum says the steps in s 961B(2) are not intended to be exhaustive, but he submits that they will come to be read that way by advice providers and in time by the courts.[64]

Further, some in the financial services industry have expressed reservations that because the catchall is open-ended, it will create legal uncertainty and that this will make the checklist/safe harbour in s 961B(2) unworkable for advice providers. They argue that advice providers who have followed the checklist may not have confidence that they have discharged their statutory best interests obligations. In fact, this open-endedness in the best interests duty is exactly what the ‘any other step’ requirement in s 961B(2)(g) is supposed to do. It removes a static and inflexible advice model (box ticking) that may fail to take full account all of the client's relevant circumstances.[65]

There are further criticisms that interpretation of the best interests duty in s 961B may be difficult for courts, internal dispute resolution schemes and external dispute resolution

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[63] See ASIC, RG 175, above n 44 at RG 175.339. ASIC has said that the best interests duty in s 961B(2)(g) does not prevent scaled advice, and that for the advice provider to meet its obligations under this provision will depend on the subject matter of the advice being given and the client’s relevant circumstances: ASIC, ‘Giving Information, General Advice and Scaled Advice’, RG 244, December 2012 at RG 244.82.

[64] G Craddock, ‘The Ripoll Committee Recommendation for a Fiduciary Duty in the Broader Regulatory Context’ (2012) 30 *C&SLJ* 216 at 236.

[65] Corones and Galloway, above n 45 at 24. The static test resembles the former static test of the ‘fit and proper’ person as the basis for occupational licensing, now replaced by the general obligation of the licensee in s 912A(1)(a) to provide financial services ‘efficiently, honestly and fairly’: see, eg, P Latimer, ‘Providing Financial Services “Efficiently, Honestly and Fairly”’ (2006) 24 *C&SLJ* 362.

schemes because of the open-ended nature of the catchall in s 961B(2)(g), and that these interpretations of best interests in case law and practice may affect the original policy aim of both the then government and the legislation as passed. In addition, there are criticisms, as with all new legislation, that the catchall is hard to understand, and that as a result, premiums will rise to the disadvantage of clients.

The Liberal-National Party Coalition in the Australian parliament issued a dissenting report on FOFA when it was in opposition in 2012.[66] Following the Coalition's return to government after the elections in September 2013, the Assistant Treasurer released the government's proposed amendments to FOFA in line with the earlier dissenting report for public consultation. The repeal in full of the catchall in s 961B(2)(g) is proposed by clause 13 of the Corporations Amendment (Streamlining of Future of Financial Advice) Bill 2014 (Cth).[67]

The proposed amendments to weaken the best interests duty have been barely noticed by the public not aware of what might be at stake for standards of professional advice on their investments and their life savings. The amendments are not 'political', are rarely in the media, and the effect of removing the catchall by lowering the best interests duty expected of advice providers may not be apparent to an apparently disengaged public lacking the financial literacy to understand the changes or their likely consequences. Indeed, the effect of the proposed changes may not become known until evidence of conflict of interest and unprofessional conduct is revealed in a future inquiry following the next round of boom and bust in the economic cycle. As with the setting up of the Ripoll Committee in 2009, an inquiry, investigation, Parliamentary Committee or Royal Commission may be set up after

[66] Parliamentary Joint Committee on Corporations and Financial Services, *Corporations Amendment (Future of Financial Advice) Bill 2011 and Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011*, Dissenting Report by Coalition Members of the Committee, February 2013, at

<http://www.aph.gov.au/Parliamentary_Business/Committees/Joint/Corporations_and_Financial_Services/Completed_inquiries/2010-13/future_fin_advice/report/d01> (accessed at March 2014).

[67] Australian Government, Treasury, 'Exposure Draft – FOFA Amendments', at <http://futureofadvice.treasury.gov.au/content/Content.aspx?doc=consultation/fofa_amendments/default.htm> (accessed 5 March 2014). The best interests duty will further be amended to facilitate the provision of low-cost scaled advice.

The FOFA amendments in the *Corporations Amendment (Streamlining of Future of Financial Advice) Bill 2014* (Cth) would be unlikely to pass the current Commonwealth Parliament as the current government, led by the Coalition Liberal and National Parties with a majority in the House of Representatives, does not have a majority in the Senate. The Coalition parties may gain a majority in the Senate in 2014 in which case the amendments may be passed. In the meantime, the government wishes to repeal the 'time sensitive' FOFA amendments immediately by means of tabling regulations and then replacing them if and when the new Senate in 2014 supports the amendments: *Draft Explanatory Memorandum, Corporations Amendment (Streamlining of Future of Financial Advice) Bill 2014*, 4. Attempting to amend the Corporations Act by passing regulations may prove to be invalid: *Morton v Union Steamship of New Zealand Ltd* [1951] HCA 42, with multiple citations including, eg, *Plaintiff M47/2012 v Director General of Security* [2012] HCA 46 per Crennan J at [382]: 'It is settled that a provision in such terms precludes the making of regulations which vary or depart from positive provisions made by the relevant Act'.

the next 'bust' to investigate, inter alia, the role of financial advisers, the general regulatory environment, the role played by commission arrangements relating to product sales and advice (including conflicts of interest, better disclosure and remuneration models), the appropriateness of the information and the advice provided to consumers, and the levels of consumer education and understanding of these financial products and services.[68] Predictably, this future inquiry may lead to proposals to amend the law to raise the standards of advice with recommendations for new regulation which may include the requirement that advice providers take 'any other step' to act in the best interests of the client to promote independent judgment and so to professionalise the role of the advice provider and to prevent this market failure in information happening again.

Developments in the financial services sector over recent years have seen the reduction in the numbers of commission salesmen for product manufacturers and their replacement by financial planning professionals with access to the whole market in financial products and financial services. These professionals provide independent professional advice and accept remuneration from their clients seeking their advice like all professionals on a fee for service basis instead of by non-transparent commissions, payments and soft dollars from financial product wholesalers and product manufacturers. Instead of the requirement that the advice provider take 'any other steps …. in the best interests of the client' in s 961B(2)(g) of FOFA being criticised by some in the financial planning industry as too 'vague', with the prospect of the clock being turned back with its repeal in 2014, the financial planning industry should embrace this and the other FOFA reforms. The reforms now provide further protections for consumers of financial services, will help to restore trust in the system following the post-GFC collapses in the financial services industry and should be embraced by the financial planning industry as one more step towards the professionalising of the industry.

[68] Based on the Ripoll Report Terms of Reference, above n 19.