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Submission to the Parliamentary Joint Committee on Corporations and Financial Services Inquiry into proposals to lift the professional, ethical and education standards in the financial services industry

Professor O'Brien is Director of the Centre for Law Markets and Regulation (CLMR) within the Faculty of Law, UNSW Australia, and Dr. Gilligan is a Senior Research Fellow at the CLMR. Please find below our joint submission to the Inquiry into proposals to lift the professional, ethical and education standards in the financial services industry chaired by Senator David Fawcett.

We hope that this submission assists the Committee in its deliberations. If you require further information please do not hesitate to contact us.

Yours sincerely

Professor Justin O'Brien and Dr. George Gilligan

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Introduction

1. A key trigger for this Inquiry is Recommendation 54 of the Final Report (the Report) released in June 2014 by the Senate Economics References Committee Inquiry into the performance of the Australian Securities and Investments Commission (ASIC), which stated that: 'The committee recommends that the Parliamentary Joint Committee on Corporations and Financial Services inquire into the various proposals which call for a lifting of professional, ethical and education standards in the financial services industry.'[1] We are pleased that Parliamentary Joint Committee on Corporations and Financial Services (PJC) has established such an inquiry and we appreciate the opportunity to make a submission. 2014 is likely to prove a watershed year for the financial advice industry in Australia. Like a dam that finally bursts, the cumulative pressure of a litany of scandals in the sector in recent years such as Storm, Trio, Financial Wisdom and Commonwealth Financial Planning Limited (CFPL) have created the conditions in which substantial meaningful reform that prioritises investor protection can occur. In this context, this Inquiry (as well as the Financial System Inquiry), can help shape a more professional, knowledgeable and ethical Australian financial services industry in the future.

2. It is worth recalling some of the comments of then Economic References Committee Chair Senator Mark Bishop when launching the Report when he described past practices at CFPL as 'appalling', and the conduct of a number of CFPL advisers as: '..unethical, dishonest, well below professional standards and a grievous breach of their duties….The CFPL scandal needs to stand as a lesson to the entire financial services sector. Firms need to know that they cannot turn a blind eye to rogue employees who do whatever it takes to make profits at the expense of vulnerable investors…That a major financial institution could have tolerated for so long conduct that included apparent criminal behaviour is not easy to accept.' [2] As the PJC is aware, CFPL is a wholly owned

[1] Senate Economics References Committee, *the performance of the Australian Securities and Investments Commission*, xxiii, June 2014,
http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/ASIC/Final_Report/index
[2] Senate Economics References Committee, *the performance of the Australian Securities and Investments Commission, Media Release*, 26 June 2014,
http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/ASIC/Media_Releases

subsidiary of Australia's largest bank the Commonwealth Bank of Australia (CBA), CFPL operates under the business advice structure of Colonial First State (CFS) which is also part of CBA. The lesson for the *entire financial services sector*, to use Senator Bishop's phrase, is that problems associated with lack of accountability and deflection of responsibility apply not only to the activities of individual financial planners, but also sometimes can be widespread within subsidiary organisations. Moreover, these have contributed to substantial harm to many thousands of Australian investors in recent years, while not necessarily having a negative impact on the share price of parent organisations.

Recommendation One: The PJC should make detailed recommendations to Government to ensure that Australia's financial licensing regime is more proactive, accountable and transparent. In particular:

(i) tighten the licensing requirements so that the licence under which an individual gives financial advice is tied to that individual and their performance history, rather than them being sheltered under the licence of a large institution;

(ii) improve the mandatory education and training requirements for those who practice in the financial services sector; and

(iii) raise substantially the transparency surrounding the activities of those who give financial advice.

3. In short, what is required is an integrated program that can enhance the professionalisation of the financial sector in a meaningful, verifiable and sustainable manner. That professionalisation challenge is a significant but not insurmountable one. The political and commercial reality is that all regulatory battles are won and lost at the implementation stage, which occurs far outside short-term media and political timeframes. Proposed solutions will have to be negotiated and followed through with the most important change needing to be wrought in the prevailing operational culture of the Australian financial services sector.[3]

4. This is an environment in which to date lip-service may have been paid to ethical

[3] J. O'Brien and G. Gilligan, *Submission to The Senate Economic References Committee Inquiry into the Performance of the Australian Securities and Investments Commission - ASIC*, (2013), http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/ASIC/Submissions

standards in some quarters as short-termism driven by bonus and other incentives structures may leave the best interests of clients in its wake, creating the space in which unscrupulous actors can flourish, as seen in the scandals of recent years.[4] **Changing that operational culture to restore to an equitable position the balance between the privileged participation and potential for rewards as licensed financial services actors that individuals and organisations receive, in comparison to the civic duties and obligations that could, and indeed should, accompany that privileged status, can be the valuable legacy of this inquiry to Australian society.** The overarching need to achieve such balance should be a key factor in guiding this Inquiry and other key actors in the production of specific reform initiatives in this area such as: appropriate classification and standards for personal advice, general advice, and sales and product advice; issues of vertical integration, in particular regarding appropriate transparency standards regarding independent and tied advisers; a comprehensive and accessible register of financial professionals, especially those giving advice; national examination and ongoing capability monitoring systems; accessibility issues for the investing public; and compensation pathways.

5. The existence of multiple inquiries into the sector can be interpreted as the strength rather than the limitation associated with the parliamentary process. It is indicative that the concerns expressed by the Senate Economics References Committee stand in marked contrast to the interim report handed down by the Financial System Inquiry, although that latter has stated that the Senate Committee findings will inform its own final report.

Recommendation Two: The framing of the PJC inquiry should take account of the FSI and other relevant parliamentary inquiries so that gaps are identified and narrowed and evidence-based policy calibration is privileged.

6. So how does an operational culture emerge within an industry like the Australian financial services sector? Societies, firms, professional associations, specific industries and other groups (including regulatory actors), develop modes of preserving and transmitting through time and generations the mental programming that constitute routines, or *the ways that things are done* in processes that may be difficult to discern specifically, but which none the less are well understood not only by those who may be

[4] J. O'Brien and G. Gilligan, *First Round Submission to the Financial System Inquiry*, 31 March 2014, http://fsi.gov.au/consultation/submissions20140520/

involved directly, but also by those who are not.[5] These mental programs interact with individual and collective value systems, which simultaneously are reflexively interacting with prevailing cultural influences, and thus inevitably shape behaviours. So, specific sites, whether industry-wide or sales units within individual organisations for example, develop patterned modes and mechanisms for evaluating issues and events that are transmitted within their core groups as well as to the broader populations at home, and abroad, as the routine and legitimate ways of doing business – in short, the operational culture of an industry or organisation.[6]

7. Culture can be simultaneously local and general, and can be seen from many different perspectives. For example, Becker perceives culture as a set of shared understandings that permit a group of people to act in concert with each other.[7] Cotterrell sees culture as having four general components: beliefs/values; traditions; instrumental (economic/technological) matters; and matters of effect (emotion).[8] These elements can be especially mutually reinforcing amongst professional communities that have a history of shared customs and business practices such as financial services. So, when one analyses how a regulatory culture evolves within any given industry numerous sources of regulatory culture are apparent. Significant amongst these are: general culture (especially in a national context); social structures; law (particularly statutes and court decisions); regulatory traditions; and the practice of regulatory work itself.[9] It is important to remember that as these regulatory sources emerge and grow, the groups that comprise *the regulated* are often much larger than the regulatory agencies charged with regulating them. This is certainly true of the Australian financial services sector which is large and of national strategic importance. For example, 2013 Australian Trade Commission data reveals that the Australian financial services sector:

   - contributed 8.6% of Australia's real gross value added by industry;
   - held assets of Aus$6,145 billion (nearly four times Australia's nominal GDP); and

[5] The residual, seemingly perennial relative regulatory autonomy (especially in the Anglo-American context), of the financial sector to shape its own regulatory discourse and infrastructures over many centuries is testimony to this power. For a detailed analysis of these forces at work in the UK context, see: G Gilligan, *Regulating the Financial Services Sector,* (London, Kluwer Law International, 1999).

[6] G. Hofstede, *Culture's Consequences: International Differences in Work-Related Values*, (Thousand Oaks, CA, Sage, 1980), 25 (Culture could be defined as the interactive aggregate of common characteristics that influence a human group's response to its environment. Culture determines the identity of a human group in the same way as personality determines the identity of an individual.').

[7] H S Becker, 'Culture: A Sociological View' (1982) 71 *The Yale Review* 513.

[8] R Cotterrell, 'Law and Culture – Inside and Beyond the Nation State' (2008) 31 *Retfærd: Nordisk Juridisk Tidsskrift* 23.

[9] E Meidinger, 'Regulatory Culture: A Theoretical Outline' (1989) 9 *Law & Society* 355.

- had US$1.62 trillion pools of funds under management (3rd largest in the world).[10]

8. This national economic, political and social significance of the financial sector needs to be borne in mind when considering why these regulatory source imbalances have become pronounced over the years and created the conditions under which scandals such as CFPL and Trio emerge.[11] Professional, structural and cultural embeddedness condition the interplay of regulatory authority and regulatory responses. These coalitions of embeddedness allow those industries, players or firms with the requisite resources and inter-organisational alliances to build up and legitimate their image of regulatory authority.[12] If their regulatory authority is strong, then they can subsequently challenge and/or negotiate the rules of regulation.

9. At an operational level ingrained cultural forces can distort perceptions within organisations about risk and incentives, especially in the hyper-competitive environment of finance which may adapt ever-increasing matrices of risk as the norm.[13] Moreover, the complexity of modern finance and fragmented chains of command governing the production and dissemination of specialised knowledge increases the information asymmetry risk. As a consequence and as has been seen most painfully in Australia in recent years, the risk that the unscrupulous will take advantage of what the economist David C. Rose has termed the 'golden opportunities' of deception is increasing.[14]

10. These risks are of course not solely a problem for Australian society, its regulators and its legislators. For example, Martin Wheatley CEO of the UK Financial Conduct Authority in March 2014:

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[10] Australia Trade Commission, *Why Australia Benchmark Report, June 2014 Update*, http://www.austrade.gov.au/Invest/Reports-Resources/Benchmark-Report

[11] G. Gilligan, 'Financial services regulation in Australia', *Commonwealth of Australia, Joint Parliamentary Committee on Corporations and Financial Services, Oversight of the Australian Securities and Investments Commission, Hearing, Sydney, 25 November 2011*, Canberra: Official Committee Hansard, pp.1-8

[12] The term regulatory authority is being used advisedly. It refers to those situations in which it is deemed legitimate for the regulated to have power and this legitimacy is recognised by regulators. The larger and more influential a firm is within the financial services sector, the more likely it is that it can legitimately build up its image of regulatory authority.

[13] D C Langevoort, 'Chasing the Greased Pig Down Wall Street: A Gatekeeper's Guide to the Psychology, Culture and Ethics of Financial Risk Taking' (2011), 96 *Cornell Law Review*, 1209.

[14] DC Rose, *The Moral Foundations of Economic Behavior* (New York, Oxford University Press, 2011) 16; see also P Pettit, 'Republican Reflections on the Occupy Movements,' in F O'Toole (ed), *Up the Republic* (Dublin, Faber & Faber, 2012), 169-81 (noting 'it is a sad fact of human nature that while not many of us might be corrupt, not many are incorruptible; when opportunity offers not many are capable of resisting the temptation to make a quick buck. The timber may not be rotten but it is crooked:' at 177).

> 'We have the narrowest of windows here to make cultural change stick before memories of financial crisis fade. The narrowest of windows to restore the long link between ethics and growth that dominated financial services for most of their history…One of the more worrying stats to emerge last year was a survey of senior executives in UK financial services by the Economist Intelligence Unit. In a poll that should set alarm bells ringing, some 53% of financial service executives reported that career progression at their firm would be tricky without 'flexibility' over ethical standards – rising to 71% of investment bankers…These Economist figures suggest…that not all cultural reform proposals have been understood or accepted; it is an imperative they are'.[15]

11. There is little evidence to support the proposition that those involved in Australian financial services are substantially more ethical than their counterparts on the UK. So a core challenge for this Inquiry is to confront this issue of *ethical flexibility* in the Australian financial services sector.

Recommendation Three: The framing of professional obligation must take into account empirical evidence of the failure of existing codes of conduct and the dangers associated with the licensing regime limited to entities rather than attaching to individual advisers.

12. It is important to remember that having a degree is insufficient in itself. **Not only should minimum entry standards be raised to ensure that ethics training is a mandatory component in order to receive a licence to provide financial advice, but ongoing ethical training with continuing ethical self-reporting should be a mandatory feature of a future licence retention system.** Such a system would have every individual licensed, even if they are an employee of a large organisational licence holder such as one of the major banks. All who hold licences, whether individuals or organisations would have their licence status and financial services professional history detailed on a publicly accessible website administered by an independent agency such as ASIC. The objective of such a system is to raise standards of transparency and accountability at both individual and organisational levels.

[15] M. Wheatley, *Ethics and Economics*, Financial Conduct Authority Speeches, March 2014, http://www.fca.org.uk/news/speeches/ethics-and-economics

13. Mandatory ethical self-reporting is an important element of our proposals as it sheets individual accountability within what to date has been an ambiguous system that to an extent has nurtured ambivalence about ethical and other behavioural standards, not only amongst individuals and organisations generating profits from the provision of financial services and products, but also amongst many of the investing community and some of those with regulatory responsibilities in the area.

14. Such a reform is necessary to counter the lack of transparency and evidential detail that has had the effect of many so-called *bad apples* of the financial advice industry been camouflaged and at times sheltered within their organisational structures. On occasion, as infamously shown in the CFPL scandal, this can be in spite of whistleblowers and victims seeking to highlight harmful behaviours that may be systematic and pervasive. These structural processes of organisational ambivalence, denial and sometimes cover-up are structural problems not limited solely to financial services and can apply in other sectors as well. Nevertheless problems with generating evidence that can reveal, and/or prove, harmful behavior in the provision of financial advice have been significant causal factors in the generation of relative ambivalence not only within the industry, but also within the wider community.

15. Ongoing mandatory ethical self-reporting would make a substantial contribution to the evidential database thereby facilitating corporate and regulatory oversight. Just as important it would compel each individual to critically evaluate their own behavior and know that they could well be held accountable by the justice system for those decisions and bear the consequences of those decisions if they are non-compliant or fail to report that they have been non-compliant.

16. Moral evaluations are inherent in the exercise of choice and discretion is an intrinsic element of the law. This means that regulators and those whom they regulate are engaged constantly in a moral balancing process about regulation. Most people believe that laws should be obeyed and it this broader normative commitment to compliance as a general principle amongst those regulated which is perhaps the greatest asset that regulators can access. Harnessing this broader normative commitment should be a primary objective for regulation, compliance, risk management and crime prevention strategies.

Recommendation Four: The PJC should render explicit the normative foundations of regulatory intervention, wherever it is situated (i.e. within professional associations or through a regime licensed by the regulator).

17. Mandatory ethical self-reporting can support the individual in their efforts to be compliant, especially in those contexts where organisational priorities may stimulate them to be ethically flexible, morally numb or downright non-compliant. Similarly, the increased evidentiary detail and subsequent transparency and accountability, can act as powerful stimuli for organisations involved in the provision of financial services and products to construct not only appropriate product lines, sales and marketing processes, but also incentive regimes that are less short-term and align finance sector priorities more closely with civic society goals. There can be a rational symbiosis between sensible commercial strategies, notions of individual and corporate ethical responsibility, and statutory legal obligations within the Australian financial services sector.[16] However, historical experience has demonstrated clearly that this is unlikely to happen without sufficiently high bars of mandatory standards, which specify the normative foundations on which compliance is based.[17]

18. This Inquiry can make recommendations to set those bars at appropriate levels upon which the industry, its employees, its regulators and the investing public can build a sustainable financial services sector that meets not only intrinsic industry demands for profit and reward, but also community needs and the broader national interest. This cannot be achieved without specifying the duties and responsibilities that attend to the privilege of operating within the financial services sector.

[16] J. O' Brien, G. Gilligan and S. Miller, 'Culture and the Future of Financial Regulation: How to Embed Restraint in the Interests of Systemic Stability,' (2014), *Law and Financial Markets Review*, Vol.8, No.2, 115, http://www.hartjournals.co.uk/lfmr/sample.html

[17] J. O'Brien and G. Gilligan, *Second Round Submission to the Financial System Inquiry*, 20 August 2014, http://fsi.gov.au/consultation/second-round-submissions/