HERBERT SMITH FREEHILLS

FINANCIAL SERVICES INDUSTRY ROYAL COMMISSION FINAL REPORT

BRIEFING PAPER FOR CLIENTS

FEBRUARY 2019

Contents

Introduction – an "Industry Reset"

> "The financial services industry is too important to the economy of the nation to allow what has happened in the past to continue or to happen again"
>
> **(Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Final Report Vol 1, p.4)**

Unprecedented in its forensic examination of the conduct of Australia's financial services industry, the completion of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry is likely to represent a pivotal point in the history of the industry. With the exposure of past wrongdoing, and commitments to effect change which will improve the way in which business is conducted in the future, the industry is poised to reset. A new beginning.

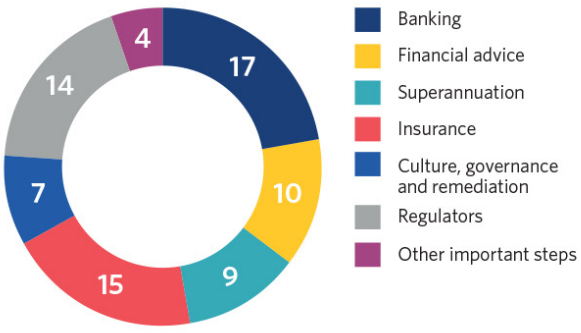
Although directed toward the financial services industry, the Hayne Report has a much broader potential application. Many of the key themes are universal across businesses and industries. Complex issues such as determining the design of regimes to appropriately connect desired conduct and reward in a 'for profit' industry are not peculiar to the financial services sector.

While a number of specific reforms are identified in the Hayne Report, we anticipate that the insights and observations of the Commissioner may provide the foundation for more substantial legal reform in the years ahead.

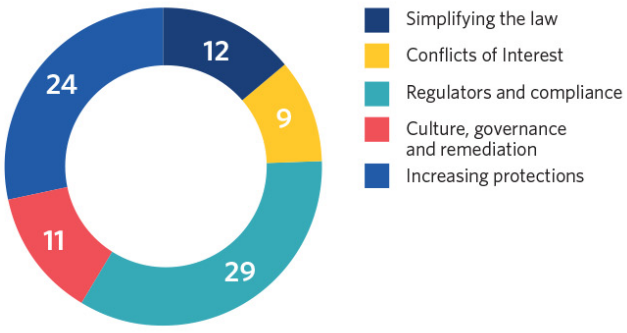
The Hayne Report is essential reading for all corporates and senior executives operating in financial and non-financial services sectors alike. We hope our analysis of this important report is of assistance to you and your business.

We welcome the opportunity to discuss any aspect with you in further detail.

76 recommendations



Five key themes (recommendations under each)



Highlights

A governance overhaul

- As a result of the Hayne Report we expect that Boards will need to step up their scrutiny of management, as well as modify existing executive remuneration structures.
- In view of the introduction of a new concept of 'prudential regulation', businesses should also expect (and embrace) constant and rigorous scrutiny of their governance systems, policies and procedures.

Focus on conflicts

- The potential for, and the impact of, conflicts is a central theme which emerges from the Hayne Report. The observations made suggest that often processes for managing potential conflicts have fallen short of their objective.
- A number of the changes proposed by the Hayne Report are designed to alter the objective from one of 'managing' to one of 'eliminating' conflicts of interest.

Individual accountability

- The Hayne Report has identified that the alignment of individual reward and consequence with desired behaviours is a core component of a financial services system which achieves its policy and legislative objectives.
- The proposed changes to remuneration and accountability regimes are significant. More than ever, individuals will be held to account for the adequacy of increasingly complex systems, policies and procedures.

Principles not prescription

- The Hayne Report observes that prescriptive laws which are vast and complex may be less effective than statements of broad matters of principle.
- Although not the subject of any explicit recommendations, these observations may provide the foundation for future consolidation of the complex array of laws which regulate activity across the financial services industry. Were it to be pursued, such an approach would not be novel. A similar approach is employed in the UK to regulate behaviour in the financial services industry and the Australian takeover provisions aim to fulfil a series of principles known as the "Eggleston Principles". Perhaps the time is now to revisit the current approach to regulation of the provision of financial services within Australia.

An enforcement revolution

- Greater personal accountability coupled with stronger regulators with an incentive to investigate and hold wrongdoers to account make for 'an enforcement revolution'. This new world is likely to highlight the importance of getting governance right. Organisations which do not proactively seek to identify and address inadequacies in their systems will likely find themselves redirecting resources toward activities which will do little to enhance their reputations or shareholder wealth.

Each of these themes are explored below in relation to the key areas assessed in the Hayne Report. In particular, we consider the key changes and what this will mean for your business.

Governance, remuneration and culture

Culture: Self-assessments and APRA supervision

Culture is a central theme of the Hayne Report. The report recognises that primary responsibility for an entity's culture rests with itself (and the Board and senior management that manages and controls it).

Some financial services entities undertook (voluntarily or at APRA's request) a cultural self-assessment against the recommendations in the Final Report of the Prudential Inquiry into the Commonwealth Bank of Australia (**APRA Report**). The Hayne Report recommends that **all** financial services entities undertake a self-assessment of governance and culture (including determining whether changes it has implemented to deal with culture and governance issues previously identified are effective). Importantly, as culture can shift and evolve over time, the report recommends that this type of review be undertaken 'as often as reasonably possible'.

Culture will also be a key aspect of APRA's supervision of financial services entities going forward. While primary responsibility for culture rests with the entity itself, the Hayne Report recognises that there are dangers in relying purely on self-assessments ('everyone can be blind to their own faults') and considers that the regulators have an important role in supervising culture. The Hayne Report recommends that APRA build a supervisory program with a focus on culture and that APRA assess each entity's cultural drivers of misconduct with a view to helping the entity manage its conduct risk and improve its governance.

Given that every entity has its own unique culture, APRA will need to take a flexible and nuanced approach when supervising 'culture'. One size will not fit all.

> "There can be no doubt that the primary responsibility for misconduct in the financial services industry lies with the entities concerned and those who managed and controlled those entities: their boards and senior management. Nothing that is said in this Report should be understood as diminishing that responsibility.
>
> Everything that is said in this Report is to be understood in the light of that one undeniable fact: it is those who engaged in misconduct who are responsible for what they did and for the consequences that followed."
>
> **(Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Final Report Vol 1, p.4)**

Remuneration: Reflects culture and accountability

The Hayne Report recognises that remuneration both affects and reflects an organisation's culture. It is a key part of telling staff what the entity values. Remuneration should be used to reflect accountability, with ex ante incentives for good conduct and ex post adjustments when misconduct occurs.

The report recommends that APRA make a number of changes to its prudential standards and guidance on the design and implementation of remuneration systems. It also recommends that APRA expand its supervision of financial services entities to include remuneration arrangements.

For front-line staff, remuneration arrangements should be reviewed annually to ensure that the focus is not only on *what* staff do, but also on *how* they do it. The Sedgwick Review recommendations are now the 'base line' (not an aspirational target) for remuneration arrangements.

The release of the report is a timely opportunity for entities to rethink their approach to employee and executive remuneration, to ensure that:

- remuneration structures and arrangements are designed to encourage sound management of non-financial risks and good conduct and to reduce the risk of misconduct;
- there is sufficient discretion for the Board (or remuneration committee) to tailor (i.e. "risk adjust") remuneration outcomes and reduce unvested or vested remuneration to reflect non-financial risks or misconduct; and
- any decisions to reduce variable remuneration to reflect poor management of non-financial risks are communicated within the organisation (since remuneration is an indicator of what the entity values).

In particular, this is an opportunity for listed entities to rethink their long term incentive plans. Commissioner Hayne has recommended that LTIs be subject to non-financial hurdles (as well as financial ones). Traditionally institutional investors and proxy advisers have been sceptical about the use of 'soft hurdles', but now financial institutions are being told they need to experiment and think about 'what will work' (not what will avoid a first strike). While listed companies will need to engage with proxy advisors and institutional shareholders to seek their "buy-in" for any changes, we predict that the market will become less concerned about getting a 'strike' and more focused on 'getting it right'. Having said that, it will always help if the company can find an external independently measured non-financial hurdle (eg net promoter scores). Gauging the level of trust from institutional investors will be key to determining whether investors will support potentially more meaningful internally self-assessed non-financial metrics.

Role of the Board: Directors as "superintendents"

The Hayne Report confirms that the report is not intended to displace the traditional division of responsibility between the Board ("overall superintendence") and senior management ("day-to-day management"). Instead, the report confirms that the Board's role is to be aware of significant matters arising within the business and to set the strategic direction of the business in relation to those matters. Further, Boards must be able and willing to "challenge" management on key issues whenever necessary.

> "Because it is the entities, their boards and senior executives who bear primary responsibility for what has happened, close attention must be given to their culture, their governance and their remuneration practices"
>
> **(Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Final Report Vol 1, p.4)**

We expect that the concept of 'Boards challenging management' will become increasingly important both under BEAR and in meeting APRA's new approach to supervision.

In addition, consistent with the APRA Report, Commissioner Hayne considers that in order for Boards to effectively discharge their functions, they must have the **right** information (in terms of quality, rather than quantity).

In light of the discussion, we recommend that:

- Boards and senior management agree on an approach for the Board to request additional information and "challenge" management in a way that does not create dysfunction or distrust;
- entities reassess their approach to preparing Board papers, with a view to ensuring the key messages for the Board are clear and that Boards are getting sufficient amounts of the right information; and
- Boards regularly assess whether they are getting the right amount and quality of information from management. This may result in additional information being requested. It may also result in requests for less documentation and more insights.

Professional discipline: how to stop 'rolling bad apples'

Commissioner Hayne has made a number of recommendations with a view to increasing oversight over, and accountability of, financial advisers and mortgage brokers who engage in misconduct. This is to reduce the risk that "bad apples" simply roll from engagement with one AFSL/ACL holder to the next, in circumstances where they have not faced the consequences of their actions.

These recommendations include:

- requiring all AFSL/ACL holders, as a condition of their licence, to give effect to reference checking and information protocols for financial advisers; report 'serious compliance concerns' about individual advisers to ASIC on a quarterly basis; and make reasonably necessary inquiries to determine the nature and extent of any adviser misconduct (and, where misconduct is established, advise and remediate affected clients promptly); and
- amending the law to establish a new disciplinary system for financial advisers that requires them to be registered; provides for a central disciplinary body; requires AFSL holders to report 'serious compliance concerns' to the disciplinary body; and allows clients and other stakeholders to report information about the conduct of financial advisers to the disciplinary body.

In practice, we see that this will require affected AFSL and ACL holders to put in place robust and effective procedures across their organisations that incorporate:

- 'best practice' audit and consequence management systems in order to identify misconduct (and the relative seriousness of it) and apply appropriate disciplinary action in a considered and consistent way;
- reference-checking and information-sharing between AFSL and ACL holders, which are to apply more broadly than to signatories of the ABA '*Financial Advice – Recruitment and Termination Reference Checking and Information Sharing Protocol*' (**ABA Protocol**). Recruitment and exit procedures will need to be considered in this context and liaison channels will need to be established with other AFSL and ACL holders (as applicable);
- a comprehensive investigation framework which facilitates fulsome inquiries being conducted into misconduct issues and supports client remediation outcomes. These frameworks will need to be linked to consequence management systems in place (see above); and
- processes to support reporting of 'serious compliance concerns' to ASIC on a quarterly basis, which will require (amongst other things) open channels of communication between relevant departments in an organisation (including those involved in investigating misconduct and those in regulator liaison roles).

It is important that these procedures are regularly reviewed to ensure they are effective in practice, as the report makes clear that a 'tick the box' exercise will not suffice. In addition, a review of employment contracts of affected staff should be undertaken to ensure there are appropriate contractual rights and obligations which reflect the recommendations of Commissioner Hayne, as outlined above.

We expect that the implementation of these recommendations will lead to increased employment litigation, particularly where there is more robust consequence management and information sharing between AFSL/ACL holders. For example, we have seen that signatories to the ABA Protocol have been careful of what they will agree to with exiting employees in light of their obligations under the protocol and the broader regulatory and political environment. This has often resulted in contentious exits not settling and resulting in protracted litigation, even if the amounts in contention are relatively small.

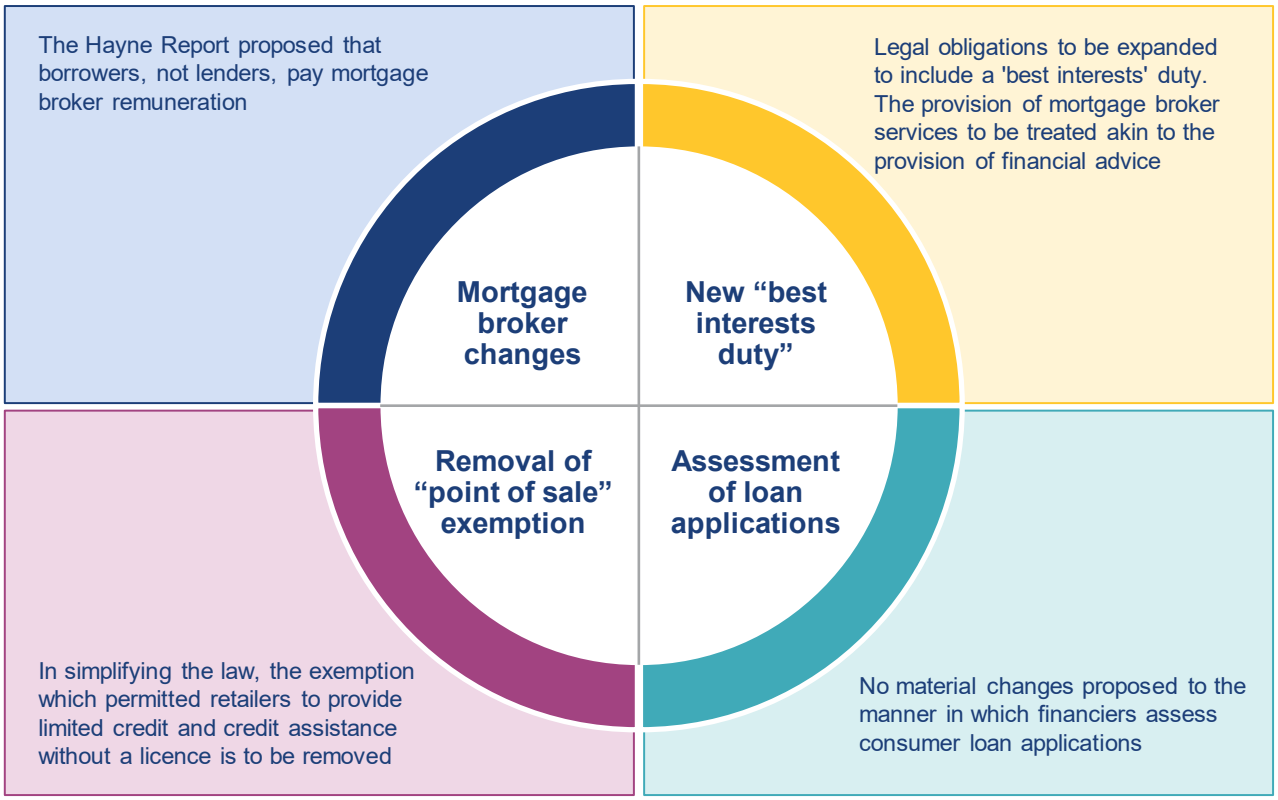
Whistleblowing

Consistent with broader regulatory reform which is underway in the whistleblowing space in Australia, Commissioner Hayne has subtly alluded to the importance of having a culture in which staff feel comfortable to "speak up" when they see something is not right and for entities to ensure that compliance issues are identified, escalated and addressed promptly and effectively.

Adopting a 'best practice' whistleblowing policy and procedures framework, as many financial services organisations will be doing in light of proposed changes to whistleblowing laws in Australia, will go a long way to fostering an open and transparent culture that allows for systemic and serious issues to be brought to the forefront and effectively addressed.

As part of this, it will be important that appropriate metrics relating to whistleblower complaints are reported to the Board as part of their oversight of financial and non-financial risks, subject to compliance with any applicable confidentiality requirements under law.

Consumer lending and business banking



The responsible lending laws

While interventionist legislative reform is unlikely, a continued focus upon compliance with existing principles, as they are interpreted by the Courts and modified through regulator guidance is the key outcome likely to follow from the Hayne Report.

However, this result ought not to convey a sense of inertia. This area has already experienced, and will likely continue to experience, significant change. At present ASIC has multiple consumer lending reviews underway and has also increased its enforcement activity in this area. This approach is likely to be strengthened as a result of broader observations found within the Hayne Report regarding the effectiveness of ASIC's more nuanced approach to enforcement in recent times, which has emphasised earlier negotiated outcomes over protracted contested disputes.

The Hayne Report's approach to business lending reveals a relatively light touch approach. Broadly, small business lending will remain excluded from the responsible lending laws within the *National Consumer Credit Protection Act 2009* (Cth). The only major changes proposed are to expand the definition of "small business" in the 2019 Banking Code of Practice and make industry codes capable of enforcement by the regulator. Laws concerning the use of guarantors will remain unchanged.

Finally, consistent with the focus upon simplification of these laws, the Hayne Report has proposed the removal of the current exemption which certain retailers can avail themselves to provide limited credit and credit assistance. Motor vehicle dealers, and retailers who provide 'buy now, pay later' credit services may now need to seek an Australian credit licence or cease the provision of these services.

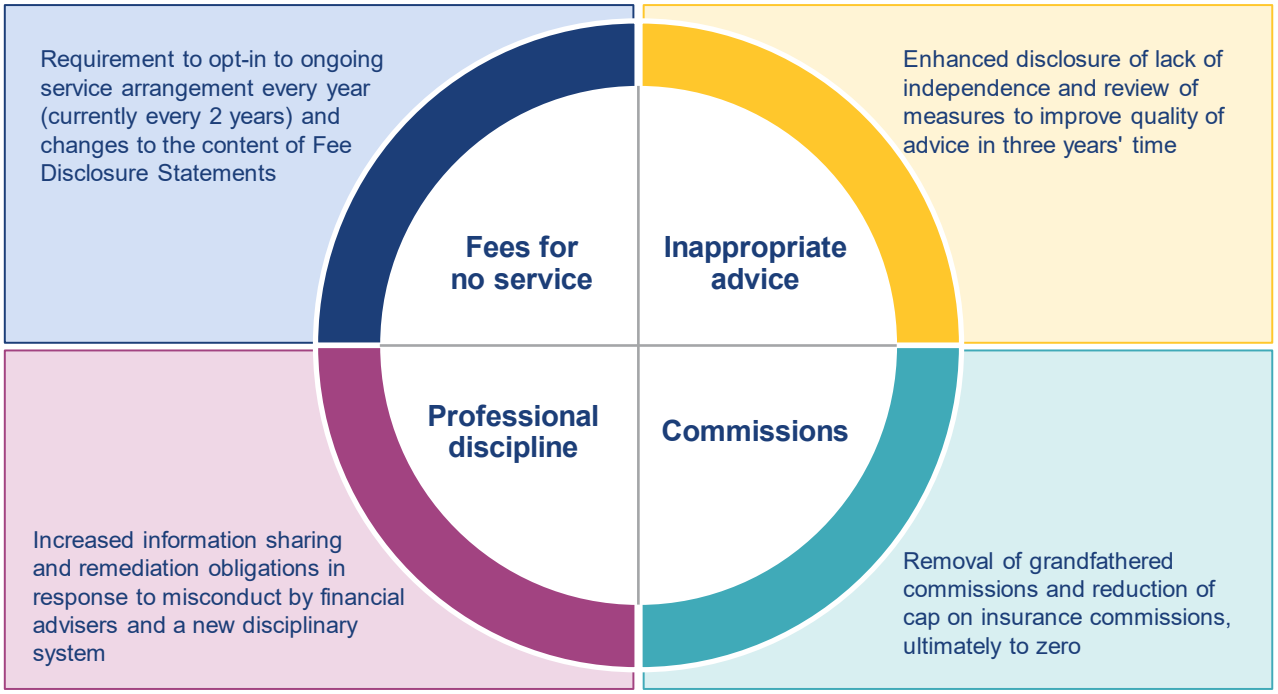
> "The interests of client, intermediary and provider of a product or service are not only different, they are opposed. An intermediary who seeks to 'stand in more than one canoe' cannot. Duty (to client) and (self) interest pull in opposite directions"
>
> **(Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Final Report Vol 1, pp. 2-3)**

Mortgage broker industry reforms

Consistent with the broad focus upon the potential for conflicts, the Hayne Report has recommended a number of key reforms in relation to the delivery of intermediary services in the consumer lending market.

- First, the provision of mortgage broker services will be regulated in the same way as the provision of financial advice. While such a change is likely to affect each mortgage broker business differently, at a minimum close attention will need to be applied to assess whether existing policies, systems and procedures will be sufficient to enable brokers to comply with the more prescriptive obligations which apply to the provision of financial advice. By way of example, if mortgage brokers do not have access to all potential mortgage facilities available in the market, they will likely need to disclose such matters to consumers as part of the provision of broker services in accordance with the consumer's best interests.
- Second, the Hayne Report has proposed that borrowers be required to pay mortgage brokers directly for these services, not lenders. This reform may have broad ramifications for the affordability of such services for consumers and also has the potential to impact the market. We understand that the Federal Government's current intention is not to implement this recommendation.

Provision of financial advice



What is expected to change?

The changes proposed in relation to financial advice feel very much like evolution rather than revolution.

That is perhaps surprising given that financial advice was the source of many of the instances of misconduct that led to, and were examined by, the Commission. During the course of the hearings and in the interim report, some drastic proposals were mooted to address the issues identified, including a prohibition on vertical integration and abolition of ongoing fee arrangements. However, those more interventionist proposals have not found their way into the final report as recommendations. The recommendation that will be felt most keenly and immediately is the clearly telegraphed removal of grandfathered commissions.

The fact that the recommendations appear to build on existing work rather than being real disrupters to the industry appears to be a result of the significant steps already being taken by the industry and ASIC to address the problems of the past. Vertical integration, as the final report notes, is largely unwinding. Not only have steps been taken to ensure that promised services are provided, there is a move towards a different fee model for ongoing service – partly industry led and partly prompted by ASIC.

The industry has also been taking steps to professionalise – with some licensees increasing requirements for educational qualifications and membership of industry associations. Those steps have been, or now following the Royal Commission will be, followed by legislation mandating the same.

The next step towards professionalisation will be the development of a system of discipline that will enable advisers who are guilty of misconduct to be publicly reprimanded or, in appropriate cases, banned.

It appears to be as a result of the steps that are already being taken, as well as the fact that there is only so much change that can be undertaken at any one time, that many of the recommendations are a form of suspended sentence. Both measures to improve quality of advice and removal of insurance commissions are recommendations for future consideration, rather than for immediate implementation.

The challenge for the industry and ASIC is to keep progressing the work that is already being undertaken, rather than confronting a new world order.

What will this mean for your business?

Advice businesses will need to continue to demonstrate that they are making progress in three key areas:

- Pricing and value for money, including ensuring that fees are only charged where service is provided;
- Ensuring the quality and independence of advice provided; and
- Taking effective steps to address instances of misconduct, including by banning advisers who have been guilty of misconduct.

Superannuation and Insurance

The Hayne Report has made a series of recommendations which we expect to have the following potential impacts:

- **Default account**: The Hayne Report's recommendation that individuals have only one default account and for that person to be 'stapled' to the account will likely shift the balance in favour of industry funds nominated in the employment agreements of those in the hospitality and retail sectors.
- **Hawking prohibition**: Amending the existing anti-hawking provisions will limit the ability to promote or offer either superannuation or insurance products unless the customer made contact with the express purpose of entering into negotiations about such products.
- **Related party transactions**: While the Hayne Report does not recommend any changes in the law, for-profit trustees will need to continue to carefully scrutinise any related party arrangements they enter into. This is likely to be an area of regulatory focus.
- **Ongoing advice fees**: The services which can be paid for from deductions will be limited and would not, in the Commission's view, cover general wealth management advice.
- **Deferred sales model and caps for add-on insurance**: Limits on commissions, together with a requirement that the sale of insurance be disconnected from the sale of the financed product, may lead to a reduction in the sale of add-on insurance to consumers.
- **Proposed change to the law regulating insurance contracts:** In addition to a proposal to reduce the pre-contractual burden of disclosure upon insureds, the Hayne Report has also recommended that the unfair contract terms regime be extended to apply to insurance contracts.
- **Related party engagements – life insurance:** Amendment of a prudential standard to require certification that arrangements are in the best interests of members will lead to increased trustee due diligence for those arrangements and greater accountability.

Default funds

The Hayne Report recommends that individuals should have only one default superannuation account. While this may initially appear to weaken the position of industry funds with respect to default funds nominated as part of employment agreements, we consider it more likely to tilt the balance in favour of industry funds which are nominated in the employment agreements of those in the hospitality and retail sectors. Those sectors contain a large proportion of young entrant employees who will not have an existing superannuation account, and the funds which are nominated under employment agreements in those sectors will then become stapled to those young employees when they move from those sectors.

Default fund nomination is likely to be a vexed political issue as the Government seeks to implement the Hayne Report recommendations. The proposal for members to be "stapled" to a single account, which was supported by the recent Productivity Commission report on superannuation, differs markedly to a competing proposal of Industry Funds Australia: the "balance rollover" method – which was rejected by the Productivity Commission. Under the "balance rollover" method, a member's balance would be "rolled over" from one fund to the next when the member changed employers.

Hawking of superannuation and insurance products and use of a general advice model

In some cases, the Commission has been reluctant to recommend changing legislation when it appears that an existing provision will address a perceived wrong (see, for example, the Commission's views about the role of the existing best interests obligation and the sole purpose test in relation to 'political' advertising). In other cases, the Commission has made recommendations to clarify doubt in the operation of the law. The hawking of superannuation products is an example of the latter.

The comments of the Commission in respect of the sale of superannuation products under a 'general advice' model need to be viewed against recent case law on the distinction between general advice and personal advice. The Commission found that certain attempts to sell superannuation products in bank branches under a 'general advice' model may have contravened the law. However, the recent decision in ASIC v WSAL about a general advice model in respect of superannuation demonstrates that a general advice model can be used even where staff of a financial services provider have knowledge of a customer's financial circumstances.

> "The person to whom an unsolicited offer is made will very often not be in a position to judge the merit of what is offered. In particular, that person will seldom if ever be in a position to compare what he or she is offered with what he or she already has under some existing superannuation arrangement."
>
> **(Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Final Report Vol 1, p.248)**

Similar to the position with respect to superannuation above, the Commission recommended a prohibition on unsolicited offers/sales of insurance products, save for offers/sales made to non-retail clients, or employees under employee share schemes. The Commission outlined that the key problem with hawking of insurance products is that the offeree is 'unsuspecting', and will not typically possess the questions or information they should seek from, or test with the offeror, in order to critically assess the insurance product.

Related party transactions

The Commission found that there are inherent conflicts which arise for any for-profit trustee. This conflict arises given the trustee's duties to members on the one hand, and the desire of the parent company of the trustee to make a profit.

Conflicts may arise in this way from two sources. The first is in the choice of outsourced service provider, and arises from the desire of the parent to maximise the return of related party outsource service providers. This may also manifest itself in the administration of the fund – the Commission citing an example of related party administrators providing information to the trustee which is in the interests of the parent of the administrator (such as to enhance the relationships of the parent with advisors).

The Commission was not persuaded that a form of structural separation on RSE Licensees was justified, and instead considered that the conflicts associated with using related parties could be resolved by the trustee fulfilling its existing duties. The Commission acknowledged that even if separation was required, there would still be an inherent conflict between the desire of members to maximise their returns and the desire of the trustee to make a profit.

The findings of the Commission are likely to lead to greater scrutiny by trustees of their related party arrangements. This scrutiny will involve greater review of how a related entity may have been chosen to provide a service, and whether any non-related entities were considered to provide that service. The price at which the arrangements were agreed will also need to be carefully reviewed by comparing against the price offering of non-related entities.

It is likely that ASIC and APRA will focus on related party transactions in the near term. The Commission did not recommend any changes to the law, and did not favour the prohibition of for-profit funds.

Ongoing advice fees

The deduction of ongoing advice fees from member balances was considered by the Commission to be 'odd'. Some comments of the Commission are likely to mean that trustees more closely scrutinise the arrangements between advisers and member clients of those advisers for the deduction of fees from member balances.

The Commission considered that 'the nature of advice that may be properly paid for from a superannuation account is limited to advice about particular actual or intended investments'. Examples were given of consolidation, fund selection and fund asset allocation as being acceptable for deductions. However, advice to a client about wealth management generally was said by the Commission to be not something which is appropriate for a deduction from member balances.

The recommendation of the Commission that the trustee 'receive annual confirmation of the members agreement to keep paying [advice] fees' will necessitate changes to trustee operational procedures, and greater burden imposed on advisers dealing with confirmation requests. Trustees are likely to make deeper enquiries of advisers in respect of the nature of the services that are being provided after payment by member account balance deductions.

Deferred sales model and caps for add-on insurance

The Hayne Report has recommended that add-on insurance should generally be sold on an deferred sale basis (excluding comprehensive motor insurance). Under such a model, insurers will not be able to off or sell add-on insurance products until a specified period of time had expired. The report suggests that such a model should be implemented as soon as possible, and its impact would very likely lead to a reduction in the level of add-on insurance sold to consumers.

In another key change, the Hayne Report also recommends that caps should be placed on the commissions paid to vehicle dealers for the add-on insurance products sold with respect to motor vehicles.

In combination, these changes may lead to a reduction in the volume of the sale of such consumer insurance products.

Proposed changes to the law regulating insurance contracts

Two key changes are proposed to the law regarding insurance contracts:

1. modification of the existing pre-contractual duty of disclosure for consumer insurance contracts from one to notify all matters relevant to the risk being insured, to one where the obligation is to take reasonable care not to make a mispresentation to the insurer; and
2. application of the unfair contract terms to insurance contracts.

The reduction in the burden which applies to insureds in relation to pre-contract disclosure may result in the material repricing of certain consumer insurance risks. The Hayne Report observed that the current duty of disclosure does not appropriately have regard to the difference between the knowledge of a consumer and that of an insurer. That is, there is an information asymmetry between the level of knowledge of an insurer about what they consider relevant to making a risk assessment and what a consumer may consider to be relevant to that assessment. The potential impact on the price of consumer insurance products was highlighted during the course of the Royal Commission and is a matter acknowledged in the Hayne Report.

The application of the unfair contract terms to insurance contracts will require a review of standard insurance policy terms. In some cases, wording changes will be required and consumers informed of such changes.

Related party engagements – life insurance

The Hayne Report has also recommended that APRA amend Prudential Standard SPS 250 to require that independent certification that the arrangements and policies entered into are in the best interests of members and otherwise satisfy legal and regulatory requirements. This is likely to lead to an increased level of due diligence being undertaken by trustees of life insurance arrangements with related parties, and increased accountability for trustee board members.

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Accountability and Enforcement

Expansion of the BEAR

The Report recommends that the Banking Executive Accountability Regime (**BEAR**) be changed in three ways.

1. BEAR will be extended, over time, to apply to all APRA-regulated financial services institutions.
2. APRA will create a new obligation for financial services institutions to designate an accountable person for the end-to-end management of all their products.
3. Regulation of the BEAR will be shared between ASIC and APRA, with ASIC regulating conduct and APRA overseeing the prudential aspects of the BEAR.

The BEAR is an unusual regime because it imposes 'fuzzy law' obligations on accountable persons and, at the same time, provides the regulator with substantial powers to disqualify such persons (with a right of appeal). In effect, the BEAR reverses the onus of proof, because an accountable person must appeal their disqualification and in order to do so, they will be required to demonstrate that they are a competent and honest manager, and that they have complied with their obligations under the BEAR.

Despite this combination of 'fuzzy law' and punitive consequences, the banking sector has taken some comfort in the fact that the regime is focussed on improving the prudential standing of ADIs, rather than prosecuting conduct and is being enforced by APRA, a prudential regulator.

The report recommends that the BEAR be included within ASIC's remit (as well as APRA's). This extension could radically increase ASIC's power to enforce conduct-based consequences. ASIC's power to punish accountable persons (managers) under BEAR could far exceed its power under the Corporations Act to pursue those guilty of actual misconduct. To avoid such a disconnect, it will be critical that the amended BEAR legislation is carefully thought through.

The introduction of accountability for the end-to-end oversight of all products is likely to create some initial practical issues for financial services institutions where the responsibility for the development, delivery, maintenance and remediation of products is owned by different people. In our experience (when assisting numerous clients in implementing the BEAR) this split of responsibilities has been an issue for many ADIs. If a new requirement is created, where one individual must be accountable for all products end-to-end, this is likely to create an additional burden on resources and may require the development of a new role within the organisation. However, if implemented well, the additional effort may pay off with greater customer satisfaction.

The extension of the BEAR to all APRA-regulated entities over time is consistent with developments in the UK and somewhat levels the playing field for all financial services institutions. Many of the grievances that the BEAR was introduced to address did not arise in ADIs, and we therefore consider that this extension is appropriate.

Change in Regulator focus

> "Misconduct will be deterred only if entities believe that misconduct will be detected, denounced and justly punished. Misconduct, especially misconduct that yields profit, is not deterred by requiring those who are found to have done wrong to do no more than pay compensation. And wrongdoing is not denounced by issuing a media release"
>
> **(Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Final Report Vol 1, p.3)**

The Hayne Report has sent a clear message to the Regulators – financial services entities and individuals must be held to account for misconduct. Customer remediation activity in and of itself is not enough.

Focussing upon the perceived culture of the conduct regulator ASIC, the Hayne Report has emphasised that unlike private litigants, the regulator is often uniquely positioned to pursue court based remedies following proof of misconduct. Critical of the frequent use of administrative powers such as infringement notices and enforceable undertakings, the Hayne Report has singled out litigation as a particularly effective means of encouraging compliance with the law. By their nature successful court outcomes are visible displays of the regulator at work.

The change in regulator focus has already begun. With the release of the Hayne Report that focus is likely to intensify. Financial services businesses should expect frequent engagement with, and thorough testing of their actions and approaches by, both the conduct and prudential regulators. Where misconduct is suspected, the default position is likely to be for those matters to be

tested in Court. Such matters are unlikely to be restricted to obvious misconduct and may include industry practices or approaches where the question of compliance may be more uncertain. The renewed focus upon enforcement is likely to yield a greater amount of guidance from the judiciary about what is, and what is not, acceptable conduct than has been observed in recent years.

The Regulators themselves will not be immune from review. As a result of the Hayne Report a new oversight authority will be established which will be tasked with the need to test and assess regulator performance. While this is unlikely to have a direct impact upon businesses, this additional level of accountability will ensure that the change in regulator focus is maintained once the dust settles on the Hayne Report.

Conclusion – “time will tell”

The true impact of the Hayne Report will only fully emerge in years to come. As may be expected, with an investigation of the breadth and scale of the Hayne Royal Commission, some of the consequences of the changes proposed will be predictable. However, many will not.

The financial services industry has witnessed numerous inquiries over the past decade. While each inquiry has led to improvements, history tells us that new issues are likely to continue to emerge given the industry is in a constant state of change. The central message from the Hayne Report is that culture is key. This insight provides a useful reminder that the answer to many of the new challenges which will inevitably arise may lie in the manner in which central questions of governance, remuneration and reward are addressed. Of all of the matters raised in the past 12 months, these core themes remain the most important to the sustainable future success of the industry.

“Culture”

REFERENCED 304 TIMES IN THE REPORT

> “First, it is time to start reducing the number and the area of operation of special rules, exceptions and carve outs. Reducing their number and their area of operation is itself a large step towards simplificiation. Not only that, it leaves less room for ‘gaming’ the system by forcing events or transactions into exceptional boxes not intended to contain them.
>
> Second, it is time to draw explicit connections in the legislation between the particular rules that are made and the fundamental norms to which those rules give effect”
>
> **(Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Final Report Vol 1, pp.16-17)**

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