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22 December 2011

Parliamentary Joint Committee on Corporations and Financial Services
PO Box 6100
Parliament House
CANBERRA ACT 2600
Sent by email to: corporations.joint@aph.gov.au

Senate Standing Committees on Economics
PO Box 6100
Parliament House
CANBERRA ACT 2600
Sent by email to: economics.sen@aph.gov.au

Dear Sir or Madam,

Re: Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011 (Bill)

The Trust Company has more than 125 years of experience in providing financial services and is pleased to provide its comments in respect of the Bill.

EXECUTIVE SUMMARY

1. The Trust Company believes that the best interest and conflict of interest provisions for financial advisers set out in the Bill do not capture the spirit of the Future of Financial Advice Reforms (**FoFA Reforms**). The Bill establishes prescriptive and legalistic obligations for advisers in place of what should be a clearly expressed fiduciary duty. We believe that the Bill as drafted will further complicate and muddy the waters around the scope and depth of professional standards that should be applied to the provision of financial advice.

2. We believe that the Bill should instead provide for statutory recognition of the fiduciary duty owed by financial advisers to their clients.

3. A principles based approach is far more favourable than a prescriptive duty which will prove confusing and costly to discharge.

4. A statutory fiduciary duty which is simply stated would provide a higher benchmark against which to measure the professionalism of financial advice. If the financial advice industry is ever to be elevated to the status of a profession the individuals practising in that industry, need to demonstrate professional values and behaviours such as competence, integrity and abiding commitment and loyalty to the interests of their clients. To achieve this, it is necessary that financial advisers be clearly bound by a fiduciary duty, as is the case with other professions.

5. It is accountability and confidence that is required in the financial advice industry and the best way of achieving this is by an express fiduciary duty.

6. A further concern of The Trust Company is that by splitting out a best interest duty and a duty to consider one's clients' interests as a priority, the fiduciary duty is being distorted and thus the Bill is weakening the overriding principle of what it means to be a fiduciary.

EXPLANATION

What is a 'fiduciary duty'?

7. The term fiduciary derives from the Latin word "*fiducialis*" which in turn derives from the verb "*fidere*" meaning "*to trust*". A fiduciary is a person who can be trusted. That is to say that the person who engages a fiduciary acting in his or her interest, is entitled to assume utmost confidence in the actions of that fiduciary. The fiduciary must strictly adhere to the principle and always act with righteousness toward the person to whom they owe the duty. In short, a fiduciary duty is a duty of undivided loyalty.

Distinguishing a fiduciary duty from a duty of care

8. A duty of care is a requirement to meet a standard of reasonable care and skill when performing a service or providing a product. The standard is objective and based on what is expected of the "reasonable" person, service provider or manufacturer. A person can owe another person a duty of care without being subject to a duty of loyalty.

9. A professional person owes their client both a duty of care and a duty of loyalty. In the case of a professional person, the duty of care will bring with it a requirement to exhibit the skill expected of a reasonable professional in the relevant field. The "care and skill" required of a

professional will be objectively assessed by the standards and procedures adopted in the relevant field. It is the observance and promotion of those standards which underpins the competence and quality of the service provided, but competence and quality in the provision of a service is quite distinct from loyalty to the client's interest.

10. A fiduciary duty is the duty to put your client's interest above and beyond your own and to act solely in pursuing and furthering that interest. The duty of loyalty is quite distinct from the duty of care and it is the duty of loyalty that underpins the confidence or trust that a client can place in their professional adviser.

11. The very essence of the fiduciary duty is that the professional adviser is prevented from acting in any way other than in the interests of the person to whom the duty is owed. The only way an adviser may be excused for breach of their obligation of undivided loyalty is with the informed consent of the person who is owed the duty.

12. It is this sort of duty and nothing less, which should be placed upon financial advisers.

Background to the introduction of the Bill

13. In November 2009 the Parliamentary Joint Committee on Corporations and Financial Services chaired by Mr Bernie Ripoll (**the Ripoll Inquiry**) recommended in its Report that the *Corporations Act 2001* (Cth) should 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".*

14. The Ripoll Inquiry considered that there was no reason why financial advisers should not be required to meet this professional standard and neither is there any justification for the current arrangements whereby advisers can provide advice <u>not</u> in their clients best interests, yet still comply with section 945A of the *Corporations Act.*

15. On 26 April 2010 the Hon Chris Bowen MP, announced the FoFA Reforms in response to the Ripoll Inquiry. The main objective of the FoFA Reforms, as set out in the general outline in the Explanatory Memorandum (**EM**) to the Bill, was "*to improve the quality of financial advice while building trust and confidence in the financial advice industry through enhanced*

standards which align the interests of the adviser with the client and reduce conflicts of interest'.

16. We entirely endorse the findings of the Ripoll Inquiry and the policy response announced by the Government in 2010. The circumstances surrounding Storm Financial illustrate only too well the importance of the duty of loyalty. Arguably, Storm Financial and the relevant advisers were entirely compliant with the requirements of the legislation and regulations at the time, but Storm Financial and the advisers were acting in their own interest and did not demonstrate any loyalty or professional commitment to their clients.

17. As the Chairman of the Inquiry brought out in his examination of Mr Cassimatis, Storm Financial effectively became a factory delivering a single product. Everyone received the same outcome. What was missing was not a lack of care or skill but rather any sense of loyalty to the interests of the clients.

Where are we now?

18. On 24 November 2011 the Bill was introduced into Federal Parliament who referred it for inquiry and report. As a result the Parliamentary Joint Committee on Corporations and Financial Services and Senate Economics Committee are now considering the Bill and inviting further submissions.

19. The Bill addresses the question of a fiduciary duty by introducing the following two pronged approach:

    a) (**Best interest**) A best interests obligation upon financial advisers to "*act in the best interest of the client in relation to the advice provided*"; and

    b) (**Conflict provision**) An obligation on the adviser to prioritise the interest of the client in the event of a conflict between the interests of the client and either the person providing the advice, or the licensee or authorised representative.

How does the Bill fall short of an "explicit fiduciary duty"?

The best interests obligation

20. The best interests obligation is set out in section 961B(1) of the Bill and it is supplemented by provisions in section 961B(2) which set out a framework to fulfil and discharge the duty. These are described in summary at paragraphs 1.31 to 1.47 of the EM.

21. According to the Bill the adviser must:

    a) consider the objectives, financial situation and needs of the client as disclosed to the adviser through the client's instructions: section 961 B(2)(a);

    b) identify the subject matter of advice sought by the client and consider the objectives, financial situation and needs of the client relevant to that subject matter: section 961 B(2)(b);

    c) make further inquiries where it is obvious that information provided is incomplete or inaccurate. This is only required if relevant to the clients relevant circumstances and the test is what would be apparent to a person with a reasonable level of expertise on the subject matter of the advice. If the information about relevant circumstances is still incomplete or inaccurate, the advice may still be given provided the client is warned of this: section 961 B(2)(c);

    d) assess whether they have the necessary expertise to provide advice on the subject matter, if not they must decline to provide the advice: section 961 B(2)(d);

    e) if it is reasonable for the adviser to recommend a financial product, conduct a reasonable investigation into products that might achieve the outcome and assess the information gathered in the investigation. This does not necessitate an investigation of every product on the market and requires professional judgement on whether to go beyond approved product lists: section 961 B(2)(e); and

    f) base all judgements in advising the client on the clients relevant circumstances and take any other step that would reasonably be regarded as being in the best interests of the client given their circumstances at the time of the advice: section 961 B(2)(f) and (g).

22. The EM details the reasoning behind this approach as follows:

a) In paragraph 1.21 of the EM, it is stated that the prescriptive approach is needed because of the broad nature of the best interests obligation and indicates that the steps were established with regard to the current conditions on which advisers operate. It states that the approach allows an adviser to demonstrate compliance by taking the steps set out in the Bill;

b) In paragraphs 1.22 -1.23 of the EM, it is stated that the guiding principle is meeting the objectives, financial situation and needs of the client and this must be the paramount consideration when going through the process of providing advice. It states that the best interests requirement is intended to be about the process of providing advice and that a "good process will improve the quality of advice that is provided";

c) In paragraphs 1.25 to 1.27 of the EM, it is stated that the steps are not meant to be exhaustive or mechanical and that it is possible to demonstrate the duty has been fulfilled without regard to the steps in subsection 2 but it is generally expected that subsection 1 will be interpreted by reference to subsection 2;

d) In paragraph 1.26 of the EM, it is stated that the concept of reasonableness is built into the steps to reflect the type of behaviour that is expected of the advisers;

e) In paragraph 1.28 of the EM, it is stated that the catchall in section 961B(2)(g) obliges the adviser to demonstrate on the balance of probabilities that it took each of the steps set out in (a) to (g). This step has been added because subsection 2 as a whole gives the adviser a chance to demonstrate compliance and the catchall is a means of ensuring a higher standard of compliance if it wishes to rely on the section. It also specifies that it is for the party taking action against the provider to demonstrate that this has not occurred.

How does the best interests duty fall short of a fiduciary duty?

23. The Trust Company believes this best interest duty falls short of a fiduciary duty because of the following:

a) The best interest duty as expressed in the Bill is a prescriptive duty and will cause confusion and uncertainty in the industry. It is confusing a duty of care on one hand with a duty of loyalty on the other. The Bill attempts to address a duty of loyalty by using standards and rules which are associated with the duty of care. These two duties cannot be confused. It is the duty of loyalty that underpins the fiduciary obligation and it is this duty that should be met;

b) The prescriptive nature of the obligation adds further confusion, as the EM states that not all steps must be discharged to satisfy the duty but in paragraph 1.25 assumes that while the broad principle may be satisfied without reference to the prescriptive detail, it is expected that the general principle will be informed by those prescriptive measures. Furthermore, the catchall in 961B(2)(g) begs the question of the purpose of the preceding steps as arguably this broadens the obligation and adds complexity. The confusion and complexity is bound to increase cost in the industry when looking to discharge the duty;

c) The EM states that the articulation of the best interest duty in the Bill is the minimum standard to be followed to discharge the duty. However, we believe that there is a risk with this approach that advisers will simply not strive to better this and will do a bare minimum to get across the line, which does nothing to increase the standards or professionalism in the industry. Similarly, the built in concept of reasonableness waters down any real affect of the provisions;

d) The best interest duty and a series of prescriptive steps do not capture the essence of what was intended for the FoFA Reforms. To act in a client's best interest, is only one aspect of a fiduciary duty and what was intended was an inclusive and more accountable professional duty for advisers to adhere to;

e) The best interest obligation does not extend to providers of basis banking products and general insurance on the basis that they are more simplistic in nature. However, we think that there should be no distinction with basic and complex products as the point is to enhance the standards of the industry as a whole, regardless of the nature of the product.

The conflict provision

24. The conflict provision is set out in section 961J(1) of the Bill. The conflict provision in the Bill provides that priority must be given where the provider knows or reasonably ought to know, that there is a conflict of interest between the interests of the client and the interests of the provider. This obligation extends to licensees and authorised representatives of the provider to prevent using related parties to avoid the obligation.

25. The EM details the reasoning behind this approach as follows:

    a) In paragraph 1.64, it is stated that the conflict of interest provision is only triggered in situations where the provider knows or reasonably ought to know, there is a conflict. So if the provider did not know of a conflict because no interest was pointed out to him by the client, this will not be a breach unless it can be established that he or she ought to reasonably have known;

    b) In paragraph 1.66, it states this obligation does not prevent an adviser from pursuing his own interests or those of another party, but he or she will breach the provision if he or she fails to give priority to the client in such circumstances.

How does the conflict provision fall short of a fiduciary duty?

26. The Trust Company believes this duty falls short of a fiduciary duty in the following respects:

    a) The duty not to act in conflict to your client is the very essence of a fiduciary duty and should not be subject to reasonableness or watered down;

    b) In a strict fiduciary obligation, the only way to escape liability for this duty is through the informed consent of the client. It is for the client to give its consent following disclosure of all facts and information from the adviser;

    c) It is confusing to have a duty to prioritise your client on one hand, and a duty to only comply with what is reasonable on the other;

d) Splitting out the best interest duty and the duty not to act in conflict causes uncertainty and confusion about what the overriding principle of being a fiduciary means;

e) This obligation does not extend to providers of basic banking products and general insurance, which is inconsistent with raising the standard and professionalism of financial advice across the industry.

The Trust Company's proposal

27. The Trust Company advocates removing the best interests duty and conflict provisions from the Bill (sections 961 B – 961J) as currently drafted and replacing these with a simple statement as follows:

"***The Provider owes a fiduciary duty to their client and must act in good faith and in the best interests of their client.***"

28. A simple statement that a financial adviser owes a fiduciary duty to his client will:

a) fulfil the objective of the FoFA Reforms;
b) raise the standards of the industry; and
c) align the industry to the spirit of a profession.

29. It is difficult to see how financial advisers can aspire to be recognised as a profession without such a duty. Professionalism promotes a higher standard of expectation on the adviser not minimum standards to reach. True professionals do not measure their behaviour by rules and standards but by basic moral principles. The concept is best defined by Dean Roscoe Pound of Harvard Law School who said of a "*profession*" that :

"*The term refers to a group....pursuing a learned art as a common calling in the spirit of public service...not less a public service because it may incidentally be a means of livelihood. Pursuit of the learned art in the spirit of a public service is the primary purpose*"[1]

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[1] Pound, Roscoe (1953) *The Lawyer from Antiquity to Modern Times*, St. Paul, Minnesota: West Publishing Company

30. Once a fiduciary duty is clearly established, this is no need to add prescriptive steps to clarify what that duty means, since the principles are well established. A principles based approach would also prove less costly than attempting to discharge a prescriptive duty, as in regard to the former the financial adviser just needs to be satisfied that, above all else, they acted with undivided loyalty towards their client's interest.

31. A principles based approach is evidenced and supported by reference to the *Competition and Consumer Act 2010* (Cth) (formerly the *Trade Practice Act 1974* (Cth)). By way of example, section 52 of the *Trade Practices Act* (which has now been incorporated into the *Competition and Consumer Act*) was described by Justice Fox in *Brown v The Jam Factory Pty Ltd*[2] as:

> "*a comprehensive provision of wide impact, which does not adopt the language of any common law cause of action. It does not purport to create liability at all; rather, it establishes a norm of conduct, failure to observe which has consequences provided for elsewhere in the same statute".*

Since its introduction, section 52 has had an enormous impact in lifting the standards of conduct in all aspects of Australian commerce. It has had that impact because it simply states a principle of conduct. Interestingly, the ability to bring action for breach of Section 52 was extended to other corporations. The most vigorous use of section 52 has been by competitors in the same sector (for example, one of the earliest cases was an action brought by Colgate Palmolive complaining about the misleading advertising of Aim toothpaste). Competitors have effectively held each other to the relevant standard. Statutory recognition that a financial adviser owes their clients a fiduciary duty will have a similar impact in the financial services sector.

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[2] [1981] 53 FLR 340

Opposing arguments

32. The Trust Company would like to acknowledge the arguments of opponents and its response as follows:

Against	Our response
There is fundamentally no difference between a best interest duty and a fiduciary obligation and to impose a broad fiduciary duty would lead to confusion and uncertainty	A best interest duty is not a complete fiduciary obligation but one aspect of it. A fiduciary obligation is a principle based on undivided loyalty and trust to act in good faith and in the best interests of a client. Looked at in isolation a best interest obligation is not as far reaching
To impose a broad fiduciary duty would result in a 'trustee style duty' being placed on advisers and that should be avoided	The overall objective of the FoFA Reforms should be to enhance the standards of the financial advice industry and elevate the industry to the level of a profession. As Minister Bowen observed, the legislation should promote trust and confidence. You cannot have a profession without an explicit fiduciary obligation
Under general law the fiduciary duty already exists for financial advisers and the Bill proposes a stricter application than a fiduciary obligation as it imposes an objective standard to be met in preparing advice	There cannot be an objective standard around a duty of loyalty and this shows confusion with the application of a duty of care, A duty of care is measured against objective standards which are considered reasonable, a duty of loyalty is measured by putting your clients interest above all else.
Imposing a fiduciary duty could lead to a substantial restructure of the industry and as a result more costly advice	The cost involved in discharging a duty of loyalty is negligible and this demonstrates the essence of the confusion. It is far more costly to discharge a prescriptive duty as an adviser would need to show compliance with a series of steps. To discharge a duty of loyalty, the adviser just needs to be satisfied that it put the client first and obtained the clients informed

Against	Our response
	consent to any benefits they may derive from the relationship or the provision of advice

Conclusion

Whilst we acknowledge that the Bill as drafted is an improvement on previous iterations, it falls short of a clear fiduciary obligation. The Bill should be drafted in the spirit of what was intended by the FoFA Reforms and should serve to increasing standards and professionalism across the financial advice industry as a whole.

It is only by ensuring that financial advisers are held to a clear fiduciary duty in the provision of financial advice that the financial advice industry will move forward in terms of the perception of consumers.

We would be happy to appear before the Committee in person to discuss this submission in further detail.

Yours sincerely,

John Atkin
Chief Executive Officer
The Trust Company Limited