Submission to Inquiry into Financial Products and Services in Australia

Michael Legg[*]

1. Defining Conflicts of Interest

Conflict of interest may be defined broadly: (a) an incompatibility between the concerns or aims of different parties; (b) a situation whereby two or more of the interests held by, or entrusted to, a single person or party are considered incompatible.[1]

A conflict of interest may also be defined more narrowly by reference to a particular category of legal relationship.[2] In the context of fiduciary relationships a conflict of interest may arise where, except with the informed consent of the principal, a fiduciary places themselves in a position where there is a real and sensible possibility of (a) a conflict between the duty as a fiduciary and his or her own interest (duty-interest conflict) or (b) between the duty as a fiduciary to two or more persons (duty-duty conflict).[3]

Here the broader definition is applied but with the qualification that the main concern is where the incompatibility of aims or interests arises in a context where one party is holding itself out as able to be relied on, or acting "for" the other party.

2. Background to Conflicts of Interest

(a) Australian financial services licensees

The issue of conflicts first attracted substantial attention in 2001-2002 when New York Attorney-General Eliot Spitzer commenced an investigation into the conflicts of interest that research analysts at a number of investment banks faced and enforcement actions resulted in the banks paying $1.4 billion in penalties and disgorgement.[4] The conflicts arose because analysts recommended the purchase of securities to the public and to customers of their own firms without disclosing the fact that they owned those securities, that their compensation was tied to their recommendations, and most significantly, that their firms received compensation in the form of investment banking business from the issuer.[5] In the US the

---

[*] Senior Lecturer, Faculty of Law, University of New South Wales. B Com (Hons), M. Com (Hons), LLB (UNSW) and LLM (UC-Berkeley). Solicitor of the Supreme Court of New South Wales and Member of the New York Bar.

[1] Oxford English Dictionary (Online Edition).

[2] See generally, Charles Hollander QC and Simon Salzedo, *Conflicts of Interest* (3d ed 2008).

[3] GE Dal Pont and DRC Chalmers, *Equity and Trusts in Australia* (4th ed 2007) [4.15].

[4] See Press Release, Securities and Exchange Commission, Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking (April 28, 2003), available at www.sec.gov/news/press/2003-54.htm and *In re New York ex rel Spitzer v Merrill Lynch & Co. Inc* No. 02/401522 (N.Y. Sup. Ct. 21 May 2002) (stipulation and order of discontinuance of investigation and proceeding against Merrill Lynch), at www.oag.state.ny.us/investors/merrill_agreement.pdf

[5] See Affidavit of Eric Dinallo in Support of Application for an Order Pursuant to General Business Law § 354, available at http://www.oag.state.ny.us/press/2002/apr/MerrillL.pdf (April 8, 2002) and J Gross, Securities Analysts' Undisclosed Conflicts of Interest: Unfair Dealing or Securities Fraud? 2002 *Columbia Business Law Review* 631 at 632.

enforcement actions were followed by the enactment of section 501 of the Sarbanes-Oxley Act, Securities Exchange Commission rules, and rule changes by the National Association of Securities Dealers and the New York Stock Exchange.[6]

In Australia the concern about conflicts of interest resulted in amendments to the *Corporations Act 2001* (Cth) to insert section 912A(1)(aa) which imposed an obligation to "have in place adequate arrangements for the management of conflicts of interest" on all Australian financial services licensees.[7]

Section 912A(1)(a)'s requirement that financial services be provided "efficiently, honestly and fairly" was thought to include managing conflicts of interest but a firmer legislative basis for the regulation of conflicts was thought desirable.[8] It was also determined that the Australian approach should be principles based and not be limited to analysts, rather it should apply to financial services licensees more generally.[9]

The *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill Explanatory Memorandum* ("**CLERP 9 EM**") stated that section 912A(1)(aa) would require adequate arrangements for managing conflicts of interest including:

> ensuring that there is adequate disclosure of conflicts to investors, who can then consider their impact before making investment decisions. It will require internal policies and procedures for preventing and addressing potential conflicts of interest that are robust and effective. The obligation will apply to all conflicts of interest, other than those that occur wholly outside the financial services business of the licensee or its representative.[10]

The Parliament also noted that section 912A(1)(aa) would provide a strong legislative basis for ASIC to develop guidance and take enforcement action.[11]

ASIC issued Policy Statement 181 - Licensing: Managing Conflicts of Interest on 30 August 2004 ("**PS 181**").[12] The Corporations Act does not contain a definition of a "conflict of interest" in this context. However, ASIC's PS 181 states that licensees will be taken to have a conflict of interest where there are "circumstances where some or all of the interests of people (clients) to whom a licensee (or its representative) provides financial services are inconsistent with, or diverge from some or all of the

---

[6] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 501, Order Approving Proposed Rule Changes by the NYSE and NASDAQ Relating to Research Analyst Conflicts of Interest, Exchange Act Release No. 34-48252, 68 Fed. Reg. 45,875 (Aug. 4, 2003); Order Approving Proposed Rule Changes by NASDAQ and NYSE Relating to Research Analyst Conflicts of Interest, Exchange Act Release No. 34-45908, 67 Fed. Reg. 34,968 (May 16, 2002), Barbara Moses, The "Discovery" of Analyst Conflicts on Wall Street (2004) 70 *Brooklyn Law Review* 89 and Jill Fisch, Fiduciary Duties and the Analyst Scandals (2007) 58 *Alabama Law Review* 1083.

[7] CLERP 9 EM at [4.169] and [5.595], A Tuch, Investments Banks as Fiduciaries: Implications for Conflicts of Interest (2005) 29 *Melbourne University Law Review* 478 and Jeremy Cooper - Deputy Chairman, ASIC, Managing Conflicts of Interest in the Australian Financial Services Industry, *Paper Presented to Securities & Derivatives Industry Association 2006 Conference*, 26 May 2006.

[8] CLERP 9 EM at [4.169] and [5.595].

[9] CLERP 9 EM at [5.596].

[10] CLERP 9 EM at [5.597].

[11] CLERP 9 EM at [5.598].

[12] Available from http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ps181.pdf/$file/ps181.pdf. From 5 July 2007, this document may be referred to as Regulatory Guide 181 (RG 181) or Policy Statement 181 (PS 181).

interests of the licensee or its representatives".[13] ASIC considers that a conflict of interest includes an actual, apparent or potential conflict.

PS 181 also indicates that to comply with section 912A(1)(aa), arrangements to manage conflicts of interest must include arrangements to control, avoid and disclose conflicts of interest, as appropriate.[14] This was consistent with the CLERP 9 EM that states that section 912A(1)(aa) "will require internal policies and procedures for preventing and addressing potential conflicts of interest that are robust and effective" (emphasis added).[15]

PS 181 suggests that controlling a conflict requires monitoring procedures, documentation, implementation, regular review and oversight by specific persons.[16] PS 181 goes on to state:

> Some conflicts of interest have such a serious potential impact on a licensee or its clients that the only way to adequately manage those conflicts will be to avoid them. In such cases merely disclosing them and imposing internal controls will be inadequate. A licensee's conflicts management arrangements must enable the licensee and its representatives to identify those conflicts of interest that must be avoided.
>
> Licensees are responsible for their own conduct and that of their representatives. The conflicts management arrangements of a licensee need to take this into account. As far as possible, licensees (and their representatives) should avoid placing themselves in a position where there is a material conflict between their own interests and those of their clients. This is to minimise the risk that the licensee will be tempted to unfairly prefer their own interests to those of their clients.[17] (emphasis added)

PS 181 also recommends that licensees should make appropriate disclosures to clients as part of their arrangements to manage conflicts of interest.[18] Disclosure is an integral part of managing conflicts, and adequate disclosure to clients "means providing enough detail in a clear, concise and effective form to allow clients to make an informed decision about how the conflict may effect the service being provided to them".[19] PS 181 goes on to state that:

> In our view, the use of generic ('boilerplate') disclosures is unlikely to satisfy the conflicts management obligation. In order to be effective, conflicts of interest disclosure should refer to the specific service to which it relates, and should be specific and clear enough for the client to understand the conflict and its potential impact on the service they are being offered.[20]

The issue of conflicts of issue and investment banks were brought to the fore in *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 160 FCR 35 (ASIC

---

[13] PS 181 at [15].

[14] PS 181 at [20]-[21].

[15] PS 181 at [42]-[43] and CLERP 9 EM at [5.598].

[16] PS 181 at [30]-[34].

[17] PS 181 at [42]-[43].

[18] PS 181 at [49].

[19] PS 181 at [50].

[20] PS 181 at [53].

v Citigroup).[21] In *ASIC v Citigroup*, a case that turned on the exclusion of any fiduciary duty between investment bank and client, Justice Jacobson in obiter rejected ASIC's approach to the interpretation of section 912A(1)(aa) that some conflicts must be avoided as it was inconsistent with the plain meaning of the text.[22] Justice Jacobson reasoned that the section uses the word "management" which does not require the elimination of a possible conflict, although one way of managing conflicts would be to eliminate them if a licensee chose to do so.[23] Further, the phrase "management of conflicts of interest" assumes that there will be conflicts which must be managed by adequate arrangements rather than eliminated.[24] ASIC's view that some conflicts will have such a serious impact on clients that they must be avoided is not the law.

(b) Auditors

The section 912A(1)(aa) approach can be contrasted with the regulatory approach adopted in relation to auditors. Following the collapse of the HIH Insurance Group in Australia and Enron in the United States, there was widespread debate as to the adequacy of the regulation of the auditing profession, and in particular the current legal requirements for independence of auditors. In Australia, further concerns were raised by the collapse of One.Tel, Ansett and Harris Scarfe. Reforms to address independence were made through the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (Cth) (also known as CLERP 9) which resulted in Division 3 of Part 2M.4 of the *Corporations Act 2001* (Cth).[25]

Division 3 of Pt 2M.4 sets out general requirements for auditor independence and specific relationships that will compromise auditor independence. In relation to the general requirements, the Act creates offences to promote the avoidance of a "conflict of interest situation" between an auditor and the "audited body".[26] A conflict of interest situation is defined as existing when circumstances mean that:

- the auditor is not capable of exercising objective and impartial judgment in relation to the conduct of the audit of the audited body; or
- a reasonable person, with full knowledge of all relevant facts and circumstances, would conclude that the auditor is not capable of exercising objective and impartial judgment in relation to the conduct of the audit of the audited body.[27]

The specific independence requirements create offences aimed at prohibiting certain relationships between the auditor and audited body that are set out in s 324CH(1).[28] Those relationships may be described as nine employment and ten financial relationships that compromise an auditor's independence.

---

[21] See Michael Legg and Nicholas Mavrakis, ASIC v Citigroup: Fiduciary Duties, Managing Conflicts and Chinese Walls (2009) *Macquarie Journal of Business Law* forthcoming.

[22] *ASIC v Citigroup* (2007) 160 FCR 35, [443].

[23] *ASIC v Citigroup* (2007) 160 FCR 35, [311] and [444].

[24] *ASIC v Citigroup* (2007) 160 FCR 35, [445].

[25] See H A J Ford, R P Austin and I M Ramsay, *Ford's Principles of Corporation Law* (Online LexisNexis) [10.010].

[26] *Corporations Act 2001* (Cth) ss 324CA, 324CB and 324CC.

[27] *Corporations Act 2001* (Cth) s 324CD.

[28] *Corporations Act 2001* (Cth) ss 324CE, 324CF and 324CG.

The conflict of interest faced by auditors who received substantial income through consulting and other services resulted in independence requirements that ceased to rely on disclosure and effectively banned such conflicts through creating criminal offences.[29]

3. The GFC and the Continuing Problem of Conflicts of Interest

Conflicts of interest have been a major part of the behaviour that fuelled the Global Financial Crisis (GFC).[30] In the US sub-prime market the mortgage origination and distribution model meant that mortgage brokers were paid for originating a mortgage but did not bear the risk of the non-performance of that mortgage due to it being on-sold. The mortgage broker had an incentive to maximise the number of loans that they wrote which conflicted with the need to assure the quality of the mortgages which was in the best interests of the investor that purchased the Mortgage Backed Security (MBS).[31]

A further conflict was between individual bankers and the investment banks that they worked for in that their remuneration or bonuses was based on them being able to be rewarded for continuing to create, sell and underwrite financial products such as Collateralised Debt Obligations (CDO) although the risk inherent in the CDO was borne by their employer or the shareholders in the investment bank.[32]

The conflict created in investment banks may also be seen as a specific example of the more general situation where executive remuneration is directed to short term profitability rather than to long term success so that a CEO is incentivised to take steps to maximise their wealth in the short term by maximising the corporate performance short term even though that may involve significant risks that ultimately reduce or destroy shareholder wealth in the long term. There is therefore a conflict of interest created between the CEO's interests and the shareholders' or corporations' interests.[33]

These conflicts have seen a number of proposals for reform put forward with the common thread of aligning interests. Mortgage brokers would retain an interest in the mortgages they wrote, investment bankers and executives would receive bonus payments over time so as to encourage long term performance.[34]

The issue of conflicts also permeates the problems experienced with credit rating agencies. A conflict of interest arose as the rating agency was paid by the issuer of the CDO or MBS who then used the rating to be able to market the financial product to investors. The credit rating agencies remuneration and continued utilisation depended upon them providing sufficiently high ratings therefore creating a conflict

---

[29] Michael Legg, Auditor Independence and Criminal Liability Under CLERP 9 (2006) 34 *Australian Business Law Review* 156, 156. See also *Corporations Act 2001* (Cth) Division 5 of Pt 2M.4 which provides for auditor rotation and s 307C which requires an auditor to provide a declaration of independence to the audited body.

[30] See Michael Legg and Jason Harris, How the American Dream became a Global Nightmare: An Analysis of the Causes of the Global Financial Crisis (2009) *UNSW Law Journal* forthcoming.

[31] Steven Schwarcz, Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown (2008) 93 *Minnesota Law Review* 373 and Securities and Exchange Commission, Proposed Rules for Nationally Recognised Statistical Rating Organisations release no. 34-57967 (16 June 2008), 9.

[32] Stephanie Tsao, Managing Investment Banks during the Mortgage Crisis (2008) 27 *Review of Banking and Financial Law* 323, 328 - 329.

[33] Paul Krugman, Banks Gone Wild, *NY Times*, 23 November 2007.

[34] See Make them pay, *Special Report on International Banking - The Economist*, 17 May 2008 p16-17 and Financial Stability Forum, *Principles for Sound Compensation Practices*, 2 April 2009 Available at http://www.financialstabilityboard.org/publications/r_0904b.pdf

between their financial interest and the interest of investors who relied on the ratings.[35] The credit rating agencies conflict has been addressed in Australia through bringing them under the coverage of Chapter 7 of the Corporations Act.[36]

4. Conflicts of Interest and Financial Advisers

In Australia the most prominent conflict of interest has related to financial advisers and consumers where the adviser is paid a commission by the provider of the financial product that they sell to the consumer. Examples include consumers who were advised to invest in Westpoint, Fincorp, Storm Financial, Great Southern, Timbercorp and Opes Prime products - all of which failed.[37] The commission-based remuneration creates an incentive for the adviser to put consumers into products paying the best commissions not the products most suitable for the consumer.

A particular egregious example of potential conflicts of interest was Great Southern which used a network of 1100 financial planners and accountants who were paid up-front fees of 10c for every dollar invested in Great Southern financial products. In relation to 337 of Great Southern's authorised representatives it has been alleged that they were only authorised to sell Great Southern products so that there could not have been any assessment of whether a different product would have better suited an investor's needs. Through this scheme Great Southern raised $1.8 billion from 47,000 investors in five years.[38] Great Southern was placed into administration on 18 May 2009.[39]

Conflicts of interest in the financial sector have traditionally been addressed through disclosure[40] and more recently through section 912A(1)(aa). The GFC and collapse of multiple investment schemes in Australia suggests that both need to be revisited.

The aim of disclosure is to allow the recipient of the advice to discount the advice to the extent it is influenced by the conflict.[41] The act of disclosure may also reinforce the existence of the conflict and the need to counteract it leading to greater honesty on the part of the advisor.[42] Disclosure is favoured as a regulatory policy as it is the least intrusive way of addressing the conflict and it informs the recipient of

---

[35] David Matthews, Ruined in a Conventional Way: Responses to Credit Ratings Role in Credit Crisis (2009) 29 *Northwestern Journal of International Law and Business* 245, 257 and Securities and Exchange Commission, Proposed Rules for Nationally Recognised Statistical Rating Organisations release no. 34-57967 (16 June 2008), 12.

[36] Hon Nick Sherry, *Improved Australian Controls for Credit Rating Agencies and Research Houses*, Media Release 77/08, available at www.treasury.gov.au.

[37] Nicola Berkovic, Probe into conflicts of interest that cost small investors billions, *The Australian*, 27 February 2009 and Patrick Durkin, Corbett says commissions flawed, *The Australian Financial Review*, 29 May 2009 p 5.

[38] Anthony Klan, Agribusiness Scheme pay-offs cost 40c in dollar, *The Australian*, 20 May 2009 p 20 and Anthony Klan, 'Sales professionals' pushed Great Southern products, *The Australian*, 21 May 2009 p 7.

[39] McGrathNicol, Receivers and Managers Appointed to Great Southern, 19 May 2009.

[40] Chapter 7 of the *Corporations Act 2001* (Cth) which employs product disclosure statements, financial services guides and statements of advice, John McLaren, Melissa Simpson and Mary Toohey, *Law of Investments* (2d ed 2008) 61-78 and Peter Kell, Sins of Commission, *Sydney Morning Herald*, 17 August 2005 available at http://www.smh.com.au/news/money/sins-of-commission/2005/08/15/1123957999313.html

[41] Daylian Cain, George Loewenstein and Dan Moore, Coming Clean but Playing Dirtier – The Shortcomings of Disclosure as a Solution to Conflicts of Interest in Don Moore, Daylian Cain, George Loewenstein and Max Bazerman (eds), *Conflicts of Interest: Challenges and Solutions in Business, Law, Medicine and Public Policy* (2005) 105.

[42] Cain et al, 114.

the advice so that they can take the action appropriate to their situation.[43] It is also acceptable to the individual or entity facing the conflict as they are not forbidden from acting and can reap the benefits that flow from the conflict – usually financial rewards.[44] The disclosure solution also allows advisers to offer free or at least affordable advice to investors as the advisor is remunerated by the financial product provider.[45]

The problem with disclosure is that (1) recipients of disclosure cannot utilise the disclosure effectively, and (2) the disclosure becomes routine or a "boilerplate" clause in documentation that ceases to reinforce, or even undermines, the advisor's obligations to the recipient.[46]

A substantial body of cognitive psychology research has found that recipients do not correctly discount advice from biased sources. The recipient does not know if or how the conflict may affect the advice they receive. They only know that it might have an effect which they are not in the position to quantify. The exaltations in PS 181 to "provid[e] enough detail in a clear, concise and effective form to allow clients to make an informed decision about how the conflict may effect the service being provided to them"[47] may simply not be possible. However, disclosure can also have a counter-productive result. A recipient having been warned of a conflict of interest may then put greater trust in the adviser because of their honesty. The advisor having disclosed the conflict may then feel that they have satisfied their obligation to the recipient and if the recipient relies on the conflicted advice they do so from an informed position.[48] Significantly, these findings do not suggest that the recipient is uneducated or gullible, nor that the advisor is corrupt or fraudulent, only that both are human. Where the recipient is not financially literate and/or the advisor is corrupt then the insufficiency of disclosure is magnified.

Disclosure also allows conflicts to continue and does not effectively alleviate the underlying problem of tainted advice or actions.[49] It is very much a second-best solution for addressing conflicts. This then raises the question of whether some conflicts are so egregious or harmful that the conflict should be removed or banned. The independence requirements imposed on auditors that were discussed above are examples of identified conflicts of interest not being permitted through structuring relationships so that a conflict cannot arise.[50] It should be noted that after *ASIC v Citigroup*, section 912(1)(aa) does not require the elimination of conflicts of interest, only that they be managed.

The conflict that exists in relation to investment advice may be too great a risk for a system of privately-funded retirement to deal with through disclosure. For many consumers their entire economic well-being can be tied to the investments they make to fund their retirement. Conflicts of interest need to be avoided rather than simply disclosed. However, the range and complexity of financial products that are for sale

---

[43] Cain et al, 107.

[44] Cain et al, 107.

[45] Peter Cartwright, *Banks, Consumers and Regulation* (2004) 75.

[46] See generally, William Whitford, The Functions of Disclosure Regulation in Consumer Transactions (1973) 2 *Wisconsin Law Review* 400, 403 and Ross Cranston, *Consumers and the Law* (2d ed 1984) 304-306.

[47] PS 181 at [50].

[48] Cain et al, 114-116. See also Susanna Ripkin, The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation (2006) 58 *Baylor Law Review* 139, 160-176.

[49] James Surowiecki, The talking cure, *The New Yorker*, 9 December 2002 available at http://www.newyorker.com/archive/2002/12/09/021209ta_talk_surowiecki

[50] Samuel Issacharoff, Legal Responses to Conflicts of Interest in Don Moore, Daylian Cain, George Loewenstein and Max Bazerman (eds), *Conflicts of Interest: Challenges and Solutions in Business, Law, Medicine and Public Policy* (2005) 198-199

means that unbiased expert advice is essential. The need for that advice to be affordable may mean that it needs to be provided by government or form part of a person's superannuation benefits.

5. Conclusion

- Commission-based remuneration for financial advisors creates a clear of conflict of interest.
- Disclosure is an ineffective mechanism for addressing conflicts in relation to consumers or retail investors.
- Conflicts of interest have arisen in a number of other circumstances and they provide useful sources of comparison for regulation. For example legislation could seek to align interests or it could ban conflicts of interest.
- Conflicts of interests faced by financial advisors could be addressed in a manner specific to them or it could be addressed through section 912A(1)(aa) of the Corporations Act which applies to all AFSL holders.
- This submission favours the removal of conflicts of interest rather than allowing them to continue but provide for disclosure of the conflict.
- Section 912A(1)(aa) of the Corporations Act needs to be revisited in light of *ASIC v Citigroup*. A possible reform would be to require the avoidance of conflicts of interest in relation to retail investors but allow for the 'management' of conflicts in relation to sophisticated investors.
- Consideration needs to be given to how retail investors may be encouraged to avail themselves of investment advice. Financial literacy and education are one method. Another would be to make investment advice available as one of the benefits of being in a superannuation fund.