FUTURE OF FINANCIAL ADVICE REFORM: THE CHANGING CONTENT AND NATURE OF THE 'BEST INTERESTS OBLIGATION'

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Abstract

In 2009, the Parliamentary Joint Committee on Corporations and Financial Services questioned whether the formulation of a statutory fiduciary duty might ensure that client-focused advice was provided to financial service clients. In 2012, amendments were made to the *Corporations Act 2001* (Cth) in response to the Joint Committee's recommendations. This paper examines the evolution of the 'best interests obligation' to demonstrate that the statutory obligation now in place in the *Corporations Act* does not an enact a statutory fiduciary duty.

I Introduction

The Parliamentary Joint Committee on Corporations and Financial Services (The Parliamentary Committee) was convened to, 'inquire into and report … on issues associated with recent financial product and services provider collapses'.[1] One of the issues the Parliamentary Committee examined in

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1 Parliamentary Joint Committee on Corporations and Financial Services, Commonwealth Parliament, *Inquiry into Financial Products and Services in Australia* (November 2009) 1. The Committee's Terms of Reference required the Committee to pay particular reference to:

1. the role of financial advisers;
2. the general regulatory environment for these products and services;
3. the role played by commission arrangements relating to product sales and advice, including the potential for conflicts of interest, the need for appropriate disclosure, and remuneration models for financial advisers;
4. the role played by marking and advertising campaigns;
5. the adequacy of licensing arrangements for those who sold the products and services;
6. the appropriateness of information and advice provided to consumers considering investing in those products and services, and how the interests of consumers can best be served;

its November 2009 Report was the nature of the financial adviser/client relationship. Ultimately the Committee supported 'the proposal for the introduction of an explicit legislative fiduciary duty on financial advisers requiring them to place the clients' interests ahead of their own.'[2] The Parliamentary Committee suggested that an explicit recognition of a fiduciary duty being owed to clients by financial advisers would assist in resolving any conflicts of interest issues that may be inherent in the role of the financial adviser. It recommended that 'the *Corporations Act* [needs to] 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.[3] Introduced as Bills into Federal House of Representatives on 24 November 2011, the *Corporations Amendment (Future of Financial Advice) Act 2012* (Cth) and the *Corporations Amendment (Further Future of Financial Advice Measures) Act 2012* (Cth) were passed by both Houses on 25 June 2012 and assented to on 27 June 2012 (the FoFA Reforms). Whilst the statement of the 'best interests obligation' changed minimally between the release of the Exposure Draft to the Bill[4] and the Bill,[5] the steps that a provider must take so as to satisfy the obligation to act in the best interests of the client did change as between the Exposure Draft[6] and what ultimately was enacted. This paper examines the content and nature of the 'best interests obligation' to suggest that the current conception of the obligation is not, and should not be regarded as a statutory manifestation of the general law fiduciary duty as supported by the Parliamentary Committee.

The paper is presented in 4 parts. The first part examines the departure from the statutory fiduciary duty as propounded by the Committee. This departure leads into a discussion of the 'best interests obligation' (Part 2), the provisions regarding remuneration (Part 3) and penalties/compensation (Part 4) to demonstrate the argument that the new reforms do not represent a statutory manifestation of the general law fiduciary duty.

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8. consumer education and understanding of these financial products and services;
9. the adequacy of professional indemnity insurance arrangements for those who sold the products and services, and the impact on consumers; and
10. the need for any legislative or regulatory change.

Added later was the requirement that:

The committee will investigate the involvement of the banking and finance industry in providing finance for investors in and through Storm Financial, Opes Prime and other similar businesses, and the practices of banks and other financial institutions in relation to margin lending associated with those businesses.

2 Ibid 110.

3 Ibid.

4 Corporations Amendment (Future of Financial Advice) Bill 2011 s 961C(1).

5 Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011 (Cth) s 961B.

6 Corporations Amendment (Future of Financial Advice) Bill 2011 s 961C(2).

II Fiduciary Duty or Best Interests Obligation?

As noted above, the Committee recommended that a statutory expression of the fiduciary duty be inserted into the *Corporations Act 2001* (Cth). It is accepted that the fundamental duties of a fiduciary are that a fiduciary must not place themselves in a situation where their interest will conflict with that of the client, without the client's express, informed consent, and that a fiduciary must not make a profit out of the relationship without the client's express and informed consent.[7] As Professor Finn notes:

> Two themes, it may be noted, are embodied in this: the one concerns itself with misuse of the fiduciary position: the other with conflicts of duty and interest or conflicts of duty arising in or in virtue of that position.[8]

Advisers, particularly those within the accounting and legal professions are accustomed to being regarded as being in a fiduciary relationship with their client. Conversely those in the financial advice industry have not consistently been regarded as being in such a relationship with a client.[9] Rather the existence of the fiduciary relationship is determined to exist on a case-by-case basis with much depending upon the particular facts and circumstances of the engagement.[10] This situation arises due to the industry being product-focused rather than singularly client-focused. The development of the industry and the complexity of its client relations makes the distinction between product promotion and client service more blurred than in other professional relationships. This is not to say though that the industry is not regulated. To the contrary, financial services have been regulated by a number of legislative instruments including the *Corporations Act 2001* (Cth).

Relevantly, from a financial service and advice perspective the *Corporations Act 2001* (Cth) has allowed for conflicts of interest to be present in client relationships provided that the conflict of interest was managed and the client placed in an informed position. This is a very different proposition to the fiduciary relationship. The historical allowance of conflicts of interest under the framework for financial advice work within the *Corporations Act 2001* (Cth) is of great importance to the context of the obligation ultimately enacted. Rather than imposing a requirement that there be no conflicts, as would be the case under the fiduciary duty, the duty imposes an obligation that requires consideration of what might be in the best interests of a particular client notwithstanding any conflicts of interest.

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7 Michael Perkins and Robert Monahan, *Estate Planning* (2nd ed, 2008) 364.

8 PD Finn, 'The Fiduciary Principle' in TG Yourdan (ed), *Equity, Fiduciaries and Trusts* (1989) 27.

9 Vince Battaglia, 'Dealing with conflicts: The Equitable and Statutory Obligations of Financial Services Licensees' (2008) 26 *Company and Securities Law Journal* 483.

10 Ibid.

On this basis alone then, the formulation of the duty as expressed in the statutory duty imposed upon a financial adviser, is significantly different to the general conception of the fiduciary duty. Ken Lindgren QC, writing prior to the release of the FoFA Reforms suggested that:

> It is not appropriate to describe fiduciary duty in terms of a positive duty to act. A fiduciary duty is only ever proscriptive: if you act, you must not make a profit out of doing so and you must not have an interest that conflicts with your duty to the beneficiary of the duty. If a fiduciary does have a duty to act, the jurisprudential basis of that duty will be non-fiduciary …

so that in his view then, it:

> is therefore inconsistent with the proscriptive nature of fiduciary obligations to conceive of a positive duty to act in the best interests of the client. The better view seems to be that an undertaking formulated by reference to the best interest of another is a precursor or basis of the existence of fiduciary duty, rather than an actual component of the duty.[11]

In arguing for a separation of the concept of a statutory fiduciary duty from that of the general law conception, Lindgren QC suggested that, '[e]nough has been said to emphasise that the invocation of the word "fiduciary" will not answer the questions that arise and will give rise to questions of its own'.[12] In promoting a move away from seemingly replicating the nuances of the fiduciary duty within a statutory framework, Lindgren QC suggested that:

> A better approach is not to use the word 'fiduciary' but to grapple directly with the underlying problems. This could be imposed by imposing more specific obligations and prohibitions and, where appropriate, providing for the remedies that are to be available to the client in respect of them.[13]

As will be seen, this is the formulation of the obligation that has been enacted. In the next Part, we examine the Act's description of the obligation and, in particular, the fact that it does not include any reference to the term 'fiduciary'.

III The 'Best Interests Obligation'

The Explanatory Memorandum for the Corporations Amendment (Future of Financial Advice) Bill 2011 noted that:

> The reforms focus on the framework for the provision of financial advice. The underlying objective of the reforms is to improve the quality of financial advice whilst building trust and confidence in the financial planning industry through

11 Ibid 441.
12 Ibid 442.
13 Ibid 442–443.

> enhanced standards which align the interests of the adviser with the client and reduce conflicts of interest.[14]

The Explanatory Memorandum highlights a step away from the focus on the client-adviser relationship. Rather the focus is on the quality of the financial advice and the need to build trust and confidence in the financial planning industry through compliance standards. The necessarily vague notion of the fiduciary relationship or fiduciary duty is not contained within its reform objectives.

Enacted in s 961B of the *Corporations Act*, the 'best interest obligation' simply stipulates that 'the provider must act in the best interests of the client when giving the advice'. The section then provides that the provider will satisfy the duty if the provider is able to prove they have attended to a number of matters, namely:

> (2) The provider satisfies the duty in subsection (1), if the provider proves that the provider has done each of the following:
> (a) identified the objectives, financial situation and needs of the client that were disclosed to the provider by the client through instructions;
> (b) identified:
> (i) the subject matter of the advice that has been sought by the client (whether explicitly or implicitly); and
> (ii) the objectives, financial situation and needs of the client that would reasonably be considered as relevant to advice sought on that subject matter (the ***client's relevant circumstances***);
> (c) where it was reasonably apparent that information relating to the client's relevant circumstances was incomplete or inaccurate, made reasonable inquiries to obtain complete and accurate information;
> (d) assessed whether the provider has the expertise required to provide the client advice on the subject matter sought and, if not, declined to provide the advice;
> (e) if, in considering the subject matter of the advice sought, it would be reasonable to consider recommending a financial product:
> (i) conducted a reasonable investigation into the financial products that might achieve those of the objectives and meet those of the needs of the client that would reasonably be considered as relevant to advice on that subject matter; and
> (ii) assessed the information gathered in the investigation;
> (f) based all judgements in advising the client on the client's relevant circumstances;
> (g) taken any other step that, at the time the advice is provided, would reasonably be regarded as being in the best interests of the client, given the client's relevant circumstances.

14 Explanatory Memorandum, Corporations Amendment (Future of Financial Advice) Bill 2011 (Cth) 3.

As noted by Lindgren QC above, this is a positive and prescriptive obligation which is inconsistent with the proscriptive general law formulation of the fiduciary duty;[15] therefore, by definition the obligation cannot be regarded as a statutory manifestation of the fiduciary obligation.

That the obligation is something different to a statutory fiduciary duty is further highlighted by the prescriptive elements of the obligation. In other words, the obligation details the elements for consideration and the actions through which the obligation might be satisfied. Or even more simply, the standards for compliance are expressed. Therefore there is no vague notion of proscriptive compliance based upon equitable principles and maxims as is the case with the general law statement of the fiduciary duty.

The compliance steps proposed in the original Bill were more proscriptive and lengthy. To assist this paper's argument, the proposed elements are reproduced in full below to illustrate the extent to which the obligation was ultimately re-drafted and enacted.

The original Bill's proposed section provided that the steps a provider had to take in acting in the best interests of the client included, but were not limited to:

> (a) identifying the objectives, financial situation and needs of the client that are disclosed to the provider by the client through instructions; and
> (b) identifying the subject matter of the advice that has been requested by the client; and
> (c) where it is reasonably apparent that information relating to the objectives, financial situation and needs of the client that is given by the client in instructions is:
>   i. incomplete for the purposes of providing the advice on the subject matter requested; or
>   ii. inaccurate;
>
> make reasonable inquiries to obtain complete and accurate information; and
> (d) where it is reasonably apparent that the client's objectives could be better achieved, or the client's needs better met, if the client obtained advice on another subject matter, either in addition to or in substitution for the advice requested, advising the client in writing of that fact; and
> (e) assessing whether the provider has the expertise required to give the client advice on the subject matter requested and, if not, declining to give advice; and
> (f) assessing whether the client's objectives could be achieved, and needs met, through means other than the acquisition of financial products; and

15 Ken Lindgren QC, 'Fiduciary Duty and the Ripoll Report'(2010) 28 *Company and Securities Law Journal* 435, 437.

(g) either:
   i. conducting a reasonable investigation into the financial products that might achieve the objectives and meet the needs of the client of which the provider is aware and assessing the information gathered in the investigation; or
   ii. if another individual has made such an investigation and the provider has access to the results of the investigation—assessing the information gathered in the investigation; and

(h) if the provider proposes to advise the client to acquire a financial product in substitution for or in addition to another financial product:
   i. assessing the disadvantages (including risk and increased complexity) in acquiring the product; and
   ii. weighing them against the advantages of not acquiring the product; and

(i) advising the client to acquire the product only if, having weighed those disadvantages against the advantages, it is reasonable to conclude that the client's objectives could be better achieved, and the client's needs better met, if the client acquired the product; and

(j) basing all judgements in advising the client on the objectives, financial situation and needs of the client.[16]

However, concerns were raised with respect to the ability of members of the financial advice industry to comply with this fuller set of obligations. Based on these objections the Bill was referred for further inquiry by the Parliamentary Joint Committee on Corporations and Financial Services. Ultimately, the statement of the duty as a positive and proscriptive obligation was not changed. However, the steps to satisfy the obligation were reworded (as indicated above) to clarify what is required for compliance with the obligation. Ultimately, though these requirements are different to those originally suggested, this does not alter the fact that the obligation created is not a statutory version of the general law fiduciary duty.

That the statement of the 'best interests obligation' is not a statutory version of the general law fiduciary duty is further explained in the acknowledgment of the conflict of interest with respect to remuneration, particularly non-client remuneration which forms part of the industry. As indicated earlier in this paper, the issue with respect to remuneration falls within the second aspect of the fiduciary duty.

16 Some terms are further explained, for example s 961D provides that, '[s]omething is reasonably apparent if it would be apparent to a person with a reasonable level of expertise in the subject matter of the advice that has been requested by the client, were that person exercising care and objectively assessing the information given to the provider by the client. And s 961E provides that a *reasonable investigation* conducted for the purposes of the duty does not require an investigation into every financial product available. But if the client requests the provider to consider a specified financial product, or financial products of a specified class, a *reasonable investigation* into the financial products that might achieve the objectives and meet the needs of the client includes an investigation into that financial product, or financial products of that class.

IV Remuneration

The area of remuneration further highlights that the 'best interests obligation' is not to be regarded as a statutory manifestation of the fiduciary duty. The issue of conflict of interest through remuneration has been resolved by again permitting a conflict of interest to exist provided that it is appropriately managed and the client is informed so as to be able to make an appropriate determination. Again, such a conflict would be untenable under the general law obligation imposed on the fiduciary relationship. Section 961J as enacted requires that if there is a conflict of interest through remuneration that the provider of the advice gives priority to the client's interests when giving their advice.[17]

Arguably, such a requirement highlights that the statutory 'best interests obligation' is not a statutory formulation of the general law fiduciary duty. This argument is acknowledged by the Explanatory Memorandum by the following comments:

> 1.49 The obligation to give priority to the interests of the client does not mean that the provider can never pursue their own interests or the interests of another party (for example, the licensee). However, the provider will breach this obligation if, in pursuing their own interests or the interests of another party, the provider fails to give priority to the interests of the client if there is a conflict.
>
> 1.50 Consistent with the best interest obligations, a provider does not breach the obligation to give priority merely by accepting remuneration from a source other the client (for example, a commission paid by an insurance provider). However, if the provider gives priority to maximising a non-client source of remuneration over the interests of the client, the provider will be held in breach of their obligations.[18]

There is also a difference between the penalties available through breach of a fiduciary duty and through breach of the 'best interests obligation' which again serves to highlight that the 'best interests obligation' is not a manifestation of the general law fiduciary duty.

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17 Given this, the *Corporations Act* requires licensees to have adequate arrangements in place to manage conflicts of interests (s 912A(1)(aa)) and for information about remuneration and interests that are capable of influencing the advice to be disclosed to clients through the statement of advice (s 947B when the statement of advice is provided by licensees and s 947C when the statement of advice is provided by the authorised representative). In addition, the *Corporations Act* places an obligation on licensees and authorised representatives to ensure that the advice is appropriate for the client (s 945A).

18 Explanatory Memorandum, Corporations Amendment (Future of Financial Advice) Bill 2011 (Cth) 15.

V Penalties and Compensation

As Lindgren QC noted:

> The monetary remedies for breach of fiduciary duty will be, at the client's election, equitable compensation or an accounting for profit made by the financial adviser ... equitable compensation is compensation for loss suffered by the client, although the measure is not necessarily the same as for general damages.[19]

Under the remedies available in the Exposure Draft a breach of the statutory best interests obligation did not open the door to such equitable remedies. This was particularly the case with the account of profit remedy. Rather, and in line with the objective of the reforms to build trust and confidence in the industry, the remedies were disciplinary in nature and focussed on penalising the advisor for non-compliance. Interestingly, under the provisions of the Act an addition to the Court's remit has been granted. In determining the damage suffered to the client, the Court is now permitted to consider the profits resulting from any contravention. This is a reflection of the equitable 'account of profits' remedy that would be an available remedy for breach of the fiduciary duty.

There is no doubt that the imposition of the 'best interests obligation' through the framework of the *Corporations Act 2001* (Cth) is significant.[20] As with all legislative change there are those that support the legislation and those that are critical of the legislation.[21] The *real* question remains one of how and to what extent the imposition of the 'best interests obligation' will change practice, particularly given its prescriptive form?[22]

19 Lindgren, above n 15, 438.

20 As Money Management noted on 18 August 2001, 'The Government's Future of Financial Advice (FoFA) proposals combined with the long delays in delivering the actual legislation have served to drive down confidence among Australian financial advisers, with some so concerned, they are thinking of exiting the industry altogether. ... planner attitudes to the FoFA changes over the past 12 months [are] to a stage where 65 per cent of advisors now expect their businesses to be either worse off or significantly worse off under the new regime. Of that group 4 per cent have indicated they would likely be closing or selling their businesses': Mike Taylor, 'Confidence waning as FOFA Looms', *Money Management* (Sydney), 18 August 2011, 14.

21 See for example, the comments of Richard Batten who has suggested that, 'When it comes to the "best interest" obligations contained in the drafting, they represent the "worst of both worlds" ... We have principle-based regulation that you have to comply with, and the uncertainty of that, and then we also have a very prescriptive regime and the inflexible "tick a box" regime that comes with that.': Tim Stewart, *Draft FoFA Legislation 'Ridiculously Prescriptive'* 16 September 2011, Money Management <http://www.moneymanagement.com.au/news/Draft-FOFA-legislation--ridiculously-prescriptive> at 26 September 2011

22 See Duncan Hughes, 'Advisers, Clients Agree on Key Point', *The Australian Financial Review* (Sydney), 26 September 2011, 42.

With that said, it still must be acknowledged that the imposition of a 'duty' has been anticipated since the 2009 Parliamentary Report, with much work done within the industry to prepare for it. Even without the imposition of the obligation it should be noted that many financial advisers, as a matter of course, have been applying a form of the 'best interests obligation' through compliance with professional Codes of Ethics and Rules of Professional Conduct.[23] Consequently, there can be said to be recognition within this profession that being 'a professional' includes a concomitant professional obligation to put the client first. In this context the 'heat' must have been taken out of the argument of whether the financial adviser/client relationship needs to be reconsidered to be accepted as sufficiently 'fiduciary-like'.

Further, the industry through the profession had already made changes to practice in advance of the FoFA reforms. In this sense, the regulation is only in place to capture those (very small percentage of) financial advisers who act unprofessionally by putting their own interests ahead of their client's interest. From that perspective, the compliance requirements of the FoFA Reforms are already inherent within the profession. The prescriptive nature of the duty then just becomes a process through which that professionalism is communicated and monitored. Obviously changes will need to be made within practices to ensure that each of the elements of the 'best interest obligation' are met and communicated to clients, and thus discharged. Arguably, the prescriptive elements of compliance in that regard should be treated (and welcomed) as a lens through with advice can be crafted.

VI Conclusion

The 2009 Parliamentary Report recommended that a statutory fiduciary duty be imposed upon financial advisers. This recommendation has been tempered somewhat within the 'best interests obligation' ultimately enacted. Whilst the 'best interests obligation' requires that the client's interests be put first, a number of factors – the prescriptive nature of the elements of compliance with the duty, the recognition that there may be circumstances in which there may be a conflict of interest with respect to remuneration, and the imposition of a penalty for non-compliance and breach of the duty highlight that the 'best interests obligation' – is not a statutory manifestation of the general law fiduciary duty. This is not to dismiss the importance or significance of the imposition of the statutory duty on the industry or to suggest that no change

23 In that regard it should be noted that the Financial Planning Association of Australia has been doing a lot of work in this area and has rewritten/updated its Code of Ethics and other professional practice standards. See <http://www.fpa.asn.au/media/FPA/FPA%20Standards/CodeofPractice_July%202011.pdf>.

to practice will be required. Rather, it highlights that the position of financial advisor has developed to require a client-focused approach be taken with respect to financial advice provision. Through this statutory rather than equitable – lens, the prescriptive nature of the obligation should be seen then as a guidance mechanism through which advice is communicated and compliance monitored.

Case notes