NAVIGATING THE AUSTRALIAN BANKING AND FINANCIAL SERVICES REGULATORY LANDSCAPE IN THE WAKE OF THE BANKING ROYAL COMMISSION FINAL REPORT

The final report brings Australia's highly retail-focused Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry to a close, with a series of recommendations which, in an election year, promise to reshape the regulatory compliance and enforcement landscape for the entire industry.

OVERVIEW

Picking up from where the interim report (published in September 2018) left off, the final report details a range of issues that have been identified from the matters examined by the Commission over its seven rounds of public hearings, as well as their causes, before laying out the Commission's responses and some 76 recommendations for legal and regulatory reform. Key among these are recommendations designed to address identified cultural failings pervading both the industry and its regulators, including failings by the industry to eliminate conflicts of personal interest and duty, and failings by regulators, particularly the Australian Securities and Investments Commission (**ASIC**), properly to take account of the public interest in its pursuit of enforcement outcomes.

Some of the recommendations are more prescriptive than others, leaving room for political and policy considerations to weigh heavily on legislative and regulatory reform. And though both major political parties have expressed unequivocally an intention to implement all but one of the Commissioner's recommendations, with an election due in May 2019 and the Government having resisted the Labor Opposition's calls for additional sitting days to implement the Commissioner's recommendations, the finer details of a great many of the recommendations and the shape of their implementation will remain up for debate and will not likely be known until after the election. Nevertheless, the impact of several of the Commissioner's recommendations is already being felt, and the nature of several others is such that banks and financial services firms need to be taking steps now to prepare for inevitable reform and a new era of more intensive regulatory scrutiny.

Key issues

- The final report outlines a range of issues (largely retail-focused) identified by the Commission, and sets out its responses and 76 recommendations for legal and regulatory reform.
- Key recommendations include reforms to address culture, governance, accountability and remuneration given widespread failings by industry and regulators.
- The Government and Opposition are committed to implementing the Commission's recommendations but the final form and timing of reforms is unclear.
- What is clear is that the reforms will give rise to a new era of more intensive regulatory scrutiny, including more investigations, enhanced cooperation and information-sharing between regulators and a "Why not litigate?" approach to enforcement by ASIC.

KEY MATTERS RAISED BY THE FINAL REPORT

The final report is structured around a series of four key questions which were submitted to the Commission by the Australian Department of Treasury in response to the interim report. These questions were directed at understanding how:

- the law can and should be simplified so that its intent is met;
- the approach to addressing conflicts should be changed from managing conflicts to removing them entirely;
- improvements could be made to ensure compliance with the law and industry codes, and the effectiveness of the regulators, to deter misconduct and to ensure that grave misconduct is met with proportionate consequences; and
- to achieve effective leadership, good governance and appropriate culture within financial services firms so that (amongst other things) firms obey the law, and do not mislead or deceive.

The Commissioner did not hesitate to agree with Treasury's statement that the answers to these four questions would "provide the four pillars of any comprehensive policy response to what the Commission has publicly exposed". Indeed, the Commissioner has made several recommendations touching on each of these four topics. Among these are recommendations which are likely to change the financial services regulatory landscape in three key areas:

- **structural improvements to the banking and financial services regulatory regime**, including simplifying the law by reducing the number of exceptions and carve-outs, introducing overarching principles or "norms of behaviour" to better ensure that the intention of particular and detailed rules is met, carrying into effect the recommendations of the Department of Treasury's 2017 ASIC Enforcement Review Taskforce regarding self-reporting, and better cooperation and information sharing between the conduct regulator ASIC and the Australian Prudential Regulation Authority (**APRA**);
- **firm culture, governance, remuneration and individual accountability**, including recommendations regarding the administration and scope of the Banking Executive Accountability Regime (**BEAR**); and
- **ASIC's approach to regulatory enforcement**, including laying down the challenge to ASIC to consider as a starting point in any enforcement action the question "**Why not litigate?**".

Structural improvements to the banking and financial services regulatory regime

From as early as the first sign of misconduct in the Commission's work, public debate has centred around how the law can be improved to produce better regulatory outcomes. Much of the focus of this debate has been on the complexity of the current regime, with the Commissioner himself acknowledging in the interim report that a solution to the problem is unlikely to be found in adding a new layer of regulation, which would only serve to distract from the core and objectively simple concepts that ought to inform the conduct of financial services entities, namely: obey the law, do not mislead or deceive, be fair, provide services that are fit for purpose, deliver services with

reasonable care and skill and when acting for another, act in the best interests of that other.

In the final report, the Commissioner has made it plain that he considers the law ought to be considerably simplified. His recommendations on this topic are somewhat scattered through the final report and leave considerable room for policymakers to deliberate on the shape that any legislative reform should ultimately take. A number of the recommendations suggest that the Commissioner had in mind a shift towards a regulatory model which more closely resembles the UK financial services regulatory regime. In particular, the Commissioner has recommended that:

- so far as possible, legislation governing financial services entities should identify what fundamental norms of behaviour are being pursued when particular and detailed rules are made about a particular subject matter—a recommendation which may be interpreted by the major parties as a directing a shift towards principles-based regulation akin to the UK model;
- all exceptions and limitations to generally applicable norms of conduct in legislation governing financial services should be eliminated, since these detract from and serve to complicate the law and obscure its underlying principles and purposes;
- the BEAR be co-regulated between ASIC and APRA (see below)—which importantly would involve Authorised Deposit-Taking Institutions (**ADIs**) and authorised persons (and potentially other financial services entities, if the scope of the BEAR is extended) being required to deal with both ASIC and APRA in an open, constructive and cooperative way;
- implementation of the 2017 ASIC Enforcement Review Taskforce Report recommendations regarding self-reporting, including:
    - retaining but clarifying the "significance test" to ensure that the significance of breaches is determined objectively;
    - that the obligation to report should expressly apply to misconduct by an employee or representative;
    - that significant breaches and suspected significant breach investigations that are continuing must be reported within 30 days;
    - that the required content for breach reports should be prescribed by ASIC and be lodged electronically;
    - that criminal penalties should be increased for failure to report as and when required;
    - that a civil penalty should be introduced in addition to the criminal offence for failure to report as and when required;
    - that a cooperative approach should be encouraged where licensees report breaches, suspected or potential breaches or employee or representative misconduct at the earliest opportunity—the Commissioner emphasising, however, that it should always be recognised that making a proper breach report on time is what the law requires;
    - that ASIC should publish breach report data annually—the Commissioner adding that breach report data should not only be aggregated by breach type but also by individual reporting entity, and

that those who deal with licensees should have access to the reports that the law obliges the licensee to make to the regulator about objectively significant breaches or likely significant breaches of the financial services laws.

In addition, the Commissioner has recommended that the law be changed to oblige each of ASIC and APRA to cooperate with each other, share information to the maximum extent practicable and notify the other when it forms the belief that a breach in respect of which the other has enforcement responsibility may have occurred, including requiring them to prepare a joint memorandum of understanding setting out how they intend to comply with their legislative obligation to cooperate with each other, to be reviewed biennially.

These recommendations, taken together, have the potential to redefine the relationship between firms and, in particular, the conduct regulator ASIC. They could also serve to highlight further a present tension between a desire, on the one hand, to promote openness, transparency and cooperation to produce better regulatory outcomes, and the policy of a law which in many instances attaches criminal liability to underlying misconduct and requires ASIC to discharge a heavy onus of proof to achieve a court-ordered regulatory enforcement outcome. This tension is heightened further by the Commissioner's focus in his final report on ASIC's enforcement culture, as discussed in further detail below. Much will depend on precisely how these recommendations are implemented and whether we will see a wholesale reform of the regulatory regime or more subtle, incremental change.

Firm culture, governance, remuneration, individual accountability and the BEAR

Inevitably, the final report has heaped further considerable pressure on all banks and financial services entities to improve their culture, governance and remuneration practices, including ensuring that they remain under close internal review, that any problems are promptly identified and dealt with, and that any changes which are made as a result of this process are reviewed for their effectiveness.

This recommendation is directed at all banks and financial services entities themselves rather than lawmakers and regulators and, as the Commissioner has admitted, "expressed only at a level of generality", though the Commissioner has gone to considerable lengths to emphasise the importance of the recommendation as a vital step towards preventing misconduct. Further, the Commissioner has explained that the recommendation should be seen as reflecting and building upon other recommendations made in the final report, several of which are directed at eliminating where possible conflicts of interest and conflicts between personal duty and personal interest.

Though this recommendation is rather unlike others in the final report in the sense of its generality and the fact that it does not stipulate a change in the law—to the contrary, the Commissioner recognises that "culture cannot be prescribed or legislated"—legislative and regulatory reform aimed at addressing poor culture is certain to follow. For one reason, the Commissioner has, almost in the same breath, issued a series of reprimands and recommendations directed at the regulators—chiefly APRA but also ASIC—cautioning them not only to maintain but intensify their recent scrutiny

of firm culture, governance and remuneration practices in the discharge of their supervisory and regulatory enforcement functions.

For another reason, the Commissioner has paid special credence to international regulatory reform in this area, including the recent work of the Financial Stability Board (**FSB**) and G30 pinpointing areas for urgent reform as a function of proper supervision, particularly proper regulatory supervision. The Commissioner has charged APRA in particular with building a supervisory program reflective of the FSB's April and November 2018 recommendations, that should be focused on building culture that will mitigate the risk of misconduct, including taking a risk-based approach to its reviews, assessing cultural drivers of misconduct and encouraging entities to give proper attention to sound management of conduct risk and improving entity governance. APRA has also been tasked by the Commissioner with improving its prudential standards governing the design and implementation of remuneration systems.

Legislative change in this area and the related topic of individual accountability is also likely to follow in the shape of adjustments to and the expansion of the scope of the BEAR. The Commissioner has made a series of recommendations to bring the BEAR more into line with overseas equivalents (in particular the UK Senior Managers and Certification Regime), including that the BEAR be administered by APRA and ASIC jointly, and that, over time, it be extended to all APRA-regulated institutions, not just ADIs.

The Commissioner has envisaged a division of responsibility between ASIC and APRA such that ASIC would be responsible for overseeing and enforcing relevant parts of the BEAR that concern consumer protection and market conduct matters, with APRA responsible for overseeing and enforcing the BEAR to the extent it concerns prudential matters. And, importantly, the Commissioner has also recommended that the existing obligations on ADIs and accountable persons should be extended to make it clear that an ADI and accountable person must deal with both APRA and ASIC in an open, constructive and cooperative way—a legislative change which is likely to have significant repercussions both in respect of any role that ASIC acquires in implementing the BEAR and in the discharge by ASIC of its wider functions.

Legislative and regulatory reforms in these areas and an increased regulatory focus on culture, governance and remuneration practices will likely put regulated firms under considerable pressure, both as to time and resources. As the Commissioner has noted, what is required of regulated firms is more than a "box-ticking" exercise. A review of an assessment of culture, governance and remuneration practices is likely to require a considerable investment of time, money and intellectual rigour, including undertaking thorough internal investigations and, potentially, a holistic realignment of the firm's values, systems and practices. These factors would suggest that there is no time to waste in embarking upon this process—particularly if legislative and regulatory changes are introduced as a matter of priority following the May 2019 election, as both major parties are promising.

Why not litigate?

Though this question has an air of the rhetorical, it must be understood in context. The Commissioner has not said that ASIC ought to proceed to litigate every identified regulatory breach. Nor has the Commissioner said that ASIC should always rule out the use of enforceable undertakings or other forms of negotiated outcomes. On the contrary, the Commissioner was at pains to

emphasize that litigation requires careful thought and planning, and that all forms of regulatory enforcement must remain under active consideration throughout a regulatory investigation, unless and until it is plain that the public interest requires that there be no litigation. The Commissioner's recommendations were more subtle than imbuing ASIC with a one-size-fits-all approach to regulatory enforcement, seeking to address perceived cultural problems underpinning ASIC's enforcement approach that were considered to have provided ineffective and inequitable regulatory outcomes.

The Commissioner's point on this can be stated succinctly: ASIC's role as litigator is distinct from that of private persons because it involves the exercise of public power for public purposes. It should follow that questions as to the cost, difficulty or uncertainty involved in ASIC taking enforcement litigation as opposed to seeking to reach a negotiated outcome must always be assessed bearing in mind that ASIC's function is to enforce the financial services laws of the Commonwealth, and that the proper discharge of that function is critical to safeguarding the financial system and the economy, protecting the public, deterring misconduct and upholding the rule of law.

The bigger point involving the "Why not litigate?" question is: just what will change in practice? Will ASIC accept the Commissioner's guidance for what it is—a recommendation that ASIC adopt a different approach to enforcement decision-making, whatever shape its enforcement action may ultimately take in a given case—or will ASIC treat it as some form of mandate to "default" to litigation and disregard other regulatory tools at its disposal?

It is to be expected that ASIC will feel compelled to take a harder-line approach to serious breaches going forward, to seek to demonstrate to the public that it has taken steps towards "positive" change. It will also feel the need to be seen to be honouring its commitment (announced in its submission to the interim report) to "accelerating enforcement activities" and "conducting more civil and criminal court actions against larger financial institutions".

Nevertheless, ASIC is likely to be cautious not to be bullish for the sake of bullishness, lest it erode its reputation further. It is to be expected that ASIC will remain mindful of the requirements imposed upon it as regulator and as a model litigant, its higher onus of proof in criminal and civil penalty cases, resource constraints and other factors pointing to good public reasons not to pursue a particular case.[1] And ASIC will need to remain conscious of its markedly improved criminal and civil litigation success rate over recent years, having in its 2017-18 Annual Report announced a 100% criminal litigation success rate (up from 91% in 2016-17), 99% civil litigation success rate (also up from 91%) and recoveries of $42.2m in civil penalties (up from $5.2m)—results achieved in circumstances where ASIC had commenced around three times as many criminal proceedings in 2017-18 than 2016-17 (albeit the number of investigations and civil proceedings commenced had fallen by around 25-30%).

Despite these competing considerations, the Commissioner's admonishments of ASIC will prompt it into action in one way or another. In the short to medium term at least, this will most likely mean more ASIC investigations, even if it

[1] In this connection, ASIC Deputy Chairman Daniel Crennan QC has reportedly recently made the case to offices of Treasurer Josh Frydenberg and shadow treasurer Chris Bowen for expanding the law to make it easier to take criminal action against individuals for contraventions of financial services laws.

does not mean there is a noticeable uptick in the commencement of civil or criminal proceedings.[2]

ASIC may feel it has a mandate to investigate as though it is preparing for inevitable litigation, regardless of whether it has other forms of regulatory enforcement in mind. This mandate will be fuelled as much by the Commissioner's words as by the steps which have been taken in parallel by Parliament to implement the recommendations of the December 2017 ASIC Enforcement Review Taskforce Report, including the recent passage of legislation to significantly increase civil and criminal penalties for breaches of financial services laws. And ASIC is likely to feel that more thorough and more onerous investigations are necessary even if it ultimately pursues a negotiated outcome, including to help it properly to frame the terms of such a settlement and to avoid potentially repeating mistakes of recent past, such being unable in late 2018 to secure the approval of the Federal Court to consent orders agreed with Westpac to resolve its civil penalty proceeding for breach of responsible lending laws.[3]

A key challenge for regulated firms will be navigating their ever-evolving relationships with ASIC, bearing in mind their reporting obligations (including, as noted above, implementation of the ASIC Enforcement Review Taskforce Report recommendations in relation to self-reporting and the likely introduction into the BEAR of a requirement on ADIs and authorised persons to deal with ASIC in an open, transparent and cooperative way). Time will tell how ASIC addresses the balance between the public interest in encouraging transparency, disclosure and cooperation to bring about more efficient and effective regulatory outcomes (to remedy what ASIC had termed the "trust deficit facing the financial services sector"), on the one hand, and the public interest in properly enforcing contraventions of the law, including through the courts as appropriate, on the other hand. As the Commissioner has said, ASIC will often have to answer the "Why not litigate?" question in circumstances where the entity itself has provided a breach notification, knowing that the first document to be tendered in any such litigation will show what the entity has said it has done or may have done in contravention of the law. And, as the Commissioner has also said, answering the "Why not litigate?" question will call for skill and judgment.

The Commission's final report is available here. The ASIC Enforcement Review Taskforce Report is available here.

[2] As a start, ASIC announced on 19 February 2019 that it is undertaking or considering investigations into 41 matters revealed during the Royal Commission, including 11 specific referrals to it in the Final Report, 2 referrals made during the course of the Royal Commission's hearings, 12 matters that were case studies before the Royal Commission and another 16 case studies which it is assessing to determine whether investigations should be commenced.

[3] See *Australian Securities & Investments Commission v Westpac Banking Corporation* [2018] FCA 1733.

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