

# BEST INTEREST DUTIES OF FINANCIAL ADVISERS — MORE LAW, MORE CONFUSION

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## ABSTRACT

Best interest is a commonly used and misunderstood phrase interpreted differently in the law, media, legislature and throughout the investment chain, sometimes glibly. For investors, best interest has been confused with oft-misguided concepts of undivided loyalty to their economic interests.

These differing interpretations influence every financial advice relationship, including process. That process differs with varying statutory applications of best interest. For example, best interest in Australian investment decisions conflicts with modern portfolio theory. The law is complex, often uncertain, and lags comparative jurisdictions. The FASEA<sup>2</sup> Code of Ethics creates new law that adds to that uncertainty. Financial advice is provided throughout the investment chain. Competency requires comprehension of the underlying best interest duties governing those financial assets. The courts will also need to have regard to these other contextual interpretations of best interest to resolve uncertainty. That includes the best interest heritage in equity.

## ORIGIN OF THE BEST INTEREST DUTY

The heritage of the best interest duty lies in equity. This means a fiduciary duty to give undivided loyalty to the beneficiaries and ‘trustees must do the best they can for the beneficiaries and not merely avoid harming them’.<sup>3</sup> Meaning: ‘a combination of the established duties’<sup>4</sup> rather than ‘a distinct and separate duty ... not an obligation to act in a way which the trustee honestly considered to be in their interests, but a positive obligation to act in what are, objectively, their interests’.<sup>5</sup> The trustees’ duty of undivided loyalty is ‘the most fundamental duty of a trustee’.<sup>6</sup> ‘The duty of loyalty is, then, the fruit of the courts’ efforts to regulate the behaviour of trustees when their duties as trustees

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<sup>3</sup> *Cowan v Scargill* [1985] Ch 270, 295 (Sir Robert Megarry V-C).

<sup>4</sup> John Lehane, ‘Delegation of Trustees’ Powers and Current Developments in Investment Funds Management’ (1995) 7 *Bond Law Review* 36, 38.

<sup>5</sup> *Ibid* 37.

<sup>6</sup> Mark L Ascher, Austin Wakeman Scott and William Franklin Fratcher, *Scott and Ascher on Trusts* (Wolters Kluwer Law & Business, 5<sup>th</sup> ed, 2007) 1077.

require them to act in ways that may or do conflict with their own personal interests'.<sup>7</sup> Hence, the best interests duty

is an 'umbrella' duty which embraces a large number of individual, well recognised duties<sup>8</sup> which is in addition to other trustee duties and includes 'pursuit of the best possible authorised end or outcome for the trust as a whole but also the observance of proper procedures and processes in decision making'.<sup>9</sup>

So, whilst a trustee may not actually achieve the best possible outcome for the beneficiaries, the trustee must act objectively, not just honestly, in striving to achieve that result.

[I]t is difficult to discern the outer boundaries of the best interests duty and 'the statute alone does not make clear where the boundary lies' and it is appropriate to consider the meaning of the term under general law.<sup>10</sup>

Best interests in their statutory formulations<sup>11</sup> are mostly not defined, using general law phraseology of variable interpretation. More recent extension of superannuation covenants to corporate trustee directors personally, will require them to pay homage to the boundaries of the general law. That is also the position under the FASEA Code of Ethics, being additional to and different from other statutory provisions in the *Corporations Act*. Industry consolidation and vertical integration in financial services further complicate these duties because of the context specific interpretations of best interest. In Australia, general law interpretations of 'umbrella duty' have given way to statutory best interest duties which have little legal form, 'benefit' ... "interests" or "best interests" being used interchangeably.<sup>12</sup>

'[T]he case law directly interpreting and applying the relevant provisions is scant'.<sup>13</sup> Some guidance in a statutory superannuation context of best interest and conflicts of interest are provided in *Kelaber*.<sup>14</sup> '[T]he trustee's best interests obligation ... requires ... that the trustee seek to achieve the best outcome ... judged in relation to the risks of a particular action...'<sup>15</sup> Best interest decisions should be objective with the decision maker (the trustee)

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<sup>7</sup> Ibid 1079.

<sup>8</sup> *ASIC v Australian Property Custodian Holdings Limited (Receivers and Managers appointed) (in liquidation) (Controllers appointed) (No 3)* [2013] FCA 1342 (12 December 2013) [475] (Murphy J).

<sup>9</sup> Ibid [475] (Murphy J).

<sup>10</sup> Ibid [463] (Murphy J).

<sup>11</sup> *Corporations Act 2001* (Cth) ss 601FC(1)(c), 601FD(1)b, 961B(1), 961B(2), 181, 180(2)(d), 766E, 964, ch 8B, 921U(2)(b); Superannuation Industry (Supervision) Act 1993 (Cth) ss 52(2), 52(8), 10, 29 VN(a)-(b); Fair Work Act s 382 (amended 2016). The best interest duty of mortgage brokers is yet to be enacted.

<sup>12</sup> David Pollard, 'The Short-form "Best Interests Duty" — Mad, Bad and Dangerous to Know: Part 1 — Background, Cowan v Scargill and MNRPF' (2018) 32(2) *Trust Law International* 106, 136, 147 quoting Lord Nicholls, "Trustees and their broader community: Where duty, morality and ethics converge" (1995) 9 *Trust Law International* 7 cited in M Scott Donald, Submission to *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (21 September 2018) [3].

<sup>13</sup> Pamela F Hanrahan, 'The relationship between equitable and statutory "best interests" obligations in financial services law' (2013) 46(1) *Journal of Equity* 7 [V].

<sup>14</sup> *Australian Prudential Regulation Authority v Kelaber* [2019] FCA 1521 (Jagot J).

<sup>15</sup> Ibid [49], [64] (Jagot J).

having properly informed itself at the time of the decision. ‘The test is objective ... to be applied prospectively ... without permissible hindsight’.<sup>16</sup> Best interest is concerned with action, not process.<sup>17</sup> The conflicts of interest covenant is different and more onerous,<sup>18</sup> with subjective and objective elements, whilst recognising that conflicts of interest are ‘inevitable’ and must be managed.<sup>19</sup> Conflicts of interest must ‘have actually arisen rather than [being] mere possible future conflicts’.<sup>20</sup> In this context, ‘conflicts which need to be managed are actual conflicts which have the capacity to significantly impact on the duty to act in the best interest of the beneficiaries’.<sup>21</sup> A financial adviser meeting these tests would not be compliant with the FASEA Code of Ethics despite that advice being in a superannuation context.

Whether the superlative ‘best’ has legal meaning at all,<sup>22</sup> or whether it raises community expectations which are different from their legal basis further confuses present Australian law. It is not a formulation that can be taken literally and some opine that ‘best’ should not appear in the law at all.<sup>23</sup> Its statutory use in short form ‘does not exist [at law] ... is not a free-standing duty ... does not override the terms of the trust ... and does not replace the proper purposes requirement’.<sup>24</sup> A literal interpretation is necessarily subjective, can be retrospective, and sets ‘an impossible standard. . .’<sup>25</sup> In Australia, a literal interpretation of best interest may mean that trustees should not charge fees or seek indemnity.<sup>26</sup> Until tested, this remains a risk for financial advisers.

Indeed, ‘a literal best interest duty would be impossible to comply with fully — there could always be more that the trustee board could do’.<sup>27</sup> There is a distinction between ‘best interest’ and ‘best outcome’, this latter being akin to notions of community expectations. The benefits of hindsight may be an expectation, but it is not the law: it requires carrying out the terms of the trust which, assuming overlying statutory compliance,<sup>28</sup> constitutes best interest not only of the trust but also of the beneficiaries of the trust.

Notions of ‘broader community’ where ‘duty, morality and ethics converge’<sup>29</sup> pre-date Hayne’s confluence of ‘law and morality’. Whether these constitute best interest in

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<sup>16</sup> Ibid [55] (Jagot J).

<sup>17</sup> Ibid [62] (Jagot J).

<sup>18</sup> Ibid [78] (Jagot J).

<sup>19</sup> Ibid [78]–[79] (Jagot J).

<sup>20</sup> Ibid [71] (Jagot J).

<sup>21</sup> Ibid [79] (Jagot J).

<sup>22</sup> Pollard, (n 12) 106.

<sup>23</sup> Ibid.

<sup>24</sup> Pollard, (n 12), 106, 108–9.

<sup>25</sup> Pollard, (n 12), 106, 109.

<sup>26</sup> Joe Campbell, ‘Some Aspects of the Civil Liability Arising from Breach of Duty by a Superannuation Trustee’ (2017) Legal Studies Research Paper 17/31, Sydney Law School, University of Sydney.

<sup>27</sup> Pollard, (n 12), 106, 189 citing Lionel Smith, ‘Fiduciary relationships: ensuring the loyal exercise of a judgement on behalf of another’ (2014) 130 *Law Quarterly Review* 608.

<sup>28</sup> Superannuation Industry (Supervision) Act 1993 Cth ss 52(2)(c), 55(3), 56(2A), 29VO, 29VN, 29 VP

<sup>29</sup> Lord Nicholls, ‘Trustees and their broader community: Where duty, morality and ethics converge’ (1995) 9 *Trust Law International* 71.

Australian law are contextual with Parliament having scattered ‘statutory “best interest” duties with abandon’.<sup>30</sup>

### IS BEST INTEREST A FIDUCIARY DUTY?

Australian law has uncertain interpretation of the fiduciary status of best interest duties.<sup>31</sup> ‘Best interest’ needs to be applied carefully: the essential insight is that best interest is not the same as fiduciary duty, although its application is normally the responsibility of fiduciaries.

Fiduciaries may be status based (directors, trustees, agents) or contractors (financial planners in general law). Status based fiduciaries are subjected to positive statutory extensions of their duty conferring nexus between fiduciary and beneficiary (in APRA regulated superannuation) and member (in MIS). These statutory best interest provisions accorded fiduciaries are positive, prescriptive and sometimes discretionary. They operate concurrently with proscriptive no-conflict, no-profit without informed consent rules under statute and general law and with non-fiduciary duties including duty of care. Nonetheless, the statutory duties are essentially ‘fiduciary’.<sup>32</sup>

Unlike *Wingecarribee* and *Bathurst* where financial advice fiduciary relationships existed,<sup>33</sup> *Citigroup*<sup>34</sup> demonstrated it is possible in Australia to contract out of fiduciary responsibility: it can be extinguished — the law does not prevent an investment bank from contracting out of a fiduciary capacity; whether it should be able to do so is a matter for the legislature, not the courts.<sup>35</sup>

The critical matter in the end is the role that the alleged fiduciary has, or should be taken to have, in the relationship. It must so implicate that party in the other’s affairs or so align him with the protection or advancement of that other’s interest that foundation exists for the ‘fiduciary expectation’.<sup>36</sup>

‘Should be taken to have’ is the key to the mismatch between community expectation and practice. ‘[a] financial services licensee could make profits from information it received in the course of advising clients, or act in a way that was in conflict with the interests of a client, if it drafted its documentation so that it never had a fiduciary obligation to a client’.<sup>37</sup>

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<sup>30</sup> Pollard, (n 12), 106, 177.

<sup>31</sup> David G Millhouse, Evolution and Meaning of Fiduciary Duty — Inconsistency and uncertainty in fiduciary law for Australian directors’ in *Corporate Governance in Non-Bank Financial Entities* (Lexis Nexis Butterworths, 2019) 209 [5.1]–[5.20].

<sup>32</sup> *Alpha Wealth Financial Services Pty Ltd v Frankland River Olive Company Ltd* [2005] WASC 189 [33] (*‘Alpha Wealth’*).

<sup>33</sup> David G Millhouse, ‘Empirical Analysis supports the Hayne long run reform thesis’ (2019) 13(2-3) *Law and Financial Markets Review* 162. See generally David G Millhouse, *Corporate Governance in Non-Bank Financial Entities* (Lexis Nexis Butterworths, 2019).

<sup>34</sup> *ASIC v Citigroup Global Markets Limited (ACN 113 114832)(No 4)* [2007] FCA 963 (Jacobsen J).

<sup>35</sup> *Ibid* [7] (Jacobsen J).

<sup>36</sup> *Ibid* [274] (Jacobsen J) citing P D Finn, ‘The Fiduciary Principle’ in T G Youdan (ed), *Equity, Fiduciaries and Trusts* (Carswell, 1989) 1, 27.

<sup>37</sup> J C Campbell March 2014 ‘Fiduciary Relationships in a Commercial Context’ Legal Studies Research Paper No 14/26, Sydney Law School 54 <http://ssrn.com/abstract=2404202>.

This is the underlying tragedy of the FoFA reforms of 2012 which the Code of Ethics seeks to rectify.

### **BEST INTEREST IN INVESTMENT STRATEGY**

Best interest duties are severely compromised by lack of development of the law of what constitutes investment strategy, its deficient relationship with modern portfolio theory and practice, and the interface with investment jurisdictions that have developed the law. This affects decisions on inward outward/capital flows. It creates jurisdictional risk. There is a similar lack of definition of what constitutes a defence in due diligence.

As Donald notes, performance and appropriateness are both important objective criteria where there is no statutory definition of ‘investment strategy’.<sup>38</sup> ‘Courts are unlikely to be sympathetic towards trustees [or financial planners] whose lack of diligence or care exposes their trust to uncompensated risks’.<sup>39</sup> Risk is the corollary of return: prudence is not the absence of risk. These risks include valuation information from investment vehicles devoid of transparency (e.g. hedge and private equity funds, funds of funds). ‘Direct investment by trustees into such [alternative] investments raises the “due diligence” bar very high indeed’<sup>40</sup> with a ‘dramatic increase in the work required prior to and after investment to satisfy (and be seen to satisfy) the trustees’ duty of care’<sup>41</sup> Trustees of Australian superannuation entities must follow the prudent superannuation trustee standard in each discrete investment decision. That it may not result in optimal investment portfolio performance for the fund by the standards of modern portfolio theory is not relevant to the decision, resulting in further uncertainty.<sup>42</sup> This is not the case in US, Canada, and UK jurisdictions. Their law has evolved so that ‘prospective investments should be considered not in isolation from other investments, but rather in the context of the overall risk level of the fiduciary’s investment portfolio.’<sup>43</sup>

In the absence of a statutory definition of investment strategy,<sup>44</sup> ‘those responsible for the management of investment portfolios, such as trustees and their agents, are acutely worried that their actions will be judged with the benefit of hindsight or without regard for the portfolio context’.<sup>45</sup> ‘Due diligence’ is subjective and can ‘connote different things to different people’.<sup>46</sup>

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<sup>38</sup> M Scott Donald, ‘Prudence under pressure’ (2010) 4 *Journal of Equity* 44, 52.

<sup>39</sup> Ibid.

<sup>40</sup> Ibid 53.

<sup>41</sup> Ibid 52. See also Nuncio D’Angelo, ‘Private equity investing by financial institutions: Navigating hidden reefs in treacherous waters’ (2003) 31 *Australian Business Law Review* 311.

<sup>42</sup> Paul U Ali and Martin Gold, ‘An overview of “Portable Alpha” Strategies, with Practical Guidance for Fiduciaries and some Comments on the Prudent Investor Rule’ (2001) 19 *Company and Securities Law Journal* 276.

<sup>43</sup> Paul U Ali, ‘Adding Yield to Stable Portfolios: Regulating Investments in Australian Hedge Funds’ (2001) 19 *Company and Securities Law Journal* 426.

<sup>44</sup> Donald, (n 38).

<sup>45</sup> Ibid 51.

<sup>46</sup> Ibid 52.

Best interests of the trust are not necessarily the same as best interests of specific beneficiaries and the best interest duty allows trustees to not perform an action.<sup>47</sup> Best interest relies upon the purposes of the trust and what benefits were intended to be conferred on the trusts' beneficiaries.<sup>48</sup> It may mean 'best financial interest',<sup>49</sup> in which case choice of investment options (rather than default options) in superannuation products may expose trustee directors to claims arising from poor investment choices by the beneficiary<sup>50</sup> or their financial advisers. Best financial interest may mean long term financial interest requiring trustee responsibility for asset liquidity, beneficiary longevity, and other market-linked risks.

For MySuper products, there are additional requirements. These include a prescriptive duty to 'promote the financial interests of the beneficiaries',<sup>51</sup> and 'determine on an annual basis whether the beneficiaries are disadvantaged in comparison to beneficiaries of other funds holding a My Super product.'<sup>52</sup>

'The relationship between statutory provisions and the general law ... is much more problematic ... likely to tax the cognitive powers of its subjects just as surely as they impose a cost burden on them'.<sup>53</sup> What 'the interests' of aggrieved persons may be and how they ought to be protected are matters incapable of categorisation or of precise definition.<sup>54</sup>

### BEST INTEREST IN FINANCIAL ADVICE

Reasonable expectations of financial advice and its implementation may give rise to an equitable fiduciary relationship in personalised financial advice,<sup>55</sup> but is facts specific.<sup>56</sup> 'The precise content of that obligation is in every case, including that of each financial services firm, particular to the nature of the undertaking from which the fiduciary obligation springs'.<sup>57</sup> It may spring from the initial contact with a putative client 'advice about advice',<sup>58</sup> before providing the statutorily controlled 'substantive advice'.<sup>59</sup>

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<sup>47</sup> Ibid; See *Rouse v IOOF Australia Trustees Ltd* (1999) 73 SASR 484, 499–500.

<sup>48</sup> *Corporations Act 2001* (Cth) ss 181(1), 601FC(1)(c), 601FD(1)(c); *Superannuation Industry (Supervision) Act 1993* (Cth) s 52(2)(c).

<sup>49</sup> M S Donald, "Best" interests? (2008) 2 *Journal of Equity* 245, 256.

<sup>50</sup> Ibid 271.

<sup>51</sup> *Superannuation Industry (Supervision) Act 1993* (Cth) s 29VN.

<sup>52</sup> M S Donald, 'Regulating for fiduciary qualities of conduct' (2013) 7(2) *Journal of Equity* 142, 150.

<sup>53</sup> Ibid 159.

<sup>54</sup> *Australian Securities and Investments Commission v Bridgecorp Finance Ltd* [2006] NSWSC 836 [17] (Barrett J) citing *Australian Securities and Investments Commission v Mauer-Swiss Securities Ltd* [2002] NSWSC 684 (Palmer J).

<sup>55</sup> Pamela F Hanrahan, 'The relationship between equitable and statutory "best interests" obligations in financial services law' (2013) 7(1) *Journal of Equity* 46 [11].

<sup>56</sup> Ibid [111] citing *Maguire v Makaronis* 188 CLR 449, 467 (Brennan CJ, Gaudron, McHugh and Gummow JJ).

<sup>57</sup> Hanrahan, (n 55), [V1].

<sup>58</sup> Simone Degeling and Jessica Hudson, 'Fiduciary obligations, financial advisers and FOFA' (2014) 32 *Companies and Securities Law Journal* 527; Simone Degeling and Jessica Hudson, 'Equitable money remedies against advisers who give "advice about advice"' (2015) 33 *Companies and Securities Law Journal* 166.

<sup>59</sup> *Corporations Act 2001* (Cth) s 961B(2).

Much rests upon the Wallis inspired principles of disclosure and client ability to properly provide informed consent, both of which are subjective tests.

Mere disclosure of this information may not be enough to establish the level of fully informed consent that equity requires. The client must understand the impact of what is being disclosed in its position and its relationship with the financial services firm, and must give its consent (express or implied) to the existence of that conflict or collateral advantage ... the firm has the onus of proving that it obtained the client's fully informed consent to its obtaining any benefit, or acting when it had a conflict in, that relationship. The burden in equity is high, particularly where the client is unsophisticated.<sup>60</sup>

This echoes but is a different and lesser obligation than the German civil law doctrine of *culpa in contrahendo* being positive ex ante action requiring client comprehension which cannot be contracted away. Australian informed consent law is not a positive fiduciary duty — 'the existence of an informed consent goes to negate what otherwise would be a breach of [fiduciary] duty.'<sup>61</sup> The fiduciary must be in receipt of or obtain informed consent, but the obtaining of it is not a fiduciary duty. That process will depend on context, often in contract.<sup>62</sup>

There has been a common expectation by financial products investors seeking financial advice that there is a relationship based in fiduciary principles. Part of the mismatch in expectations has been poor financial literacy and misunderstanding of the law, but part is innate trust assumed by investors in professional persons with whom they deal.

Where a bank gives a customer advice upon financial affairs, then in addition to any contractual rights the customer may have, the relationship between the parties may be such as to found either, or both, a common law duty of care and a fiduciary duty.<sup>63</sup>

'A person offering personal advice to a retail client 'must act in the best interests of the client in relation to the advice'<sup>64</sup> The

duty is to furnish the client with all the relevant knowledge which the adviser possesses, concealing nothing that might reasonably be regarded as relevant to the making of the investment decision' and 'to give the best advice which the adviser could give if he did not have but a third party did have a financial interest in the investment to be offered, to reveal fully the adviser's financial interest, and to obtain for the client the best terms which the client would obtain from a third party if the adviser were to exercise due diligence on behalf of his client in such a transaction.'<sup>65</sup>

This applies in other advisory relationships:

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<sup>60</sup> Degeling, (n 58), 527 [111].

<sup>61</sup> *Maguire v Makaronis* 188 CLR 449, 467 (Brennan CJ, Gaudron, McHugh and Gummow JJ).

<sup>62</sup> See, eg, *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* [2007] FCA 963; *ABN Amro Bank NV v Bathurst Regional Council* [2014] FCAFC 65; *Wingecarribee Shire Council v Lehman Brothers Australia Ltd (in Liq)* [2012] FCA 1028.

<sup>63</sup> *Commonwealth Bank of Australia v Smith* [1991] FCA 375.

<sup>64</sup> Hanrahan, (n 55), 71.

<sup>65</sup> *Wingecarribee Shire Council v Lehman Brothers Australia Ltd (in Liq)* [2012] FCA 1028 [741] (Rares J).

Normally, the relationship between a stockbroker and his client will be one of a fiduciary nature and such as to place on the broker an obligation to make the client a full and accurate disclosure of the broker's own interest in the transaction. ... The duty arises when, and because, a relationship of confidence exists between the parties.<sup>66</sup>

Variance from these duties requires the fiduciary to obtain fully informed consent from their client. 'What is required for a fully informed consent is a question of fact in all of the circumstances of each case and there is no precise formula which will determine in all cases if fully informed consent has been given'.<sup>67</sup>

'The duties and obligations that Australian financial services firms owe to their clients derive from a complex set of rules and principles arising in common law (particularly contract and tort), equity (including fiduciary principles) and statute'.<sup>68</sup> Whilst financial services businesses are not recognised as status-based fiduciaries, and financial planners have no statutory fiduciary duty, the obligations are specific to the context in which financial services are provided and the contracts under which they are provided.

Where both the equitable and statutory obligations apply, the statutory duties do not displace the equitable principles ... [and] may well impose different (and more onerous) obligations on financial services firms than the statutory duties...<sup>69</sup>

The statutory best interest duty in financial advice is prescriptive,<sup>70</sup> including seven measures, and requires an appropriateness test for retail clients.<sup>71</sup> These are 'highly relevant to the Court's assessment of compliance with the best interest duty'.<sup>72</sup> They add to concepts of fiduciary duty in the same case, perhaps even subsuming them.<sup>73</sup> 'It is likely to be many years before the courts can interpret the content of the duty ... will take many years and many cases before it is clear how the best interest duty operates<sup>74</sup> ... and greatly complicates the existing regime of protections'.<sup>75</sup>

[T]he statutory best interest provision is a long way from what equity understands the 'best interest' concept to mean, on even the narrowest view of that understanding. ... The statutory best interest obligation is expressed as a series of steps to be undertaken, not as an obligation to prefer the client's interest over the firm's or to avoid the situations of conflict or collateral damage that fiduciary law proscribes ... [and is] a significant departure from the best interest obligations that apply in equity to financial advisers.<sup>76</sup>

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<sup>66</sup> Ibid [739] (Rares J).

<sup>67</sup> Ibid [742] (Rares J).

<sup>68</sup> Hanrahan, (n 55), 72.

<sup>69</sup> Hanrahan, (n 55), 73.

<sup>70</sup> *Corporations Amendment (Further Future of Financial Advice Measures) Act 2012* (Cth) s 961B; *Corporations Act 2011* (Cth) s 961B(1).

<sup>71</sup> *Corporations Amendment (Further Future of Financial Advice Measures) Act 2012* (Cth) s 961G.

<sup>72</sup> *ASIC, in the matter of NSG Services Pty Ltd* [2017] FCA 345 [18] (Moshinsky J).

<sup>73</sup> Donald, (n 52), 142.

<sup>74</sup> S Corones and T Galloway, 'The effectiveness of the best interest duty — enhancing consumer protection?' (2013) 41 *Australian Business Law Review* 5.

<sup>75</sup> Ibid 9.

<sup>76</sup> Hanrahan, (n 55), [V].



It is process driven, not outcome driven, provides a safe haven for advisers,<sup>77</sup> does not fulfil its original policy objectives of statutory fiduciary duty and therefore does not meet community expectations of what the law should mean. These include fiduciary obligations of undivided loyalty of financial and corporate advisers to their clients, and restorative remedies for breach. It further entrenches the doctrine of prioritisation over prohibition. '[I]t may operate to limit existing duties of financial advisers ... apparently contrary to the intention of the post-GFC reforms'.<sup>78</sup>

Subsequent testing in 2017 provides the proof: 100% of advisers in the sample relied on the statutory safe harbour provision. 75% of those advisers claiming reliance on it did not comply with their statutory best interest duty with 10% leaving their client in a worse financial position.<sup>79</sup> This is damning evidence of the subsuming of general law fiduciary obligation by compromised statute. It arose from the politicisation of the debate: it was a sop, sought to be remedied by the FASEA Code of Ethics.

Accretive statutory change has bizarre results:

the new law applies to some financial services firms who are not fiduciaries with respect to the giving of that advice at general law. However, because of the narrow definition of retail client, many financial advisers who are fiduciaries (for example, the advisers in *Wingecarribee* and *Bathurst*<sup>80</sup>) are not subject to the new law.<sup>81</sup>

'We live in the 'Age of Statutes'.<sup>82</sup> Insightfully, the intrusion of statute 'is all too evident in both the FoFA and Stronger Super reforms. It is manifest in the sheer number of provisions that have been required to achieve a small number of easily articulated objectives'.<sup>83</sup> 'The provisions relating to the prohibition of certain types of "conflicted remuneration" are particularly Byzantine'.<sup>84</sup>

### **BEST INTEREST IN FINANCIAL ADVICE IN THE UNITED STATES — AUSTRALIAN ECHOES**

Best interest duties in the US, as in Australia are:

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<sup>77</sup> *Corporations Act 2001* (Cth) s 961B(2)(a)–(g).

<sup>78</sup> Hanrahan, (n 55), [V].

<sup>79</sup> ASIC, *Financial advice: Vertically integrated institutions and conflicts of interest* (Report 562, January 2018) [151]–[152].

<sup>80</sup> *ABN Amro Bank NV v Bathurst Regional Council* [2014] FCAFC 65 (Jacobson, Gilmour and Gordon JJ).

<sup>81</sup> Hanrahan, (n 55), [V].

<sup>82</sup> Dimity Kingsford Smith, 'Is "due diligence" dead? Financial Services and products disclosure under the Corporations Act' (2004) 22 *Company and Securities Law Journal* 130.

<sup>83</sup> Donald, (n 52), 142 [3].

<sup>84</sup> *Ibid* [1].

highly ambiguous,<sup>85</sup> leaving significant practical questions unanswered, and investment advisers and their clients left to ‘divine, if not guess, the application in everyday business life of basic fiduciary obligations, such as the duty to provide impartial advice’.<sup>86</sup>

This ambiguity consumes hundreds [400] of pages describing the [proposed] new ‘best interest’ standard’.<sup>87</sup> Duties of financial advisers, however termed, in the US, are not necessarily fiduciary in nature and should only apply ‘where there is a broad delegation of power to manage another’s property...’<sup>88</sup> Describing non-fiduciary duties as part of the attempted uniform fiduciary standard has only served ambiguity and those that prosper from it. In Canada, these operate concurrently within the Client Relationship Model which provides for the alignment of fiduciary duty with the client engagement contract. In the US, a client engagement contract is mandatory with an alignment of fiduciary duty with the scope of engagement.<sup>89</sup>

Some opine that ‘standards should be based on analogous trust law concepts’,<sup>90</sup> and trust law should ‘inform the best interest standard’,<sup>91</sup> being in the entrustor’s sole interest.<sup>92</sup> Legal uncertainty is manifested, as in Australia, by the use of the adjective ‘fiduciary’ and the aphorism ‘best interest’, each applying in the different legal contexts of broker-dealers, investment advisers, including as they apply to DOL regulated pension funds. ‘A fiduciary under [ERISA] ... means something other than a fiduciary under the Investment Advisers Act of 1940. Even within the same legal context, the term “fiduciary” can change over time’.<sup>93</sup>

What is clear is that there is a difference between the meaning of fiduciary and the meaning of best interest. For broker-dealers, best interest is process driven, akin to s 961B(2) of the *Corporations Act*, a significant difference in the US being for the broker-dealer to eliminate rather than manage conflicts of interest with their clients, consistent with the FASEA Code of Ethics. For investment advisers, the fiduciary standard is principles-based but the proposed statutory best interest rules also apply. However, an investment adviser has an ongoing duty, whereas the broker-dealer has a transactional duty.

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<sup>85</sup> L Paglia, *Standard of Conduct for Advisors and Dealers: Exploring the Appropriateness of Introducing a Statutory Best Interest Duty when Advice is provided to Retail Clients* (Canadian Securities Administrators Consultation Paper 33—403, 2013) 19 citing A B Laby, ‘Current Issues in Fiduciary Law — SEC v. Capital Gains Research Bureau and the Investment Advisers Act of 1940’ (2011) 91 *Boston Law Review* 1051.

<sup>86</sup> Ibid citing Barry BP Barbash and Jai Massari, ‘The Investment Advisers Act of 1940: Regulation by Accretion’ (2008) 39 *Rutgers Law Journal* 627, 654.

<sup>87</sup> Hester M Peirce, What’s In A Name: Regulation Best Interest v. Fiduciary—Remarks before the NAPA DC Fly-in Forum (Washington DC, 24 July 2018) cited in Pamela Hanrahan, Information about Selected Aspects of Foreign Financial Services Regulation, Background Paper 30, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry [‘Hayne’] 41.

<sup>88</sup> Larry E Ribstein, ‘Fencing Fiduciary Duties’ (2011) 91 *Boston University Law Review* 899, 919.

<sup>89</sup> Knut A Rostad, *Re: Rule Making – Duties of Brokers, Dealers, and Investment Advisers* (Letter to the SEC, The Institute for the Fiduciary Standard, 2013) cited in Paglia, (n 85), 16.

<sup>90</sup> Nicholas S Di Lorenzo, ‘Defining a New Punctilio of an Honour: The Best Interest Standard for Broker-Dealers’ (2012) 92 *Boston University Law Review* 291, 292.

<sup>91</sup> Ibid 314.

<sup>92</sup> *Uniform Trust Code 2000* (US) § 802(a) followed in 2005 by 14 states and Washington DC cited in Di Lorenzo, (n 90), 315.

<sup>93</sup> Peirce, (n 87), 41.

As in Australia, where ‘best interest’ leaps from the lips of the less thoughtful, ‘[p]roposed Regulation Best Interest does not attempt to define best interest [other than the process of its application] because nobody can explain what it means’.<sup>94</sup> Including SEC Commissioners.<sup>95</sup>

#### THE FINANCIAL STANDARDS AND ETHICS AUTHORITY CODE OF ETHICS BEST INTEREST OBLIGATIONS

FASEA was established by amendments to the *Corporations Act*.<sup>96</sup> FASEA is subject to Ministerial oversight and parliamentary reporting. It is new law and does not replace existing best interest provisions:<sup>97</sup> It is not an overlay on, or consistent with those provisions. FASEA is statutorily mandated to create and enforce a Code of Ethics.<sup>98</sup> Its best interest obligations compulsorily apply to ‘relevant providers’, being financial planners (now a restricted term) and their firms, and to ‘monitoring bodies’. ASIC must be notified in cases of relevant provider actual or possible non-compliance.<sup>99</sup> A monitoring body must have ‘sufficient resources and expertise to appropriately monitor and enforce compliance with the Code of Ethics...’<sup>100</sup> This means that the relevant provider and the monitoring body must be able to decipher the Code’s best interest duties. The determination by the monitoring body is not a legislative instrument, but the Code is.<sup>101</sup>

The Code contains five values and twelve standards, imposed personally. The standards contain the best interest duties. These and the values are mostly subjective, but nonetheless have the force of law. Civil penalties apply. It applies to ‘relevant providers’<sup>102</sup> not only to traditionally termed financial advisers.<sup>103</sup> It introduces further confusion into the retail/wholesale investor typology by extending the interpretation of retail investor, an area which already requires law reform.<sup>104</sup> These values, noble as they are intended to be, the best interest duties, and the monitoring bodies’ enforcement power will need to be tested in the courts. Until then, ‘[e]ach [adviser] must be ready to give an account of how they have interpreted and applied the Code in specific situations’.<sup>105</sup>

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<sup>94</sup> Ibid.

<sup>95</sup> Brian Menickella, What Defines Best Interest? The SEC’s Entry into The Regulation Game, May 18, 2018 <https://www.forbes.com/sites/brianmenickella/2018/05/18/what-defines-best-interest-the-secs-entry-into-the-regulation-game/>

<sup>96</sup> *Corporations Amendment (Professional Standards of Financial Advisers) Act 2017* (Cth).

<sup>97</sup> *Corporations Act 2001* (Cth) Pt 7.7A Div 2 s 961B.

<sup>98</sup> Ibid s 921U(2)(b).

<sup>99</sup> Ibid s 922HD.

<sup>100</sup> Ibid s 921K.

<sup>101</sup> Ibid s 921E.

<sup>102</sup> Ibid s 910A.

<sup>103</sup> A relevant provider can be any person or entity licensed and engaged in transactional personal advice to FASEA’s interpretation of retail client. It could include stockbrokers, accountants, mortgage brokers, and sales representatives. See below (n 105).

<sup>104</sup> See, eg, (‘Wingecarribee’), (‘Bathurst’). See especially, David G Millhouse, *Corporate Governance in Non-Bank Financial Entities* (Lexis Nexis Butterworths, 2019) 194 [4.17]–[4.30].

<sup>105</sup> FASEA, *Financial Planners and Advisers Code of Ethics* (Guidance FG002, 2019) 6.

Best interest duties appear in Standards 2 (broader, long-term interests, likely future circumstances), 3 (indirectly, through conflict of interest), 5 (client comprehension, appropriateness), 6 (broader, long-term interests), 7 (indirectly, through value for money), and 9 (broad effects, broader long-term interest, likely circumstances, competence). The Code 'must be read and applied as a whole'.<sup>106</sup> Therefore, other provisions which themselves have been problematic in financial services law, become relevant to the interpretation of best interest duties. These other duties include truly informed consent and client comprehension. In addition, there is a public interest duty which will interface with evolving whistle-blower law.

Doubtless, the Code and FASEA itself are well-intentioned responses to egregious behaviour identified by Hayne and others, quantified by this author.<sup>107</sup> It seeks to convert an industry into a profession. However, the FASEA Code of Ethics is unlike Codes of various forms in other jurisdictions which operate on a comply-or-explain basis.

The Law Matters thesis<sup>108</sup> suggests jurisprudence underpins a competitive economy and the presumption that the law can facilitate economic development and not simply coerce, regulate and control.<sup>109</sup> 'Canadian corporate law follows the normative prescription that the law ought to provide the rules that parties want.'<sup>110</sup> The German Corporate Governance Code operates on a comply-or-explain basis, and with demonstrably improved empirical outcomes for investors.<sup>111</sup>

What is missing for effective and equitable implementation is the jurisprudence required to give the FASEA Code support. In civil law jurisdictions this is provided by the *untreue* principle (now codified in European Union statutes) and supported by contractual *culpa in contrahendo* standards. Together, these make for a close-to-personal liability jurisdiction. Also missing is the necessary supervisory architecture. In Canada, this is provided by the Client Relationship Model (which includes all form of fiduciary and non-fiduciary duties which may constitute best interest) enforced through Self-Regulatory Organisations. This model includes client comprehension in 'teachable moments'. Canadian financial advisers do not have the 'safe-harbour defence'.<sup>112</sup> These are jurisdictions which FASEA would be wise to follow.

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<sup>106</sup> Ibid 17.

<sup>107</sup> David G Millhouse, 'Empirical analysis supports the Hayne long run reform thesis' (2019) 13(2-3) *Law and Financial Markets Review* 162.

<sup>108</sup> Brian R Cheffins, 'Corporate Law and ownership structure: A Darwinian Link?' (2002) 25(2) *University of New South Wales Law Journal* 346 [2] citing Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property* (Macmillan, 1932).

<sup>109</sup> Justice Michael Kirby, 'The company director: past, present, and future' (Speech delivered at the Australian Institute of Company Directors, Tasmanian Division, Hobart, 1998).

<sup>110</sup> Anita I Anand and Edward M Iacobucci, 'An Empirical Examination of the Governance Choices of Income Trusts' (2011) 8(1) *Journal of Empirical Legal Studies* 147 citing Douglas J Cummings and Jeffery G MacIntosh, 'The Role of Interjurisdictional Competition in Shaping Canadian Corporate Law' (2000) 20 *International Review of Law and Economics* 141.

<sup>111</sup> Igor Goncharov Joerg Richard Werner and Jochen Zimmerman, 'Does Compliance with the German Corporate Governance Code have an impact on Stock Valuation? An empirical analysis' (2006) 14(5) *Corporate governance: The international journal of business in society* 432.

<sup>112</sup> *Corporations Act 2001* (Cth) s 961B(2).

## CONCLUSION

In Australia a financial adviser may comply with the existing best interest provisions of the *Corporations Act*, with trustee obligations as if they were a fiduciary, maintain their ‘punctilio of honour’ and honesty, comply with their client contract, but nonetheless not be compliant with the FASEA Code of Ethics.

Despite the publication of cameos describing various client circumstances,<sup>113</sup> these are not cases, do not establish precedent, and are not law. That is the realm of the courts. There is no obligation for the publishers of these cameos to follow their own guidance in future litigation. Relevantly, as Donald insightfully noted in a FoFA best interest context,

It is ironic, then that those same political processes that are privileging these nobler qualities [of fiduciaries] are in fact de-coupling the regulatory regimes from the general law antecedents in which those qualities were initially expressed. Political processes are ensuring that what the law expects of Mason J’s quintessential fiduciaries, or at least those whose activities encroach on areas of public policy, are regulated by multi-layered, highly specific, bespoke regulatory regimes that largely eclipse the proscriptions and prescriptions of the general law.<sup>114</sup>

In the meantime, financial advisers have unlimited personal liability – in quantum and in tenor, outcomes being dependent on future judicial determinations. *Caveat venditor*.

Future boards of FASEA will have no choice but to come to grips with the legal uncertainty its Code of Ethics has created. To quote David Pollard, ‘Short Form Best Interest — Mad, Bad and Dangerous to know’.<sup>115</sup> The reading list for the compulsory examination<sup>116</sup> contains no direct authoritative references to the central questions of best interest and, because of the way the Code is drafted, other law (for instance, what constitutes ‘informed consent’) which support the best interest duties. This raises doubts about the veracity of the examination for the adviser in their quest for legal certainty.

Its objectives are doubtless pure, but its Code of Ethics does not have the jurisprudence and statutory support of pure liability civil law countries or the necessary supervisory architecture for effective implementation. These will take some years. In the meantime, the Code should operate on a comply-or-explain basis. Advisers, for their own defence, may themselves want to become status-based fiduciaries by virtue of contract and apply absolutist fiduciary principles.<sup>117</sup> FASEA does not deploy ‘fiduciary’ either as noun or

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<sup>113</sup> FASEA, *Financial Planners and Advisers Code of Ethics* (Guidance FG002, 2019) 6.

<sup>114</sup> Donald, (n 52), 142 [2].

<sup>115</sup> Pollard, (n 12).

<sup>116</sup> FASEA, *Exam Preparation* (Guidance FG003, 2019) 6–9.

<sup>117</sup> David G Millhouse, *Corporate Governance in Non-Bank Financial Entities* (Lexis Nexis Butterworths, 2019) 286 [6.126]–[6.127]. See generally, *Meinhard v Salmon* 164 NE 545 (NY 1928) (Cardozo J) cited in Robert B Thompson, ‘The Story of Meinhard v. Salmon and Fiduciary Duty’s Punctilio’ (Working Paper Number 08044, Vanderbilt University Law School Public Law and Legal Theory, 2008) quoting Allison Gray Anderson, ‘Conflicts of Interest: Efficiency, Fairness, and Corporate Structure’ (1978) 25 *University of California Los Angeles Law Review* 738, 760.

adjective, but that is the legal implication of its Code of Ethics. This new law is de-coupled from its general law antecedents.<sup>118</sup>

The present danger is the Code be applied rigidly and onerously, becoming an end in itself, rather than a tool to benefit the financial consumer.<sup>119</sup> It is a reform with significant legal ramifications.

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<sup>118</sup> Donald, (n 113).

<sup>119</sup> Rt Hon Lord Denning, 'In the Court of Appeal — The need for a new equity', in *The Denning Family Story* (Centre for Commercial Law Bond University, 1981) 219, ch 10 227 [4][ii]. See also, Jesse Norman, *Adam Smith — What He thought, and Why it Matters* (Allen Lane Penguin Random House, 2018) Ch 10 The Moral Basis of Commercial Society.