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Ethical Dilemmas in Financial Service Conglomerates.

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Ethical Dilemmas in Financial Service Conglomerates

Christopher Wilson

Submitted in total fulfilment of the requirements of the degree of Doctor of Philosophy (PhD)

November 2021

Faculty of Law

Professor John Farrar, Dr Simone Kelly and Dr Louise Parsons

ABSTRACT

Conflicts of interest, related party transactions and other ethical dilemmas are common in financial services and present challenges for corporate law, regulation and self-regulation in Australia and the UK. Deregulation encourages conglomeration, reduced competition and increased complexity, opacity, and regulatory arbitrage.

The global financial crisis and the Hayne Royal Commission have demonstrated shortcomings in the organisational culture of financial services conglomerates. This thesis addresses these problems and the role that culture and governance play in the management of these dilemmas. It makes some recommendations for reform of the law and practice.

These recommendations include the production of a clear, regulatory instrument, clearly explaining the obligations of persons engaging in potential conflict of interest and related party transaction situations. They also include the production and/or reinforcement of appropriate internal procedures for managing ethical dilemmas and calls for further conglomeration in financial services to be prohibited, with fringe operations being sold off by these financial service conglomerates.

Keywords

ethical dilemmas, conflicts of interest, financial services, related party transactions, banks, financial service conglomerates.

DECLARATION BY AUTHOR

This thesis is submitted to Bond University in fulfilment of the requirements of the degree of Doctor of Philosophy by Research.

I declare that the research presented within this thesis is a product of my own original ideas and work and contains no material which has previously been submitted for a degree at this university or any other institution, except where due acknowledgement has been made.

Name: Christopher Wilson

Signature:

Date: 30th November 2021

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The second (and most important) half of this PhD was conducted amidst a global pandemic. When the pandemic hit, everything changed. I had a life, and I had friends, and I miss all of them. Regardless, my supervisors and I remained resilient throughout and pushed this project through to completion. I learned that with hard work and the right support, no obstacle is insurmountable, even the ones you didn't see coming.

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LIST OF ABBREVIATIONS

AASB	**Australian Accounting Standards**
ABA	**Australian Banking Association**
ACCC	**Australian Competition and Consumer Commission**
ADI	**Authorised Deposit-Taking Institution**
AFCA	**Australian Financial Complaints Authority**
AFS	**Australian Financial Services License**
ANZ	**Australia and New Zealand Banking Group**
APRA	**Australian Prudential Regulation Authority**
ASIC	**Australian Securities and Investments Commission**
ASX	**Australian Securities Exchange**
BEAR	**Banking Executive Accountability Regime**
BIS	**Bank for International Settlements**
BoE	**Bank of England**
CBA	**Commonwealth Bank of Australia**
CPMA	**Consumer Protection and Markets Authority**
EU	**European Union**
FCA	**Financial Conduct Authority**
FOFA	**Future of Financial Advice Amendments**
FRC	**Financial Reporting Council**
FSA	**Financial Services Authority**
FSB	**Financial Stability Board**
FSMA	**Financial Services and Markets Act 2000**
GFC	**Global Financial Crisis**
HBOS	**Bank of Scotland**
IAS	**International Accounting Standard**
IOSCO	**International Organisation of Securities Commissions**
LCFI	**Large Complex Financial Institutions**
LR	**Listing Rules**
NAB	**National Australia Bank**
NAO	**National Audit Office**
PRA	**Prudential Regulation Authority**
RBA	**Reserve Bank of Australia**
RBS	**Royal Bank of Scotland**
RFC	**Registered Financial Corporation**
RG	**Regulatory Guide**
RoW	**Rest of the World**
SPV	**Special Purpose Vehicles**
SMCR	**Senior Managers and Certification Regime**
TLOD	**Three Lines of Defence**

CHAPTER 1: GENERAL INTRODUCTION

This thesis considers ethical dilemmas [1] that are common in financial service conglomerates. It also considers that some ethical dilemmas, such as conflicts of interest and related party transactions, have become more prevalent as financial service conglomerates have grown.

This thesis identifies common ethical problems in financial service conglomerates, and explores why they have become more frequent. It compares the regulation of specific ethical predicaments, such as conflicts of interest and related party transactions, in the UK and Australia. It discusses the importance of culture[2] in managing ethical quandaries in financial service conglomerates. It explores the lessons learned from the global financial crisis and the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Hayne Royal Commission). It concludes by answering how ethical dilemma management in financial service conglomerates can be improved through regulatory changes and self-regulation. This thesis does not focus on the selling of financial services, although it mentions conflicted remuneration and advice with an emphasis on disclosure of conflicts of interest. Thesis deals with theoretical ethical dilemmas in a normative sense, rather than positivist. As such, recommendations in this thesis are based on how things should or ought to be, expressing judgements on the desirability of a situation. It is intended that a normative approach is the most effective method in providing useful recommendations for improvement, rather than just analysing how things are.

This chapter defines the term 'financial service conglomerate' used throughout the thesis, then:

- discusses the types of ethical dilemmas that are common in financial service conglomerates;

[1] Ethical dilemmas in financial services are important as the financial services industry generates and moves trillions of dollars every year. There are some reasons why ethical lapses occur. These are predominantly self-interest, selfishness and greed, and conflict between professional duties and company, personal or client interests.

[2] This thesis discusses culture in financial service conglomerates often throughout and considers positive culture in terms of values and business practices in an idealist sense. Positive culture includes things like honesty, integrity, and good customer outcomes. It is a culture that rewards compliance with the regulatory frameworks that exist. Circumventing the rules or pursuing personal gain are characteristics of negative culture, and a positive culture ensures such things do not take place. Positive corporate culture embodies accountability, responsibility for actions and ethical behaviour. Such a culture in financial services would be beneficial by restoring public trust in the system and promoting consumer confidence in the products and services offered by financial service conglomerates. This thesis states that culture is set by the 'tone at the top', so positive culture begins with the board.

- introduces some peculiarities which make ethical problems more common; and
- outlines the relevance of the global financial crisis and Hayne Royal Commission in terms of ethical behaviour in financial service conglomerates.

After this, the chapter:

- outlines the research questions for this thesis;
- explores the methodologies selected for the research; and
- provides a literature review of the leading material.

I. *FINANCIAL SERVICE CONGLOMERATE DEFINITION*

This thesis uses the term 'financial service conglomerates' throughout, which is based on the definition of 'financial conglomerate'. 'Financial conglomerate' refers to 'any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors (banking, securities, insurance)'.[3] This term has been broadened to incorporate the word 'service' to reflect the multitude of products and services now offered by financial conglomerates.

The term 'financial service conglomerate(s)' refers to the institutions in Table 1 on the following page. They have been chosen because they account for the majority of market share in their respective countries. They are large, complex and offer various financial products and services under a single corporate umbrella. These conglomerates often serve multiple clients and vertical and horizontal integration occurs within their corporate groups. Specific individuals within these groups often play multiple roles, as directors within group subsidiaries.[4]

Financial service conglomerates marked with an (*) have been identified as systemically important by the UK's Prudential Regulation Authority[5] or the Australian Prudential

[3] Tripartite Group of Bank, Securities and Insurance Regulators, The Supervision of Financial Conglomerates, A Report by the Tripartite Group of Bank, Securities and Insurance Regulators, July 1995, i.
[4] M Scott Donald, 'A servant of two masters? 'Managing' conflicts of duties in the Australian funds management industry' (2018) 12 *Journal of Equity* 1, 2.
[5] 2020 list of UK firms designated as other systemically important institutions (8 May 2021) Bank of England <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/crd-iv/2020-list-of-uk-firms-designated-as-osiis.pdf?la=en&hash=2EFECF4EC47BBDB9C6CF745DCBC299D56EA3A44C>.

Regulation Authority[6], and are deemed 'too big to fail', almost guaranteeing government intervention in times of crisis. The moral hazard associated with implicit government guarantees can encourage excessive risk-taking and reduce market discipline[7], potentially leading to the improper management of ethical predicaments. Size, interconnectedness and complexity are generally accepted measurements in assessing the systemic importance of financial service conglomerates.[8]

UK Financial Service Conglomerates	**Australian Financial Service Conglomerates**
HSBC Holdings*	Commonwealth Bank of Australia*
Barclays PLC*	Westpac Banking Corporation*
Royal Bank of Scotland*	Australia and New Zealand Banking Group*
Lloyds Banking Group*	National Australia Bank*
Nationwide Building Society*	
Santander UK*	
Co-operative Building Society	

Table 1. Financial Service Conglomerates

II. *JUSTIFICATION FOR COMPARING THE UK AND AUSTRALIA*

The shared imperial history is one of the reasons the UK and Australia have been chosen for comparison. Both the UK and the Australian legal system share similar laws and philosophies because of their common roots in English legal history.[9] Australia is a former British colony and as such, refers to the legal precedents of the English system.[10] English law was introduced to Australia during colonisation based on *terra nullius*. As

[6] APRA Decides to Increase Loss-Absorbing Capacity of D-SIBs (8 May 2021) Moody's Analytics <https://www.moodysanalytics.com/regulatory-news/jul-09-19-apra-decides-to-increase-loss-absorbing-capacity-of-d-sibs>; APRA Information Paper, Domestic systemically important banks in Australia, December 2013, 12-17.
[7] Karl Okamoto, 'After the Bailout: Regulating Systemic Moral Hazard' (2009) 57(1) *UCLA Law Review* 183, 185.
[8] Basel Committee on Banking Supervision, Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement, July 2013, 7.
[9] Nathalie Martin, 'Common Law Bankruptcy Systems: Similarities and Differences' (2003) 11(2) *American Bankruptcy Institute Law Review* 367, 367.
[10] John Farrar, 'Harmonisation of Business Law between Australia and New Zealand' (1989) 19(4) *Victoria University of Wellington Law Review* 435, 435.

such, the colonised land took on the laws and customs of the relevant colonial power.[11] A court system based on the English model was adapted in Australia in 1824 through English legislation.[12] This means there are fundamental similarities in the government and regulating powers of both countries.

Australia's legislative independence was achieved with the passing of the *Australia Act*[13], a pair of separate but related pieces of legislation to eliminate the remaining possibilities for the UK to legislate with effect in Australia, for the UK to be involved in Australian government, or for an appeal from an Australian court to an English court. This formally severed all legal ties between the two countries.

The shared imperial history has left some distinct commonalities between these two nations. The UK and Australia are both constitutional monarchies, with power invested in their monarch, or the Governor-General in the case of Australia. The Crown delegates power to the governments of both countries. A key difference is the constitution in each country. The UK does not have a written constitution, with the machinery of government based on convention or legislation. The many restrictions on the Crown, Parliament and the Cabinet are uncodified. This is due to the evolution of the UK's government over many hundreds of years. Australia has a constitution, which is an Act of British Parliament, and forms the highest law in the country.[14] In the UK and Australia, the heads of regulating bodies are elected members of parliament. Both systems include different modes and intensity of political and legal oversight in their regulation making process.[15]

The UK still holds major international significance in the financial world, and this is something that still has great effect in Australia. The UK is the world's leading exporter of financial services[16], with its convenient time zone, light regulations and use of the

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[11] *Anonymous* (1722) 24 ER 646, 75.
[12] *New South Wales Act 1823* (4 Geo IV, c 96); *Australian Courts Act 1828* (9 Geo IV, c 83).
[13] *Australia Act 1986* (Cth); *Australia Act 1986* (UK) c 2.
[14] The Same but Different: The UK election compared to Australia (8 March 2021) Museum of Australian Democracy <https://www.moadoph.gov.au/blog/the-same-but-different-the-uk-election-compared-to-australia/>.
[15] Andrew Edgar and Kevin Stack, 'The Authority and Interpretation of Regulations' (2019) 82(6) *Modern Law Review* 1009, 1017.
[16] Key facts about the UK as an international financial centre 2018 (3 March 2021) The City UK <https://www.thecityuk.com/research/key-facts-about-the-uk-as-an-international-financial-centre-2018/>.

English language[17] cited as reasons for its success. London is also the leading foreign exchange market, with around 2.5 times as many dollars traded each day in the UK as the US.[18] The UK's insurance sector is fourth largest in the world, and one of the world's largest for fund management. The UK is important in any discussions involving financial service conglomerates, due to London's leading role in international finance. It is also a major centre for professional services supporting the financial industry such as legal, accounting and consulting.[19] The two countries are also economically linked, and the UK is Australia's second largest source of foreign investment, valued at AUD574.8 billion in 2018. It is also the eighth largest two-way trading partner and third largest services trading partner.[20]

III. *Types of Ethical Dilemmas Common in Financial Service Conglomerates*

A. Conflicts of Interest

There is no single definition of 'conflict of interest' in English or Australian law, and is generally used in corporate governance as an umbrella term to cover a wide range of situations involving an actual or potential conflict. These can include a conflict between an interest and a legal duty[21], a conflict between two duties[22], and a conflict of loyalty more generally.[23] The National Audit Office in the UK defines a conflict of interest as a 'set of circumstances that creates a risk that an individual's ability to apply judgement or act in one role is, or could be, impaired or influenced by a secondary interest'.[24] Actual conflict situations in financial service conglomerates are more complex than this single definition suggests. This thesis develops an understanding of conflicts conceptually and

[17] How London Became the World's Financial Hub (6 August 2021) Investopedia <https://www.investopedia.com/how-london-became-the-world-s-financial-hub-4589324>.
[18] The City, *Key Facts about the UK as an International Financial Centre 2020*, December 2020, 4.
[19] Ibid 7.
[20] DFAT United Kingdom country brief (30 August 2021) The Department of Foreign Affairs and Trade <https://www.dfat.gov.au/geo/united-kingdom/Pages/united-kingdom-country-brief>.
[21] For example, a financial interest as a director, and a fiduciary duty to not act in self-interest: Bank of England, The Bank of England's Approach to conflicts of interest, August 2017, 7.
[22] For example, a duty of confidentiality owed to one company and a duty to act in the best interests of a supplier to that company: Ibid.
[23] Where a person who makes or influences decisions has competing loyalties between the primary duties they owe the corporation and some other person or entity: Ibid.
[24] Bank of England, The Bank of England's Approach to conflicts of interest, August 2017, 7.

how they are influenced by the peculiarities of financial service conglomerates and the financial services industry.

Financial service conglomerates are subject to agency problems, regardless of their design. There are three main agency problems in the sphere of corporate law. These are conflicts between managers and shareholders, conflicts between controlling and minority shareholders and conflicts between shareholders and other stakeholders such as creditors.[25] Conflicts of interest can be internal, between entities in the group structure, or between shareholders and managers, or conflicts may be external, between shareholders and creditors, and between the firm and its customers. These conflicts may be pursued because one party's interests are favoured over another, as they may bring strategic or financial gains. When the correct regulatory frameworks are ignored, the exploitation of conflicts is often detrimental to the other party.

Research has shown that the potential for conflicts of interest is endemic in all multifunctional financial services firms.[26] In the UK, as early as 1992, the Law Commission recognised that conflicts of interest were inevitable given the multiple capacities in which financial conglomerates act.[27] Under perfect competition and in the absence of asymmetric information, exploitation of conflicts of interest cannot take place. As a result, the necessary conditions for such exploitations involve information and market imperfections.[28] This potential has been depicted in a matrix shown below. Each of the matrix cells represents the intensity and degree of conflicts, demonstrating that some cannot be avoided and others are manageable through compliance initiatives.

[25] Reinier Kraakman et al, *The Anatomy of Corporate Law* (Oxford University Press, 3rd ed, 2017) 35.
[26] *See generally*, Ingo Walter, 'Conflicts of Interest and Market Discipline Among Financial Service Firms' (2004) 22(4) *European Management Journal* 361.
[27] The Law Commission, *Fiduciary Duties and Regulatory Rules*, Consultation Paper No 124, 1992, 61.
[28] Ingo Walter, *Mergers and Acquisitions in Banking and Finance* (Oxford University Press, 2004) 85.

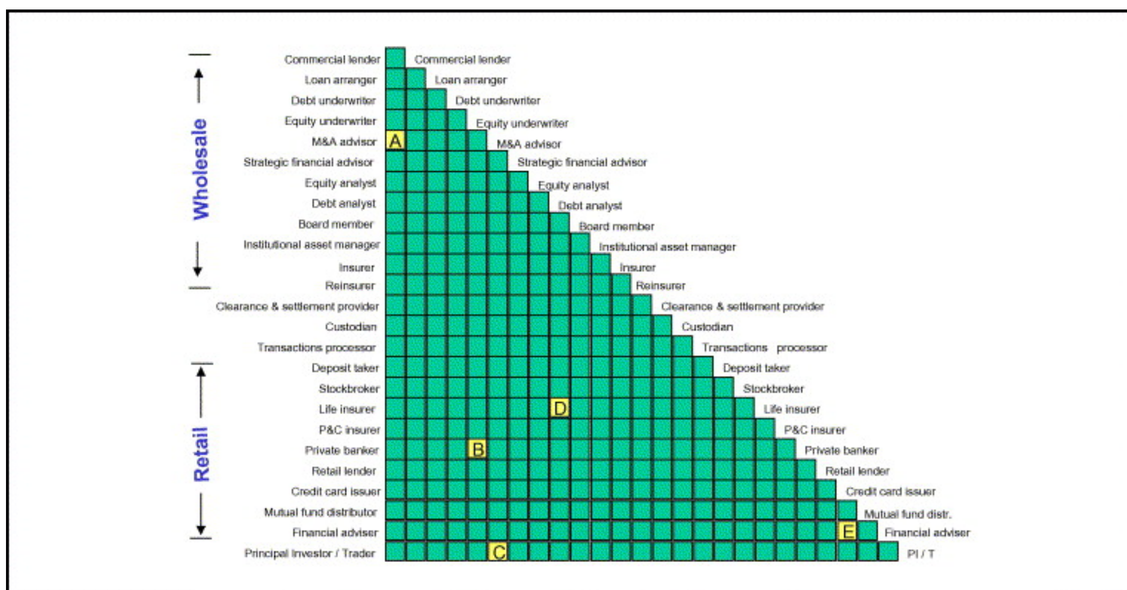

Figure 1. Ingo Walter's Indicative Matrix of Potential Conflicts of Interest[29]

The graph depicts 625 different conflict situations in the offering of wholesale and retail banking services. Some conflicts are basically intractable, others can be managed, and some may not pose serious conflict situations. Cell D, for example, is unlikely to pose a serious conflict as there is little scope for abuse and secret profits. Cell C operations have traditionally been ring fenced by internal compliance systems. Cells B and E can be handled by ensuring adequate transparency, but some, such as A (when advising on a hostile takeover when the target is a banking client), have proved difficult to manage.[30] This shows that conflicts of interest are common and pronounced in financial service conglomerates. Increases in the scale and diversity of operations, a characteristic of growth in large, complex financial institutions, has magnified the risk of conflicts.[31] This increased product and service diversity could lead to problems with effective management, which may be detrimental to the corporation. By this logic, mergers in the financial services industry may have increased conflict of interest situations, and increased related party transactions by reducing competition.

Conflicts are unavoidable in financial service conglomerates globally, and courts have acknowledged that agency doctrine makes it difficult for a single firm to combine banking and trading activities.[32] 'Without information barriers, agency doctrine would lead to the

[29] Ingo Walter, 'Conflicts of Interest and Market Discipline Among Financial Services Firms' (2004) 22(4) *European Management Journal* 361, 367. Reproduced with permission from Elsevier.
[30] Ibid.
[31] Gordon Smith and Andrew Gold, *Research Handbook on Fiduciary Law* (Edward Elgar, 2018) 360.
[32] Ibid 359.

disaggregation of commercial and investment banking functions from asset' management[33], eliminating economies of scale and scope. Ultimately, the financial conglomerate's structure risks violating its agency and other duties.

This thesis focuses on two conceptual conflicts: (1) conflicts that arise due to the nature and structure of financial service conglomerates, and (2) conflicts that arise from the company's actions under the directors' stewardship. This is a two-tier comparison of conflicts of interest in this sector of the economy, and how these conflicts are managed. Directors are considered in this thesis because of the critical role that they play in financial service conglomerates, their subsidiaries, and the relationships within. The board of directors steers the individual and collective direction of the conglomerate and its parts and maintains the relationship with the other group members. As such, directors are a key to the issues analysed in this thesis.

Numerous specific conflicts of interest can arise, but Chapter Five considers related party transactions in the UK and Australia as one specific type of conflict, and Chapter Nine considers conflicted remuneration in financial advice in Australia. Related party transactions are important because conglomeration has reduced competition, leading to more related parties. Conflicted advice is important because the Hayne Royal Commission has deemed it an issue of public interest in Australia.[34] Financial advice is considered in this thesis as a conflict of interest, rather than a distinct issue in Australian financial services.

B. Related Party Transactions

Related party transactions are a focus of this thesis. These are transactions between a company and its directors, managers or shareholders, or transactions between companies in which the implicated director, manager or shareholders may have a material interest.[35] Related party transactions are problematic for numerous companies worldwide because they damage company value, harm shareholder value and hurt stakeholders by

[33] Andrew Tuch, 'Financial Conglomerates and Information Barriers' (2014) 39(3) *Journal of Corporation Law* 563, 577.
[34] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Final Report, Volume 1, 26-28.
[35] *Berezovsky v Abramovich* [2012] EWHC 2463 (Comm) 350.

misappropriating value. They also undermine the tax system by minimising tax liabilities illegally.

Since the original related party transaction case, *Aberdeen Railway v Blaikie Bros*[36], numerous cases in the UK and Australia involving related party transactions have resulted in alleged or actual financial loss. In the UK, cases involving financial services corporations [37] are not uncommon. UK case law demonstrates that related party transactions are not appropriately disclosed[38], and the frameworks for managing these transactions are ignored.[39] This suggests that if appropriate frameworks exist to manage related party transactions, there is another reason why abuse continues. In both the cases *National Crime Agency v A*[40] and *Erste Group Bank AG v JSC*[41] substantial amounts of money were involved[42], highlighting the value that can be diverted from the corporation in instances of related party transaction abuse.

Cases involving financial services corporations with related party transactions at their core also arise in Australia.[43] Australian cases show that related party transactions are

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[36] *Aberdeen Railway Co v Blaikie Bros* [1854] UKHL 1.
[37] *Lehman Brothers Holdings Scottish LP 3 v Lehman Brothers Holdings Plc (In Administration)* [2021] EWCA Civ 1523; *Dooley v Castle Trust and Management Services Ltd* [2021] EWHC 2682 (Comm); *Deutsche Bank AG London v Comune di Busto Arsizio* [2021] EWHC 2706 (Comm); *Re Rhino Enterprises Properties Ltd* [2021] EWHC 2533 (Ch); *Re Lendy Ltd* [2021] EWHC 2285 (Ch); *PJSC Bank "Finance and Credit" v Zhevago* [2021] EWHC 2522 (Ch); *Lindsay v Outlook Finance* Ltd [2021] CSOH 82; *Re Gallium Funds Solutions Group Ltd* [2021] EWHC 765 (Ch); *National Bank Trust v Yurov* [2020] 1 WLUK 148 (‘*Yurov*’); *Oversea-Chinese Banking Corp Ltd v Ing Bank NV* [2019] EWHC 676 (Comm) (‘*Ing Bank*’); *National Crime Agency v A* [2018] EWHC 2534 (Admin) (‘*National Crime Agency*’); *Erste Group Bank AG (London) v JSC (VMZ Red October)* [2015] EWCA Civ 379 (‘*Red October*’); *UBS AG v HSH Nordbank AG* [2009] EWCA Civ 585 (‘*UBS*’); *JSC BTA Bank v Ablyazov* [2013] EWHC 3691 (Ch) (‘*Ablyazov*’); *National Westminster Bank Plc v Rabobank Nederland* [2007] EWHC 1056 (Comm) (‘*Rabobank*’).
[38] *Yurov* (n 37) [2020]; *Ing Bank* (n 37); *Rabobank* (n 37).
[39] *Yurov* (n 37); *National Crime Agency* (n 37); *Red October* (n 37); *UBS* (n 37); *Ablyazov* (n 37).
[40] *National Crime Agency* (n 37).
[41] *Red October* (n 37).
[42] *National Crime Agency* (n 37) concerned elements of fraud, embezzlement and related party transactions totalling USD$39 million, and *Red October* (n 37) concerned a syndicated loan of USD$80 million, USD$20 million of which was being sought by the appellants.
[43] *Broadway Plaza Investments Pty Ltd v Broadway Plaza Pty Ltd (No 2)* [2021] NSWSC 1374; *Bentley Capital Ltd v Keybridge Capital Ltd (No 2)* [2021] FCA 1318; *Australian Securities and Investments Commission v M101 Nominees Pty Ltd (No 3)* [2021] FCA 354; *Coronica v Federal Commissioner of Taxation* [2021] AATA 745; *Australian Securities and Investments Commission v Mayfair Wealth Partners Pty Ltd (No 2)* [2021] FCA 247; *Re Australasian Mortgage Finance Ltd (Admins Apptd)* [2021] FCA 189; *Re Walsh & Company Investments Ltd* [2020] NSWSC 1746; *Australian Securities and Investments Commission v Marco (No 6)* [2020] FCA 1781; *Shear v Campbell* [2020] WASC 391; *Australian Securities and Investments Commission v King* [2020] HCA 4; *Australian Securities and Investments Commission v Linchpin Capital Group Ltd (No 2)* [2019] FCA 398 (‘*Linchpin*’); *King v Australian Securities and Investments Commission* [2018] QCA 352 (‘*King*’); *Australian Securities and*

often not approved by shareholders[44], and that fiduciary and statutory directors' duties are regularly breached.[45] These cases can also involve substantial amounts of money. *Bruce v LM Investment Management Ltd*[46] involved related party transactions totalling AUD168 million, giving rise to conflicts of interest between the fund and its responsible entity and potentially compromising the safety of investments. This further highlights the financial value that improper related party transactions can misappropriate.

There is a greater number of cases in Australia than the UK, which suggests that Australia has a more significant problem, but many mentioned cases are undertaken by the regulators, suggesting that Australian regulators may be more comfortable bringing legal proceedings against offenders. Unapproved related party transactions are covered by Section 208 of the *Corporations Act*[47] in Australia, which may account for more straightforward prosecution of offences. The UK's *Companies Act*[48] has no equivalent section. The low number of cases overall brought by the regulators[49] against financial

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Investments Commission v Linchpin Capital Group Ltd [2018] FCA 1104; *Lewski v Australian Securities and Investments Commission (No 2)* [2017] FCAFC 171 ('*Lewski*'); *Australian Securities and Investments Commission v Avestra Asset Management Ltd (in liq)* [2017] FCA 497 ('*Avestra*'); *O'Sullivan v Australian Securities and Investments Commission* [2017] AATA 644 ('*O'Sullivan*'); *Australian Securities and Investments Commission v Managed Investments Ltd (No 9)* [2016] QSC 109 ('*Managed Investments*'); *Mutual Holdings Pty Ltd v Shepard* [2015] WASC 412 ('*Shepard*'); *Gittany v Director-General, Department of Finance and Services, NSW Fair Trading* [2014] NSWCATOD 119; *Allco Funds Management Ltd (in liq) v Trust Company (RE Services) Ltd* [2014] NSWSC 1251 ('*Allco*'); *Australian Securities and Investments Commission v Rangwala* [2014] NSWSC 961; *Re Commonwealth Managed Investments Ltd* [2014] NSWSC 74; ('*Re Commonwealth*'); *Bruce v LM Investment Management Ltd* [2013] QSC 192; *Mercedes Holdings Pty Ltd v Waters (No 2)* [2010] FCA 472 ('*Waters*'); *TZ Ltd v ZMS Investments Pty Ltd* [2010] NSWSC 196; *Wallace Funds Management Pty Ltd v Wallace Absolute Return Ltd* [2009] NSWSC 190; *Donald Financial Enterprises Pty Ltd v APIR Systems Ltd* [2008] FCA 1112; *Re: Macquarie Capital Alliance Ltd [*2008] NSWSC 745; *VCA v Australian Prudential Regulation* Authority [2008] AATA 580 ('*VCA*'); *Dartberg Pty Ltd v Wealthcare Financial Planning Pty Ltd* [2007] FCA 1216; *Australian Securities and Investments Commission v Tasman Investment Management Ltd* [2006] NSWSC 943 ('*Tasman*'); *Australian Securities and Investments Commission v Carey* [2006] FCA 366; *Preuss v Australian Prudential Regulation Authority* [2005] AATA 748; *Australian Securities and Investments Commission v Australian Investors Forum Pty Ltd (No 2)* [2005] NSWSC 267 ('*Australian Investors Forum*'); *Forge v Australian Securities and Investments Commission* [2004] NSWCA 448 ('*Forge*'); *Australian Securities and Investments Commission v Loiterton* [2004] NSWSC 172; *Adler v Australian Securities and Investments Commission* [2003] NSWCA 131 ('*Adler*'); *Chocolate Factory Apartments Ltd v Westpoint Finance Pty Ltd* [2003] NSWSC 547.

[44] *Linchpin* (n 43); *King* (n 43); *Lewski* (n 43); *Avestra* (n 43); *Managed Investments* (n 43); *Shepard* (n 43); *Re Commonwealth* (n 43); *Waters* (n 43); *Adler* (n 43).

[45] *Avestra* (n 43); *O'Sullivan* (n 43); *Allco* (n 43); *VCA* (n 43); *Tasman* (n 43); *Australian Investors Forum* (n 43); *Forge* (n 43); *Adler v Australian Securities and Investments Commission* [2003] NSWCA 131.

[46] *Bruce v LM Investment Management Ltd* [2013] QSC 192 [109].

[47] *Corporations Act 2001* (Cth).

[48] *Companies Act 2006* (UK) c 46.

[49] ASIC Commissioner Sean Hughes, 'ASIC's approach to enforcement after the Royal Commission' (Speech, 'Banking in the Spotlight': the 36Annual Conference of the Banking and Financial Services Law Association, Gold Coast, Queensland, 30 August 2019).

service conglomerates suggests that prosecution is aimed at small business compliance. This suggests that the Australian Securities and Investments Commission (ASIC) prefers to litigate easier, compliance-based cases against small enterprises.

The UK and Australian cases demonstrate that related party transactions are not uncommon. The cases show that vast sums of money can be misappropriated when related party transactions are not executed properly.[50] Related party transactions can be legitimate and are recognised in law with their own accounting standards. In some corporate structures, related party transactions may be tainted with conflicts of interest that could undermine the interests of investors. For example, an entity may guarantee the investments of a related party, without the knowledge of shareholders. If those investments were to fail, the shareholders would lose money by way of the guarantee.

In financial service conglomerates, sums of money originate from depositors and other customers. The vast sums mentioned vindicate the rationale for further research and demonstrate the broader societal impact of these institutions. The trustees of these entities should ensure that improper related party transactions are not allowed to occur, and fiduciary and statutory obligations are followed to mitigate misconduct. This further extends the relevance of directors to this discussion.

Recent research[51] details instances of related party transactions, deceptive and misleading conduct, dishonesty, conflicts of interest, breaches of directors' fiduciary and best interests duties and failures of disclosure by directors in Australian case law. This research suggests problematic governance of ethical dilemmas in the financial system, with ineffective law and enforcement.[52]

IV. *Peculiarities of Financial Service Conglomerates That Make Ethical Dilemmas More Common*

[50] *Erste Group Bank AG (London) v JSC (VMZ Red October)* [2015] EWCA Civ 379 (USD$80 million of unlawful related party transactions); *National Crime Agency v A* [2018] EWHC 2534 (Admin) (USD$39 million relating to fraud, embezzlement, misappropriation and related party transactions.

[51] David Millhouse, 'Systemic and cyclical failure in Australian financial services and financial products sectors: have weaknesses in law contributed to these failures?' (PhD Thesis, Bond University, 2018).

[52] Ibid 141-144.

The following section explores certain peculiarities that make ethical dilemmas more common in financial service conglomerates. These peculiarities are the conglomerate's structure, moral hazard, international regulatory inconsistencies, regulatory arbitrage, and the effects of contagion.

A. STRUCTURE

The structure of financial service conglomerates has become increasingly complex with growth. Structure can help exploit economies of scale but also leads to various risk exposures. Structures may also impair supervision, as acquiring information about conglomerates becomes difficult. To overcome this, supervisors must understand the conglomerate's structure and have powers to prohibit structures that impair supervision.[53] This complexity, teamed with geographically wide-ranging activities, pose further difficulties for regulators. If a financial service conglomerate were to encounter financial problems, many customers [54] could be adversely affected domestically and internationally. There would also be implications for deposit and consumer protection measures.[55]

There is no single dominant structure of a financial service conglomerate. It will differ depending on the local laws. A financial conglomerate primarily involved in banking would typically be a banking institution with subsidiaries engaged in insurance, securities and associated businesses. Some significant ethical predicaments are more likely to occur due to intra-group exposures stemming from their structure. Intra-group exposures can originate through intra-group shareholdings, trading operations[56], 'central management of short-term liquidity within the conglomerate, guarantees and commitments provided to or received from other companies in the group, and provision of such services' as pensions in the UK, or superannuation in Australia.[57] These exposures have liquidity and solvency implications connected to contagion risks.[58] These exposures may be created on less favourable terms than if the parties were dealing at arm's length, an issue far less

[53] The Supervision of Financial Conglomerates (n 3) 7.
[54] Including depositors, insurance policy holders, investors or other creditors: Ibid.
[55] The Supervision of Financial Conglomerates (n 3) 10.
[56] Whereby one group company deals with or on behalf of another group company: Ibid.
[57] The Supervision of Financial Conglomerates (n 3) 20.
[58] Ibid 13.

likely when dealing with third parties. These exposures are relevant as they may not be readily apparent to supervisors.

Financial service conglomerates are subject to numerous legal relationships and multiple incompatible client duties. They probably owe their continued existence to the information barriers, or Chinese walls, that exist to protect the exploitation of non-public information. The problem for regulators and clients is that these barriers do not always work as intended, especially when under stress.[59] Empirical evidence suggests that information barriers are ineffective and have not addressed the challenges posed by financial conglomeration, despite their legal effect.[60] Evidence confirms that information barriers fail in important contexts and are 'nothing but a convenient fiction aimed at avoiding liability for market abuses'.[61] The sharing of information between entities for non-legitimate purposes is unethical.

Ethical dilemmas can be 'acute in loosely structured financial service conglomerates where matrix management is practised'[62], as opposed to a pyramid structure in each entity. Due to the issues arising in structure and supervision, management of ethical problems in financial service conglomerates must be undertaken by directors and regulators. Regulators must pay special attention to fit and proper tests for managers, as outsiders may influence a regulated entity. Managers may also influence policy that makes supervision or compliance with supervisory standards difficult for employees.

B. Too Big to Fail

The size of financial service conglomerates and their systemic importance are two factors that contribute to the concept of 'too big to fail'. An organisation becomes 'too big to fail' when the economic costs associated with failure would be so high that a government could not afford to refuse to support that institution. The global financial crisis of 2007-2009 showed that culture and behaviour changed when an institution reached this point as they pursued riskier strategies to generate profits. Such financial institutions expanded

[59] Frank Dierick, 'The Supervision of Mixed Financial Services Groups in Europe' (August 2004) ECB Occasional Paper No. 20, 15.
[60] Tuch (n 31) 585.
[61] Norman Posner, 'Chinese Wall or Emperor's New Clothes? Regulating Conflicts of Interest of Securities Firms in the US and UK' (1988) 9 *Michigan Yearbook of International Legal Studies* 91, 93.
[62] The Supervision of Financial Conglomerates (n 3) 27.

rapidly and became more dependent on debt funding, leaving them interconnected and highly leveraged. Reliance on wholesale funding, derivatives and securitisation markets encouraged financial intermediaries to become highly connected.[63]
This interconnectedness propagated isolated shocks, quickly spreading through the system. Shocks also spread through the internal structure of the conglomerate due to their complexity and interconnectedness. Giving the second Bagehot Lecture at the Buttonwood Gathering, Mervyn King stated '[G]reater risk begets greater size, most probably greater importance to the functioning of the economy, higher implicit public subsidies and hence yet larger incentives to take risk'.[64]

Financial service conglomerates are structurally complex, which can exacerbate ethical dilemmas. Structural complexity is also a significant source of risk; hundreds of legal entities would need to be involved in the event of a conglomerate's bankruptcy. Of the sixteen financial conglomerates that the Bank of England classifies as 'large, complex, financial institutions' (LCFIs), all 'have several hundred subsidiaries. Eight have more than 1,000 subsidiaries, and one (Citi) has nearly 2,500 subsidiaries'.[65] When these subsidiaries exist, the potential for ethical problems stemming from asymmetric information is greater.[66] This complexity also causes regulatory issues; substantial and complex intragroup relationships make mapping an institution's business activities into its legal entities and operations a formidable challenge.[67]

C. Moral Hazard

Moral hazard is best considered through the lens of the global financial crisis. Before the crisis, financial service conglomerates had strong incentives to take more significant risks while understating the risk being taken. Their size incentivised morally hazardous

[63] Mark Manning et al, Evolution of the UK banking system, *Quarterly Bulletin 2010 Q4,* 329.
[64] Peter Twigg, Submission to the Productivity Commission into Competition in the Australian Banking System, 25 February 2018, 17
[65] Richard Herring and Jacopo Carmassi, 'The Corporate Structure of International Financial Conglomerates' in Allen Berger et al (eds), *The Oxford Handbook of Banking* (Oxford University Press, 2010) 200.
[66] Asymmetric information problems tend to afflict financial institutions more seriously than other kinds of firms, and these information problems exacerbate conflicts of interest which can arise in the agency relationship between shareholders and creditors, shareholders and managers and between the firm and its customers.
[67] Richard Herring and Jacopo Carmassi, 'The Corporate Structure of International Financial Conglomerates' in Allen Berger et al (eds), *The Oxford Handbook of Banking* (Oxford University Press, 2010) 197.

behaviour based on the perception of 'too big to fail'[68], and their complexity, opacity, and operational diversity undermined effective supervision. As a result, the motivation to act prudently became disproportionately weaker. A moral hazard arises here as the potential rewards associated with imprudent behaviour outweigh the costs, creating systemic conflicts of interest.[69]

Moral hazard is also a problem in financial service conglomerates as it undermines measures that promote less risky behaviour. It undermines external and internal forces to control misconduct and causes difficulties in regulatory responses to tackle systemic moral hazard. An individual's excessively risky behaviour cannot cause a global financial crisis, but a systemically entrenched reliance on 'too big to fail' can.[70] Employees had more significant incentives to pursue risk, with little or no incentives for prudent and ethical conduct.

The perception of a government guarantee or at least the high likelihood of a public rescue package that comes with being 'too big to fail' meant unethical behaviour had no real personal consequence for individuals, and the culture of misconduct blossomed under these conditions. As such, culture alongside heightened accountability and responsibility may be a useful tool in managing ethical dilemmas in financial service conglomerates. This is discussed in Chapters Eight, Nine and the conclusions in Chapter Ten.

D. International Regulatory Inconsistencies

Although not peculiar to financial service conglomerates, international regulatory inconsistencies can promote regulatory arbitrage, discussed in the next paragraph. Compliance is costly and financial service conglomerates will try to reduce these costs. Different countries have different regulations for financial services, causing further irregularities internationally. Sophisticated parties may exploit international regulatory inconsistences by obtaining classification under one regime which is inconsistent with another[71], but more beneficial to their purpose. These parties may 'design an instrument

[68] Angelo Borselli, 'Keeping Watch on Giants: The Supervision of Insurance Group and of Insurance Undertakings within Financial Conglomerates in European Law' (2012) 3 *Insurance Law Review* 26, 28.
[69] Okamoto (n 7) 185.
[70] Ibid 185.
[71] Emily Cauble, 'Exploiting Regulatory Inconsistencies' (2017) 74(4) *Washington and Lee Law Review* 1895, 1895.

that is treated as debt for tax purposes, but equity for purposes of capital requirements instituted by financial regulators'.[72] Further complications arise where financial service conglomerates undertake regulated or unregulated activities overseas, which are not subject to any capital regulation.[73] Operations such as 'leasing, reinsurance, consumer credit, bridge financing, custody operations and certain financial derivatives may be conducted outside regulated entities in many countries'.[74] How supervisors should respond to the increasingly integrated and international financial markets is contested.

E. Regulatory Arbitrage

A general understanding of regulatory arbitrage implies an avoidance strategy for those looking for decrease their regulatory burdens.[75] By locating an activity in one corner of the market rather than the other, the arbitrageur gets the same economic value at a lower regulatory cost.[76] This may be beneficial to the entity but is not beneficial for the regulators or the financial service conglomerates' customers. In terms of this thesis, financial service conglomerates may structure their activities to reduce the impact of regulation, but there is no reduction in the underlying risks. This risk then becomes insufficiently regulated.[77] This undermines supervision and makes supervision of specific activities more difficult. At its core, regulatory arbitrage is about avoiding regulatory costs. The complex nature of financial service conglomerates and their opacity aids regulatory arbitrage.[78] If a conglomerate has a culture of regulatory arbitrage, then they are damaging social value.

When conglomerates are managed on a group-wide basis, transactions may occur in certain entities to exploit regulatory differences. Intra-group transactions can be generated to meet regulatory requirements but circumvent the aims of those requirements at the

[72] Ibid.
[73] The Supervision of Financial Conglomerates (n 3) 10.
[74] Ibid 10.
[75] Katja Langenbucher, 'Regulatory Arbitrage: What's Law Got To Do With It? (2021) 11(2) *Accounting, Economics, and Law: A Convivium* 91, 93.
[76] Anna Gelpern, 'Exhausting Regulatory Arbitrage' (2014) *Jotwell: The Journal of Things We Like (Lots)* 222.
[77] Gaming the rules or ruling the game? – How to deal with regulatory arbitrage – Speech by Daniele Nouy, Chair of the Supervisory Board of the ECB, at the 33rd SUERF Colloquium, Helsinki, 15 September 2017.
[78] Frank Partnoy, 'The Law of Two Prices: Regulatory Arbitrage, Revisited' (2019) 107(4) *Georgetown Law Review* 1017, 1035.

same time.[79] For example, a regulatory restriction or fee levied on domestic transactions in foreign currency creates a wedge between the domestic price and the price outside the domestic market. This results in two prices for the conglomerate: one for currency traded domestically and one for trading offshore. To the extent that offshore parties of the group can use financial engineering to access the domestic market, they can benefit from a net reduction in costs.[80] This happens in equity, fixed income, foreign exchange and other financial markets.[81] This undermines the spirit of the law. Rules are implemented for a reason, and exploiting loopholes is unethical and dangerous given the impact financial conglomerates have on the economy. The global financial crisis revealed that banks can reduce their regulatory burden in innovative ways. This can cause instability across borders and markets.

Arbitrage is tough to address; there is no single approach to supervision, there is no way to close all regulatory loopholes, and each financial conglomerate is different. A strict rulebook will encourage arbitrage and push financial conglomerates to circumvent the rules. The path of least resistance leads to an increased offering of the least regulated financial product, or worse, the repackaging of products to avoid burdensome legislation.[82] Some control might be achieved by addressing corporate culture in financial service conglomerates and reinforcing integrity from the top. Regulatory arbitrage can undermine economic stability if the rules promoting stability are avoided. Arbitrage should be considered as a risky aspect of financial service conglomerates' behaviour.

On an international level, regulatory inconsistencies might allow for multiple gearing of capital, meaning the solvency requirements of more than one subsidiary can be met with the same capital amount.[83] There are risks related to intra-group transactions since they may become a means of allocating resources to the detriment or advantage of certain entities in the group, particularly when those activities are non-homogenous. Excessive intra-group transactions increase contagion risk, which may spread throughout the group.

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[79] Dierick (n 59) 15.
[80] Partnoy (n 78) 1019.
[81] Ibid.
[82] Veerle Colaert, 'European banking, securities and insurance law: towards a cross-sectoral approach?' (2016) 31(5) *Journal of International Banking and Financial Law* 295, 295.
[83] Tzung-bor Wei, 'The Equivalence Approach to Securities Regulation' (2007) 27(2) *Northwestern Journal of International Law and Business* 254, 272.

Contagion may also affect reputation, and a negative impact on reputation in one part of the group may spread to other parts.[84]

F. Contagion

Another issue related to ethical dilemmas in financial service conglomerates is cultural and financial contagion. Contagion and culture have long been intimately linked. A specific aspect of culture that has been entangled with contagion is ethics.[85] In this thesis, 'contagion' refers to the spread of a negative ideology, being an aspect of the organisational culture, or an ethical standpoint that is perpetuated throughout the conglomerate starting from a dominant entity in the conglomerate. A less ethical dominant entity may cause its attitudes towards ethical behaviour to spread throughout the group, normalising or validating improper management. It is for this reason that a positive organisational culture may be useful in managing ethical quandaries.

Contagion may also be financial, when financial difficulties in one entity in the group spill over to others, or from one conglomerate or sector to other parts of the economy. This originates from economic links between entities in the group structure. For financial conglomerates, this means specifically contagion risk that would not have been present if financial conglomerates were merely separate entities, a separate bank and a separate insurer, for example. Research indicates that spillovers from the financial sector to the real economy are more substantial during financial crises.[86] This interconnectedness is one of the factors that makes contagion so dangerous.

Many conclude that the financial system is unusually susceptible to shocks.[87] Small shocks in particular parts of the economy spread by contagion and interconnectedness to other parts of the financial sector and the wider economy, threating financial crisis.[88] Financial crises raise the costs of intermediation and restrict credit, restraining market

[84] Borselli (n 68).
[85] Martin Pernick, 'Contagion and Culture' (2002) 14(4) *American Literary History* 858, 862.
[86] Wan-Chien Chiu et al, 'Industry characteristics and financial risk contagion' (2015) 50 *Journal of Banking and Finance* 411, 413.
[87] Franklin Allen and Douglas Gale, 'Financial Contagion' (2000) 108(1) *The Journal of Political Economy* 1, 2.
[88] Ibid.

activity in the economy and potentially leading to low growth and recession.[89] Contagion is a very prominent threat to economic stability.

Conclusively, there are numerous characteristics peculiar to financial service conglomerates. Due to their size, assessment of their risk exposure is problematic. Their size affects their ability to be regulated[90], and intensifies their negative impact on the broader economy if they become unstable. Their size also leads to concentration in the industry, which makes ethical dilemmas such as conflicts of interest and related party transactions more common. They are also highly complex, which gives rise to numerous issues for regulators and the institutions themselves. They are systemically important, which has exacerbated the improper management of ethical problems as incentives for prudent behaviour are negated through the expectations of an implied government guarantee. All these factors mean that financial service conglomerates are peculiar and unique.

V. *The Relevance of the Global Financial Crisis and the Hayne Royal Commission*

The global financial crisis and the Hayne Royal Commission are two events central to this thesis. Both revealed examples of misconduct in financial services and the effects on the economy.

The global financial crisis is relevant to the discussions in this thesis, as conflicts of interest and systematically fraudulent and predatory behaviour became commonplace in financial institutions in the run-up to the crisis.[91] The financial crisis also highlighted that corporate governance incentivised recklessness in the pursuit of short-term shareholder value.[92] Corporate governance case studies are analysed in Chapter Seven, and governance changes after the global financial crisis are explored in Chapter Eight. This thesis suggests that poor governance and culture in financial service conglomerates exacerbated ethical dilemmas and considers the role of culture in managing these.

[89] Ibid.
[90] The Supervision of Financial Conglomerates (n 3) i.
[91] John Cioffi, 'The Global Financial Crisis: Conflicts of Interest, Regulatory Failures and Politics' (2010) 4(1) *Policy Matters* 1, 2.
[92] Ibid 1-3.

The Hayne Royal Commission is important to this thesis as it showcased shortcomings in the Australian financial sector. Australia did not have the same experience of the GFC that the UK did, and the Hayne Royal Commission is a far more appropriate exposure of the falling standards of behaviour in Australian banks[93], and the subsequent loss of public trust in the banking system.[94] The outcomes of the Hayne Royal Commission are central to this thesis, including the notion that ethics are important to foster public confidence and integrity in the industry.[95] Lessons have not been learned from the global financial crisis, and history has repeated itself. This thesis suggests that problematic culture and governance has exacerbated misconduct in the Australian financial services industry too. Commissioner Hayne made four observations about misconduct, conflicts of interest, and unethical behaviour in the industry[96]:

- First, Commissioner Hayne identified a connection between poor conduct and the pursuit of profits and gains, as in many cases, financial service conglomerates have chosen the pursuit of profits over the interest of customers and compliance with the law[97];
- Second, he noted that the asymmetry of power and information between financial services entities and their customers was a factor allowing the improper resolution of ethical dilemmas. Clients did not have access to the information that would allow them to make informed decisions on the nature of the products recommended or offered to them, nor did they have the appropriate power to negotiate terms[98];
- Third, he observed that the existence of conflicted intermediaries meant that customers' best interests were sacrificed, as intermediaries often acted in their own interests or the interests of the entity rather than the client's[99];
- Fourth, Commissioner Hayne found that 'financial services entities that broke the law were not properly held to account'.[100]

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[93] Royal Commission (n 34) 6.
[94] Ibid 134.
[95] Ibid 211.
[96] Ibid 1-4.
[97] Key findings from the banking Royal Commission final report (16 May 2021) Australian Institute of Company Directors <https://aicd.companydirectors.com.au/membership/company-director-magazine/2019-back-editions/march/royal-commission>.
[98] Royal Commission (n 34) 2.
[99] Ibid 2.
[100] Ibid 3.

The recommendations to address the industry's shortcomings were published in February 2019, although the industry has not accepted all the recommendations, and their implementation remains hampered by reluctance in light of the global pandemic.[101]

The remainder of this chapter:

- Outlines the research questions for this thesis;
- Explores the methodologies selected for the research; and
- Provides a literature review of the leading material.

VI. *Research Questions*

The research questions stem from two events: the UK's experience of the global financial crisis and the Hayne Royal Commission. The research questions are relevant because the global financial crisis highlighted shortcomings in financial service conglomerates' reconciliation of ethical problems. The Hayne Royal Commission has highlighted that these shortcomings still exist. Both events were an opportunity to reimagine the sector, and rethink the boundaries and roles of financial service conglomerates. The UK and Australia have failed to address the source of these dilemmas in the wake of these two pivotal events in time.

	Research Questions
1.	What ethical dilemmas, such as conflicts of interest and related party transactions, are common in financial service conglomerates?
2.	What are the shortcomings in the legal frameworks for the management of ethical dilemmas, such as conflicts of interest and related party transactions, in financial service conglomerates, and how has supervision changed?
3.	What is the role and importance of culture in financial service conglomerates in the management of ethical dilemmas? Have the lessons from the global financial crisis and the Hayne Royal Commission recommendations had a positive impact on governance measures in financial service conglomerates?

[101] 'NAB banker led successful push to delay banking royal commission recommendations', *ABC News* (online, 16 September 2020) <https://www.abc.net.au/news/2020-09-15/nab-banker-led-successful-push-to-delay-hayne-recommendations/12662560>.

4.	How can the management of ethical dilemmas in Australian financial service conglomerates be improved by changes to the regulatory framework and self-regulation?

Table 2. Research Questions

This thesis uses a blend of methodologies. Doctrinal and comparative methodologies are primarily used, and law and economics, social study and case studies are accessorial.

VII. *Methodologies*

A. Doctrinal Methodology

Richard Posner suggested that legal methodology is an amalgam of applied logic, rhetoric, economics and familiarity with specialised vocabulary, texts, practices and institutions.[102] In this sense, the doctrinal methodology in this thesis focuses on judgements in case law, and the intention of legislators and regulators in the production of regulatory frameworks.

Doctrinal legal research can be categorised as qualitative because it involves selecting and interpreting materials based on their authority and social context.[103] Doctrinal research involves the location and analysis of the primary documents that establish legal rules and boundaries. Some aspects of the law are unclear and are better understood when applied to factual situations[104], such as the global financial crisis and the Hayne Royal Commission. Law is not a datum: it is constantly evolving in endlessly inventive ways.[105]

Traditionally, the doctrinal study of law is used to produce information and systematise legal norms. The other limited methodologies are useful sources of information, but the doctrinal study of law forms the practical arguments used in legal reasoning.[106] Doctrinal

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[102] Richard Posner, 'Conventionalism: The Key to Law as an Autonomous Discipline' (1988) 38 *University of Toronto Law Journal* 333, 345.
[103] Ian Dobinson and Francis Johns, 'Qualitative Legal Research' in Michael McConville and Wing-Hong Chui (eds), *Research Methods for Law* (Edinburgh University Press, 2nd ed, 2017) 42.
[104] Terry Hutchinson, *Researching and Writing in Law* (Thomson Reuters, 2018) 52.
[105] Christopher McCrudden, 'Legal Research and the Social Sciences' (2006) 122 *Law Quarterly Review* 632, 648.
[106] Aulis Aarnio, *Essays on the Doctrinal Study of Law* (Springer, 2011).

study answers questions concerning the law's normative content and validity and usually comprises the study of legal rules or texts. A doctrinal study involves interpretation and systematisation; interpretation by justifying legal text, and systematisation by organising a system as coherently as possible. These two elements are closely linked as interpretation inevitably leads to systematisation. The doctrinal research methodology forms the basis of this thesis and includes the analysis of the existing legal framework of the management of ethical dilemmas in financial service conglomerates.

B. Comparative Methodology

Comparative law is an instrument for improving domestic law and legal doctrine by considering the experience of a neighbouring country with a similar legal problem.[107] It aims to understand the law through comparison to promote harmonisation[108] and eliminate significant differences. This thesis compares the shortcomings in the legal frameworks for managing ethical predicaments, such as conflicts of interest and related party transactions in financial service conglomerates. It demonstrates how supervision has changed in the UK and Australia. It also establishes the role and importance of culture in managing ethical dilemmas in financial service conglomerates in both countries. It compares the governance lessons learned from the global financial crisis and the Hayne Royal Commission recommendations. A comparative methodology is particularly appropriate for this study. The comparison of the UK and Australian experiences will help conclude how ethical dilemma management in Australian financial service conglomerates can be improved.

Doctrinal study, unlike comparative law, is normative.[109] Despite being different, comparative law can be closely linked to the doctrinal study of law in two ways. Firstly, problematic situations may require that decision-makers look further afield than their jurisdiction to find solutions. Secondly, national doctrinal law systematisation becomes easier when approaches to the same problem abroad are studied. Both methodologies require a familiarity with the relevant legal documents and a comparative approach

[107] Mathias Siems, *Comparative Law* (Cambridge, 3rd ed, 2018) 1.
[108] Martin Boodman, 'The Myth of Harmonisation of Law' (1991) 39(4) *The American Journal of Comparative Law* 669, 669.
[109] Jaakko Husa, *A New Introduction to Comparative Law* (Bloomsbury, 2015) 31.

requires an understanding of the rules in a foreign jurisdiction. Both are committed to the institutional structures, concepts and doctrines under the system of study.[110]

'Comparative law… is not a topic, but a method. It is the common name for a variety of methods of looking at law, and especially of looking at one's own law'.[111] The act of comparison 'reveals to us certain details of the different models under consideration'.[112] There are no generally accepted theoretical frames, established aims or terms which, on the one hand, means insecurity, lacking an established research tradition, but on the other allows better opportunities for free research than a discipline that has been rigidly defined.[113] Comparative law has been chosen to cross borders between legal systems; in this case, the UK and Australia. A comparative approach can be utilised in doctrinal research.[114] Such a methodology attempts to reconstruct and reorder different countries' systems to facilitate lay parties' understanding.[115]

Other appropriate methodologies are law and economics, social science and a case study approach.

C. *Law and Economics Methodology*

Law and economics is concerned with the laws and regulations that affect markets, industries, firms, and economic variables. This approach considers how the law influences individuals' behaviour in the industries they work in, specifically in response to legal rules and institutions with an emphasis on how law complements traditional legal theory and the nature of law and its normative claims.[116] Essentially, law and economics analyses laws and legal processes from the viewpoint of economic efficiency.[117] Law and economics is both theoretical and practical and relevant for tackling the problems that

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[110] Ibid 34.
[111] Geoffrey Samuel, *An Introduction to Comparative Law Theory and Method* (Oxford and Portland, 2014) 13.
[112] Ibid 45.
[113] Husa (n 108) 1.
[114] Ibid 17.
[115] John Bell, 'Legal Research and the Distinctiveness of Comparative Law' in Mark Van Hoecke (eds), *Methodologies of Legal Research* (Oxford, 2011) 176.
[116] The Economic Analysis of Law, Stanford Encyclopedia of Philosophy, 26 November 2001, revised 17 July 2017 (26 May 2021) Stanford University <https://plato.stanford.edu/entries/legal-econanalysis/#Rational>.
[117] Shubhashis Gangopadhyay, *Law and Economics: Volume I: Theory, Volume II: Practice* (SAGE, 2013) 6.

may arise from human beings embedded in a given legal setting, such as scholars, law practitioners and policy-makers.[118]

Law and economics, as a methodology, is the application of economic methods to legal analysis. In this sense, economics is another word for rationalism. When applied, it accepts rationality and seeks to find rationality in irrational actions.[119] Economics can be seen as the study of human behaviour when faced with scarcity. The legal system can also be seen as coping with scarcity; if good behaviour were abundant, there would be no need for law.[120] The law and economics are, therefore, inseparable.[121] Both disciplines assume rational behaviour, and both seek to prescribe social interaction. Herein lies a point of concern. One may assume that this approach believes people are rational, which they are not, but it can be assumed that people seek to maximise their preferences, and the only source of their preference is themselves.[122] Sometimes people prefer to break the law, act unethically, be fuelled by greed, and act selfishly. The global financial crisis is a prime example of such tendencies. It is noteworthy that some themes of this thesis would not be so problematic if irrational behaviour were not part of human nature. For clarity, the economics approach does not contend that all individuals are rational or that such assumptions are realistic. The presumption of people as rational is fiction, but a fiction that has proved useful in analysing the behaviour of groups. Although much of economics is framed in terms of individual behaviour, there is no belief that this behaviour is uniform. The economic person is an average of their group, which accounts for extreme behaviours, but this approach argues that the group behaves as if people are rational.[123]

Law and economics is an appropriate methodology choice for an Australian study in particular. Economics has become a dominant theme in public affairs, and the success of a political party hinges on their economic policies, making economics as important now as ever. As a result, we as lawyers may have assumed that economics would significantly

[118] Giovanni Ramello, 'The past, present and future of comparative law and economics' in Theodore Eisenberg and Giovanni Ramello (eds), *Comparative Law and Economics* (Edward Elgar, 2016) 6.
[119] Frank Easterbrook, 'The Inevitability of Law and Economics' (1989) 1(1) *Legal Education Review* 3, 3.
[120] Ibid.
[121] Ibid.
[122] Joel Trachtman, 'The Methodology of Law and Economics in International Law' (2004) 6(2) *International Law FORUM Du Driot International* 67, 68.
[123] Cento Veljanovski, 'The Economic Approach to Law: A Critical Introduction' (1980) 7(2) *British Journal of Law and Society* 158, 163.

contribute to the law. Economics is concerned with the methodology of decision-making. Subsequently, it can contribute to legal decision making, but the impact on substantive law, especially judge-made law, has been much less than proponents would have predicted.[124]

For this thesis, insights from economics are used to reveal the relationship between legal rules and the economic behaviour of financial service conglomerates and the markets they operate in. In this sense, the law is consequentialist. It is also necessary to state that economics is limited as one element of the social sciences and offers one view on how laws affect human behaviour.

D. *Case Study Methodology*

Case study research has developed as an effective methodology to investigate and understand complex issues in actual events. Case study designs have been used across several disciplines, particularly education, business, law, health, and the social sciences, to address a wide range of research questions.[125]

Case study research has an extensive history, with several different approaches. Yin's definition of a case study is 'an empirical enquiry that investigates a contemporary phenomenon within its real-life context, when the boundaries between phenomenon and context are not evident, and in which multiple sources of evidence are used'.[126]

A case study is a form of research that concentrates on one thing, looking at it in detail, not seeking to generalise from it. 'When you do a case study, you are interested in the thing in itself, as a whole'.[127] The term 'thing' in this context refers to a financial service conglomerate. This approach explores an event from a variety of angles, gaining in-depth insight. The case being studied requires a clear definition. The case is a phenomenon occurring within contextual boundaries. The case itself the unit of analysis. Studies may be of a singular case or multiple cases.[128]

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[124] Anthony Mason, 'Law and Economics' (1991) 17(2) *Monash University Law Review* 167, 168.
[125] Helena Harrisson, 'Case Study Research: Foundations and Methodological Orientations' (2017) 18(1) *Forum Qualitative Social Research* 1, 1.
[126] Dan Reymenyi, *Case study research the quick guide series* (Reading, 2012) 16.
[127] Ruth Taylor and Annette Thomas-Gregory, 'Case study research' (2015) 29(41) *Nursing Standard* 36, 37.
[128] Ibid.

The case study analysis in this thesis involve selected financial service conglomerates and are presented in a chronological format. Events are recalled in the order they occurred. This approach has been chosen as the easiest way to show the events which took place. These case studies are contained in Chapter Seven where the corporate governance and culture failures in the Co-operative Bank and the Commonwealth Bank of Australia are detailed. The Co-operative Bank is used as a UK-based case study analysis, and the Commonwealth Bank of Australia is used as an Australian-based case study analysis. These case studies look at governance failings in these banks to understand if there is something peculiar about governance and culture in financial service conglomerates and if anything makes ethical dilemmas more common. If commonplace in financial service conglomerates, poor governance and culture could potentially propagate the improper resolution of ethical predicaments such as conflicts of interest and related party transactions.

In the case of the Co-operative Bank, numerous factors were blamed for the capital shortfall and subsequent restructuring of the institution. These included flawed culture, mis-selling of financial products, the global financial crisis, and weak governance stemming from the board's lack of skill and expertise[129], an element required by law and generally accepted as prudent business practice. These factors, bar the global financial crisis, were within the bank's control. Another key point is that the Kelly Review[130] had already noted shortcomings in capital planning, poor management and bad corporate culture[131], yet no action was taken to address this. This makes the bank ideal for a case study.

The Commonwealth Bank of Australia has been chosen for a case study because it has been involved in numerous scandals in the past[132] and more recently, such as fees for no

[129] Mark Zelmer, Independent Review of the Prudential Supervision of The Co-operative Bank plc, March 2019, 31.
[130] The Kelly Review (n 8).
[131] Zelmer Review (n 128) 71.
[132] Australian Prudential Regulation Authority, Prudential Inquiry into the Commonwealth Bank of Australia, April 2018.

service[133], misleading regulators[134], and the sale of worthless, junk insurance policies.[135] The global financial crisis exposed weak governance, professional misbehaviour and lapses in compliance at the bank.[136] Lessons were not learned from the event, as more recently the bank was found to have contravened the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006*[137] on 53,750 occasions.[138] The case study explores the issues detailed by the Australian Prudential Regulation Authority in its 2018 inquiry into the Commonwealth Bank of Australia. The main issues arising from this inquiry are:

> Widespread complacency; reactivity rather than pre-emption regarding risk; uneven influence of the risk function; not fully 'walking the talk' when it comes to risk management; less tendency towards reflection, introspection and learning (from mistakes); collegial, high trust environment, leading to some over-confidence and over-collaboration; striving to balance empowerment with challenge, although not well executed; aiming to be a values-led institution, but an over-reliance on good intent; and self-perceived, but incomplete, focus on the customer.[139]

The bank has been chosen because poor corporate governance is one of the Hayne Royal Commission's key conclusions, another theme of this thesis.

These case studies have been used to provide insight into financial service conglomerates that have demonstrated poor culture and governance. These instances might not have been brought to light if the global financial crisis or Hayne Royal Commission had never happened. The case study analysis intends to show that financial service conglomerates who operate 'properly' are better placed to survive significant industry events. This underlines the importance of culture to financial service conglomerates. There are

[133] 'Fees for no service payouts and offers approach $900m', *Business News Australia* (online, 4 February 2021) <https://www.businessnewsaustralia.com/articles/fees-for-no-service-payouts-and-offers-approach--900m.html>.
[134] 'AMP could face criminal charges for misleading ASIC, banking inquiry hears', *The Guardian* (online, 4 February 2021) <https://www.theguardian.com/australia-news/2018/apr/27/amp-could-face-criminal-charges-for-misleading-asic-banking-inquiry-hears>.
[135] Watchdog oversee $160m in payouts from Australian banks that sold junk insurance', *The Guardian* (online, 4 February 2021) <https://www.theguardian.com/australia-news/2020/may/14/watchdog-oversees-160m-in-payouts-from-australian-banks-that-sold-junk-insurance>.
[136] Australian Prudential Regulation Authority (n 130) 3.
[137] *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (Cth).
[138] 'Commonwealth Bank agrees to pay $700m to settle money laundering lawsuit', *The Guardian* (online, 27 August 2020) <https://www.theguardian.com/news/2018/jun/04/commonwealth-bank-agrees-to-pay-700m-to-settle-money-laundering-lawsuit>.
[139] Australian Prudential Regulation Authority (n 131) 83.

numerous other options for case studies using UK and Australian financial service conglomerates. The Co-operative Bank and Commonwealth Bank have been chosen due to authoritative data availability.

VIII. *Literature Review*

The emergence of financial conglomerates is a notable development of recent years. The term 'financial conglomerate' reflects its organisational structure, rather than legal status. The leading literature deals with the terms 'universal bank', 'financial conglomerate' and 'large complex financial institution', interchangeably.[140] These entities provide banking, insurance and financial products under a single corporate umbrella, motivated by economies of scale and scope, and the perceived advantages of risk diversification. This reduces risk management costs and allows greater control of capital, liquid assets and reserves.[141] Their popularity has been spurred by demographic developments, deregulation and increasing competition and innovation.[142]

There are numerous issues peculiar to financial service conglomerates. The literature suggests that financial conglomerates who were 'too big to fail' and their continued desire for expansion and market share[143] were at the centre of[144] the global financial crisis. The crisis demonstrated that the main problems which arise are: risk management; 'opaqueness of financial products; compensation policies; conflicts of interest; and government support and politics'.[145] Conflicts of interest and compensation or remuneration policies are two themes that will be identified in this thesis. Other literature suggests a regulator-focused rationale for conglomerate's role in the crisis, namely shortcomings in the regulatory structure. These shortcomings are a lack of uniform standards; lack of regulator coordination; failure of regulators to understand risks posed by conglomerates; regulatory arbitrage; and regulators' failure to address the growth and

[140] Arthur Wilmarth, 'The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis' (2009) 41 *Connecticut Law Review* 963, 968.
[141] Joseph Hughes and Loretta Mester, 'Who said large banks don't experience scale economies. Evidence from a risk-return-driven cost function' (2013) 22(4) *Journal of Financial Intermediation* 559, 560.
[142] Dierick (n 59) 6.
[143] Hughes (n 140) 560.
[144] James Fanto, 'Breaking up is hard to do: Should financial conglomerates be dismantled' (2010) 79(2) *Cincinnati Law Review* 553, 553.
[145] Ibid 563.

concentration that allowed firms to become too big to fail.[146] This thesis is primarily concerned with the internal elements of financial service conglomerates, rather than external forces such as regulators.

Consolidation of businesses in the banking industry has made banks more extensive, operating globally.[147] This growth has led to diversification. Diversification within a single financial conglomerate intensifies agency problems, making them difficult to manage and creating problems aligning internal and outsider's interests.[148] Diversification also led to interconnectedness. Interconnectedness is a key measure of systemic importance in banks[149] and indicates the systemic dimension between financial institutions. Interconnectedness means financial distress in one institution can materially increase the likelihood of financial distress at another, given the network of contractual obligations between these firms.[150] Capital adequacy requirements address risk concentration, but not interconnectedness. The overlapping and interconnected structure of financial conglomerates may create contagion pathways between banking, insurance, and other sectors.[151]

The structural complexity of financial service conglomerates needs exploring further. The corporation has a legal definition covering the requirements of, and obligations imposed upon, an entity. Still, financial conglomerates comprise more vitality and complexity than the law can account for by way of definition. Some even appear to take on personalities of their own, shaped by reputation and culture. The corporation can be considered a nexus of contracts, suggesting a corporation is the collective total of its business decisions. It can be regarded in admiration; capitalism leaves every person free to choose the work they likes, to specialise in it, to trade their product for the product of others, and to go as far as their ambition and ability will allow.

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[146] Elizabeth Brown, 'The New Laws and Regulations for Financial Conglomerates: Will They Better Manage the Risks than the Previous Ones' (2011) 60(5) *American University Law Review* 1339, 1357.
[147] Celine Meslier et al, 'The Benefits and Costs of Geographic Diversification in Banking' (2016) 69 *Journal of International Money and Finance* 287, 289.
[148] Luc Laeven and Ross Levine, 'Is There a Diversification Discount in Financial Conglomerates?' (2007) 85 *Journal of Financial Economics* 331, 332.
[149] Mathias Drehmann and Nikola Tarashev, 'Measuring the Systemic Importance of Interconnected Banks' (2013) 22 *Journal of Financial Intermediation* 586, 587.
[150] Basel Committee on Banking Supervision (n 8) 7.
[151] Gael Hauton and Jean-Cyprien Heam, 'Interconnectedness of Financial Conglomerates' (2015) 3 *Risks* 139, 140.

These days, groups of companies as opposed to single legal entities dominate the world markets. The organisational structure of conglomerates varies globally. In the UK and US, wholly-owned subsidiaries are commonplace. In the UK and Europe, universal banks have a complex organisational structure which provides various financial services through its divisions or through subsidiaries, and their structure is almost impossible to map given their divergence and complexity.[152] In the UK and Europe, parent companies generally maintain just enough control over subsidiaries to maintain control overall. In Australia, research into the top 500 listed companies in 1997 revealed that 89 per cent had at least one controlled entity, with each listed company holding 28 controlled entities on average.[153] Australian corporate groups have benefitted from limited liability, and this application has resulted in multiple layers of protection that have been deemed 'an accidental and unjustified extension of the doctrine without any adequate reasoning in terms of principle and policy other than a dogmatic application of Salomon itself'.[154] An Australian court has stated that application of the Salomon principle to corporate groups 'ignores commercial reality despite legislative recognition that a group of companies could be treated as a single unit'.[155] As a result, the economic concept of the group differs.[156] This global phenomenon has differing domestic approaches, which add more complexity when operating or regulating cross-border.

A. Fiduciary Duties and Conflicts of Interest in Financial Service Conglomerates

Financial service conglomerates adopt complex organisational structures. This complexity can lead to regulatory arbitrage, moral hazard and contagion in intra-group transactions. The complex structure also may pose transparency issues, conflicts of interest and the abuse of economic power.[157] Conflicts of interest between the group as a whole and individual subsidiaries may arise, for example, with the distribution of financial resources.[158] The complex organisational structure also produces significant

[152] Jeffrey Gordon and Wolf-Georg Ringe, 'Bank Resolution in the European Banking Union: A Transatlantic Perspective on What it Would Take' (2015) 115(5) *Columbia Law Review* 1297, 1363.
[153] Ian Ramsay and Geoff Stapledon, 'Corporate Groups in Australia', Research Report, University of Melbourne, 1997, v.
[154] John Farrar, 'Frankenstein Incorporated or Fools' Parliament? Revisiting the Concept of the Corporation in Corporate Governance' (1998) 10 *Bond Law Review* 142, 147.
[155] *Briggs v James Hardie & Co Pty Ltd* (1989) 16 NSWLR 549 [577].
[156] Jeffrey Gordon and Wolf-Georg Ringe, *The Oxford Handbook of Corporate Law and Governance* (Oxford University Press, 2018) 605.
[157] Dierick (n 59) 4.
[158] Borselli (n 68) 28.

regulatory challenges, both legal and practical.[159] The law has not kept stride with the development of financial service conglomerates, as the agency law doctrine does not always account for large, multi-function firms who may act as both agents and principals.[160] The conflict in duties 'is the classic problem encountered by one who serves two masters'.[161]

In addition to the conflict of duties, a conglomerate may face conflicts of interest when a firm's self-interest is at odds with their duty to the client. There are substantial conflicts of interest inherent in commercial banking organisations, especially when acting in a fiduciary capacity. When a financial conglomerate trades for its own account, it will almost inevitably conflict with the interests of a customer at the bank. It would be unrealistic to assume all conflicts of interest can be removed from banking, due to the interconnected and overlapping structure of financial service conglomerates. It would be equally unrealistic to assume that Chinese Walls will remain resistant to the pressures of profit pursuit and personal gain.[162] This greed may be an element of culture that encourages the improper resolution of ethical dilemmas.

When considering conflicts of interest, the specific position of financial advisors working in financial service conglomerates should be considered. In Australia, the *Corporations Act*[163], and the mandatory Future of Financial Advice (FOFA) amendments, sit alongside common law and equity's principles of the fiduciary relationship arising 'from ascendancy, confidence, dependence, disadvantage, influence, trust, unequal bargaining power'[164] and vulnerability. The relationship between client and advisor gives rise to a fiduciary expectation parallel with the new best interest duty of FOFA[165]: 'A fiduciary is a person who undertakes to act in the interest of another person'.[166] The scope of the fiduciary's interest increases as the independent authority to be exercised grows. 'No part

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[159] It is appreciated that the Chinese wall may serve two purposes; firstly, as a prophylactic, to prevent information from being misused, and secondly, as a legal tool to provide a defense against liability: Tuch (n 33) 572.
[160] Ibid 572.
[161] *Black v Shearson Hammill & Co* 72 Cal Rptr 157 (Cal Ct App 1968).
[162] 'Paul Volcker's prepared testimony to Senate Banks panel', *Reuters* (online, 24 November 2020) <https://www.reuters.com/article/us-financial-regulation-volcker-text-idUSTRE6115WK20100202>.
[163] *Corporations Act 2001* (Cth).
[164] Paul Latimer and Philipp Maume, *Promoting Information in the Marketplace for Financial Services* (Spring, 2014) 89.
[165] RG 175.242-266 states that an advice provider must act in the best interests of the client in relation to the advice they provide to the client.
[166] Austin Scott, 'The Fiduciary Principle' (1949) 37 California Law Review 539, 540.

of the jurisdiction of the Court is more useful than that which it exercises in watching and controlling transactions between persons standing in a relationship of confidence with each other'.[167] These fiduciary duties, unlike FOFA amendments[168], can be excluded by contract.[169]

In the UK, the relationship between a customer and the bank can be fiduciary. In the ordinary case of banker and customer, the relationship depends entirely or mainly on implied contract.[170] In Australia, the Federal Court confirmed that the law does not recognise the relationship of banker and customer as a fiduciary one:

> [I]t is not a critical feature of a banker/customer relationship that the banker undertakes or agrees to act for or on behalf of or in the interests of its customer in the exercise of some power or discretion affecting the interests of the customer in a legal or practical sense… Absent therefore some special feature, such as the giving of advice in *Smith*[171] there is no reason to erect a fiduciary relationship between banker and customer when that relationship is essentially one founded in contract.[172]

This principle has been applied more recently:

> [C]ases in which a bank lending to a customer comes to occupy a fiduciary position in which it must prefer the customer's interests to its own are rare. Fiduciary responsibility arises only where the bank's role is seen to extend beyond that of finance provider into the area of advice, as in *Commonwealth Bank of Australia v Smith*. The fact that a bank has information about a customer's proposed purchase and the subject matter of that purchase suggesting that transaction over-values the subject matter or that the subject matter may be unprofitable is, of itself, insufficient to give rise to such responsibility.[173]

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[167] *Billage v Southee* (1859) 68 ER 62.
[168] *Corporations Act 2001* s 960A.
[169] *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 160 FCR 35; *Chan v Zacharia* (1984) 154 CLR 178; Pamala Hanrahan, 'The Relationship Between Equitable and Statutory "Best Interests" Obligations in Financial Services Law' (2013) 7 *Journal of Equity* 46, 72.
[170] *N Joachimson v Swiss Bank Corporation* [1921] 3 KB 110 [117].
[171] *Commonwealth Bank of* Australia *v Smith* (1991) 42 FCR 390.
[172] *Golby v Commonwealth Bank of Australia* (1996) 72 FCR 134 [136].
[173] *Timms v Commonwealth Bank of Australia* [2005] NSWCA 137.

The preeminent text on directors' conflicts of interest is by Rosemary Langford.[174] The book provides a detailed analysis of directors' duties in the UK and Australia, with extensive reference to the law in other jurisdictions. It provides a comprehensive analysis of conflicts of duties, unauthorised profits, corporate opportunities and multiple directorships. The content of the book features many things to consider when exploring such a topic as this. This extensive examination presents solutions to complex issues and clarifies existing legal approaches.[175] This book provides a cornerstone of reference for this thesis.

Another leading publication from Langford[176] is grounded in Australian legislative developmental history, which provides evidence to support the paper's premise. Langford et al cite leading cases and scholarly works in a contradictory sense, and contribute heavily to this thesis through their thorough cross-section of the development of directors' duties over the past century. They provide a linear timeline of key moments in legislative development and provide an extensive list of cases central to the development of directors' duties over the years.

In another leading publication, Langford and Ramsay discuss the distinction between the possibility of conflict, and the pursuit of conflict. The paper champions the 'pursuit approach', with a clear set of reasons, justified in evidence that informs and then persuades the audience of the author's point of view. Langford and Ramsay do not necessarily critically evaluate the other literature but rather revaluates and criticises the case interpretation in this field. This article informs on conflicts of interest and introduces a concept that requires a high level of understanding and critique. The references throughout are commonplace in the discussion of this topic, but there are some beneficial sources. This article adds a dimension to this thesis that was previously missing.[177]

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[174] Rosemary Langford, *Company Directors' Duties and Conflicts of Interest* (Oxford University Press, 2019).
[175] Ibid Introduction.
[176] Rosemary Langford et al, 'The Origins of Company Directors' Statutory Duty of Care' (2015) 37(4) *Sydney Law Review* 489.
[177] Rosemary Langford and Ian Ramsay, 'Directors' conflicts: Must a conflict be pursued for there to be a breach of duty?' (2015) 9 *Journal of Equity* 281.

B. *Related Party Transactions*

Historically, banks could not operate with only their customers' best interests in mind, as it would be uncommercial to do so. A bank 'is not a charitable institution'.[178] US case law gives some context and states 'when a bank transacts business with a depositor or other customer, it has no special duty to counsel the customer and inform him of every material fact relating to the transaction'. [179] This is true unless special circumstances exist, like when the bank knows that the customer is placing their trust and confidence in the bank and relies upon them. [180] This may remain true for a financial service conglomerate's banking arm, but current accounts have been vehicles to peddle financial advice, investments, loans, insurance, and more. These products usually come from an approved list of related parties and may not be appropriate or in the customer's best interests.

Financial conglomerates raise unique problems for supervision. When a group operates in both regulated and unregulated markets, decision making is shifted to a central body within the conglomerate. Often directors of subsidiaries are not responsible for the overall direction of the group. It can be challenging to ascertain the fitness and proprietary of those central decision-makers in regulated operations. It also poses problems when conducting business intra-group. Such business must be undertaken at arm's length. Supervisors must be satisfied that transactions are not taking place on terms that differ significantly from market rates.[181]

Davies comparatively analyses the regulation of related party transactions in the UK and the US. [182] The paper provides a comprehensive history of the area's development, highlighting the key difference in the UK's reluctance to use substantive fairness for the legality of related party transactions. Davies builds on the history of related party transactions[183], highlighting the vital relationship between the shareholders and the board. Directors are dealt with in some detail, although not to the extent that this thesis does.

[178] *National Westminster Bank v Morgan* [1983] 3 All ER 85 [91].
[179] *Klein v First Edina National Bank* (1972) 196 NW 2d 619 [623].
[180] Ibid.
[181] The Supervision of Financial Conglomerates (n 3) 8.
[182] Paul Davies, 'Related Party Transactions: UK Model' (February 2018) ECGI Working Paper Series in Law, Working Paper Number 387/2018.
[183] Harold Marsh, 'Are directors trustees? (1966) 22 *The Business Lawyer* 35.

Davies provides a leading cross-jurisdictional analysis of the general English and US law on related party transactions. The opportunity for additional contribution lies in the lack of direct comparison with Australia, with a greater focus on directors.

Enriques et al[184] provide a theoretical framework for the comparison and understanding of related party transactions cross-jurisdiction. The paper deals extensively with legal strategies and ownership regimes concerned with related party transactions in a comparative approach between the US and the EU, and in certain instances, the UK, Brazil and Japan. The paper focuses on the duty of loyalty and intra-group transactions and not just directors exclusively, much like Davies.

Gordon et al[185] initiate research on related party transactions in finance by highlighting two opposing views of related party transactions; they are conflicts of interest that compromise the responsibility of management but can also be efficient. The paper links related party transactions heavily with corporate governance but with an exclusive focus on the US, leaving scope for comparison with other jurisdictions. Although it is not specific to financial institutions and conglomerates, the paper uses exact and extensive empirical data and research, leaving the opportunity to drill down specifically into this area.

Gordon's paper confirms that current research does not address the complexity or diversity of related party transactions and, consequently, a lack of understanding of such transactions' economic impact. Such statements reinforce the idea of a gap in the current knowledge about this area. The paper also lays the foundations for further exploration into the identification and classification of related party transactions.

C. The Global Financial Crisis and the Hayne Royal Commission

The global financial crisis started with the US subprime mortgage crisis in 2007, after the housing bubble burst in late 2006. In true domino-style, the US's credit crunch spread to other economies and jurisdictions, and a series of financial and economic crises in the US

[184] Luca Enriques et al, 'Related Party Transactions' in Reinier Kraakman et al, The Anatomy of Corporate Law, A Comparative and Functional Approach (Oxford University Press, 3rd ed, 2017).
[185] Elizabeth Gordon et al, 'Related Party Transactions and Corporate Governance' (2004) 9 *Advances in Financial Economics* 1.

and Europe began. Housing markets, stock markets, financial markets and financial systems crashed, and numerous banks and financial institutions failed or filed for bankruptcy. The causes of the crisis are complex, and much literature exists on the subject. This thesis does not seek to restate the extensive knowledge base on the subject but rather use the global financial crisis as context for financial service institutions' social impact.

The global financial crisis generated a large, diverse body of academic and non-academic analysis. The literature details the flood of foreclosures, crushed real estate and stock market valuations, numerous failed financial service conglomerates, the sharp economic downturn across the globe and spike in unemployment rates.[186] The global financial crisis represents a focusing event or policy shock, attracting attention from the press, experts and politicians, and prompting investigations by legislative committees, administrative agencies, task forces and inquiries.[187] Few responses are instantaneous, but over a decade has passed since the crisis, so existing analysis is more meaningful and authoritative than ever before.

The economic and market challenges of the crisis renewed focus in the UK on addressing the financial system's vulnerabilities. Numerous papers were written post-crisis, including the influential Turner Review.[188] A Treasury White Paper on Reforming Financial Markets followed soon after in 2009.[189] David Walker then released his report on corporate governance in UK banks.[190] The *Banking Act 2009*[191] filled gaps in the banking framework after the crisis to be better prepared should a large financial service conglomerate fail in the future. In this sense the UK appeared to use the momentum of the crisis to make some changes, although they were heavily governance focussed. The UK is still favoured for 'feather-light' regulation[192] in the financial industry, and many changes in the UK regarding governance and culture remained voluntary.

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[186] Edward Balleisen and Melissa Jacoby, 'Consumer Protections After the Global Financial Crisis' (2019) 107(4) *Georgetown Law Journal* 813, 814.
[187] Ibid 815.
[188] Financial Services Authority, A Regulatory Response to the Global Banking Crisis (March 2009) (The Turner Review).
[189] HM Treasury, *Reforming Financial Markets* (July 2009).
[190] David Walker, A review of corporate governance in UK banks and other financial industry entities (July 2009).
[191] *Banking Act* 2009 (UK) c 1.
[192] Investopedia (n 17).

Numerous other official publications in the UK came in response to those mentioned above. These include a series of papers written by the Bank of England, the Treasury and the Financial Services Authority (FSA), in 2007 and 2008.[193] The Treasury issued a paper on international finance issues, and the Bank of England issued a separate document on its money market operations. The House of Commons Treasury Select Committee produced a series of reports[194] and the House of Lords committees published reports on regulatory reform and regulatory architecture.[195] The FSA ordered an internal review on Northern Rock's supervision in March 2008, leading to the Supervisory Enhancement Programme.[196] The National Audit Office (NAO) published its report on Northern Rock's nationalisation in March of 2009.[197] UK authorities have issued other more specific and technical regulatory papers in the years following the crisis.

The Turner Review[198], mentioned earlier, was chaired by Lord Adair Turner in 2009. Lord Turner was chairman of the FSA at the time, and had been asked by the Prime Minister to report on how the crisis happened by assessing the shortcomings in regulation, and making recommendations for reformation.[199] Turner and other key FSA personnel outlined a number of the key issues within the review and the financial services industry generally in January 2009.[200] The Turner Review also considers product regulation[201], counter-cyclical tools[202] and the imbalance between liquidity and stability[203] and

[193] HM Treasury, Bank of England and the Financial Services Authority, Banking Reform-Protecting Depositors: A Discussion Paper (2007); HM Treasury, Bank of England and Financial Services Authority, Financial Stability and Depositor Protection: Strengthening the Framework, Cm 7308 (2008); Tripartite Authority, Financial Stability and Depositor Protection (2008) Cm 7436; Tripartite Authority, Financial Stability and Depositor Protection: Special Resolution Regime, Cm 7459 (2008).
[194] Treasury Commission, 'Too Important to Fail – Too Important to Ignore' House of Commons, 2010, HC 261.
[195] Economic Affairs Committee, 'Banking Supervision and Regulation' House of Lords, 2009, HL 101.
[196] FSA publishes summary of internal audit review of Northern Rock supervision and announces supervisory enhancement programme (2 February 2021) Thompson Reuters <https://uk.practicallaw.thomsonreuters.com/0-381-1469?service=fs&lrTS=20180918003122655&transitionType=Default&contextData=%28sc.Default%29>.
[197] National Audit Office, 'HM Treasury: Nationalisation of Northern Rock' House of Commons, 2009, HC 298.
[198] The Turner Review (n 186).
[199] Ibid 7.
[200] Adair Turner, Chairman, Financial Services Authority, Address at The Economists Inaugural City Lecture: The Financial Crisis and the Future of Financial Regulation (Jan 21 2009).
[201] The Turner Review (n 186) 106.
[202] Ibid 110.
[203] Ibid 53.

implementation and transition.[204] The FSA issued a further discussion paper supporting and expanding upon the Turner Review.[205]

Until recently, very little research existed to understand the effects of culture in financial service conglomerates and how it was linked to the global financial crisis in the UK. Even less exists on the link between culture and the global financial crisis in Australia, which weathered the event well. Some research since has reassessed what was believed, accepted or took for granted from global financial conglomerates.[206] The Hayne Royal Commission highlighted that the notion of culture being directly linked to financial soundness and stability only took hold in the wake of the global financial crisis.[207] Despite this knowledge, the corporate culture of financial service conglomerates failed to contain the widespread misconduct in the industry subsequent to the global financial crisis. It also demonstrated that lessons from the global financial crisis were not learned in Australia. The Australian Prudential Regulation Authority (APRA) focused on risk culture, a significantly narrower concept than organisational culture, and were not well equipped to tackle the broader spectrum of culture in financial services. Supervision was embryonic, and the regulators lacked a central core of expertise in the types of issues that promoted bad organisational culture.[208] The good thing is we know more about the role of culture in financial stability than we did before.

The Hayne Royal Commission uncovered inappropriate products, contracts[209] and provision of advice[210], encouraged by inappropriate commission structures and a problematic risk-taking culture[211] in the big four banks. Banks have changed considerably and undertake far more than deposit-taking. The concentration of financial services now means that many banks are financial service conglomerates, and although they are referred to as banks, they no longer resemble the banks of years gone by. This is true in the UK and Australia. Modern banking practices involve a complicated structure of credit

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[204] Ibid 115.
[205] Financial Services Authority, Discussion Paper: A Regulatory Response to the Global Banking Crisis (2009).
[206] Sun et al, *Introduction: rethinking corporate governance – lessons from the global financial crisis* in Sun et al, *Corporate Governance and the Global Financial Crisis: International Perspectives* (Cambridge, 2011) 2.
[207] Royal Commission (n 34) 377.
[208] Ibid 382.
[209] Ibid 420.
[210] Ibid Recommendation 2.9.
[211] Ibid 340.

and other products and services, often thrusting an institution into an advisory role, thereby creating a relationship of trust and confidence, potentially resulting in a fiduciary duty.[212] Peculiarities of financial service conglomerates can lead to confusion on whether a duty is owed. Conglomeration and concentration mean they offer overlapping products and services, some attracting fiduciary elements and some not. Complex regulation leads to confusion about employees and directors' duties and obligation. Interconnectedness means products and services from related parties are sold without proper disclosure and not always through the appropriate channels. The negative culture of profit pursuit means duties have been breached, and conglomerates have not acted in their client's best interests.

[212] *Deist v Wachholz* 678 P 2d 188 [193] (1984).

CHAPTER 2: THE FINANCIAL SERVICES SECTOR

This chapter will discuss how financial service conglomerates have evolved in the UK and Australia. It will do so by:

- Briefly outlining the importance of financial institutions;
- Providing key definitions;
- Stating how conglomerates have evolved;
- Showing the operations of UK and Australian financial institutions;
- Stating peculiarities of financial service conglomerates that can cause ethical dilemmas; and
- Considering the role of the Banking Executive Accountability Regime (BEAR) in Australia in managing ethical dilemmas.

I. THE IMPORTANCE OF FINANCIAL INSTITUTIONS

Financial institutions and financial markets are crucial for the global economy.[1] A financial system comprises banks, insurance, investments, finance companies, mutual funds and more, all regulated through multiple channels. These entities form a system that serves three primary objectives; allocating capital, sharing risks and facilitating intertemporal trade.[2] At times, this system fails and can lead to crises that can affect global markets, such as the global financial crisis of 2007-2009.

As finance has become more globalised, capital flow between countries has affected domestic financial systems and reduced financial intermediaries' local monopoly power.[3] This capital flow also means that countries are more exposed to the effects of financial or economic turmoil overseas, evidenced by the global financial crisis. As such, the need to manage risk in financial institutions is more important than ever before.

[1] Friederike Niepmann, 'Banking Across Borders' (2015) 96 *Journal of International Economics* 244, 244.
[2] Harold Cole, *Finance and Financial Intermediation* (Oxford University Press, 2019) 2.
[3] Matteo Cacciatore et al, 'The domestic and international effects of interstate US banking' (2015) 95 *Journal of International Economics* 171, 171.

Firstly, this chapter will introduce key definitions generally used in the financial services industry, and map the UK and Australian financial services systems. It will then highlight peculiarities of financial service conglomerates.

II. KEY DEFINITIONS

A. Banks

A bank is a financial institution that is permitted, through its corporate charter, to accept deposits and extend commercial and retail loans, and perform various intermediation and fiduciary functions. Commercial banks specialise primarily in traditional forms of commercial lending and deposit-taking, while investment banks and securities firms are active in corporate finance, securities underwriting and trading. Universal banks and bancassurance groups engage in a broader range of activities, including traditional banking, securities underwriting, investment management, insurance and trading. Regulators monitor the activities of banks to ensure that clients, particularly small depositors, are properly protected.[4]

B. Financial Crises

Financial crises are characterised by major disruptions in financial markets, usually associated with sharp declines in asset prices and the failure of financial and non-financial firms. Financial crises have been a feature of capitalist economies for hundreds of years. The financial crisis of particular interest to this thesis is the global financial crisis of 2007-2009, the worst in living memory for most.[5]

C. Financial Innovation

Financial innovation is the development of new financial products and services which can make the financial system more efficient. The other side to financial innovation is that it can lead to devastating financial crises, much like the one of 2007-2009.[6]

D. Financial Intermediary

An institution that stands between two clients, or a client and a market, in the provision of financial services, including advice, execution, deposit-taking and financing.[7]

[4] Erik Banks, *Dictionary of Finance, Investment and Banking* (Palgrave Macmillan, 1st ed, 2010) 43.
[5] Frederic Mishkin and Stanley Eakins, *Financial Markets and Institutions* (Pearson, 8th ed, 2015) 48.
[6] Ibid 49.
[7] Banks (n 4) 277.

III. HOW FINANCIAL SERVICE CONGLOMERATES HAVE EVOLVED

There may be multiple motivations for conglomeration, but cost savings and revenue enhancements are two attractive prospects. Economies of scope reduce the fixed costs of products and services[8], and greater market power helps a conglomerate limit entry and enforce mandatory joint product sales.[9] Banks have moved into areas beyond their traditional roles, searching for economies of scale or scope[10], creating the financial service conglomerates we know today.

Some countries have struggled with conglomerates, and restructured and unified their regulatory and supervisory systems to better deal with them.[11] However, restructuring and unifying in response to regulatory failure is a weak ground for reform. 'New structures do not guarantee better regulation… better regulation comes from stronger laws, better-trained staff and enforcement. Any country that thinks tinkering with the structure of agencies will… fix past shortcomings is doomed to relive its past crises'.[12]

Many international financial service conglomerates have achieved systemic importance. Theoretically, larger, diversified firms are less likely to fail, but the consequences are significant if they do.[13] This chapter will now consider the recent historical and regulatory developments in the UK and Australian banking sector.

A. Recent Historical and Regulatory Developments in the UK and Australian Banking Sector

1. The UK

Due to recent consolidation in the financial sector, the largest banks are genuinely universal; activities include underwriting, trading, fund management insurance, and derivatives, to name just a few.

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[8] Business Essentials: Guide to Mergers and Acquisitions (13 April 2021) Investopedia <https://www.investopedia.com/terms/e/economiesofscope.asp>.
[9] Richard Herring and Jacopo Carmassi, 'The Corporate Structure of International Financial Conglomerates' in Allen Berger et al (eds), *The Oxford Handbook of Banking* (Oxford University Press, 2010) 196.
[10] Patrick Gaughan, *A Strategic Growth Guide* (Wiley, 2013) 117.
[11] Ibid.
[12] Jeffrey Carmichael, 'Australia's Approach to Regulatory Reform' in Jeffrey Carmichael et al (eds), *Aligning Financial Supervisory Structures with Country Needs* (World Bank Institute, 2004) 95-96.
[13] Herring (n 9) 197.

The financial services landscape looked very different in the mid-1900s. At the end of the 1950s, around 100 banks were operating in the UK. Around 85% of banking assets and 30% of UK GDP was attributed to the 16 clearing banks, holding about £8.3 billion in assets.[14] The sector also included building societies, accounting for around £2.6 billion of predominantly mortgage-based assets. Banks and building societies flourished from approximately 50% of GDP in 1962 to 65% in 1979.[15] During the 1960s and 1970s, foreign banks increased their presence in the UK, and by 1979 UK institutions held £172 billion of foreign assets. Throughout these decades, the UK banking sector was slowly consolidating.

Presently, over 300 banks and building societies are licensed to accept deposits, but the retail banking sector is saturated. Of the 16 clearing banks mentioned above, 15 are owned by the big four UK banks of Barclays, Royal Bank of Scotland, HSBC and Lloyds Banking Group. With Nationwide and Santander, these banks account for almost 80% of UK lending and deposits.[16] This shows the complex and consolidated ownership structure of UK banks; four banks account for 80% of lending and deposits in the UK. This concentration is predominantly due to the regulatory changes in the UK's financial sector throughout the 19th and 20th century. A similar concentration exists in Australia, where the Big Four banks undertake the majority of banking business. Before discussing Australia, the remainder of this section will discuss the events that led to regulatory change and the effects of those changes on UK banks.

Regulation shapes the competitive environment and dictates how financial institutions pursue their objectives, and banking crises drive new regulatory controls.[17] Reform in response to regulatory failure is a weak ground for change. Still, crises played a role in regulatory reform throughout the UK's history. A banking crisis in 1824-25 resulted in essential legislative change[18]; banks no longer had to be small, private partnerships but could be incorporated as joint-stock companies. Banks of issue comprising more than six

[14] The term 'clearing' refers to a bank that is a member of an organized arrangement for clearing cheques and settling the resulting claim between banks.
[15] Mark Manning et al, Evolution of the UK banking system, *Quarterly Bulletin 2010 Q4,* 322.
[16] Ibid 323.
[17] Simon Ashby, 'Risk Management and the Global Banking Crisis: Lessons for Insurance Solvency Regulation' (2011) 36 *The Geneva Papers* 330, 330.
[18] *Banking Co-Partnership Act* 1826 (UK) c 46.

partners were now permitted to be formed at a greater distance than sixty-five miles from London.[19] This enabled them to raise capital from shareholders and quickly superseded the old bank model. Banks began to grow through acquisition. The level of deposits increased, meaning that much more banking took place, but by far fewer institutions.[20] Change did not end there.

The 20th century saw several key events alter the UK financial system. Competition and Credit Control was a UK consultative document, representing a decisive break with the previous method of controlling bank lending to the private sector.[21] Competition and Credit Control proposed a new approach towards monetary policy to combine control over credit conditions with innovation and competition. The recommendations aimed to stimulate competition between the banks and increase reliance on interest rates as a means of credit control.[22] Recommendations included: '(1) all banks should hold no less than 12% of their deposit liabilities in reserve assets, which included cash, money at call, treasury and local authority bills, and UK government securities with less than one year to run; (2) placing special deposits, variable in amount, by the banks with the Bank of England; and (3) withdrawing Bank of England support for the UK Gilts Market'.[23]

The implementation of these recommendations in 1971 sought to promote competition between banks and non-banks.[24] At this time, clearing banks were beginning to face increased competition from non-bank intermediaries, and end interest rate collusion and widen the scope of banking activities. This meant removing barriers that previously defined types of financial intermediary. Quantitative ceilings were removed, special deposits were repaid, and the old banking cartels were dissolved.[25] The changes meant

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[19] James Gilbart, 'The Laws of the Currency, as Exemplified in the Circulation of Country Bank Notes in England, since the Passing of the Act of 1844' (1854) 17(4) *Journal of the Statistical Society of London* 289, 291.
[20] Manning (n 15) 327.
[21] Charles Goodhart, 'Competition and credit control: some personal reflections' (2015) 22(2) *Financial History Review* 235, 235.
[22] Jonathon Law, *A Dictionary of Finance and Banking* (Oxford University Press, 6th ed, 2018) Online citation.
[23] Donald Rutherford, *Routledge Dictionary of Economics* (Routledge, 3rd ed, 2013) 105-106.
[24] Time machine: London clearing banks' response to Competition and Credit Control (11 February 2020) London Institute of Banking and Finance <https://www.libf.ac.uk/news-and-insights/insights/detail/2019/03/13/time-machine-london-clearing-banks-response-to-competition-and-credit-control>.
[25] Duncan Needham, *UK Monetary Policy From Devaluation to Thatcher, 1967-1982* (Palgrave Macmillan, 2014) 46.

that deposit banks could participate freely in the wholesale market, and liquidity requirements were relaxed.[26] One of the most intense periods of monetary chaos in British history followed.[27]

Before 1971, clearing banks were required to hold liquid assets equivalent to 28%. This was relaxed and extended to all banks, which had to hold assets equal to 12.5%[28], which led to an improvement in clearing banks' competitiveness. It was expected to trigger a reintermediation away from the fringe banking sector, but expansion continued after the reformation, reflecting the economy's growth in the early 1970s.[29] By 1973, money supply had grown by 72% and one of the most rapid growth periods of the 20th century began. Unfortunately, Competition and Credit Control led to Britain's highest-ever period of inflation, the worst banking crisis since the 19th century, and a blow to the banks' reputation.[30] It also contributed to the decline of liquidity requirements down to just 5% by the end of the 1970s.[31]

As the UK's financial system became more global through the 1970s, existing foreign currency exchange arrangements[32] became counterproductive[33], and in 1979, exchange controls were lifted.[34] In the same year, the *Banking Act 1979*[35] was passed, which created a two-tier system of deposit takers and banks. Although this created barriers to entry in some cases, the change increased competition from foreign banks, secondary banks, and non-bank institutions.[36] Following the removal of exchange controls, international capital flows accelerated, and GDP grew. This mirrored the internationalisation of markets, and UK banks continued to become more globally exposed. Exchange control removal encouraged financial liberalisation as jurisdictions became less strictly regulated.[37] This deregulation was a contributing factor to the conglomeration of financial services and the diversification of product portfolios. Shortly after the lifting of exchange controls, the

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[26] Manning (n 15) 327.
[27] Needham (n 25) 46.
[28] Manning (n 15) 327.
[29] Ibid.
[30] Needham (n 25) 46.
[31] Manning (n 15) 327.
[32] As of 1939, only authorised UK banks had permission to deal in foreign currency exchange.
[33] Manning (n 15) 328.
[34] Peter Newman et al, *The New Palgrave Dictionary of Money and Finance* (Palgrave, 1992) 555.
[35] *Banking Act 1979* (UK) c 37.
[36] Andrew Mullineux, *International Banking and Financial Systems: A Comparison* (Graham and Trotman, 1987) 9.
[37] Manning (n 15) 328.

Thatcher government changed the face of financial services in London in 1986, with many of the old firms being taken over by bigger banks.

The 'Big Bang' reforms following deregulation by the Thatcher government sought to increase global competitiveness by ending anti-competitive practices at the London Stock Exchange. It removed barriers to entry to the Stock Exchange and removed price rigidities in securities provision.[38] The abolition of minimum commissions changed brokerage and market-making, ensuring that joint-provision and foreign entry were inevitable. A wave of consolidation followed in the broking and market-making industry and an increase in the number of individual Stock Exchange members.[39]

The deregulation in the 1970s and 1980s discussed above removed the regulatory and institutional restrictions on banks, allowing them to react to economic drivers. Deregulation also increased competition and encouraged banks to expand into new, profitable areas[40], where they experienced significant growth from diversified product portfolios. A possible downside would be that market concentration and the diversification of product portfolios could exacerbate ethical dilemmas such as conflicts of interest and related party transactions. However, the evidence of the benefits of deregulation relies on case studies and anecdotal evidence, so it remains inconclusive. Empirical research is hindered by a lack of specialist companies that compare the outcomes of functionally diverse companies[41], such as financial service conglomerates. We can say that the economies of scale and scope that came with conglomeration and diversification allowed banks to generate substantial profits. These profits provided the basis for their continued growth and product diversification, but perhaps meant the increase in frequency of ethical dilemmas, and the development in regulation and self-regulation essential to their correct resolution, were overlooked.

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[38] Ibid.
[39] Ibid.
[40] Alex Bowen et al, 'The Recent Evolution of the UK Banking Industry and Some Implications for Financial Stability' from BIS (11 February 2020) Bank of International Settlements <https://www.bis.org/publ/confp07l.pdf>.
[41] Manning (n 15) 325.

This continued growth and diversification led to some financial service conglomerates becoming 'too big to fail'.[42] The size of these conglomerates and their systemic importance generated an implicit government guarantee, as their failure might disrupt the whole financial and real economy. If such an institution were on the brink of failure, the taxpayer might be forced to step in to save the bank or prevent a worse outcome.[43] 'Too big to fail' and the associated government bailout packages were a defining characteristic of the global financial crisis and may have influenced financial service conglomerates' attitude towards ethical dilemma resolution. This represents one of the peculiarities of financial service conglomerates, discussed in detail later in this chapter.

To summarise, the structure of the UK financial system has changed significantly over the 19th and 20th century. Where regulatory pressures, deregulation and competition have allowed, banks have grown in size.[44] With the freedom stemming from deregulation, banks began to diversify their portfolios to become universal. Universal banks could combine banking, insurance, and other financial products under a single corporate umbrella.[45] It has been shown that deregulation encouraged financial institutions to grow. Unfortunately, some institutions became 'too big to fail' due to this growth. The concept of 'too big to fail' in financial services is peculiar given their risk exposure and the role they play in a modern society. The existence of 'too big to fail' may alter decision making, resulting in less ethical decisions.

Deregulation in the UK led to large, complex financial institutions with diversified balance sheets, product offerings and services and worldwide interconnectedness. Pre-

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[42] During the Global Financial Crisis, governments across the world went to great lengths to prevent the failure of institutions that they considered too big to fail. Many shareholders suffered losses despite that support, but government intervention made losses infrequent among bondholders and other creditors at systematically important financial institutions. If anything, the market disruptions that followed bondholder losses at Lehman Brothers and Washington Mutual made governments even more reluctant to allow similar failures during the crisis. More recently, large financial institutions face new regulatory burdens and stringent liquidity and capital requirements that raise the cost of being big. These changes redefine the playing field for large, interconnected financial companies. On a global level, the G-20 member countries and the Financial Stability Board identified a group of 29 banks that were rated systematically important financial institutions (G-SIFIs) which were to be subject to more stringent prudential regulations: James Barth et al, 'Just How Big is the Too-Big-To-Fail Problem?' (2012) 13(4) *Journal of Banking Regulation* 265, 266.

[43] Andreas Dombret, 'Cutting the Gordian Knot or splitting hairs – The debate about breaking up the banks' in Andreas Dombret and Patrick Kenadjian (eds), *Too Big to Fail III: Structural Reform* (De Gruyter, 2015) 7.

[44] Keith Pond and Matthias Hloucha, *Retail Banking* (Gosbrook Professional, 4th ed, 2017) 18.

[45] Alan Morrison, *The Oxford Handbook of Banking* (Oxford University Press, 2nd ed, 2014) Abstract.

crisis, the structural changes of conglomeration were championed.[46] John Lipsky of the International Monetary Fund observed that globalisation and financial innovation had increased credit availability.[47] Post-crisis analyses are very different. 'Too big to fail' is an issue for public policy. The social and economic costs associated with pursuing conglomeration commands further attention, and 'too big to fail' is a concern that must be addressed.

2. *Australia*

The Australian financial system has changed from a closed oligopoly in the 1950s and 1960s to a more competitive structure.[48] This process has been driven by market forces, regulation and supervisory arrangements. Despite more competition, Australian banks dominate the financial system as much now as they ever did.[49] The four major banks have significant pricing power, which can be detrimental to consumers[50], and a lack of genuine competition makes ethical predicaments in banking more common. 'The decline in traditional banking' in Australia is similar to the United States, in the sense that there exists a long-term trend involving financial disintermediation and a reduction in the size of the banking sector compared to other forms of financing.[51] There is also a move towards financing through securities markets.

The Australian financial system can be considered in two halves; the financial intermediaries sector and the managed-funds sector. The financial intermediaries sector comprises institutions whose core business activities involve borrowing and lending. The managed-funds sector includes insurance and superannuation funds, and other investments like trust units.[52]

[46] Iain Hardie, 'Banks and the False Dichotomy in the Comparative Political Economy of Finance' (2013) 65(4) *World Politics* 691, 693.
[47] Speech by John Lipsky, First Deputy Managing Director, International Monetary Fund, at the Lowy Institute, Sydney, Australia, July 31st, 2007 <https://www.imf.org/en/News/Articles/2015/09/28/04/53/sp073107a>.
[48] Malcolm Edey and Brian Gray, 'The Evolving Structure of the Australian Financial System' (1996) *RBA Research Discussion Papers 9605*, Reserve Bank of Australia, 1.
[49] Reserve Bank of Australia, Financial Stability Review, March 2006, The Structure of the Australian Financial System (28 February 2020) <https://www.rba.gov.au/publications/fsr/2006/mar/struct-aus-fin-sys.html>.
[50] House of Representatives Standing Committee on Economics, Review of the Four Major Banks: First Report, November 2016, 22.
[51] Gabriela Cornelia Picui et al, 'The Decline of Traditional Banking Activities' (2011) 6(1) *EIRP Proceedings* 351, 353.
[52] Edey (n 48) 2.

Until the 1950s in Australia, financial intermediation was synonymous with banking. In 1953, banks accounted for 88% of the sector. Balance sheets from the time represent a traditional banking product mix. Banks faced little competition from other institutions, and the system was closed to offshore transactions and foreign market entrants. Banking was a low-risk proposition conducted at regulated prices. The other side of the sector, managed-funds, offered very different services than banks.[53]

Banks experienced declining market share through the 1960s and 1970s as non-bank intermediaries prospered due to banks' regulatory disadvantage.[54] To bypass this, banks created new non-bank subsidiaries outside the regulatory scope.[55] While it was agreed that the banks could not be nationalised, the government could intervene in other sectors, such as non-bank financial institutions. Hire purchase, fringe banking, and additional credit creating institutions were regulated to control demand.[56]

Foreign banks would often use non-bank intermediaries to achieve a financial presence in Australia[57] as they were precluded from establishing a formal bank. In other cases, domestic and foreign banks created non-bank joint ventures. The government stated there was no desire for new foreign non-bank institutions, as Australia was 'already adequately supplied with non-bank financial institutions'. 'Generally, there would be little benefit in allowing additional institutions to be established by foreign interests'.[58]

After deregulation, system assets as a ratio to GDP more than doubled between the 1960s and 1990s.[59] Despite an initial slump following deregulation, the Australian economy grew as banks were more competitive. Furthermore, banks began to reabsorb non-bank intermediaries as non-bank intermediaries found it advantageous to convert to banks in the late 1980s and early 1990s. The restrictions on foreign banks were eased in the mid-1980s, and a more open entry policy in the early 1990s saw foreign banks increase at the expense of the merchant banking sector.[60]

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[53] Ibid 3.
[54] Ibid 5.
[55] Ibid 6.
[56] Christopher Berg, 'Safety and Soundness: An Economic History of Prudential Bank Regulation in Australia, 1893-2008' (PhD Thesis, RMIT University, 2016) 141.
[57] Edey (n 48) 6.
[58] Berg (n 56) 141.
[59] Ibid
[60] Edey (n 48) 7.

Deregulation was a critical moment in Australian financial history. It caused a credit boom in the 1980s, which saw Australian banks taking on riskier lending.[61] Deregulation teamed with macroeconomic factors allowed the system to fulfil demands for finance. Availability of finance led to an asset price boom, subsequently feeding back into credit growth. Rising real asset prices and high interest rates meant the managed-funds sector generated high returns in the 1980s. As these were generally superannuation funds and reinvested automatically, the high return rates were paramount to the growth in this sector. The financial sector almost doubled relative to GDP in just over a decade.[62] Although deregulation was a critical factor in the evolution of financial service conglomerates, foreign banks also impacted the Australian financial service sector. Their introduction encouraged competition and imported international banking practices to a previously isolated industry.

(a) Impact of Foreign Banks in Australia

Only two foreign institutions conducted authorised banking business in Australia before 1985.[63] As stated, foreign banks participated in the sector through other means. The Campbell Committee[64] focused on formally opening the domestic banking system to foreign outfits, hoping their inclusion would promote competition. Their ability to do so was doubted, given their presence in the market already. It was stressed that as banks, rather than non-banks, they could provide more diverse services, structure more effectively and be more competitive.[65] Entry restrictions were relaxed in 1984 and saw a limited amount of existing, non-bank intermediaries convert into banks. There were also genuine new entrants. One feature of entry was that foreign banks adopted a subsidiary rather than a branch structure, which allowed capital to be held locally.[66] Capital levels were also set high to encourage applicants with sufficient financial standing only.[67]

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[61] 'What the rest of the world can learn from the Australian Economic Miracle', *New York Times* (online, 24 March 2020) <https://www.nytimes.com/2019/04/06/upshot/australia-lessons-economic-miracle.html>.
[62] Edey (n 48) 7.
[63] These were the Bank of New Zealand and the Banque Nationale de Paris. The Bank of China was also operation up to 1972, then again in 1985.
[64] Parliament of Australia, The Campbell Report, 1981.
[65] Edey (n 48) 22.
[66] Ibid 27.
[67] The minimum Tier 1 capital requirement was AUD20 million and subsequently increased to AUD50 million.

The introduction of foreign-owned banks promoted a new competitive focus on the entire banking system. Australian banks quickly adopted foreign innovations in retail banking. In wholesale banking, foreign banks continued to innovate in financial and derivative markets. As a group, however, foreign banks accounted for around 10% of total system assets.[68] Generally, foreign banks could not impact the Australian banks' position in retail and commercial markets due to established customer loyalty. The second round of entry began in 1992. This time foreign banks were encouraged to apply and were permitted to adopt subsidiary or branch structures if they met the requirements. The number of foreign players rose sharply from 1992, but the total share of banking system assets remained low, with foreign banks focusing on wholesale or institutional markets.[69]

(b) Post-1990 Australian Regulatory Reform

The Australian banking industry experienced the worst losses in almost a century between 1990-1992[70], which might be why entry barriers were relaxed. The losses were due in part to deregulation; competition soared, and asset prices increased quickly. Poor credit assessment in institutions resulted in an overvaluation of assets. High interest rates exposed some of the riskier loans, and the economy entered a recession.[71] Although public confidence in the banks fell, system stability was not a significant concern. Despite considerable losses, Australia's big four banks[72] kept capital ratios high, securing depositors' funds.

The difficulties in the 1980s and 1990s highlight shortcomings in risk management and prudential regulation of financial institutions.[73] As a result, the first half of the 1990s was devoted to overhauling these processes. The second half focused on ensuring that

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[68] Edey (n 48) 28.
[69] Ibid.
[70] David Rodgers, 'Credit Losses at Australian Banks: 1980-2013' (2015) *RBA Research Discussion Papers*, Reserve Bank of Australia, 9.
[71] Ibid 17.
[72] The Four Pillars Policy was introduced in 1990 in order to prevent any merger between the four largest banks in Australia, thereby maintaining competition in the banking market. In recent years, the policy has been called outdated and unsuitable for the digital age. Productivity Commission Chairman Peter Harris stated that the policy has resulted in some very bad commercial decisions and that it 'is an ad hoc policy that, at best, is now redundant as it simply duplicates competition and governance protections in other laws': Productivity Commission, 'Competition in the Australian Financial System', (online, 25 March 2020) <https://apo.org.au/sites/default/files/resource-files/2018-02/apo-nid131551_2.pdf> 5.
[73] Marianne Gizycki and Philip Lowe, The Australian Financial System in the 1990s (10 February 2020) Reserve Bank of Australia <https://www.rba.gov.au/publications/confs/2000/gizycki-lowe.html#r13>.

regulation promoted stability, competition, investor protection and incorporated innovation in the sector. Numerous actions were taken to supervise deposit-taking institutions.[74] Insurance supervision improved with the *Life Insurance Act*[75], which protected people's interests in line with a viable, competitive and innovative life insurance industry.[76] As reforms reached completion in the middle of the decade, the Commonwealth Government established the Wallis Inquiry in 1996. The final report[77] recommended changing financial regulation from a regulatory structure based on institutions, to one based on functions. This was accepted, and separate regulatory agencies deal with prudential supervision, market conduct and payments.[78] One area where regulatory reform benefits are apparent is the harmonisation of prudential standards across financial institutions. Most progress has been made in the development of consistent rules which apply to all deposit-taking institutions.[79]

Unlike the previous decade, the 2000s were quieter until the global financial crisis, bar the 'tech stock' boom and bust, and the collapse of HIH Insurance Group.[80] While all financial systems are different, the Australian system is not drastically different from other high-income countries.[81] Some differences explain the Australian experience of the financial crisis. Australian banks had low exposure to the US housing market and banks, partly because domestic lending was profitable. The historical focus of lending standards meant that risky loans formed a small part of total assets, and ties with China ensured exports buoyed Australia's economy. As the situation worsened, the policy response in Australia mitigated the damage. Central banks quickly lowered interest rates, and the Australian government increased spending to stimulate demand and support employment.

[74] Bank reviews by the Reserve Bank; strengthening consolidated supervision; development of guidelines and measuring and reporting of impaired assets; clarification of the role of auditors and bank directors in oversight of risk management; the passing of formal responsibility for the supervision of state-owned banks to the Reserve Bank and the establishment of the Australian Financial Institutions Commission.
[75] *Life Insurance Act 1995* (Cth).
[76] Ibid s 3(1).
[77] Wallis Inquiry, Final Report, 18 March 1997.
[78] Ibid Recommendations 1 and 2, 37; see also 17.
[79] Gizycki, (n 72).
[80] HIH Insurance was Australia's second largest insurance company before it was placed into liquidation. Their failure is considered the largest corporate collapse in Australia's history. Investigations into the causes of the collapse have resulted in conviction and imprisonment of some members of HIH management relating to fraud: *See generally* Report of the Royal Commission into HIH Insurance, no 32, 13 May 2003.
[81] Kevin Davies, The Australian Financial System in the 2000s: Dodging the Bullet (10 February 2020) Reserve Bank of Australia <https://www.rba.gov.au/publications/confs/2011/davis.html>.

The global financial crisis exposed the corporate governance shortcomings discussed in Chapter Seven. The subsequent improvements discussed in Chapter Eight highlight the link between good governance and stability. Unfortunately, Australian banking has still experienced scandals such as fees for no service[82], misleading regulators[83], charging dead people[84], and the sale of worthless, junk insurance policies.[85] The Hayne Royal Commission, discussed in Chapter Nine, is the most recent and cites conflicts of interest, poor culture and governance, a confusing legal framework and poor leadership as the inciting misconduct.[86]

Financial deregulation has been vital in Australia to increasing competition between banks and other financial services. Banks in Australia continue to run large deposit and lending businesses which account for most assets and profits in the financial intermediation sector. Today the system is better equipped for withstanding turbulence; capital levels are above the mandated amount, and major banks are around the top quartile on a comparable basis for international peers.[87]

IV. What Operations Do They Undertake?

A. The UK's Financial Services Sector

The financial services sector in the UK contributed £132 billion to the economy in 2019. It is responsible for 1.1 million jobs, a surplus in financial services trade of £44 billion and contributed £29 billion in tax in 2017-18.[88]

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[82] 'Fees for no service payouts and offers approach $900m', *Business News Australia* (online, 4 February 2021) <https://www.businessnewsaustralia.com/articles/fees-for-no-service-payouts-and-offers-approach--900m.html>.

[83] 'AMP could face criminal charges for misleading ASIC, banking inquiry hears', *The Guardian* (online, 4 February 2021) <https://www.theguardian.com/australia-news/2018/apr/27/amp-could-face-criminal-charges-for-misleading-asic-banking-inquiry-hears>.

[84] 'Banks still charging dead people months after royal commission, Banking Code Compliance Committee finds', *ABC News* (online, 4 February 2021) <https://www.abc.net.au/news/2020-08-31/banks-still-charging-the-dead-bccc-finds-royal-commission/12614758>.

[85] 'Watchdog oversee $160m in payouts from Australian banks that sold junk insurance', *The Guardian* (online, 4 February 2021) <https://www.theguardian.com/australia-news/2020/may/14/watchdog-oversees-160m-in-payouts-from-australian-banks-that-sold-junk-insurance>.

[86] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Final Report, Volume 1, 1-2.

[87] APRA Information Paper, Strengthening banking system resilience – establishing unquestionably strong capital ratios*,* 18 July 2017, 5.

[88] Chris Rhodes, *Financial services: contribution to the UK economy,* House of Commons Briefing Paper Number 6139, July 2019, 3.

In 2015 the Bank of England published a map of the UK's financial services sector[89], demonstrating the money involved. The figures below are constructed using the data from the Bank of England's document and are in terms of billions of British pounds. For context, Prime Minister Boris Johnson set out a plan in June 2020 to rebuild schools, roads and hospitals to help the UK 'bounce forward' after the coronavirus pandemic. The total figure set aside was £5 billion.[90] This figure is a fraction of the assets and liabilities held by banks. Understanding the size of financial service conglomerates in financial terms helps understand the threat they pose to the wider economy should they fail. If any part of the sector were to fail, the repercussions on the financial system and the real economy could be severe. The sector is detailed below. Finance companies and securitisation special purpose vehicles (SPV) sit on the border of banking and are marked with an asterisk. These entities are considered part of the semi-banking sector.

[89] Oliver Burrows et al, *Mapping the UK Financial System*, Bank of England Quarterly Bulletin, 2015 Q2, 114.
[90] 'Boris Johnson pledges 'New Deal' to rebuild Britain: PM unveils £5 BILLION programme to construct schools, hospitals and roads to help country 'bounce forward' after coronavirus', *The Daily Mail* (online, 1st July 2020) <https://www.dailymail.co.uk/news/article-8472349/Boris-Johnson-unveils-massive-programme-construct-schools-hospitals-roads.html>.

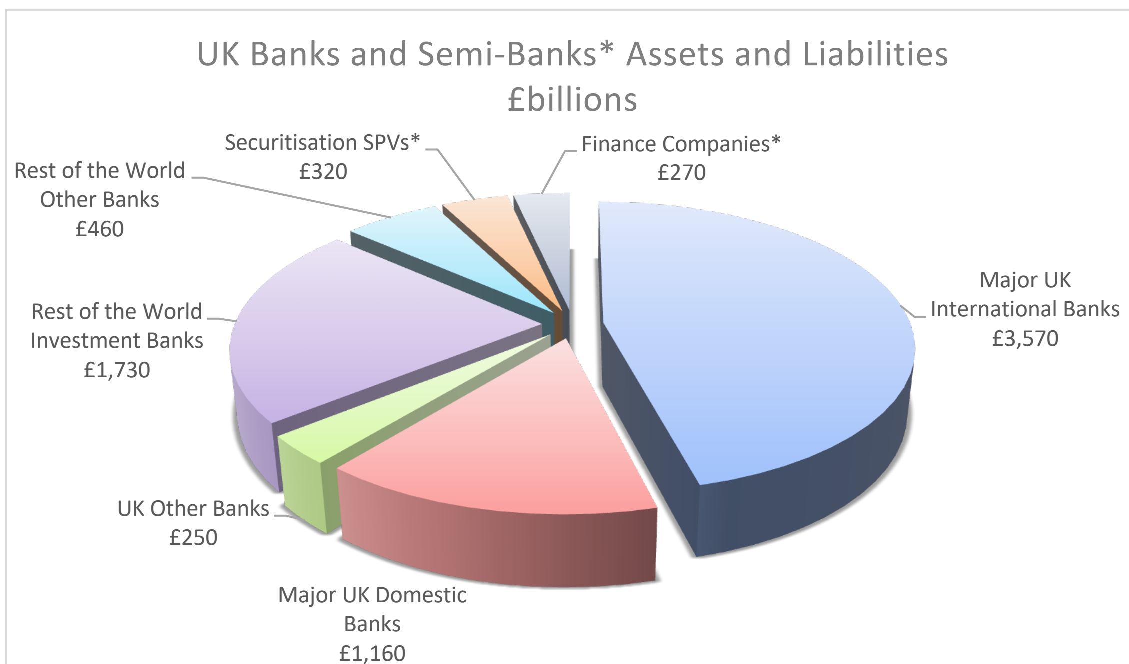

Figure 2. UK Banks and Semi-Banks Assets and Liabilities[91]

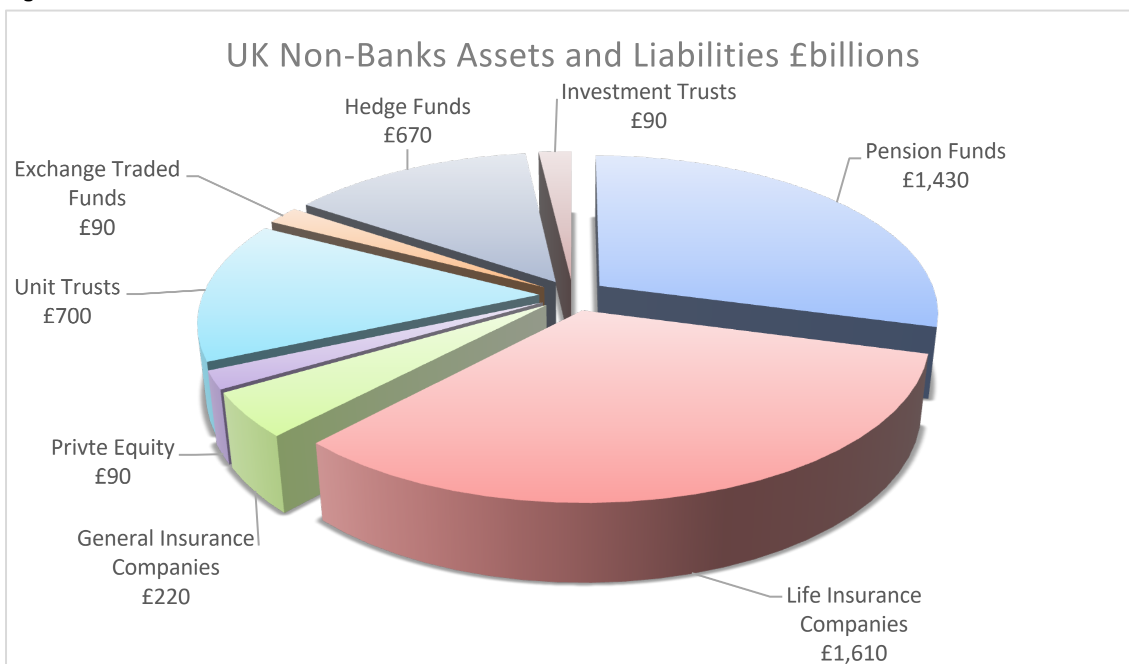

Figure 3. UK Non-Banks Assets and Liabilities[92]

This section will now explore the operations within the UK banking sector.

1. *Banks*

Banks execute critical functions at the core of the financial system. The UK has a large banking sector in terms of foreign bank activity and international operations of UK banks,

[91] Figures generated with data taken from Burrows (n 89) 114.
[92] Ibid.

making it genuinely global. Banks in the UK can be split into three distinct groups; the major UK domestic banks, the major UK international banks and UK other banks. The branches of overseas banks are divided into two parts; investment banks and Rest of the World (RoW) other banks. Investment banks operate in capital markets and include 'designated firms' subject to the Prudential Regulation Authority, which do not accept deposits. The RoW other banks are international banks who operate in London but do very little business with UK clients.[93]

2. *Semi-Banking Sector*

Two types of institution sit on the border of banking; finance companies and securitisation special purpose vehicles (SPV). These are usually, but not always, owned by banks. Like banks, finance companies lend money and may be owned by the banks, but customer deposits do not finance loans. A standard method of funding for finance companies and banks is via securitisation. Generally, a bundle of loans is sold to an SPV, which holds loans as assets. The SPV issues debt securities to outside investment where the interest and principal payments are covered by cash flow from the original loans. The risk associated with the loans is transferrable to other investors and traded on a secondary market as debt securities.[94]

3. *Non-Bank Sector*

Products offered in the non-bank sector include a range of structures and risk profiles. Some products are aimed at helping households plan for retirement, and others are more general and aimed at various investors. Products aimed at assisting households are life insurance, pension funds and general insurance.[95] The remainder of the non-bank sector comprises different forms of collective investment schemes, which vary depending on whether their assets are liquid or illiquid and what types of risks they can take. These include unit trusts, investment trusts and exchange-traded funds. Many of these are marketed to retail investors and must comply with conduct regulations. Hedge funds, private equity funds and unauthorised funds are typically sold to sophisticated investors

[93] Ibid 122.
[94] Ibid.
[95] Ibid.

and professional institutions and are not subject to the same rules. This generates numerous potential investment strategies.[96]

In April 2013, the UK moved to a twin peaks approach to financial regulation. The previous body, the Financial Services Authority (FSA) ceased to exist and was split to become the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA), a division of the Bank of England. The FCA and PRA are the lead bank regulators. The FCA protects consumers, enhances market integrity and promotes competition to ensure consumers get a fair deal. As part of the Bank of England, the PRA regulates and supervises financial services firms to reduce the chances of firms experiencing financial difficulty. The Bank of England is the resolution authority, responsible for regulatory intervention if banks are failing or likely to fail. The role of the Bank of England in terms of culture and conflicts is limited. Australia adopt a very similar structure of financial regulation.

Other UK authorities include Her Majesty's Treasury, which influences bank regulation and is responsible for economic and financial policy. They report to the UK parliament on serious problems in the financial system and how they might be resolved. There is also a Payment Service Regulator, a Financial Services Compensation Scheme, responsible for ensuring compensation is paid to eligible claimants when banks fail, and a Financial Ombudsman Service with the statutory responsibility to handle consumer complaints.

B. Australia's Financial Services Sector

In Australia, the financial services sector contributed around AUD140 billion to GDP over 2018-19 and employed 450,000 people. The four major banks are among the world's largest by capitalisation and are within the top 25 safest banks. They are among the most profitable banks in the world, backed by a robust regulatory system. Australia's annual economic growth is double the rate of comparable commodity-focused Canada, above the OECD average and higher than the average across G7 economies.[97]

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[96] Burrows (n 89) 123.

[97] The strength of Australia's financial sector (24 November 2019) Australia Government Treasury <https://fintech.treasury.gov.au/the-strength-of-australias-financial-sector/>.

The financial services sector in Australia has been a vital element of a growing economy. At the end of 2017, banks, credit unions, building societies, general insurance, life insurance, private health insurance, friendly societies, and the superannuation industry held a combined total of AUD7.6 trillion in assets. The financial services sector employs 3.5% of the workforce and is proportionally larger than most other advanced economies.

The banking system is highly concentrated. The four main banks, which are systemically important, account for about 80% of assets. Banks and superannuation funds dominate the sector, and Australian banks are well capitalised, reasonably liquid, make extensive use of wholesale funding markets, retain a high level of profit in global terms, and have moved their business models towards real estate lending in recent years.[98] The graphic below demonstrates the concentrated nature of banking activity in Australia, which may contribute to a greater frequency of ethical quandaries, including conflicts of interest and related party transactions.

[98] International Monetary Fund, Financial System Stability Assessment Australia, 11-13.

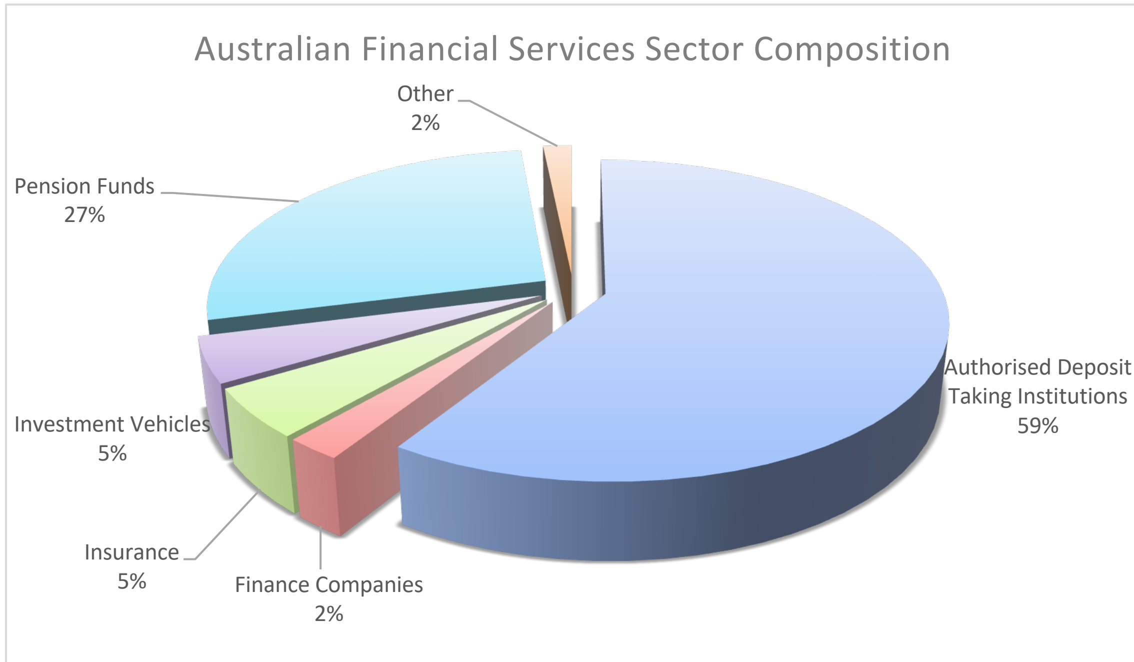

Figure 4. Australian Financial Services Sector Composition[99]

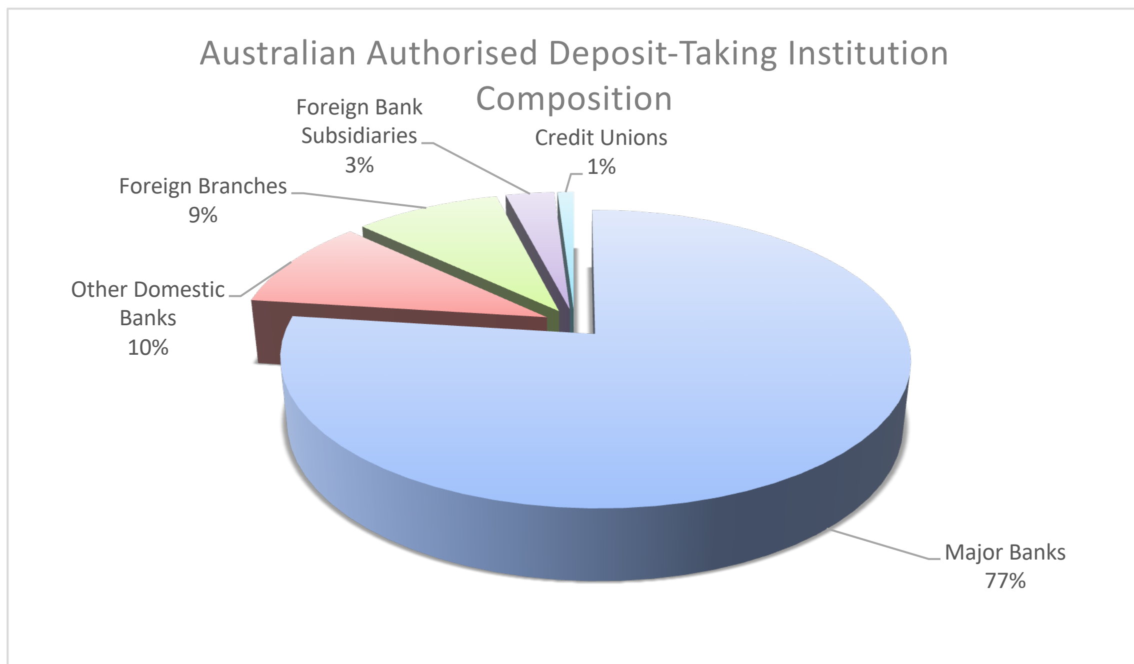

Figure 5. Australian Authorised Deposit-Taking Institution Composition[100]

[99] Figure generated with data taken from International Monetary Fund, Financial System Stability Assessment Australia, 11.
[100] Ibid.

Growth in the sector is due to a substantial increase in household borrowing, growth in the superannuation savings pool and the rapid growth of financial markets.[101] The Murray Enquiry[102] concluded that the level of competition was 'generally adequate' and suggested that '… the high concentration and increasing vertical integration in some parts of the Australian financial system has the potential to limit the benefits of competition in the future'.[103] The Australian Competition and Consumer Commission (ACCC) identified several indicators limiting competition, concluding that '…the current oligopoly structure of the banking system is not vigorously competitive and has not been for some time'.[104] As stated, the size and diversity of financial service conglomerates may pose regulatory challenges in both the UK and Australia.

1. *Banks*

Australian banks are central to the system, holding most financial assets. Alongside traditional deposit-taking and lending, Australian banks undertake trading, stockbroking, insurance and wealth management. The four largest banks within Australia, Commonwealth Bank (CBA), National Australia Bank (NAB), Australia and New Zealand Banking Group (ANZ) and Westpac, are nationwide and offer an extensive portfolio of products and services. All are financial service conglomerates also. Each bank operates overseas, the largest market being New Zealand, accounting for around a quarter of consolidated group assets. By international standards, these banks are significant in terms of market capitalisation and consolidated group assets. Australian banks have remained profitable and stable in the face of market turmoil due to their core banking business and the rapid growth of non-banking activities. Following numerous joint ventures and acquisitions, banking groups are among the largest fund managers in the country.[105]

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[101] Rodney Maddock, 'Is the Australian Financial Sector Too Big?' (Monash University and Victoria University July 2013) 5 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2288949>.
[102] Competition in the Australian Financial System, Productivity Commission Inquiry Report, No 89, 29 June 2018.
[103] Ibid 58.
[104] 'Big bank mergers: ACCC wants 'four pillars' policy examined', *Sydney Morning Herald* (online, 28 February 2020) <https://www.smh.com.au/business/banking-and-finance/big-bank-mergers-accc-wants-four-pillars-policy-examined-20170919-gykg9m.html>.
[105] Financial Stability Review (n 49).

Foreign-owned banks account for a fifth of banking system assets in Australia, and there are 39 in operation.[106] The rise of foreign banks came with deregulation when entry barriers were removed. Although many of Australia's banking groups have wealth management and insurance operations, Suncorp-Metway and AMP earn a larger share from these operations than banking.[107] Finally, Macquarie Bank, the sixth-largest in Australia, makes most of its after-tax profits from funds management, the rest accounted for by traditional investment activities. Financial trading and lending contribute to the remainder.[108]

2. *Other Authorised Deposit-Taking Institutions*

Aside from banks, only two other types of authorised deposit-taking institutions exist: credit unions and building societies. These account for 2% of domestic financial system assets.[109] Subject to the same regulator and regulations, these two types of institution differ by way of ownership and capital structure. Credit unions have a mutual ownership structure, making their customers shareholders. Building societies are member-owned, offering a range of financial products and services similar to those offered by some banks. Credit unions are not subject to capital adequacy regulations, whereas building societies are, but to a lesser extent than banks.[110]

Credit unions and building societies grew in Australia, mostly thanks to fewer regulations, and by 1985, there were 60 building societies and 400 credit unions in operation. Following deregulation, there were only 14 building societies and 157 credit unions.[111] The decline results from mergers and acquisitions and bank conversions, reflecting external industry pressures such as difficulties in raising external capital; increased competition from banks and mortgage originators; and the favourable tax treatment of mutual income in the mid-1990s. As a result, the combined share of credit unions and building societies in housing and personal loan markets fell from almost 30% in 1985 to less than 6% in 2006.[112] This concentration reflects a potential for more commonplace ethical dilemmas. In recent years credit unions and building societies have performed well

[106] Ibid.
[107] Ibid.
[108] Ibid.
[109] Ibid.
[110] Ibid.
[111] Ibid.
[112] Ibid.

thanks to low interest rates, strong competition and property price fluctuations. Total assets grew to AUD117.3 billion in 2018 and credit unions and building societies remain an attractive option to consumers, representing 2.4% of total system assets.[113]

3. *Registered Financial Corporations*

Registered financial corporations (RFCs) are not subject to the same supervision as banks, building societies and credit unions. Still, they are subject to the same disclosure regulations that ASIC applies to the non-financial corporate sector. Finance companies hold a large proportion of their assets as loans to the business and household sector, typically as lease finance for businesses and motor vehicles, and retail for households. These institutions' importance initially declined from around 19% of total domestic assets of financial intermediaries in 1985 to 6% in 2006.[114] As of 2012, there were over 300 RFCs in Australia, accounting for about 5% of financial system assets.[115] Around 120 RFCs report to APRA, 20 of which are money market corporations. Their sizes vary, with the largest holding assets of AUD15 billion while 30 or so have less than AUD100 million in assets.[116] Even though they are small, their linkages with the regulated baking system could be a source of risk.

4. *Managed Funds*

Managed funds have grown substantially in the past 30 years. Legislative changes in retirement savings arrangements and higher returns have encouraged investment and growth in the sector. Superannuation assets totalled AUD2.9 trillion at the end of the September 2019 quarter, up 7.1% on the previous year.[117] Employer-funded superannuation has spurred growth since 1986, and compulsory superannuation in 1992 kept the momentum. Currently, the superannuation guarantee is 9.5% of an employee's full-time earnings, and is set to continue rising in the coming years.[118]

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[113] KPMG, Mutuals industry review, 2018, 6 (8 January 2021) KPMG <https://assets.kpmg/content/dam/kpmg/au/pdf/2018/mutuals-industry-review-2018.pdf>.
[114] Reserve Bank of Australia (n 49).
[115] Reserve Bank of Australia, A Closer Look at the Shadow Banding System in Australia, Financial Stability Review, March 2012, 70.
[116] Ibid.
[117] Superannuation Statistics (14 February 2020) Association of Superannuation Funds of Australia <https://www.superannuation.asn.au/resources/superannuation-statistics>.
[118] ATO super guarantee percentage (8 January 2021) Australian Tax Office <https://www.ato.gov.au/rates/key-superannuation-rates-and-thresholds/?anchor=Superguaranteepercentage>.

In addition to superannuation funds, life insurance companies also account for retirement savings. There has been a notable decrease in superannuation assets held by life insurance companies, and the industry is highly concentrated. APRA has previously shared concerns for the life insurance industry's sustainability, including poor risk management practices and culture, the impact of scandals such as CommInsure[119], and poorly designed remuneration arrangements that promote misconduct and unethical behaviour in the sector. Similar issues have been addressed in the Hayne Royal Commission's final recommendations [120], evidencing these themes are common in financial services. Regulation in the industry is shared between ASIC[121] and APRA.[122] Life insurers and advisors are subject to the *Corporations Act*[123], the *Australian Securities and Investments Commission Act*[124], the *Insurance Contracts Act*[125] and the *Life Insurance Act*.[126] Public unit trusts, cash management trusts, and hedge funds make up the rest of the managed funds sector.[127]

5. *General Insurance*

Insurance profit for the year ended June 2020 was down 48.31% to AUD2,274 million[128] following a 12% drop in 2019[129] after two profitable years. Natural hazards, volatile market conditions and the Covid-19 pandemic meant the Australian insurance industry faced more challenges than ever before. As of June 2021, there are 93 insurers with a net profit after tax of AUD1 billion.[130]

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[119] The Colonial Mutual Life Assurance Society Ltd, trading as CommInsure, was fined $700,000 in 2019 after pleading guilty to 87 counts of offering insurance products through unlawful telemarketing calls, known as hawking: *See generally* Office of the Director of Public Prosecutions Annual Report 2019-20, Case Study: CommInsure fined $700,000 for hawking offences.
[120] Royal Commission (n 86) Recommendations 2.4, 2.5 and 2.6 address conflicted remuneration, and Recommendations 1.6, 2.7 – 2.9 and 5.1 – 5.7 address culture, governance and remuneration more generally.
[121] ASIC deals with licensing, conduct, product operation, product disclosure and marketing and dispute resolution.
[122] APRA deals with registration, prudential standards and data collection.
[123] *Corporations Act 2001* (Cth).
[124] *Australian Securities and Investments Commission Act 2001* (Cth).
[125] *Insurance Contracts Act 1984* (Cth).
[126] *Life Insurance Act 1995* (Cth).
[127] Financial Stability Review (n 49).
[128] KPMG General Insurance Industry Review 2020, 4.
[129] KPMG General Insurance Industry Review 2019, 6.
[130] Australian Prudential Regulation Authority, Quarterly general insurance performance statistics – highlights, June 2021, 3.

6. *Securitisation Vehicles*

Securitisation markets have grown in Australia and now form an essential part of the financial system. Securitisation allows lending activities to be funded indirectly through capital markets. The securitisation market has expanded rapidly at an average annual rate of about 30% since 1995. As of 2005, the total assets of securitisation vehicles amounted to about AUD170 billion, around 7% of total financial system assets.[131] As of 2018, around 98% of asset-backed securities are backed by residential mortgages, with a value of about AUD400 billion.[132]

The day-to-day supervision of financial institutions and markets lies with ASIC, APRA, and the Reserve Bank of Australia (RBA). The RBA's role is laid out in the *Reserve Bank Act*[133], and empowers it to issue currency and conduct monetary policy. APRA and ASIC are the lead bank regulators and form the twin peaks approach to regulation for financial service conglomerates, and regulatory responsibility is shared between the two bodies. ASIC is responsible for regulating companies, market conduct and consumer protection[134], and APRA is responsible for prudential regulation.[135] Information sharing and collaboration between regulators is essential, as some market participants may be overseen by both bodies. The problems experienced by HIH Insurance[136] and Trio Capital[137] demonstrated the need for collaboration, particularly at the operational level. Collaboration is also essential for timely and effective responses to problems. The UK also follows a twin peaks approach to financial regulation, and the model is becoming more important as other countries look to move towards it.

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[131] Financial Stability Review (n 49).
[132] The Reserve Bank's Securitisation Dataset (8 January 2021) Reserve Bank of Australia <https://www.rba.gov.au/publications/bulletin/2018/dec/the-reserve-banks-securitisation-dataset.html>.
[133] *Reserve Bank Act 1959* (Cth) s 8.
[134] Our role (8 March 2020) ASIC <https://asic.gov.au/about-asic/what-we-do/our-role/>.
[135] About APRA (8 March 2020) APRA <https://www.apra.gov.au/about-apra>.
[136] *See generally* (n 80).
[137] Trio Capital undertook highly complex fraud, originating with the establishment of a managed investment scheme. Directors and investors were continuously deceived in terms of assets and returns in the operation of the scheme. Their collapse had a significant and detrimental impact on numerous Australian investors, especially those who were ineligible for compensation because they were members of superannuation funds that were not prudentially regulated by APRA. Further investigations showed an expectations gap within the community about the regulatory responsibilities of APRA and ASIC and their ability to safeguard against investment risks: *See generally* Department of Treasury, Review of the Trio Capital Fraud and Assessment of the Regulatory Framework, 2013.

Other authorities include the Federal Treasury, an executive arm of the Government focused on economic policy, the Australian Tax Office (ATO), primarily concerned with broader issues affecting revenue systems, and the Australian Transactions Reports and Analysis Centre (AUSTRAC). AUSTRAC is Australia's anti-money laundering and counter-terrorism financing regulator, and regulates designated services carried on by reporting entities. Australia also has the Australian Competition and Consumer Commission (ACCC) which is an independent statutory authority, charged with enforcing the *Competition and Consumer Act*[138], promoting competition, fair trading, and regulating national infrastructure.[139]

V. EXAMPLES OF FINANCIAL SERVICE CONGLOMERATE'S OPERATIONS FROM THE UK AND AUSTRALIA

Australia is a good example of a highly concentrated and connected financial services industry. These characteristics have encouraged unethical practices in their operations. A 2018 study on vertical integration[140] in Australia's five largest banking and financial service institutions[141] was conducted. The study found that advice lists in these institutions comprise 21% in-house products versus 79% of external products. After receiving advice, customers invested 68% of their money in in-house products and only 32% in external product offerings. This represents a potential mismanagement of ethical dilemmas. Only 25% of the advice offered was compliant, whereas 75% was not. 10% of that advice ASIC found significantly concerning because it resulted in higher ongoing product fees or an inferior insurance arrangement for customers.[142] Non-compliance means that an advisor has not demonstrated compliance with the best interest duty and related obligations.[143] This shows that clients' interests may have conflicted with the conglomerate's interests, the personal interests of those selling financial products, or both.

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[138] *Competition and Consumer Act 2010* (Cth).
[139] About the ACCC (1 November 2021) ACCC <https://www.accc.gov.au/about-us/australian-competition-consumer-commission/about-the-accc>.
[140] ASIC Report 562, Financial advice: Vertically integrated institutions and conflicts of interest, January 2018.
[141] AMP Limited (AMP), Australia and New Zealand Banking Group Limited (ANZ), Commonwealth Bank of Australia (CBA), National Australia Bank Limited (NAB) and Westpac Banking Corporation (Westpac).
[142] ASIC Report 562 (n 141) 7.
[143] Ibid 9.

The figures below depict the UK and Australian banks which are financial service conglomerates considered in this thesis. These graphics were accurate as of 2019, before the completion of the Hayne Royal Commission. The figures show a simplified representation of the multitude of products and services that these financial service conglomerates offer consumers.

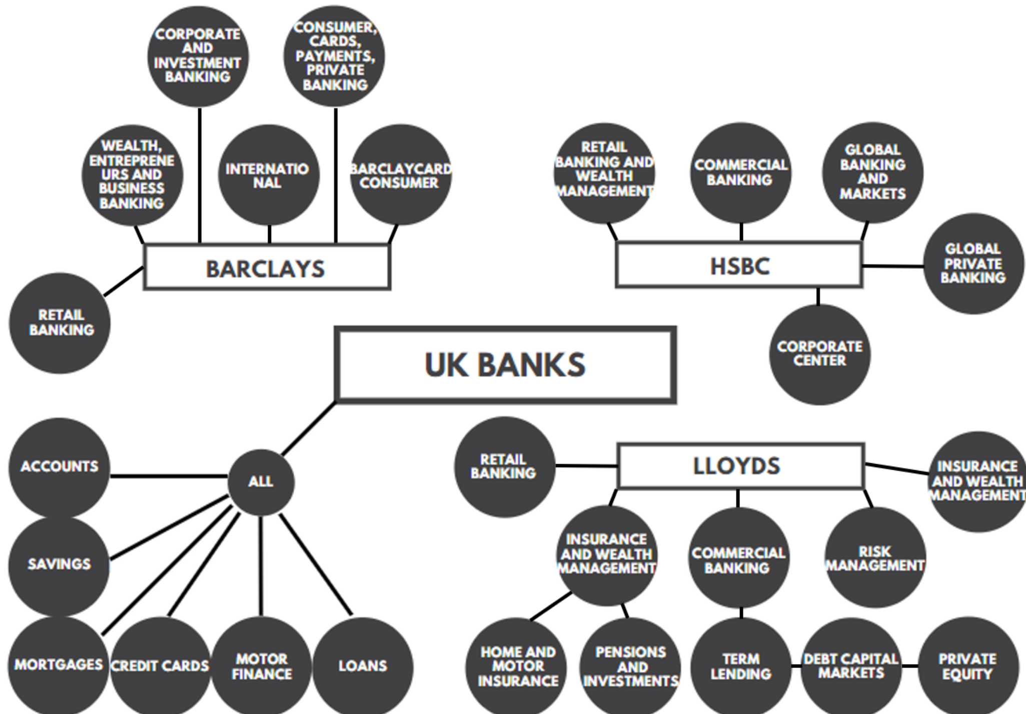

Figure 6. Busines Activities of the UK's Largest Financial Service Conglomerates in 2019

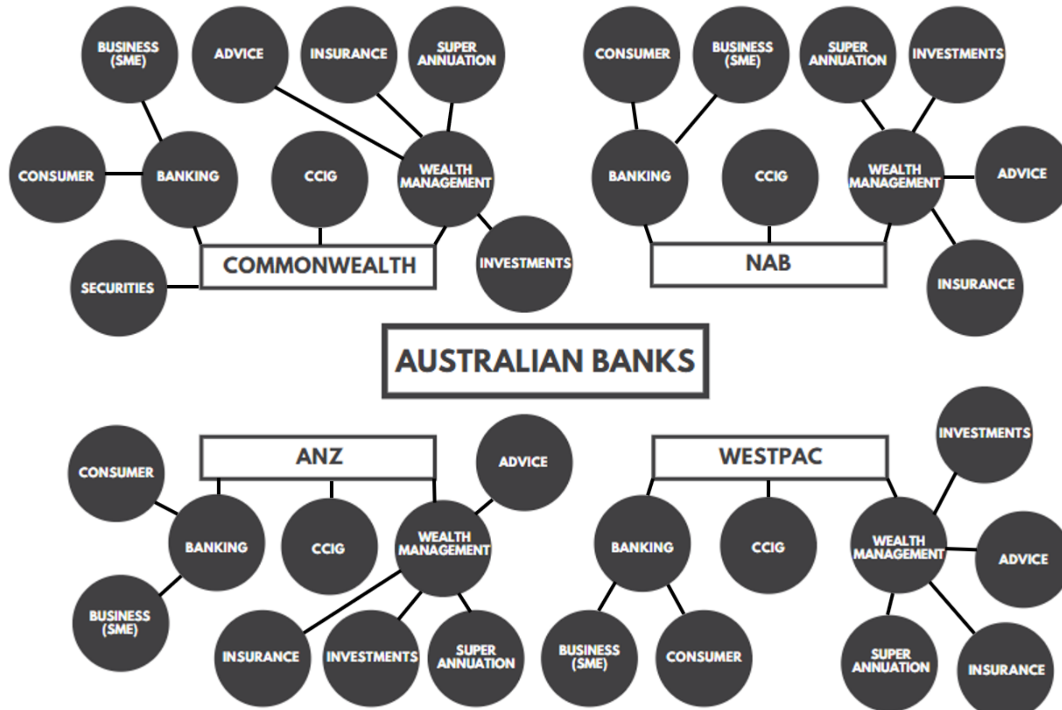

Figure 7. Business Activities of Australia's Largest Financial Service Conglomerates in 2019

*The acronym CCIG is used to describe a broad range of products and services that Australian banks provide commercial, corporate, institutional and government bodies. These products and services include but are not limited to transactional banking, financial and debt capital markets, specialised capital, and alternative investment solutions.

These various products on offer from these financial service conglomerates may, or may not, be provided through wholly-owned subsidiaries sharing the same or a different name to that of the holding or parent company. It may not always be clear who owns these subsidiaries. These subsidiaries often offer products and services owned by the parent company and sold as preferred products. The ethical issues such as conflicts of interest that can occur on an internal scale are represented in Figure 1, included in this thesis's introduction.

The figures show that financial service conglomerates are concerned with more than just banking, and genuine competition is low. Each institution has diversified through acquisition, as established earlier in this chapter. This has led to a concentration in the market where ethical predicaments like conflicts of interest and related party transactions are commonplace. The structural complexity can result in 'legislative porridge'[144] and invites various risks from diversified product portfolios. Due to their structure, organisational culture can be spread throughout the conglomerate. If this culture is less ethical, then it is likely that ethical dilemmas will be acted on improperly.

VI. The Problems with Conglomeration and the Regulatory Challenges Conglomerates Pose

A. Problems with Conglomeration in Financial Services

Conglomeration does not necessarily promote stability in the financial sector. During the global financial crisis in the UK, vast amounts of public resources were engaged. Unlike previous financial crises, which affected smaller banks, the global financial crisis impacted the largest and most important institutions. Many of the banks experiencing

[144] *Wingecarribee Shire Council v Lehman Brothers Australia Ltd (in liq)* [2012] FCA 1028 [948] ('*Wingecarribee*').

difficulties were centuries old, and all had one commonality; a policy to acquire market share.[145]

Acquisition was encouraged by deregulation, but there are consequences to deregulation and conglomeration. Large conglomerate organisations now offered clients products and services from related parties within the organisation alongside heightened conflicts of interest, related party transactions, and risk.[146] All these elements are potentially harmful to the institution and financial system when managed improperly. Below are two examples of how conglomeration undermined stability.

The Royal Bank of Scotland (RBS) pursued expansion since the 1980s. The bank grew considerably, eventually becoming a large, complex, financial conglomerate, exacerbating its problems. Substantial losses came from the subprime mortgage lending of its US arm, Greenwich Capital, which had been acquired during its expansion with the purchase of the National Westminster Bank. The disastrous takeover of ABN Amro in October 2007[147] formed a significant part of its £24.1 billion loss in 2008, as RBS paid three times the book value of the Amsterdam-based bank, failing to amend the buying terms when the credit crunch hit in the summer of the same year.[148] A lack of due diligence led to the acquisition of underperforming assets that were problematic when the crisis finally hit.[149]

The Bank of Scotland (HBOS), a different institution to RBS, continued to expand during the crisis, but failed to attract enough interest from investors and would have collapsed if not for Lloyds TSB's[150] takeover, also seeking increased market share through

[145] Dalvinder Singh, 'UK Approach to Financial Crisis Management' (2011) 19(3) *Transnational Law and Contemporary Problems* 868, 877.
[146] Dimity Kingsford Smith et al, 'Banking and the Limits of Professionalism Thematic: Contemporary Professionalism and Regulation' (2017) 40(1) *University of New South Wales Law Journal* 411, 417.
[147] 'What was RBS board thinking when it back ABN Amro takeover? It wasn't', *The Guardian* (online, 28 June 2020) <https://www.theguardian.com/business/nils-pratley-on-finance/2011/dec/12/what-rbs-board-thinking-abn-amro>.
[148] 'Was ABN the worst takeover deal ever?', *The Independent* (online, 28 June 2020) <https://www.independent.co.uk/news/business/analysis-and-features/was-abn-the-worst-takeover-deal-ever-1451520.html>.
[149] Singh (n 145) 878.
[150] The TSB name was used by the Trustee Savings Bank before its merger with Lloyds Bank in 1995, resulting in the name Lloyds TSB in 1999. TSB began operation as a separate business within the Lloyds Banking Group in 2013, and was floated on the stock market in 2014, after the failure of the Project Verde deal with the Co-operative Group: Bernardo Batiz-Lazo and Douglas Wood, 'Effects of regulatory

acquisition. The Office of Fair Trading in the UK advised against the takeover, as it would lead to a 30% market share for the merged entity in personal current accounts, competition problems in banking in Scotland, and the elimination of the primary challenger to the four main established banks at the time.[151] Lloyds Banking Group's takeover of Abbey Bank was blocked in 2001, as their market share of personal current accounts could have been up to 27%. Still, the Bank of England, the Financial Service Authority and the Treasury favoured the takeover in the name of stability. The Lloyds Banking Group takeover resulted in the need for a 43% government bailout at the cost of £20 billion to the British taxpayer. In 2019 a High Court judge in London dismissed claims that Lloyds Banking Group executives had misled shareholders in recommending the takeover of HBOS.[152]

Europe also had an influence on conglomeration in the UK. Financial integration in the eurozone increased markedly in the decade leading up to the global financial crisis, moving capital and fuelling property price bubbles in Ireland and Spain. As the crisis started, a process of retrenchment within national borders began, and by 2010, financial fragmentation advanced across the European Union.[153] This trend suggests that conglomeration is not conducive to stability, although bank fragility and regulatory pressure for capital adequacy in the bank's home country played a role. Big banks pioneered market concentration, and financial service conglomerates carried the momentum.

B. Regulatory Challenges Posed by Large and Diverse Financial Service Conglomerates

The FCA in the UK and ASIC in Australia provide a swathe of Regulatory Guidance documents, legislative instruments, class orders, reports and information papers that run into the high hundreds of numbers of documents for all manner of financial activities. Depending on the nature of the conglomerate's business activities, some, or all of these could apply.

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change on European banks: A case study on the strategy and stock market performance of Lloyds Bank (1980-1993)' (2003) Economic History 0301004, University Library of Munich, Germany, 23. Project Verde is discussed in Chapter Seven.

[151] Xavier Vives, *Competition and Stability in Banking: The Role of Regulation and Competition* (Princeton Press, 2016) xiv.

[152] 'Lloyds shareholders lose legal fight over HBOS takeover', *The Guardian* (online, 28 June 2020) <https://www.theguardian.com/business/2019/nov/15/lloyds-shareholders-lose-legal-fight-over-hbos-takeover>.

[153] Vives (n 151) 33.

There are also standalone documents containing conduct principles such as the FCA Listing Rules, ASX Listing Rules, the UK Corporate Governance Code, and the Banking Code of Practice. Complex and voluminous regulation and guidance may have confused some institutions in the UK and Australia regarding the scope and depth of their obligations. This has undermined the spirit of regulation. Directors are not always aware of the duties they owe[154], and the vast documentation that applies to their role, of which they may hold more than one, may be confusing.

Regulators and competition authorities have a broad range of conduct and structural rules and face many challenges. Conduct rules directly affect banks' actions and may restrict competition. Structural measures affect the boundaries of the firm and market structure. Currently, even a well-designed activities-based approach to regulation cannot prevent an individual part of a conglomerate from spreading systemic risk throughout. AIG, Bear Stearns, and Lehman Brothers in the US, all undertook a broad range of activities and failed because risks were not isolated.[155] An activities-based approach to regulation is inherently blind to the cumulative nature of a firm's systemic risk profile.[156] This means that identifying new, risky financial activities within conglomerates is impossible. Entity-based regulation, such as capital, liquidity, and risk-management requirements, is better suited to governing the cumulative effect of a conglomerate's risk.[157] It may be more effective to alter the scope of financial service conglomerates rather than redesign regulation to mirror their activities.

There should be competition and stability in the sector. The literature on the relationship between the two has been inconclusive, but it has been suggested recently that more competition does not necessarily worsen stability.[158] By discouraging the urge to merge, regulators can increase competition. Regulators have already helped new fintech entrants by making it harder for banks to use their payment networks as entry barriers[159], but more

[154] Robert Goddard, 'Directors' Duties' (2008) 12(3) *Edinburgh Law Review* 468, 469.
[155] Jeremy Kress et al, 'Regulating Entities and Activities: Complementary Approaches to Nonbank Systemic Risk' (2019) 92(6) *Southern California Law Review* 1455, 1463.
[156] Ibid 1462.
[157] Ibid 1464.
[158] Elena Catletti and Philipp Hartmann, *Competition and Stability: What's Special About Banking?* (2002) FMG Special papers, Financial Markets Group, 2.
[159] Vives (n 151) 20.

needs to be done to reform conglomerates. Further conglomeration in financial services should be discouraged to promote stability, and prevent the greater frequency of ethical dilemmas that come with conglomeration.

Competition policy and prudential regulation should complement each other to promote a healthy balance between competition and security. One of the first steps towards this goal should be discouraging concentration in the future. There is also an opportunity to reimagine or redefine the scope of financial service conglomerate's activities to clarify their purpose. Conglomeration serves to either acquire a greater market share or market power, or in times of crisis, to rescue a failing entity. Special circumstances in times of crisis must be available but limited to such times.

The next section will discuss the Banking Executive Accountability Regime (BEAR) in Australia. This section has been included because the BEAR represents an important moment in Australian financial regulatory development. It also reflects the importance of culture as a tool in managing ethical dilemmas effectively in financial service conglomerates, a key theme of this thesis.

VII. THE BANKING EXECUTIVE ACCOUNTABILITY REGIME

The Banking Executive Accountability Regime (BEAR) is an Australian initiative. The UK has a similar document, called the Senior Managers and Certification Regime (SMCR) which is deemed an integral part of the Financial Conduct Authority's (FCA) effort to improve culture within financial services. Both are recent initiatives, with the BEAR due to be implemented by all authorised deposit-taking institutions by July 2019 and the SMCR due for implementation in all FCA-regulated firms by December 2019. The scope of the SMCR is broader than the BEAR, applying to all firms regulated by the FCA including insurers. The BEAR only applies to authorised deposit-taking institutions, but the Hayne Royal Commission recommended an extension of the BEAR to all APRA-regulated financial services institutions.[160] On the 29th October 2021, the *Financial Sector Reform Bill*[161] (Financial Accountability Regime (FAR) Bill) which will extend the

[160] Royal Commission (n 86) Recommendation 6.8, 39.
[161] Financial Sector Reform (Hayne Royal Commission Response No 3) Bill 2021 (Cth).

BEAR to all APRA-regulated entities, was introduced to the House of Representatives. The FAR echoes the 'obey the law' rhetoric of the Hayne Royal Commission recommendations, and represents the implementation of Recommendations 3.9, 4.12, 6.6, 6.7 and 6.8 featured in Commissioner Hayne's final report.[162] The BEAR will be discussed primarily in this section as the FAR has not yet been implemented.

The *Treasury Laws Amendment Act*[163] alters the *Banking Act*[164] to establish the BEAR, which was introduced to improve accountability and culture in Australian financial service conglomerates. The financial system is the backbone of the Australian economy, and it must operate in a stable, efficient, and fair way to ensure trust in the system. The BEAR aims to strengthen culture, governance, and accountability by clarifying remuneration expectations and the higher level of accountability now expected of authorised deposit-taking institutions, their directors, and senior executives. It establishes the consequences for failing to meet expectations and provides APRA with additional powers to investigate BEAR breaches.

Australian banks operate under a social license and are obliged to act responsibly and in their customers' interests. The Coleman Report[165] listed several instances where banks have fallen short of expectations. These include severe cases of misconduct such as the provision of poor financial advice at NAB, the mishandling of life insurance claims at CommInsure, NAB's failure to pay wealth management customers what they were owed, the poor administration of hardship support at Commonwealth Bank, improper fee collection and undisclosed fee collections from ANZ.[166] No senior executives were terminated following these instances.[167] These instances of misconduct have undermined consumer confidence in financial institutions. Without a culture supporting appropriate risk-taking and consumers' fair treatment, financial firms will continue to fall short of community expectations.

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[162] The Treasury, Financial Accountability Regime – List of Prescribed responsibilities and positions, Policy Proposal Paper, 16 July 2021, 2.
[163] *Treasury Laws Amendment (Banking Executive Accountability and Related Measures) Act 2018* (Cth).
[164] *Banking Act 1959* (Cth).
[165] Review of the Four Major Banks (n 50).
[166] Ibid 14.
[167] Ibid.

The Coleman Report findings support the need for a heightened culture of accountability. It is understandable that Australians may not trust banks, as the banks' interests were not aligned with the customers they represented. 'The major banks have a 'poor compliance culture' and have repeatedly failed to protect the interests of consumers'. 'This is a culture that senior executives have created. It is a culture they need to be held accountable for'.[168] The same report found that obligations and responsibilities were generally not understood by directors.[169] The BEAR serves to place obligations on executives to combat these shortcomings.

A. *Heightened Accountability*

The BEAR introduces heightened accountability which has been lacking in financial service conglomerates and must be encouraged further. Accountable persons are identified through the legislation[170], but an institution's accountable persons usually comprise its directors and most senior executives.[171] The obligations placed on accountable persons do little more than restate the statutory duties contained within the *Corporations Act*[172] and ask that they cooperate with APRA. Initially, this appears underwhelming. However, company officers are businessmen and businesswomen who act in an environment involving risk and commercial decision making and are not necessarily lawyers, hence the existence of Section 1318 of the *Corporations Act*[173] which provides some protection for directors against the consequences of breach of duty in limited circumstances. Ignorance of their duties however, undermines the regulatory frameworks designed to ensure safety in the financial system, and a restatement may help clarify some aspect of the 'legislative porridge'[174] experienced by directors of financial service conglomerates.

Accountable persons must be registered. This registration creates a new, central repository of accountable persons and their role within the ADI. ADIs must submit accountability statements for each accountable person, describing the areas of

[168] Ibid 15.
[169] Treasury Laws Amendment (Banking Executive Accountability and Related Measures) Bill 2017 Explanatory Memorandum, 50.
[170] *Banking Act 1959* (Cth) s 37BA.
[171] Australian Prudential Regulation Authority, Implementing the Banking Executive Accountability Regime, 17 October 2018, 11.
[172] *Corporations Act 2001* (Cth).
[173] Ibid s 1318.
[174] *Wingecarribee* (n 140) [948].

responsibility attributed.[175] This pushes ADIs to formalise the roles and responsibilities of the board and senior management clearly and explicitly.[176] APRA expects that nominated accountable persons are closely involved in developing their accountability statement and understand and accept their accountabilities and obligations under the legislation. This restates depositor protection obligations under the *Banking Act*[177] and suggests that directors are not always aware of the full extent of their statutory duties.[178] Statutory duties also include no profit and no conflict obligations, which need to be explicitly detailed to accountable persons.

The registration of accountable persons[179] does allow for some scrutiny of those in positions of accountability, and new enforcement powers for APRA are welcomed. BEAR enhances APRA's powers to deregister and disqualify directors and executives that have not met the expectations set for them, but just how well-placed APRA is to make that decision remains to be seen. The expectations are increased in terms of conduct standards such as integrity, skill, care, and diligence, and acting prudently, but APRA has historically been reluctant to scrutinise the industry properly.[180]

The introduction of an accountability map is useful for creating a framework to understand the responsibilities of key personnel. This helps internally and provides an opaque representation for outsiders. APRA does not provide a template for this framework, suggesting that such a map requires a subjective approach from institutions, further demonstrating the problems associated with complexity. This map is undoubtedly a tool to aid ADIs in identifying breaches of accountability, which must then be reported to APRA. This could be problematic, as an ADI might choose to rectify this issue internally rather than report it. This is an issue of culture in an institution. This thesis states that poor culture is one factor that encourages the improper resolution of ethical dilemmas. Without a cultural change, such non-compliance may go unreported. BEAR introduces civil penalties for ADIs who fail to meet expectations and requires them to monitor executives' suitability, which may deter non-compliance. If the prevailing culture

[175] *Banking Act 1959* (Cth) s 37F(1)(a).
[176] Ibid s 37FA.
[177] Ibid.
[178] Goddard (n 154).
[179] Australian Prudential Regulation Authority (n 171) 13.
[180] 'APRA drops the ball on super', *Australian Financial Review* (online, 8 January 2021) <https://www.afr.com/companies/financial-services/apra-drops-the-ball-on-super-20190716-p527p6>.

is not one of strict compliance, then this obligation becomes less effective. A culture of compliance needs to be promoted in financial service conglomerates to empower BEAR and other regulations.

B. Remuneration Obligations

Conflicted remuneration has encouraged misconduct in Australian financial services (see Chapter 9 below). Poor governance, remuneration structures and accountability mechanisms contribute to a culture of managing ethical predicaments poorly, and can undermine the prudential soundness of an entity and its customer's outcomes.[181] APRA focuses particularly on the remuneration of senior executives[182], highlighting their role in culture and ethical decision making. BEAR introduces requirements for variable and deferred remuneration obligations and recognises that remuneration arrangements across the industry vary significantly in terms of complexity and structure. ADIs must comply with APRA remuneration requirements as well as internal remuneration frameworks.[183] BEAR imposes a minimum of 40% of variable remuneration to be deferred for a minimum of four years, 60% for certain executives such as the CEO. APRA is also empowered to force ADIs to review and adjust remuneration practices if they are not deemed acceptable. These measures may help curb the types of remuneration which encourage conflicts of interest, as long as the organisational culture champions compliance.

The deferral of variable remuneration may also affect talent recruitment and pose an issue for smaller financial service institutions' entry and competitiveness. BEAR alters the governance of pay arrangements in financial service conglomerates, adding to the complexity of the already blurred landscape of remuneration regulation and policy. Chapter Nine and Ten note the 'legislative porridge' [184] that financial service conglomerates are subject to, and this may intensify it. Chapter Nine states that the law in Australia is already complex, and complicated regulation confuses directors who do not understand their obligations. This confusion may not help resolve ethical dilemmas appropriately.

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[181] Australian Prudential Regulation Authority, Transforming governance, culture, remuneration and accountability: APRA's approach, November 2019, 4.
[182] Ibid.
[183] Australian Prudential Regulation Authority (n 171) 21.
[184] *Wingecarribee* (n 140) [948].

Performance measures and targets have implications for financial service conglomerates, namely that the pursuit of targets or other misaligned incentives that can encourage unethical behaviours by prioritising decisions that lead to misconduct.[185] Remuneration committees will be under more scrutiny from shareholders, as non-financial goals may affect dividends. As a result, members of these panels will have to become more comfortable exercising their judgment in remuneration matters and defend their decisions in the face of challenge.

The changes put forth by BEAR, specifically remuneration, may not seem too onerous. Alongside the Sedgwick Recommendations[186], they represent a significant overhaul for small and medium-sized institutions. The application of stringent accountability and conduct expectations may adversely affect talent recruitment if individuals can move easily between industries or jurisdictions. Identifying the correct accountable individuals will be political and impactful in diversified institutions such as financial service conglomerates. The additional expectations of these individuals will need to be embedded in internal governance and procedure, and reinforced. This will encourage the review of internal governance structure and other processes and systems, and ensure institutions clarify their policies. This will be valuable in the auditing of these institutions and promoting positive culture throughout. This may help combat unethical behaviour such as the abuse of conflicts of interest and related party transactions in these conglomerates.

C. *Problems with the BEAR*

A potential problem with the BEAR is that APRA requires a map outlining how accountability is allocated across the institution in a manner appropriate to its size, risk profile and complexity.[187] This thesis suggests that complexity can be an issue for risk management and governance issues in these conglomerates. Mapping is likely to be a laborious and costly task, which may lead to corner-cutting. On the other hand, the value is clear; promoting clarity of accountability in financial service conglomerates may

[185] G30, Banking Conduct and Culture: A Permanent Mindset Change, November 2018, 41.
[186] The Sedgwick Report (Stephen Sedgwick, Retail Banking Remuneration Review, 19 April 2017) recommended that retail banks review their approach to tasking and managing staff performance, the way they structure variable rewards and incentives and the workplace experience of retail staff. The recommendations serve to promote ethical behaviour, clear and constant leadership and the removal of incentives based directly or solely on sales.
[187] Australian Prudential Regulation Authority (n 171) 8.

improve conflicts of interest and related party transactions situations by allowing fewer offenders to slip through the regulatory net.

Another potential issue lies in BEAR's 'one-size-fits-all' approach, as it might disadvantage smaller institutions. Financial crises have shown such an approach is not appropriate for addressing financial service conglomerates. There could be potential confusion concerning the roles of the regulators as BEAR extends APRA's mandate beyond prudential supervision. For now, the BEAR only applies to ADIs, but the Hayne Royal Commission recommendations push for an extension to all APRA regulated entities.

The BEAR represents a proactive approach, informed by lessons learned worldwide of the importance of culture and accountability in the financial sector, specifically banks. It is hard to know how effective the BEAR is, with no direct comparison and no long-term data. The strengthening of measures to heighten accountability, change culture, reduce conflicts, and inspire faith is a positive step. The new examination and disqualification powers are a gift of shiny, sharp teeth for APRA. Hopefully, the new regime teaches Australian ADIs a valuable lesson; do not poke the BEAR.

D. The Financial Accountability Regime

The Financial Accountability Regime (FAR) extends the standards of conduct established by the BEAR to all APRA-regulated entities. Its purpose is to provide accountability obligations for certain financial entities[188] and for persons who hold certain positions related to those entities.[189] The FAR will apply from the later of 1 July 2022 or six months after its commencement, and ADIs will have mechanisms from the BEAR that provide a foundation for transition. FAR will commence for insurers and registrable superannuation entity licensees from the later of 1 July 2023, or 18 months after the commencement of the FAR.[190]

The FAR is important for financial service conglomerates, as it extends the entities within a group structure that will be subject to the new accountability obligations. This will have

[188] Financial Accountability Regime Bill 2021 (Cth), Exposure Draft s 3(a).
[189] Ibid s 3(b).
[190] Exposure Draft Legislation Q&A – Financial Accountability Regime, 2.

an impact on the resources engaged in these conglomerates. It also introduces new responsibilities for senior executives, such as an end-to-end product accountability.[191] FAR will force financial service conglomerates, and the financial services industry generally to consider how to drive cultural improvements, through emphasising individual accountability or alignment with the corporation's values.[192] This is because FAR is not just a compliance exercise, but about uplifting personal accountability and conduct across the industry.[193]

The key difference between the FAR and the BEAR is that the FAR will have both a prudential and conduct focus, and will be jointly administered by APRA and ASIC.[194] This will require efficient and effective joint administration between the two regulators, underpinned by robust collaboration and coordination. However, not all powers exercisable under the FAR warrant equal coordination, leading various elements subject to agreements, notifications, and consultations.[195] As of November 2021, there is no single solution to the FAR's implementation at the company level[196], nor an outline of the way the regulators would administer the regime.[197] The regulators have been given six months after the FAR receives Royal Assent to detail this.

It is too early for an assessment of the FAR's role in changing culture in financial service conglomerates, but it is useful to know that the intention to change is present. The assessment of the BEAR's impact is limited, so it is difficult to assess the potential for its extension. APRA's analysis of the BEAR's implementation in December 2020[198] provides a useful snapshot in time, even though things will have progressed since. The report showed that NAB, CBA and ANZ were starting to implement the BEAR, but needed to increase resources, enhance scenario testing, improve reporting, and integrate their consequence management and remuneration frameworks and outcomes.[199] Based on

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[191] Deloitte, Financial Accountability Regime (FAR), Preparing for accountability regimes in superannuation, insurance and beyond (14 November 2021) Deloitte <https://www2.deloitte.com/au/en/pages/audit/articles/financial-accountability-regimes-bear-far.html>.
[192] Ibid.
[193] Ibid.
[194] The Treasury, Joint Administration of the Financial Accountability Regime between APRA and ASIC, Information Paper, 16 July 2021, 2.
[195] Ibid 4.
[196] Ibid.
[197] Ibid 3.
[198] APRA Information Paper, Implementation of the Banking Executive Accountability Regime (BEAR), 11 December 2020.
[199] Ibid 6.

the BEAR, it might be years before we see meaningful feedback and analysis on the effect of the FAR.

E. Senior Managers and Certification Regime

A similar document to the BEAR exists in the UK called the Senior Managers and Certification Regime (SMCR). The SMCR is part of the UK regulators drive to improve governance and accountability of financial service firms.[200] Heightened accountability and conduct awareness seek to deter rife misconduct in the industry, uncovered in the aftermath of the global financial crisis. The SMCR applies to banks, building societies, credit unions, UK branches of foreign banks and the largest investment firms regulated by the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA).[201] The SMCR has three key elements; the Senior Managers Regime, the Certification Regime and Conduct Rules. It has been in force since March 2016, and was extended to cover all FCA-regulated firms in December 2019.[202] Similarly, Australia has extended the remit of the BEAR with the introduction of the FAR.

The Senior Managers Regime states that the PRA or the FCA must approve senior managers who undertake key functions for financial services in the UK.[203] The FCA Handbook and PRA Rulebook state which roles are considered key functions, and senior management must have a statement of responsibilities outlining what they are responsible and accountable for.[204] There are some 'prescribed responsibilities' which firms must assign to senior managers to ensure accountability for the SMCR and key conduct and prudential risks.[205] At least once a year, firms must declare that senior managers are competent in fulfilling their responsibilities.[206] This is similar to the BEAR concerning the review and responsibility mapping of accountable individuals.

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[200] Senior Managers and Certification Regime (16 November 2021) FCA <https://www.fca.org.uk/firms/senior-managers-certification-regime>.
[201] Ibid.
[202] Ibid.
[203] The Senior Managers and Certification Regime: Guide for FCA solo-regulated firms, July 2019, FCA, 13.
[204] Ibid 11.
[205] Ibid 16.
[206] Ibid 40.

The Certification Regime applies to roles that are not Senior Management Functions, but can have a significant impact on customers, the firm and market integrity.[207] There is no registration for this role, but firms still must check that individuals are fit and proper to perform it annually. The two jurisdictions differ here. The UK takes a prescriptive approach to roles and responsibilities, whereas it is unclear in BEAR which accountabilities are included in mapping. The roles and responsibilities of directors and senior executives are included, but its application is flexible.

The FCA Conduct Rules set the minimum standards of behaviour in financial services.[208] The application of these standards serves to improve accountability and awareness of conduct issues across firms.[209] The Conduct Rules apply to almost all employees who undertake financial service activities or linked activities.[210] Some Conduct Rules apply to all employees, while others only apply to senior managers.[211] Also like BEAR, the additional conduct expectations of executing business with integrity, due skill, care and diligence and acting prudently, apply to senior executive and directors in addition to the accountabilities.

There are potential shortcomings with the SMCR, mainly that parts undermine businesses' internal accountability structures and that the SMCR runs counter to traditional criminal and civil liability concepts.[212] However, when integrated, the heightened accountability may lead to less confusion, higher levels of empowerment among staff and more clarity when escalating concerns.[213]

There is value in the SMCR, especially with regards to culture. SMCR requirements can be extracted from an already effective business model to enhance awareness of senior management on what they are personally held accountable for within their role. Through this enhanced awareness, senior management can communicate an appropriate tone from

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[207] Ibid 31.
[208] FCA Handbook, Chapter 2, Individual conduct rules (18 November 2021) FCA <https://www.handbook.fca.org.uk/handbook/COCON/2.pdf>.
[209] Senior Managers and Certification Regime: solo-regulated firms (18 November 2021) FCA <https://www.fca.org.uk/firms/senior-managers-certification-regime/solo-regulated-firms>.
[210] Ibid.
[211] FCA Handbook (n 208).
[212] Review of the Four Major Banks (n 50) 20.
[213] Liezl de Villiers Getz, 'Connecting Senior Managers and Certification Regime requirements with operational risk' (2019) 12(3) *Journal of Securities Operations and Custody* 207, 209.

the top on how to conduct activities while meeting fiduciary responsibilities to stakeholders.[214] For ineffective business models, separate resourcing may be required for this task.

Both the BEAR and the SMCR have followed a similar timeline, so it is difficult to make meaningful analysis of their impact on accountability and culture in financial services. Given the behaviours that led to the GFC, change in this area should have come sooner. Time will show what sort of impact both documents have on culture in financial services.

F. IOSCO Fit and Proper Assessments

The BEAR is not a landmark document when considered in an international context. The International Organization of Securities Commissions (IOSCO) developed a guide to best practices[215] to reduce the risk that responsible persons of regulated institutions are not fit and proper to execute their role.[216] Regulated institutions are specifically those corporations or entities registered under the appropriate law or whose activities require licensing or approval from the financial regulator.[217] The assessment aims to identify key persons and their responsibilities, and ensure that they comply with the fit and proper test.[218] This is essentially the same remit as the BEAR.

Fitness encapsulates competence and capability, honesty, integrity, fairness and ethical behaviour, and financial soundness.[219] Much like the BEAR, this guide outfits the regulators with much more power to assess and approve key individuals and their ability to carry out their responsibilities. This enriches financial service conglomerates by ensuring they have the best composition of talent on their boards and senior executive. This promotes institutional and financial stability. The guide is only voluntary, so it leaves scope for the creation of a mandatory document. Australia has recognised that authorised deposit-taking institutions have a considerable impact on the economy. BEAR looks to

[214] Ibid 218.
[215] Based on the Report on Consultation and Exchange of Incorporation under Fit and Proper Assessments, December 2009.
[216] Emerging Markets Committee of the International Organisation of Securities Commissions, Fit and Proper Assessment – Best Practice, Final Report (December 2009) 3.
[217] Ibid 4.
[218] Ibid 6.
[219] Ibid 7.

tackle poor behaviour at the source, hence the mandatory yet narrowly applied requirements.

The IOSCO fit and proper guide empowers supervisors, and improves the quality of the information received from the institution. The BEAR does a better job of this, accounting for the factors that have undermined accountability and supervision in Australian financial service conglomerates in recent years.

VIII. THE IMPORTANCE OF CULTURE AND ACCOUNTABILITY IN FINANCIAL SERVICES

The global financial crisis and governance and culture in financial institutions are closely linked. The financial crisis can be to an important extent attributed to corporate governance failures and weaknesses. [220] Governance arrangements in financial institutions encouraged disproportionate risk-taking with insufficient regard to long-term risks, and this risk-taking was not subject to adequate checks and management.[221] It is for these reasons that governance and culture may be useful in managing the types of ethical dilemmas which can lead to turbulence in the financial markets.

Australia weathered the financial crisis relatively well. The UK, however, demonstrated that significant damage could be caused to financial institutions and the system if long-term sustainability objectives do not align with good governance, culture, and accountability measures. The Financial Stability Board has noted:

> Weaknesses in risk culture are often considered a root cause of the global financial crisis, headline risk and compliance events. A financial institution's risk culture plays an important role in influencing the actions and decisions taken by individuals within the institution and in shaping the institution's attitude toward its stakeholders, including its supervisors.[222]

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[220] Grant Kirkpatrick, 'The Corporate Governance Lessons from the Financial Crisis' (2009) *Financial Market Trends* 2, 1 (February 2018) Organisation for Economic Co-operation and Development <https://www.oecd.org/finance/financial-markets/42229620.pdf>.

[221] Financial Stability Forum, 'Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience' (2008), 8.

[222] Financial Stability Board, 2014, Guidance on Supervisory Interaction with Financial Institutions on Risk Culture: A Framework for Assessing Risk Culture, April 2014, 1.

The Basel Committee on Banking Supervision revised its Corporate Governance Principles for Banks to reflect the key corporate governance lessons learned from the global financial crisis. It states that:

> Effective corporate governance is critical to the proper functioning of the banking sector and the economy. Banks perform a crucial role in the economy by intermediating funds from savers and depositors to activities that support enterprise and help drive economic growth. Banks' safety and soundness are key to financial stability, and how they conduct their business, therefore, is central to economic health. Governance weaknesses at banks that play a significant role in the financial system can result in the transmission of problems across the banking sector and the whole economy.[223]

Ultimately corporate governance should be a fundamental concern for all those who have a legitimate and justifiable interest in the corporation. Corporate governance in financial service conglomerates is peculiar. Due to their societal impact, financial service conglomerates should be better governed to manage the adverse effects of their actions. They should better serve the public rather than being focused solely on making profits.

Culture is particularly important in corporations in Australia. A corporate culture which encourages, tolerates or leads to non-compliance, or a failure to create and maintain a corporate culture that complies with relevant legislation, is a criminal offence under the *Commonwealth Criminal Code Act 1995*.[224] A corporate culture is defined 'as an attitude, policy, rule, course of conduct or practice existing within the body corporate generally or in the part of the body corporate in which the relevant activities take place'.[225] Although this is not intended to be a strict definition, its serves as an illustration as to what the courts consider cultural in corporations. It also highlights the importance of culture in ensuring compliance in corporations.

The law on corporate liability is far narrower in the UK. The landmark case for the general principle of corporate liability is fifty years old[226] and the current law does not always

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[223] Basel Committee on Banking Supervision, 2015, Guidelines: Corporate Governance Principles for Banks, July 2015, Bank for International Settlements, 3.
[224] *Commonwealth Criminal Code Act 1995* (Cth) s 12.3(2)(c), (2)(d).
[225] Ibid s 12.3(6)
[226] *Tesco Supermarkets Ltd v Nattrass* [1971] UKHL 1.

appropriately criminalise corporate misbehaviour, especially in larger corporations.[227] The Law Commission confirmed that there is something wrong with the current law, however there was no clear consensus on what corporate liability offences should be created to solve this.[228] A move towards a stronger framework of corporate liability for cultural failure is being seen in the UK. Current limitations include the lack of recognition of a company's corporate culture, and whether that can encourage criminal conduct.[229] The Australian model has been used as an example of how the UK can expand criminal liability law to include corporate culture[230], and whether further criminal sanctions are needed in the financial services industry.[231] This also highlights the importance of corporate culture in mitigating wrongdoing, and promoting ethical behaviour.

Both the UK and Australian banking systems are similar, in the sense that a few financial service conglomerates account for the large majority of lending and deposits. They also account for most of the financial products and services offered outside of traditional banking. Both countries have reached this point through different routes, and both have followed a position of deregulation which has allowed conglomeration in the financial sector to occur.

The UK's deregulation has taken place in response to financial crises, whereas Australia's deregulation followed an economic rationale, with the losses in 1990-1992 serving to lift the barriers to foreign entry. Crisis plays an important role in regulatory change but is not the only reason why a country may seek change in the regulatory system. Deregulation allowed for greater competition, but the competition reduced when some participants outgrew others, usually absorbing their competition along the way. In this sense, competition created consolidation, and this continued unchecked.

Despite the emergence of too big to fail in Australia, the global financial crisis did not cause anywhere near as much concern as it did in the UK, primarily due to the factors discussed in this chapter, such as low exposure to the US housing market and profitable

[227] Joint statement by Professor Penney Lewis, Criminal Law Commissioner and Professor Sarah Green, Commercial and Common Law Commissioner (17 September 2021) The Law Commission <https://www.lawcom.gov.uk/law-commission-seek-views-on-corporate-criminal-liability/>.
[228] The Law Commission, *Corporate Criminal Liability*, A discussion paper, 1.13.
[229] Ibid 6.16.
[230] Ibid 6.18.
[231] Ibid 1.13.

domestic lending. This difference demonstrates how a few factors can change the experience of a financial crisis in two developed countries.

Both the UK and Australia share a twin peaks approach to financial regulation, and have similar authorities that undertake similar roles. This may be due in part to their shared colonial history, or maybe just good sense. Even more recently, the UK and Australia share similarities in regulating accountability and culture with the SMCR and the BEAR, and soon, the FAR. These documents have all materialised at similar times in the last few years so perhaps these two jurisdictions still look to one another as a litmus test for new financial regulation.

Conclusively, the move towards conglomeration teamed with the peculiarities of financial service conglomerates may have contributed to increased instances of ethical dilemmas in both countries. These factors may have changed internal attitudes towards ethical behaviour and risk, particularly in ‘too big to fail’ entities, leading to improper resolution of these dilemmas. The external regulation of these dilemmas has been hampered by the growth, complexity, opacity, and scale of financial service institutions, forcing the regulators to take a reactive approach to instances of unethical behaviour and misconduct. It appears that regulators in both countries have been playing catch up with these conglomerates, and the internal resolution of ethical predicaments has been influenced by a lack of accountability and a pursuit of profits among other things, which has contributed to poor culture in financial service conglomerates.

Chapter 3: The Fiduciary Concept

This chapter will discuss the role fiduciary duties play in managing ethical dilemmas, such as conflicts of interest and related party transactions, in financial service conglomerates generally. It will do so by:

- Explaining the history of the fiduciary concept in the UK and Australia, and its international relevance;
- Outlining how fiduciaries are discouraged from engaging in ethical predicaments such as conflicts of interest and related party transactions in the UK;
- Discussing the no conflict and no profit rules as the essential duties to guide directors through ethical predicaments in the UK;
- Outlining how fiduciaries are discouraged from engaging in ethical predicaments such as conflicts of interest and related party transactions in Australia;
- Exploring the role of contract in the avoidance of fiduciary relationships and duties; and
- Discussing the remedies available for breach of fiduciary duty.

The relationship between the trustee and beneficiary is pertinent in financial services. The asymmetry of information, money, trust and sometimes reliance upon financial institutions make this relationship unique and of a high standard. In financial service conglomerates, fiduciary duties regulate temptation and dissuade director misconduct, ensuring that nobody arbitrarily abuses their position to benefit themselves.

A high level of trust is demanded of directors, and the concept of fiduciary is critical for directors of financial service conglomerates. In the UK, lawmakers have failed to assess the challenges faced by fiduciary law in financial service conglomerates.[1] In Australia, legislators have disclosed their belief that the fiduciary law requires buttressing in the corporate and financial services sectors.[2] Accordingly, this chapter explores the fiduciary concept and the role of fiduciary duties.

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[1] Gordon Smith and Andrew Gold, *Research Handbook on Fiduciary Law* (Edward Elgar, 2018) 355.
[2] Scott Donald, 'A servant of two masters? 'Managing' conflicts of duties in the Australian funds management industry' (2018) 12 *Journal of Equity* 1, 12.

I. *Fiduciary History and the Concept*

This chapter demonstrates that the fiduciary concept is complex, unsettled and sometimes inconsistent. This is important because directors of financial service conglomerates are not necessarily lawyers and may be unaware of their duties and to whom they are owed.[3] Some directors require clarity on their roles and responsibilities to manage ethical dilemmas effectively, and this is something that the Banking Executive Accountability Regime (BEAR) in Australia has recognised and attempts to address.[4] After the discussion of fiduciary history and the concept, this thesis explores fiduciary duties in the UK and Australia.

The term fiduciary, deriving from the Latin fīdūciārius or fiducia, is often misunderstood[5], and may well be one of the least understood areas of the legal system.[6] This has had consequences for the development of fiduciary duties in UK and Australian financial institutions, including the lack of a principle.

In the UK, case law recognises fiduciary principles as early as 1687[7] and dates the seminal case involving fiduciary principles in 1726[8], but we still seem no closer to understanding the concept today.

This lack of clarification has led to inconsistent application internationally. In *Breen v Williams* (‘*Breen*’)[9], a woman sought to prove that her doctor owed her a fiduciary duty. The High Court refused to follow the existing Canadian Supreme Court’s decision in *McInerny v MacDonald*[10], deeming it inconsistent with English and Australian law and disapproving the Canadian approach in imposing prescriptive and proscriptive duties.[11]

[3] Robert Goddard, ‘Directors’ Duties’ (2008) 12(3) *Edinburgh Law Review* 468, 469.
[4] Treasury Laws Amendment (Banking Executive Accountability and Related Measures) Bill 2017 (Cth) Explanatory Memorandum, 50.
[5] ‘Why it’s important to know what fiduciary means’, *CNBC News* (online, 13 June 2018) CNBC News <https://www.cnbc.com/2017/09/13/why-its-important-to-know-what-fiduciary-means.html>.
[6] Leonard Rotman, ‘Understanding Fiduciary Duties and Relationship Fiduciarity’ (2017) 62(4) *McGill Law Journal* 975, 975.
[7] *Walley v Walley* (1687) 1 Vern 484.
[8] *Keech v Sandford* [1726] EWHC Ch J76 Sel Ca t King 61, 25 ER 223 (Ch).
[9] *Breen v Williams* [1996] HCA 57 (‘*Breen*’).
[10] *McInerny v MacDonald* [1992] 2 SCR 138.
[11] Shaunnagh Dorsett, ‘Comparing Apples and Oranges: The Fiduciary Principle in Australia and Canada after *Breen v Williams*’ (1996) 8(2) *Bond Law Review* 158, 158.

The Australian High Court also applied the decision in *Breen*.[12] This inconsistency may be due to several factors. One of those is a lack of definition.

II. A Concept in Search of a Principle

There exists no accepted and universal definition of a fiduciary; the term is considered a 'concept in search of a principle'.[13] Some definition attempts have proved controversial. When looking to establish a principle, one must look to the landmark decisions on this subject. Asquith LJ stated in *Reading v the King*[14] that a fiduciary relationship existed where the claimant entrusts to the defendant a job to be performed and relies on the defendant to procure the best terms available.[15] This definition proved too broad in *Hospital Products Ltd v United States Surgical Corporation* ('*Hospital Products*').[16] Sales J commented that 'fiduciary duties are obligations imposed by law as a reaction to particular circumstances of responsibility assumed by one person in respect of the conduct or affairs of another'.[17]

Although there is no definition, there are recognised characteristics of fiduciary relationships. Vital characteristics include loyalty[18] and trust[19], loyalty being crucial in establishing fiduciary relationships in Australia. These are two characteristics which directors of financial service conglomerates should have, even if there is no generally agreed and unexceptionable definition of what a fiduciary is.[20] Directors of financial service conglomerates are subject to multiple duties, although not all of them are fiduciary in nature.

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[12] *Pilmer v Duke Group Ltd (in liq)* (2001) 207 CLR 165 ('*Pilmer*').
[13] Anthony Mason, 'Themes and Prospects' in Paul Finn (ed), *Essays in Equity* (1985) 246.
[14] *Reading v the King* [1949] KB 232.
[15] Cited in *Ross River & another v Cambridge City Football Club* [2008] 1 All ER 1004 [198].
[16] *Hospital Products Ltd v United States Surgical Corporation* [1984] HCA 64 ('*Hospital Products*').
[17] *F & C Alternative (Holdings) Ltd v Barthelemy (No 2)* [2012] Ch 613 ('*Barthelemy*').
[18] *Arklow Investments Ltd v Maclean* [2000] 1 WLR 594.
[19] Trustees exist for the purposes of the beneficiaries - *Letterstedt v Broers* (1883-1884) LR 9 App Cas 371 [386] (PC).
[20] *Grimaldi v Chameleon Mining NL (No 2)* [2012] FCAFC 6 ('*Grimaldi*').

III. Are All Directors' Duties Fiduciary?

Although directors of financial service conglomerates occupy a fiduciary position, not all duties, namely the duty to exercise care and skill, are fiduciary. This is termed 'the Wheeler doctrine'[21] and relates to an equivalent and equally controversial doctrine for trustees.[22] The evolution of the doctrine began when in *Giradet v Crease & Co*[23], Southin J stated that a breach of the duty of care and skill by a solicitor or director was not a breach of fiduciary duty. This decision was affirmed in the Supreme Court of Canada in *Lac Minerals Ltd v International Corona Resources Ltd*.[24] Five years later in *Henderson v Merret Syndicates Ltd*[25], it was confirmed that the duty of care imposed on bailees, carriers, trustees, directors and agents was the same duty, despite no other member of the House of Lords agreeing with the statement made by Lord Brown-Wilkinson.[26] He could not restrain himself from speaking of 'fiduciary duties of care' in that case, and repeated the phrase in *White v Jones*[27], and quoted with approval in *F & C Alternative (Holdings) Ltd v Barthelemy (No 2)* ('*Barthelemy*').[28] The phrase was also used in *Silven Properties Pty Ltd v Royal Bank of Scotland plc*.[29] Despite a statutory equivalent in the UK[30] and Australia[31], and a common law duty[32], this doctrine's validity has been questioned, and not all commentators approve of it. Heydon goes so far as to dogmatically draw seven different points[33] why the Wheeler doctrine should not be so admired.

The Supreme Court of the United Kingdom held in *Pitt v Holt*[34] that discretionary decisions taken by trustees, even within the scope of their powers, were voidable if they breached their duty to consider all relevant factors including fiscal implications.[35] This is

[21] *Permanent Building Society (in liq) v Wheeler* (1994) 11 WAR 187 ('*Wheeler*').
[22] Dyson Heydon, *Selected Speeches and Papers* (Federation Press, 2018) 684.
[23] *Giradet v Crease & Co* (1987) 11 BCLR (2d) 361.
[24] *Lac Minerals Ltd v International Corona Resources Ltd* [1989] 2 SCR 574.
[25] *Henderson v Merret Syndicates Ltd* [1995] 2 AC 145.
[26] Heydon (n 22) 685.
[27] *White v Jones* [1995] 2 AC 207 [271].
[28] *Barthelemy* (n 17) [212].
[29] *Silven Properties Pty Ltd v Royal Bank of Scotland plc* [2004] 1 WLR 997.
[30] *Companies Act 2006* (UK) c 46, s 174.
[31] *Corporations Act 2001* (Cth) s 180.
[32] *Daniels v Anderson* (1995) 37 NSWLR 438 ('*Daniels*').
[33] Heydon (n 22) 684.
[34] *Pitt v Holt* [2013] 2 AC 108.
[35] Ibid 60.

inconsistent with *Bristol and West Building Society v Mothew* (‘*Mothew*’)[36] and *Breen*.[37] The reason is that the highest Court to approve *Bristol and West Building Society v Mothew* is the House of Lords (UK) in *Hilton v Barker Booth & Eastwood*[38] echoing the phrase ‘not every breach of a duty by a fiduciary is a breach of fiduciary duty’.[39] This quotation received commentary that its use was ‘with respect, an obiter dictum quite unrelated to the case, since breach of duty of care was not put in issue and was not seemingly tested by counsel. The Mothew theory ought to be debated in a proper way before attracting ratification in the House of Lords’.[40]

The High Court of Australia has resisted this doctrine on occasion. In *Youyang Pty Ltd v Minter Ellison Morris Fletcher* (‘*Youyang*’)[41] the High Court alluded to the dictum that ‘there was a jurisdiction in equity to keep persons in a fiduciary capacity up to their duty.[42] The Court continued:

> That there must be a real question whether the unique foundation and goals of equity, which has the institution of the trust at its heart, warrant any assimilation even in this limited way with the measure of compensatory damages in tort and contract. It may be thought strange to decide that the precept that trustees are to be kept by courts of equity up to their duty has an application limited to the observance by trustees of some only of their duties to beneficiaries in dealing with trust funds.[43]

A breach of a duty of care, skill and diligence by a fiduciary may be a breach of loyalty. ‘How can a fiduciary trustee be said to be loyal to his beneficiary if he takes no care for the running of the trust?’.[44] In *Russell McVeagh McKenzie Bartleet & Co v Tower Corp*[45], it was said that there was a duty of care in equity to ensure the principal’s interests were preserved. This is based on the duty of loyalty because true loyalty demands interest

[36] *Bristol and West Building Society v Mothew* [1998] Ch 1 (‘*Mothew*’).
[37] Heydon (n 22) 702.
[38] *Hilton v Barker Booth & Eastwood* [2005] 1 WLR 567.
[39] *Spread Trustee Co Ltd v Hutcheson* [2012] 2 AC 194 [61].
[40] Joshua Getzler, ‘Inconsistent Fiduciary Duties and Implied Consent’ (2006) 122 *Law Quarterly Review* 1, 7.
[41] *Youyang Pty Ltd v Minter Ellision Morris Fletcher* (2003) 212 CLR 484 (‘*Youyang*’).
[42] *Nocton v Lord Ashburton* [1914] AC 932.
[43] *Youyang* (n 41) [39].
[44] Joshua Getzler, ‘Equitable Compensation and the Regulation of Fiduciary Relationships’ in Peter Birks & Francis Rose (eds), *Restitution and Equity: Vol I, Resulting Trusts and Equitable Compensation* (Mansfield Press, 2000) 255.
[45] *Russell McVeagh McKenzie Bartleet & Co v Tower Corp* [1998] 3 NZLR 641.

protection. 'It would be an odd perception of loyalty to suggest that [fiduciaries] must subordinate [their] own interests to those of their [charges], but that they can so negligently'.[46] The negligent breach of a duty of importance to the principal could be characterised as disloyalty. Similarly, *Re Second East Dulwich 745th Starr-Bowkett Building Society*[47] provided authority that negligence can amount to dishonesty. 'A man who accepts such a trusteeship, and does nothing, swallows wholesale what is said by his co-trustee, never asks for explanation, and accepts flimsy explanations, is not honest'.[48]

When the law is unsure of the certainty of fiduciary duties, laypeople are too. Fiduciary law is complex, and in financial service conglomerates, this complexity dilutes its effectiveness in managing ethical dilemmas. Such dilution will inevitably lead to ignorance of duties that control the resolution of these predicaments. Research has suggested that many company directors may be unaware of the fiduciary duties they owe and whom they are owed to.[49] This undermines the effectiveness of regulation and is particularly problematic in financial service conglomerates, as the improper management of ethical issues can damage the conglomerate and the broader economy.

Financial service conglomerates introduce new relationships and structural complexities which fiduciary law may not have caught up with yet. The next section outlines how fiduciaries generally are discouraged from engaging in ethical dilemmas such as conflicts of interest by answering two main questions; what is the concept of 'fiduciary' in the UK and Australia, and what legal principles does it give rise to? Secondly, which fiduciary duties are essential to the effective management of ethical predicaments such as conflicts of interest and related party transactions in financial service conglomerates?

IV. THE DEVELOPMENT OF FIDUCIARY DUTIES IN THE UK

Directors' duties developed as an amalgamation of statute and equity in the UK. Equity has a two-pronged approach. First, it tests loyalty through rigorous standards of fiduciary duty and then imposes duties appropriately. Secondly, it allows for remedies. The

[46] Ibid 668.
[47] *Re Second East Dulwich 745th Starr-Bowkett Building Society* (1889) 68 LJ Ch 196.
[48] Ibid 198.
[49] Goddard (n 3) 469.

Companies Act[50] statutorily codifies specific core duties for directors, but the substantive content of these duties are contained in case law rather than legislation. Codification aims to classify duties but does not directly influence their development. The duties codified are to act within powers[51], to promote the success of the company in good faith[52], to exercise independent judgement[53], to exercise reasonable skill and care[54], to avoid conflicts of interest[55], not to accept benefits from third parties[56] and to declare a personal interest in any transaction.[57] Directors must only exercise their powers for the purposes for which they are conferred[58], codifying the rule in *Eclairs Group Ltd and Glengary Overseas Ltd v JKX Oil & Gas plc*.[59] The *Companies Act*[60] was drafted to modernise company law and provide a cost-effective and straightforward solution for British business in the 21st century. The Act made substantive changes to the law and introduced principles to guide the law's development more generally.[61]

In the UK, all duties, bar skill and care[62] are considered fiduciary.[63] *Bristol and West Building Society v Mothew*[64] outlined that the duty to exercise skill and care was related to competence rather than trust and not fiduciary. This case is regarded as an authoritative modern statement of the law, although it has regularly been interpreted inconsistently. There is an agreement that the term 'fiduciary' should only be applied to those duties which are peculiar to fiduciaries, but the definition of the term attracts disagreement[65], as discussed earlier in this chapter.

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[50] *Companies Act 2006* (UK) c 46.
[51] Ibid s 171.
[52] Ibid s 172.
[53] Ibid s 173.
[54] Ibid s 174.
[55] Ibid s 175.
[56] Ibid s 176.
[57] Ibid s 177.
[58] Ibid s 171(b).
[59] *Eclairs Group Ltd and Glengary Overseas Ltd v JKX Oil & Gas plc* [2015] UKSC 71.
[60] *Companies Act 2006* (UK) c 46.
[61] Companies Act 2006 Explanatory Notes – Background (5 February 2020) <http://www.legislation.gov.uk/ukpga/2006/46/notes/division/2>.
[62] *Companies Act 2006* (UK) c 46, s174.
[63] *Maidment v Atwood* [2012] EWCA Civ 998.
[64] *Mothew* (n 36).
[65] Remus Valsan, 'Understanding Fiduciary Duties: Conflict of Interest and Proper Exercise of Judgement in Private Law' (PhD Thesis, Faculty of Law McGill University, March 2012).

English law recognises the 'no profit' and 'no conflict' rules.[66] The law also recognises the proper purposes duty[67] and the duty to act in good faith in the company's best interests[68] as fiduciary duties.[69] Fiduciary duties are not 'one size fits all' so vary in degree and application. The general law is important as the codified duties are to be interpreted and applied the same way as the common law and equitable principles that they replaced, and 'regard shall be had' to those replaced elements.[70] Fiduciary law will continue to develop as duties are flexibly applied in new fiduciary relationships[71], evidencing the need for a less rigid approach to the imposition in new situations and company formations, such as financial service conglomerates. The law needs to grow to reflect an innovative and changing company landscape. The 'no profit' and 'no conflict' rules are significant in managing ethical predicaments in financial service conglomerates, especially conflicts of interest.

A. The No Conflict and No Profit Rules

The doctrine of loyalty prohibits fiduciaries from acting on a conflict between their duty and self-interest or making unauthorised profits from their position.[72] The no-conflict rule is summed up in *Aberdeen Railway Co v Blaikie Bros*.[73] The House of Lords affirmed that although the contract between the two parties was valid in law, it was voidable in equity[74], due to a conflict between the director's role and self-interest. When a person is a director of two companies, their interests in each must not conflict with their duties to the other.[75] Multiple directorships are not prohibited, but allowing duties to conflict is.[76] In the financial services industry, members of one board are often associated with another or have conflicting interests in businesses. Avoiding conflicting duties is a key challenge

[66] *Companies Act 2006* (UK) c 46, s 175-176.
[67] *Howard Smith Ltd v Ampol Petroleum Limited and others* [1974] AC 821.
[68] *Re Smith and Fawcett Limited* [1942] 1 Ch 304.
[69] *Ultraframe (UK) Limited v Fielding* [2005] EWHC 1638 (Ch) ('*Ultraframe*'); *Simtel Communications Ltd v Rebah & others* [2006] 2 BCLC 571; *Sinclair v Versailles* [2011] EWCA Civ 347.
[70] *Companies Act 2006* (UK) c 46, s 170(3).
[71] Companies Act 2006 Explanatory Notes – '[i]n the company law field, the principles being applied will frequently be taken from other areas, in particular trusts and agency. It is important that these connections are not lost and that company law may continue to reflect developments elsewhere. Frequently the courts may formulate the same idea in different ways. In contrast, legislation is formal. It is not easy to reconcile these two approaches, but the sections seek to balance precision against the need for continued flexibility and development'.
[72] Stuart Ritchie, *Fiduciary Duties – Directors and Employees* (Jordan, 2015) 32.
[73] *Aberdeen Railway Co v Blaikie Bros* [1854] UKHL 1.
[74] Ritchie (n 72) 33.
[75] *Companies Act 2006* (UK) c 46, s 175(7).
[76] Rosemary Langford, *Company Directors' Duties and Conflicts of Interest* (Oxford University Press, 2019) 152.

for those who hold multiple directorships, and empirical data shows that in 2016, 21% of UK directors of the top 500 companies had more than one directorship, and 23% of Australian directors were in the same position.[77] The financial service conglomerates in this thesis have all featured in the Fortune Global 500[78] in recent years, and financial service entities feature frequently in the top 500 companies in each country. Sophisticated directors[79] who serve larger firms and sit on larger boards like those of financial service conglomerates are more likely to attract multiple directorships.[80] The question that arises is one of balance, and to what extent those interests extend, whether interests merely exist or genuinely conflict.

London and Mashonaland Exploration v New Mashonaland Exploration Co Ltd[81] highlighted that a director does not breach their duty merely by competing or holding a directorship in a competing company if there is no misuse of sensitive information. Although criticised more recently[82], this view was upheld in *Bell v Lever Brothers*.[83] *Scottish Cooperative Wholesale v Meyer*[84] differed, based on the risk that a director holding more than one directorship may subordinate one company's interests against another. The freedom to operate on more than one board seems at odds with the no-conflict rule. It would be impossible to allow this in light of *Bristol and West Building Society v Mothew*[85], as someone who operates for two institutions with the potential for conflict, breaches their obligation of undivided loyalty if they do not obtain the informed consent of both.[86] Occasionally a director can breach their fiduciary duty by holding a competing directorship, even when the other is a technicality.[87] Many decisions hinge on full disclosure by the director to the others of their alternate agenda.[88] On this basis,

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[77] Ibid.
[78] The Fortune Global 500, known as the Global 500, is an annual ranking of the top 500 companies worldwide in terms of revenue.
[79] Anna Bergman Brown et al, 'Too Busy or Well-Connected? Evidence from a Shock to Multiple Directorships' (2019) 94(2) *The Accounting Review* 83, 83.
[80] Stephen Ferris et al, 'Too Busy to Mind the Business? Monitoring by Directors with Multiple Board Appointments' (2003) 58(3) *Journal of Finance* 1087, 1087.
[81] *London and Mashonaland Exploration Co Ltd v New Mashonaland Exploration Co Ltd* [1891] WN 165.
[82] *In Plus Group Ltd v Pyke* [2002] 2 BCLC 201; Michael Christie, 'The Director's Fiduciary Duty Not to Compete (1992) 55 *Modern Law Review* 506, 507; Ross Grantham, 'Can Directors Compete with the Company?' (2003) 15 *Modern Law Review* 66, 66.
[83] *Bell v Lever Brothers* [1932] AC 161 HL.
[84] *Scottish Cooperative Wholesale Society Ltd v Meyer* [1959] AC 324.
[85] *Mothew* (n 36).
[86] *Clarke Boyce v Mouat* [1994] 1 AC 428.
[87] *Coleman Taymar Ltd v Oakes* [2001] 2 BCLC 749.
[88] *Plus Group v Pyke* [2003] EWCH 466 (Ch).

directors holding multiple positions in different financial service conglomerates must fully disclose any potential conflicts of interest. This is especially important in terms of related party transactions. The group structure of conglomerates encourages conflicts of interest with related parties, and personal conflicts can multiply when directors in the group serve numerous roles.

The 'no profit' rule in the UK can be summed up succinctly as 'no agent in the course of his agency, in the matter of his agency, can be allowed to make any profit without the knowledge of his principal'.[89] This rule is entirely inflexible and has also been rationalised as requiring the fiduciary to account for any benefit gained, whether tangible or otherwise, to preclude the exploitation of the advantageous position[90], even if the directors have acted in the company's best interests.

The 'no profit' and 'no conflict' rules are now codified in English law[91] as duties to avoid conflicts of interest, not to accept benefits from third parties and to declare interests in transactions. Authorisation from directors negates the application of these requirements in any given situation.[92] These duties end upon the cessation of directorship as the fiduciary relationship is terminated.[93] The two rules have been described as different ways of expressing the same thing[94] and as 'the fundamental rule of equity'[95], and sometimes even as being completely separate[96], but the actual relationship between the two has not been definitively established. Still, we recognise the close proximity of the rule.[97] Fiduciary duties in the UK for managing conflicts of interest and related party transactions are to, in good faith, promote the success of the company[98], act for a proper purpose[99], avoid conflicts of interest[100] and to declare a personal interest in any

[89] *Gulliver* (n 21).
[90] *Chan v Zacharia* (1984) 154 CLR 178; *Don King Productions Inc v Warren* [2000] Ch 291; *In Plus Group Ltd v Pyke* [2002] 2 BCLC 201; *Ultraframe* (n 69).
[91] *Companies Act 2006* (UK) c 46, s 175-177.
[92] This is troublesome in cases of related party transactions as a transaction may be harmful even if it is authorised. This principle does not account for cronyism or corroboration.
[93] *Attorney-General v Blake* [1998] Ch 438; *HRH Prince Jefri Bolkiah v KPMG* [1999] 2 AC 222.
[94] *Bray v Ford* [1896] AC 44; *NZ Netherlands Society 'Oranje' Inc v Kuys* [1973] 1 WLR 1126.
[95] *IDC Ltd v Cooley* [1972] 1 WLR 443; *Furs Ltd v Tomkies* (1936) 54 CLR 583.
[96] *Brown v Inland Revenue Commissioners* [1964] AC 244.
[97] *Gwembe Valley Development Co Ltd v Koshy (No 3)* [2004] 1 BCLC 131.
[98] *Companies Act 2006* (UK) c 46, s 172.
[99] Ibid s 171(b).
[100] Ibid s 175.

transaction.[101] These can be summarised as acting in good faith and avoiding conflicts of interest.

V. THE DEVELOPMENT OF FIDUCIARY DUTIES IN AUSTRALIA

In Australia, the Constitution, the federal, state and territorial laws, and the common law constitute and form one system of jurisprudence[102] and share a symbiotic relationship.[103] The statute in Australia has mostly displaced common law as, between 1988 and 2006, Queensland Parliament enacted five times more legislation than in the 135 years from 1828 to 1962.[104] The statute in Australia imposes penalties for contraventions, whereas the UK equivalent is a codification of the developed principles of directors' duties. The relevant law governing directors' duties in Australia is the *Corporations Act*[105]; a necessary amalgamation of Commonwealth, state, and territorial legislation, with the states referring certain legislative powers to the Commonwealth. This arose in the wake of *Re Wakim; Ex parte McNally*[106] where the High Court of Australia deemed existing law unconstitutional. The states and territories agreed to confer certain powers to the Commonwealth to combat this.

Directors' duties in Australia were 'not very demanding' before the corporate excesses of the 1980s and subsequent decades.[107] Directors' duties first evolved by analogy to the duties of trustees[108], and were influenced by partnership theory as shareholders were responsible for the quality of the directors selected.[109] As such, a director's duty to act with due care and diligence was equivalent only to the level of skill they possessed.[110] A trustee's responsibilities are different from a director's; a director's obligations are business orientated. Directors conduct business while a trustee exercises constraint and

[101] Ibid s 177.
[102] *Lange v Australian Broadcasting Corporation* (1997) 189 CLR 520, 564.
[103] *Brodie v Singleton Shire Council* (2001) 206 CLR 512 [31]; *Commonwealth Bank of Australia v Barker* (2014) 253 CLR 169 [17].
[104] Transcript of Proceedings, Supreme Court of Queensland, 22 September 2006, 15.
[105] *Corporations Act 2001* (Cth).
[106] *Re Wakim; Ex parte McNally* [1999] HCA 27.
[107] Brian Cheffins, 'Comparative Corporate Governance and the Australian Experience' in Ian Ramsay, *Key Developments in Corporate Law and Trusts Law: Essays in Honour of Professor Harold Ford* (LexisNexis Butterworths, 2002) 13, 27-8.
[108] Paul Davies, *The Principles of Modern Company Law* (Stevens and Sons, 3rd ed, 1969) 515.
[109] Jennifer Hill, 'The Liability of Passive Directors: Morely Statewide Tobacco Services Ltd' (1992) 14 *Sydney Law Review* 504, 507; *Daniels* (n 32) [493].
[110] *Re Equitable Fire Insurance Co Ltd* [1925] 1 Ch 407 [428-9].

conservatism. The two are different. Accepting the distinction led to defences for errors of judgement and negligence.[111]

In 1985, Sir Anthony Mason stated that 'one element of the latest developments in equity is the increasing penetration of equitable doctrine into contract and commercial law, notwithstanding the strength of the countervailing philosophies and attitudes.'[112] Sir Anthony knew that fiduciary relations were expanding into commercial relationships, an area limited previously by the industry's lack of requirement and shortcomings in the law.

Changes in fiduciary law in Australia started late but rapidly gained momentum. By 1989 it was observed that 'fiduciary law, for Australia at least, is designed to have a very modest role in refurbishing and supplementing contract doctrine'.[113] But the impression should not be given that it plays an unimportant role in regulating contractual activity. 'The contrary is the case. A significant part of modern contractual activity occurs in context, or results in relationships, which can attract fiduciary responsibility'.[114] Ten years on, 'equity's place in the law of commerce, long resisted by commercial lawyers, can no longer be denied. What they once opposed through excessive caution they now embrace with excessive enthusiasm'.[115]

Present-day statutory duties are contained within the *Corporations Act*[116] and constitute a comprehensive regime of duties and remedies for directors' breach. Directors are to act in good faith and in the best interests of the company, for proper purposes[117], not abuse their position in office to gain an advantage for themselves or another or to cause detriment to the corporation[118], not abuse information obtained through their position[119] and to exercise their powers and discharge their duties with care and diligence.[120] The duties owed in Australia are owed to the company in which the director holds office. The

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[111] *The Overend & Gurney Co v Gibb* (1872) LR 5 HL 480 [486-7].
[112] Mason (n 13) 242.
[113] Paul Finn, 'Contract and the Fiduciary Principle' (1989) 12 *University of New South Wales Law Journal* 76, 82.
[114] Ibid.
[115] Peter Millett, 'Equity's Place in the Law of Commerce' (1998) 114 *Law Quarterly Review* 214, 214.
[116] *Corporations Act 2001* (Cth).
[117] Ibid s 181(1).
[118] Ibid s 182(1).
[119] Ibid s 183(1).
[120] Ibid s 180(1).

company is a separate legal entity, and directors should consider its interests alone in their decision-making process.[121]

There is a distinction between proscriptive and prescriptive duties in Australia. Equity provides proscriptive duties on a fiduciary, and the difference between proscriptive and prescriptive duties was first established in *Breen*.[122] There, equity imposed an obligation upon the fiduciary not to obtain any benefit nor entertain any conflict of interests. Australia does not otherwise impose positive legal duties upon fiduciaries.

The clarity of this distinction has been called in to question[123] due to the limited scope of the two parties' relationship. In other cases, the difference has been affirmed.[124] The High Court of Australia has snubbed the imposition of prescriptive obligations. The law of equity imposes the proscriptive 'no profit' and 'no conflict' rules. The rationale for the proscriptive duties of a fiduciary is stated in *Hospital Products*[125] and subsequently quoted in *Pilmer*[126] as:

> It is partly because the fiduciary's exercise of the power or discretion can adversely affect the interests of the person to whom the duty is owed and because the latter is at the mercy of the former that the fiduciary comes under a duty to exercise his power or discretion in the interests of the person to who it is owed.[127]

The High Court of Australia's emphasis on the distinction between proscriptive and prescriptive obligations meant that much closer attention has been paid to the nature of obligations imposed on directors, whether they be statutory, fiduciary, common law or equitable (or a combination of the latter two[128]). It has been observed that the distinction does not apply to fiduciary obligations at general law.[129] The doctrine of *stare decisis* requires that courts in Australia impose this distinction. Yet, difficulties have arisen with the proscriptive/prescriptive dichotomy, and subsequent cases have taken different

[121] *Walker v Wimborne* (1976) 137 CLR 1.
[122] *Breen* (n 9).
[123] *Westpac Banking Corp v Bell Group Ltd (in liq) (No 3)* (2012) 44 WAR 1.
[124] *Pilmer* (n 12); *Friend v Brooker* (2009) 239 CLR 129; *Howard v FCT* (2014) 235 CLR 83.
[125] *Hospital Products* (n 16).
[126] *Pilmer* (n 12).
[127] *Hospital Products* (n 16) [96].
[128] *Wheeler* (n 21); *Daniels* (n 32).
[129] *Duncan v Independent Comm Against Corruption* [2016] NSWCA 143.

approaches to overcome this issue. The trial judge in *Bell Group Ltd (in liq) v Westpac Banking Corp*[130] attempted to rephrase a prescriptive obligation to take steps towards a proscriptive duty of loyalty. On appeal, the Western Australia Court of Appeal distinguished the dichotomy as being limited to the facts in *Breen v Williams*.

Aside from the contractual obligations placed upon directors, they also owe a common law tortious duty to exercise care and skill.[131] That duty is also equitable, owed concurrently with the common law duty.[132] In Australia and the UK, fiduciary duties exist as a subset of equitable duties, meaning that not every equitable duty is fiduciary. In the context of directors and the company, not every duty owed is a fiduciary one, despite those duties being imposed upon fiduciaries.[133] The fiduciary relationship between director and the company is limited to certain acts and are better understood circumstantially; 'to say a man is a fiduciary only begins analysis; it gives direction to further enquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?'.[134] Even at the start of the 20th century, it has been vital that the subject matter surrounding the breach is considered.[135]

Discussed earlier in the chapter, the English case of *Bristol and West Building Society v Mothew*[136] outlined several well-recognised and accepted fiduciary duties of a director, all with loyalty at the core.[137] These mirror the duties now imposed on directors by the UK's *Companies Act*[138], but Australian company law has no statutory equivalent to Sections 171 and 172.[139] Numerous commentators refute that Sections 171 and 172 of the *Companies Act*[140] are fiduciary.[141] Therefore the fiduciary burden placed upon directors

[130] *Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* (2008) 39 WAR 1.
[131] *Daniels* (n 32); *Permanent Building Society (in liq) v Wheeler* (1994) 11 WAR 187.
[132] *Permanent Building Society (in liq) v Wheeler* (1994) 11 WAR 187.
[133] *Hospital Products* (n 13) [96–7] per Mason J; *Breen* (n 9) [92] per Dawson and Toohey JJ; *Pilmer* (n 12).
[134] *Securities and Exchange Commission v Chenery Corporation* 310 US 80 (1943).
[135] *Birtchnell v Equity Trustees, Executors & Agency Co Ltd* (1929) 42 CLR 384.
[136] *Mothew* (n 36).
[137] The duty to act in good faith, to act for a proper purpose, to avoid conflicts of interest and to not take profits or advantages from the corporation for himself or others.
[138] *Companies Act 2006* (UK) c 46.
[139] Duty to act within powers and the duty to promote the success of the company respectively.
[140] *Companies Act 2006* (UK) c 46.
[141] Matthew Conaglen, *Fiduciary Loyalty* (Hart, 2010); Robert Flannigan, 'Fiduciary Duties of Shareholders and Directors' [2004] May Issue, *Journal of Business Law* 277, 278; Charles Mitchell, 'Equitable Compensation for breach of fiduciary duty' (2013) 66(1) *Current Legal Problems* 307, 309.

by the UK and Australian legislation are similar, while the burden placed on directors *generally* in the UK could be seen as more onerous.

In Australia, the most appropriate duties for mitigating conflicts of interest and related party transaction abuses are acting in good faith, in the company's best interests, for proper purposes[142], and not abusing position to gain an advantage or causing the corporation detriment.[143] These can be summarised as acting in good faith and avoiding conflicts of interest. These are the two primary elements of the legislative framework that manage conflicts of interest and related party transaction dilemmas.

The law contains many types of fiduciary relationships, both status-based and fact-based. Fact-based relationships include situations between an arm's length transaction, where each party might act according to their own interests, and a fiduciary relationship, where the law requires one to act in the best interests of another.[144] Financial advisors and the people they advise are historically not a categorical fiduciary relationship, although the court may impose such a relationship in situations where an advisor assumes discretionary power.[145] Commercial or investment banking relationships are not fiduciary, although the court may conclude otherwise on the fact-based analysis of a relationship.[146] Therefore the law must recognise both status-based and fact-based fiduciary relationships in financial service conglomerates. This allows fiduciary law to be adapted and applied in these institutions.

VI. The Role of Contract in Managing Fiduciary Duties

A. Contractual Disclosure

Can fiduciary duties be contracted out of? An extreme argument is that 'fiduciary duties are not special duties; they have no moral footing; they are the same sort of obligations,

[142] *Corporations Act 2001* (Cth) s 181(1).
[143] Ibid s 182(1).
[144] Daniel Kelly, 'Fiduciary Principles in Fact-Based Fiduciary Relationships' in Evan Criddle et al (eds), *The Oxford Handbook of Fiduciary Law* (Oxford University Press, 2019) 3.
[145] Arthur Laby, 'Advisors as Fiduciaries' (2020) 72(5) *Florida Law Review* 953, 963.
[146] Cecil Hunt, 'The Price of Trust: An Examination of Fiduciary Duty and the Lender-Borrower Relationship' (1994) 29(1) *Wake Forest Law Review* 719.

derived and enforced in the same way, as other contractual undertakings'.[147] The law of contract will offer guidance on obligations parties may include or omit from their contracts, and three generally applicable mandatory rules will apply. Courts will not enforce unconscionable commitments, or obligations at odds with public policy, and they will impose a mandatory duty of good faith into all contracts.[148] The most significant limitation of fiduciary duties as a tool to regulate conflicts of interest in financial service conglomerates is that they can be excluded through contract in certain circumstances.[149] This will now be discussed further.

Finn suggests that we have not advanced fiduciary relationship's definition since *Hospital Products,* and in fact, we are moving further away from success.[150] His dissatisfaction has been noted in response to two decisions; *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Ltd*[151] and *Streetscape Projects (Australia) Pty Ltd v City of Sydney*.[152] In the first case, Citigroup was accused of failing to meet obligations under Section 912A(1)(aa) of the *Corporations Act* to possess adequate arrangements for managing conflicts of interest. Such a claim required the existence of a fiduciary relationship, but the relationship was explicitly excluded in the contract. As a result, the claim failed. The Court held that the law does not prevent an investment bank from contracting out of a fiduciary capacity.[153] In the second case, the Court held that Streetscape breached a fiduciary duty it owed, as such a relationship was established in contract. The Court rejected the existence of a fiduciary relationship in line with *John Alexander's Clubs v White City Tennis Club*[154], stating fiduciary duties can be owed between parties to a contract, but the duty must conform to and be founded in the contract itself.

This is relevant to financial service conglomerates as a part of the conglomerate, such as a bank, may disclaim their fiduciary obligations in their contracts with clients. Contracts

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[147] Frank Easterbrook and Daniel Fischel, 'Contract and Fiduciary Duty' (1993) 36 *Journal of Law and Economics* 425, 427.
[148] Gregory Klass, 'What If Fiduciary Obligations Are Like Contractual Ones?' in Paul Miller & Andrew Gold (eds), *Contract, Status, and Fiduciary Law* (Oxford University Press, 2016), Forthcoming.
[149] *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 160 FCR 35 ('*Citigroup (No 4)*').
[150] Paul Finn, *Fiduciary Obligations*, Chapter 25 Foreword, (Federation Press, 2016) xi.
[151] *Citigroup (No 4)* (n 149).
[152] *Streetscape Projects (Australia) Pty Ltd v City of Sydney* (2013) 85 NSWLR 196.
[153] *Citigroup (No 4)* (n 149) [7].
[154] *John Alexander's Clubs Pty Limited v White City Tennis Club* (2010) 241 CLR 1.

may stipulate that a bank is acting at arm's length[155] or deny the creation of a fiduciary relationship.[156] New York courts have found that 'contractual disclaimers of fiduciary duty are enforceable when sufficiently explicit'.[157] The term 'enforceable' means that the disclaimers are valid in preventing the fiduciary obligations from arising and should lead to the case's dismissal.[158] The key factor for analysis is how explicit the disclaimer is. *Cooper v Parksy*[159] stated that the disclaimer was to be 'explicit enough to effect the waiver'[160] and that the agreement met this requirement, providing that the parties 'shall not be held… to any specified standard of care on [sic] fiduciary responsibility and in no event shall they be liable… except for their gross negligence or wilful misconduct'.[161] The disclaimer must refer specifically to fiduciary duties or will be deemed insubstantial.[162] The Court will analyse whether the contract simply attempts to attribute labels to the parties at odds with the role they play. If the relationship is fiduciary in nature, the disclaimer will have no effect[163]; 'whether a relationship is characterised as agency in an agreement between parties' is not a controlling factor.[164] It is the 'facts and circumstances of the relationship of the parties that govern whether a [fiduciary] duty existed'[165] and not how they have labelled the relationship.

Finn argues that fiduciary standards are independent and mandatory and cannot be excluded, limited, or diminished. Whether this should be the case is 'a matter for the legislature, not the courts'[166], yet attention from the High Court of Australia on *Bhasin v Hrynew*[167] would be relished by some commentators.[168]

B. Informed Consent

[155] *CIBC Bank & Trust Co v Credit Lyonnais* 704 NYS 2d 574 [575] (NY App Div 2000).
[156] Andrew Tuch, 'Fiduciary Principles in Banking' in Evan Criddle et al (eds), *The Oxford Handbook of Fiduciary Law* (Oxford University Press, 2019) 139.
[157] *Valentini v Citigroup* 837 F Supp 2d 304, 326 (SDNY 2011); *Seippel v Jenkens & Gilchrist* 341 F Supp 2d 363 (SDNY 2004).
[158] *LBBW Luxemburg SA v Wells Fargo Sec* LLKC 10 F Supp 3d 504 [523-524] (SDNY 2014).
[159] *Cooper v Parksy* 140 F 3d 433 (2d Cir 1998).
[160] Ibid 439.
[161] Ibid.
[162] *King Country WA v IKB Deutsche Industriebank AG* 863 F Supp 2d 288 (SDNY 2012).
[163] *Veleron Holdings BV v Morgan Stanley* 117 F Supp 3d 404 (SDNY 2015).
[164] Tuch (n 156) 140.
[165] *In re Merrill Lynch Auction Rate Securities Litigation* 758 F Supp 2d 264 (SDNY 2010).
[166] *Citigroup (No 4)* (n 149) [7].
[167] *Bhasin v Hrynew* (2014) SCC 71.
[168] Finn (n 150) xiii.

Where a fiduciary relationship exists, a bank may seek a client's consent to conduct which may otherwise breach their fiduciary duties. This can be done by disclosing conflicts of interest, and clients can be taken to consent to the bank's conflicts of interest after they have been disclosed in the contract.[169] Informed consent operates narrowly, requiring approval of specifics. Anything more general may be ineffective as it cannot be said that the client fully appreciates the true nature of the conflict.

The dominant view in Australia is that fiduciary duties are proscriptive, detailing what a fiduciary must not do, rather than what they must do. *Mouat v Clark Boyce*[170] outlined rules for informed consent in conflict of interest situations where fiduciary duties are involved. The Court of Appeal in Australia held that:

> Lawyers acting where there is a conflict of interest between clients can only do so with informed consent, and their fiduciary duties are only limited to the extent that the client waives them. There is no fully informed consent if the client has less than adequate knowledge of the facts of understanding of their implication and there must be knowledge of all material facts, pro and con.[171]

C. Fiduciary Disclosure v Informed Consent

Fiduciary disclaimers are distinct from informed consent as when valid, a disclaimer makes the relationship between the parties non-fiduciary. In contrast, informed consent excuses the fiduciary from breach of duty, but the relationship remains fiduciary. Chapter Nine states that disclosure is a popular remedy but often misunderstood. Virtually all policies designed to mitigate the adverse effects of conflicts of interest include or consist solely of disclosure.[172] Disclosure is attractive because it is easily implemented and appeals to principles of transparency, empowerment, and free markets. By reducing the information gap between the advisor and advisee, disclosure allows advisees to make better-informed decisions[173] but can pose difficulties. Advisees generally do not use

[169] *HSH Nordbank AG v UBS AG* 941 NYS 2d 59 (NY App Div 2012).
[170] *Mouat v Clark Boyce* [1992] 2 NZLR 559.
[171] Solicitors – relationship with clients – conflict of interest – fiduciary duty – informed consent (New Zealand) (1992) 18(1) *Commonwealth Law Bulletin* 221, 221.
[172] Sunita Sah, 'Conflict of Interest Disclosure as a Reminder of Professional Norms: Clients First! (2019) 154 *Organizational Behavior and Human Decision Processes* 62, 62
[173] Ibid 66.

disclosures effectively. Unsure of how to react, advisees often ignore the disclosure.[174] One of the most significant disclosure conflicts is when advice is linked to remuneration.

D. Release from Fiduciary Liability

A question exists about whether a release from liability can be retracted in circumstances where disclosure has not been made fully. *Blue Chip Emerald LLC v Allied Partners Inc*[175] stated that a 'fiduciary cannot by contract relieve itself of the fiduciary obligation of full disclosure by withholding the very information the beneficiary needs in order to make a reasoned judgement whether to agree to the proposed contract'.[176] However, *Centro Empresarial Cempresa SA v America Movil SAB de CV*[177] demonstrated that the release from fiduciary duty could be effective without full disclosure; the parties cannot 'invalidate the release by claiming ignorance of the debt of their fiduciary's misconduct'.[178] A 'sophisticated principal is able to release its fiduciary from claims – at least where… the fiduciary relationship is no longer one of unquestioning trust – so long as the principal understands that the fiduciary is acting in his own interests and the release is knowingly entered into'.[179]

E. Remedies

Liability for breach of fiduciary duty can arise under trusts, agency, and torts with overlapping claims. For success, a plaintiff must establish the existence of a fiduciary relationship, a breach of that relationship, damages incurred and a causal link between the breach and damage.[180] Assessment for damages vary, and for tort actions, the basis of liability will often be a breach of fiduciary duty, fraud, or misrepresentation, with damages calculated on the basis of several different elements. These include out-of-pocket damages, benefit of the bargain damages, and consequential damages. The client would also be able to obtain disgorgement of the ill-gotten gains. Where a relationship of agency and trust exists, a breach of duty may give rise to liability under the rules governing this area of law.

[174] Ibid.
[175] *Blue Chip Emerald LLC v Allied Partners Inc* 750 NYS 2d 291 [294] (NY App Div 2002).
[176] Ibid [280].
[177] *Centro Empresarial Cempresa SA v America Movil SAB de CV* 17 NY 3d 269 (NY 2011).
[178] Ibid [278].
[179] Ibid.
[180] *Szulik v State Street Bank and Trust Co* 935 F Supp 2d 240 [275] (D Mass 2013).

In circumstances where a party relies on informed consent to manage fiduciary duties, such as *FHR European Ventures LLP v Cedar Capital Partners LLC* (‘*FHR*’)[181], proprietary constructive trust must be owned over the damages sought. In the case, FHR sought to recover a large commission obtained by a party negotiating on their behalf without the fully informed consent of FHR. The remedy was not obtained, due to their inability to assert proprietary constructive trust. The Supreme Court held that where an agent acquires a benefit as a result of their fiduciary position, or pursuant to an opportunity which came about by way of their fiduciary position, they are to be treated as having acquired said benefit on behalf of their principal, so that the principal beneficially owns it.[182]

Where an agent acquires a benefit as a result of his fiduciary position, or pursuant to an opportunity arising from their position, the equitable rule is that the benefit has been acquired on behalf of their principal, and is owned by their principal.[183] There are reasons for ensuring that a fiduciary does not retain any benefit made by way of their position, and such benefit should be repaid when acquired improperly regardless of solvency.[184] A breach of fiduciary duty renders a transaction voidable rather than void, meaning the principal can rescind the loan transactions but has no proprietary interest in the loan monies until the transaction is rejected.[185]

Generally, the approach to remedies for breach of fiduciary duty is prophylactic.[186] The facts in FHR were straightforward, and this is not always the case. In certain instances, the court may refuse to recognise proprietary remedies in a case.[187] For example, although FHR brings English law into line with other Commonwealth Jurisdictions regarding the availability of a constructive trust, the UK’s Supreme Court mentioned that the proprietary remedy it recognises is not a remedial constructive trust.[188] In Australia,

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[181] *FHR European Ventures LLP v Cedar Capital Partners LLC* [2014] UKSC 45 (‘*FHR*’).
[182] Ibid 7.
[183] *FHR* (n 181) [7].
[184] *Daraydan Holdings Ltd v Solland International Ltd* [2004] EWHC 622 (Ch) 86.
[185] *Daly v Sydney Stock Exchange Ltd* (1986) 160 CLR 371 [387].
[186] Matthew Congalen, ‘Proprietary Remedies for Breach of Fiduciary Duty’ (2004) 73(3) *Cambridge Law Journal* 490, 491.
[187] Ibid 492.
[188] Ibid 493.

however, the court can refuse to recognise a constructive trust.[189] To what extent England's inflexibility in this area of the law might generate injustice, and whether England will follow suit remains to be seen.

The development of fiduciary duties is a shared concept in the UK and Australia. This legal doctrine is not cultural, nor influenced by their geography. As such, both countries institute very similar duties, although key differences remain.

Australia does not impose positive legal duties upon fiduciaries, whereas the UK does. This is a key difference between the jurisdictions as the UK dictates what a fiduciary must do, whereas Australia details what they absolutely must not. The shared colonial history and close legal proximity in recent decades have led to a very similar approach to the management of conflicts of interest and related party transactions in the two countries. Both countries experience similar difficulties, caused by the nature of fiduciary duties, their lack of definition and their untested application into new relationships forged in the sale of financial goods and services. How the law develops remains to be seen, but the changing nature of financial services requires that the law keeps pace.

[189] *Grimaldi* (n 20) [582].

CHAPTER 4: CONFLICTS OF INTEREST

Directors in financial service conglomerates are fiduciaries due to their position on the board. As such, directors are duty-bound in equity and statute to avoid conflicts of interest, and owe their duties to the corporation. This chapter examines directors' obligations regarding conflicts of interest. It does this by:

- Defining conflicts of interest in terms of financial services;
- Examining and comparing the key elements that govern conflicts of interest for directors of financial service conglomerates in the UK and Australia; and
- Outlining the key difference in approach to managing conflicts of interest between the UK and Australia.

The key difference between the UK and Australian approach to regulation is discussed towards the end of the chapter. The chapter also provides context for the discussion of conflicts of interest in financial advice in Australia, contained in Chapter Nine.

I. CONFLICTS OF INTEREST

The term 'conflicts of interest' is used in a wide range of situations. Conglomeration and the effects of universal banking[1] have led to increased conflicts of interest in financial service conglomerates. As such, these conflicts can be considered a fundamental issue in financial services. Conflicts of interest are primarily governed by statute and case law, although other documents exist.[2] In Australia, the Hayne Royal Commission found that conflicts of interest are not being managed effectively.[3] This thesis suggests there may be an opportunity to improve regulation to address this.

[1] Jonathan Macey, 'The Inevitability of Universal Banking' (1993) 19 *Brooklyn Journal of International Law* 203, 216.
[2] The International Organization of Securities Commissions (IOSCO) 'Market Intermediary Management of Conflicts That Arise in Securities Offerings, Final Report' November 2007.
[3] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Final Report, Volume 1, 172.

Numerous, comprehensive works on board members' conflicts and conflicts of interest generally[4] exist. The development of a theoretical definition of a conflict of interest has been largely neglected, despite the principle being well established.[5] Statutory and equitable strategies to prevent and manage conflicts of interest have bloomed but not filled the gap left by the lack of definition. Figure 1 in Chapter One demonstrates the large number of conflicts that can occur in financial services, and a rigid definition may fall short of encompassing the new conflicts that have arisen with business innovation. Nevertheless, corporate law in the UK and Australia attempts to govern directors' conflicts of interest through legislation.

In the UK, section 175 of the *Companies Act* provides that 'a director of a company must avoid a situation in which he has or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company'.[6] Australia chooses to forbid the misuse of information[7] or position[8] to obtain gain personally or for another. Neither goes further to provide examples of what a conflict of interest is. Corporate governance recommendations focus on specific situations[9], but still shy from a definition.

Other disciplines have tried to define conflicts of interest[10], but the more comprehensive definitions are too broad. For directors in financial service conglomerates, the definition must be narrow enough only to include situations and relationships where one party acts in the interests of another. A broad definition would cover all manner of personal and professional circumstances. Perhaps the lack of definition is associated with the term 'interest' rather than 'conflict'.

A working definition of conflicts of interest in financial services was put forth by the Geneva Reports on the World Economy. 'Conflicts of interest arise when a financial

[4] Law Commission, 'Fiduciary Duties and Regulatory Rules', Law Com No 236, 1995; Law Commission of England and Wales and Scottish Law Commission, 'Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties', Law Com No 261, 1999 and Scot Law Com No 173, 1999.

[5] Christoph Kumpan and Patrick Leyens, 'Conflicts of Interest of Financial Intermediaries' (2008) 5(1) *European Company and Financial Law Review* 72, 74.

[6] *Companies Act 2006* (UK) c 46, s 175(a).

[7] *Corporations Act 2001* (Cth) s 182.

[8] Ibid s 183.

[9] European Commission Recommendation 2005/162/EC.

[10] Robert Greenberg, 'Conflicts of Interest: can a physician serve two masters? (2012) 30(2) *Clinics in Dermatology* 160, 161.

service provider, or an agent within such a service provider, has multiple interests which create incentives to act in such a way as to misuse or conceal information needed for the effective functioning of financial markets'.[11] Initially, this definition seems too simplistic, but when we consider the idealist vision of how financial markets should work under perfect conditions, free from abuse and unfairness, anything that inhibits this process can be seen as negative in light of this definition.

So why are conflicts of interest so crucial in financial services? The abuse of conflicts of interest undermines the law, the efficiency of the financial system, and contracting parties' interests. This abuse, in turn, undermines trust in financial institutions. Above all, it is unfair, and usually, the weaker party suffers. Conflicts of interest are rife in financial services, more so than in any other institution, which is why they must be addressed.[12]

II. CONFLICTS OF INTEREST IN THE UK

The court recognises that the duty to avoid conflicts of interest comprises two strands; the 'no conflict' rule and the 'no profit' rule.[13] These rules have been given separate consideration both before[14] and after[15] the introduction of the *Companies Act*.[16] Under the 'no conflict' and 'no profit' rules, consequences flow from situations where a director fails to avoid and manage conflicts *unless* the company provides its full and informed consent[17], the director had ceased to hold office and had no power to exercise[18], or was excluded entirely from the decision making process.[19] In *Industrial Development Consultants Ltd v Cooley* ('*Cooley*')[20], a director was held liable to the full extent of all

[11] Andrew Crockett et al, 'Conflicts of interest in the Financial Services Industry: What Should We Do About Them?' (2003) *Geneva Reports on the World Economy 5*, 5.
[12] Gordon Smith and Andrew Gold, *Research Handbook on Fiduciary Law* (Edward Elgar, 2018) 359; Royal Commission (n 3) 135.
[13] *Don King Productions Inc v Warren* [2000] Ch 291; *Chan v Zacharia* (1984) 154 CLR 178.
[14] *Ultraframe (UK) Limited v Fielding* [2005] EWHC 1638 (Ch).
[15] *Re Allied Business and Financial Consultants Ltd* [2009] 2 BCLC 666, CA; *Wilkinson v West Coast Capital* [2007] BCC 717 ('*Wilkinson*').
[16] *Companies Act 2006* (UK) c 46.
[17] *Bristol and West Building Society v Mothew* [1998] Ch 1.
[18] *Wilkinson* (n 15); *Quarter Master UK Ltd v Pyke* [2005] 1 BCLC 245 ('*Pyke*'); *CMS Dolphin Ltd v Simonet* [2001] 2 BCLC 704.
[19] *Pyke* (n 18).
[20] *Industrial Development Consultants Ltd v Cooley* [1972] 2 All ER 162 ('*Cooley*').

the profits he had made due to a lack of disclosure and company consent. Authoritative cases formed the decision.[21] Roskill J quoted:

> I do not think it is necessary but it appears to me very important that we should concur in laying down again and again the general principle that in this court no agent in the course of his agency, can be allowed to make any profit without the knowledge and consent of his principle; that that rule is an inflexible rule, and must be applied inexorably by this court, which is not entitled, in my judgement, to receive evidence, or suggestion or argument as to whether the principal did or did not suffer any injury in fact by reason of the dealing of the agent; for the safety of mankind requires that no agent shall be able to put his principal to the danger of such an inquiry.[22]

Regarding the 'no profit' rule, *Regal (Hastings) Ltd v Gulliver*[23] found that the directors had acted in good faith and in the best interests of the company and had not breached the 'no conflict' rule, but the directors had made a profit, breaking the 'no profit' rule. Lord Russell stated that:

> The rule of equity which insists on those, who by use of a fiduciary position make a profit, being liable to account for that profit, in no way depends on fraud, or absence of bona fides; or upon such questions or considerations as whether the profit would or should otherwise have gone to the plaintiff, or whether the profiteer was under a duty to obtain the source of the profit for the plaintiff, or whether he took a risk or acted as he did for the benefit of the plaintiff, or whether the plaintiff has in fact been damaged or benefitted by his action. The liability arises from the mere fact of a profit having, in the stated circumstances been made.[24]

The most relevant aspects of UK legislation for directors in financial service conglomerates regarding conflicts of interest are contained in the *Companies Act*: the duty to promote the success of the company[25], the duty to avoid conflicts of interest[26], the duty not to accept benefits from third parties[27], and the duty to disclose any interest in a transaction or arrangement.[28] This does not diminish the importance of other relevant sections. Failure to disclose an interest in a transaction under Section 182, for example,

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[21] *Keech v Sandford* (1726) Sel Cas Ch 61; *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134 ('*Gulliver*'); *Phipps v Boardman* [1967] 2 AC 46.
[22] *Parker v McKenna* (1874) 10 Ch App 96 [124-125].
[23] *Regal (Hastings) Ltd v Gulliver* [1942] UKHL 1.
[24] Ibid 9.
[25] *Companies Act 2006* (UK) c 46, s 172.
[26] Ibid s 175.
[27] Ibid s 176.
[28] Ibid s 177.

is a criminal offence. Sections 188, 228, and 237 govern director's service contracts while Section 190 deals with substantial property transactions, which require advance approval. Sections 197-214 set out restrictions on loans for directors, and Section 228 requires service contracts to be kept for inspection. Section 237 requires any indemnity provision for the benefit of directors to be kept. It is a matter of consideration just how far these statutory provisions supplement the general law fiduciary duty to avoid conflicts of interest and vice versa.

Equity usually gives rise to a broader variety of remedies for breach than the statute. Section 178 states that the consequence of breach, or threatened breach, of Sections 171 through 177 will attract corresponding common law or equitable principles.[29] Those duties are enforceable in the same way as any other fiduciary duty owed to a company by its directors.[30] Section 170 provides that the general duties are based on certain common law rules and equitable principles as they apply to the directors and have effect in place of those rules and principles.[31] These duties shall be applied or interpreted in the same manner as common law rules or equitable principles.[32] Despite codification, it seems more than permissible to turn to existing case law to interpret duties.

The *Companies Act* contains a newly expressed requirement to promote the success of the company.[33] This duty means that directors must place the interests of the company above the interests of owners or a specific class of owners.[34] The term 'success' differs from the common law equivalent of acting in the best interests of the company, but usually means a 'long term increase in value'.[35] If the company's purpose is not for the benefit of its members, then this duty is to achieve its stated purpose.[36] If insolvent or

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[29] Ibid s 178(1).
[30] Ibid s 178(2).
[31] Ibid s 170(3).
[32] Ibid s 170(4).
[33] Ibid s 172.
[34] Duties are of course owed to the company, but the question is whose interests constitute the interests of the company for this purpose? A company is artificial and therefore lacks the autonomy to decide on which elements it considers as its interests. *Greenhalgh v Ardene Cinemas* [1951] Ch 286 stated that 'the phrase, "the company as a whole" does not (at any rate in such a case as the present) mean the company as a commercial entity as distinct from the corporators. It means the corporators as a general body. You may take the case of an individual hypothetical member and ask whether what is proposed is, in the honest opinion of those who voted in its favour, for that person's benefit'. The future interest of the company also must be considered and not just the company's interests in its present form *Winkworth v Edward Baron Development Co Ltd* [1986] 1 WLR 1512.
[35] Martha Bruce, *Rights and Duties of Directors* (Bloomsbury, 12th ed, 2012) 65.
[36] *Companies Act 2006* (UK) c 46, s 172(2).

approaching insolvency, then that duty is to the creditors.[37] In decision-making, Section 172 requires the director to strike a balance between the success of the company and the interests of other stakeholders, signalling that conflicts between these interests will arise.[38] Generally a director is not under a duty to disclose his or her misconduct[39] and it is disputed whether this section provides an answer to that 'thorny' question.[40] A director is not under any obligation to disclose other employees' misconduct[41], although this gives little guidance on his or her own disclosure requirements. This is not an independent, separate duty[42], but falls under the remit of the fundamental duty to act in the company's best interests and to do so in good faith.[43] It is hard to see how a director could satisfy this requirement if their misconduct remained undisclosed.

Section 175 states that a director must avoid situations where he has or can have interests that conflict with those of the company[44], particularly in exploiting property, information, and opportunity.[45] The section also allows for authorisation to avoid breaching that duty.[46] Subsections (5) and (6) deal with approval, as in some instances, avoidance of conflicts of interest may not be beneficial to the company or even possible. In these cases, a director must seek prior approval. The failure to do so can result in severe penalties. A director is bound to avoid a situation in which he has, or can have, a conflict of interests, including a conflict of duties[47] and the interests of 'connected persons'.[48] Avoiding these conflicts of interest has always been a fiduciary duty of the director of a company.[49] Fiduciary duties' prophylactic nature serves to enforce directors' compliance by expelling any potential opportunity to appeal that the arising conflict was too slight to be considered a real conflict of interests.

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[37] Ibid s 172(3).
[38] The Companies Act 2006 Section 172(1)(a)-(f) states that directors must ensure that they have regard to the likely long-term consequences of decisions; employee interests; community and environmental impact; fostering business relationships with suppliers and customers; acting fairly between members; and maintaining a high standard of business and conduct.
[39] *Bell v Lever Brothers* [1932] AC 161 HL.
[40] Charles Hollander and Simon Salzedo, *Conflicts of Interest* (Sweet and Maxwell, 4th ed, 2011) 336.
[41] *Horcal v Gatland* [1984] IRLR 288 CA; *Sybron v Roc*hem [1984] Ch 112 CA; *Swain v West (Butchers)* [1936] All ER 261 CA.
[42] *Item Software (UK) Ltd v Fassihi* [2004] EWCA (Civ) 1244 [52] ('*Fassihi*').
[43] *British Midland Tool Ltd v Midland International Tooling Ltd* [2003] EWHC 466 ('*Midland Tool*').
[44] *Companies Act 2006* (UK) c 46, s 175(1).
[45] Ibid s 175(2).
[46] Ibid s 175(4).
[47] Ibid s 175(7).
[48] Bruce (n 35) 67.
[49] *Island Export Finance v Umunna* [1986] BCLC 460 to be contrasted with *Cooley* (n 20).

The duty to avoid a conflict situation will be infringed even if there is no loss to the company or no profit made.[50] Competing directorships could give rise to such a conflict, and directors in financial service conglomerates may hold multiple directorships. Although the Financial Conduct Authority offers guidance on the matter[51], no completely rigid rule forbids this.[52] Although based on a prior case[53], *Plus Group Ltd v Pyke* criticised this and stated that a director should not hold competing directorships without fully informed consent and authorisation within the meaning of Section 174. Lord Goldsmith stated that 'there is currently no absolute rule prohibiting directors from holding multiple directorships or even from engaging in business that competes with the company of which they are a director, but obviously a tension results from that degree of tolerance and the fiduciary duties which the director owes'.[54]

Essentially, there is no prohibition of a conflict, or potential conflict, if it has been authorised correctly, according to the minimum requirements set out in the *Companies Act*.[55] When a director is an executive, their service contract will most likely preclude them from taking on a competing directorship, but for non-executive directors, the position is unclear. These sections of the Act serve to replace the *Mashonaland* rule and reflect the growing instances, especially in financial services, of overlapping directorships and industry concentration.

A. Disclosing and Authorising Conflicts of Interest

From October 1st, 2008, the board could authorise a director's conflicts of interest, provided that the relevant provisions are contained within the Articles of Association. For private companies, the board may do the same, provided the Articles do not exclude this. For companies incorporated before this date, a shareholder resolution or an amendment to the Articles is required. For those companies in which no provision exists or the

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[50] *Wilkinson* (n 15).
[51] The FCA in the UK suggest that directors should not hold more than one suggested combination of directorships: one executive directorship with two non-executive directorships, or four non-executive directorships.
[52] *Pyke* (n 18).
[53] *London and Mashonaland Exploration Co Ltd v New Mashonaland Exploration Co Ltd* [1891] WN 165.
[54] Simon Mortimore, *Company Directors, Duties, Liabilities and Remedies* (Oxford University Press, 2nd ed, 2013) 319.
[55] *Companies Act 2006* (UK) c 46, s 175(5); s 177.

necessary resolution has been passed, shareholder approval will be required. This is a significant burden on both time and resources. Authorisation of a conflict can only be given by quorum and must be valid. Approval cannot be retrospective, and an authorisation applies to the conflict, not to the breach of associated duties. Regardless of the authorised conflict, directors' duties still exist, and conflicts should be considered on a case-by-case basis.

Much of the Act's codification has common law roots. The rule in *Aberdeen Railway Co v Blaikie Bros* ('*Blaikie Bros*') outlines that a conflict arises where a director sought to exploit or take advantage of company opportunities for himself. The company was entitled to avoid a contract with an undisclosed interest by a director, despite its merits and benefit.[56] Similarly and more recently, but pre-2006, directors were found liable for costs where their interests had superseded those of the company.[57]

The common law principle that a director must avoid conflicts of interest meant that a director could not hold an interest in a transaction with a company unless they had disclosed all material facts to the members and had their interest approved.[58] Obtaining the consent of the board alone was not sufficient.[59] Directors could be liable for breach of duty and held to account for all profits derived.[60] Previously, equitable principles disabled a director from entering into these kinds of transactions rather than allowing the transaction to occur and breaching the fiduciary duty not to make a secret profit.[61] This analysis was preferred due to the need to reconcile what is now contained in Section 232[62], rendering void any provision attempting to excuse a director from breach of duty. Presently the distinction is viewed as nothing more than a 'needless complication'.[63]

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[56] *Aberdeen Railway Co v Blaikie Bros* [1854] UKHL 1 ('*Blaikie Bros*').
[57] *Knight v Frost* [1999] 1 BCLC 364.
[58] *Newgate Stud Co v Penfold* [2008] 1 BCLC 46; *Gwembe Valley Development Co Ltd v Koshy (No 3)* [2004] 1 BCLC 131 ('*Gwembe*'); *Transvaal Lands Company v New Belgium (Transvaal) Land and Development Company* [1914] 2 Ch 488.
[59] *Gray v New Augarita Porcupine Mines Ltd* [1952] 3 DLR 1 [13] ('*Grey*'); *Imperial Mercantile Credit Association v Coleman* (1871) 6 Ch App 556 ('*Coleman*'); *Re Cardiff Preserved Coke and Coal Co* (1862) 32 LJ Ch 754; *Benson v Heathorn* (1842) 1 Y&C Ch Cas 326.
[60] *Hely-Hutchinson v Brayhead Ltd* [1968] 1 QB 549.
[61] *Movitex Ltd v Bulfield* [1988] BCLC 104; *Tito v Waddell (No 2)* [1977] Ch 106.
[62] Grounds for Court order, the various orders listed in s 233.
[63] *Gwembe* (n 58).

Before the 2006 Act's introduction, the company's Articles frequently relaxed the common law and equitable standpoint on disclosure to create a more permissive environment. The *Companies Act 1929*[64] demanded a director make known their interest in a transaction, but there were no specific penalties for non-compliance. The 2006 Act is quite different; a director must declare their interest in future[65] and existing transactions.[66] Failure to do so is a criminal offence. Compliance with Section 177 allows a corporation to decide whether to pursue the opportunity. This indication by a director supersedes the need for member's approval under equitable rules, although the Articles often impose other requirements to be met. Breach of Section 177 in the first instance can lead to a violation of Section 182 also. Equitable remedies may be sought against the director for breach of Section 177. An element of confusion exists in this regard, as although the Act states that breach attracts common law or equitable principles, there was no pre-2006 equivalent of Section 177. Authors submit that the reference to Section 177 suggests that it was intended that civil law remedies would apply.[67]

At common law, any interest in a transaction has to be made to the full board.[68] This is now codified.[69] Section 177 requires that any interest in a transaction or arrangement[70], direct or indirect, is disclosed to the company in a full and frank manner.[71] By extension, a director must not fetter their discretion to avoid a conflict between the company's interests and their own.[72] Although a director may compete with their company or be a

[64] *Companies Act 1929* (UK) c 23.
[65] *Companies Act 2006* (UK) c 46, s 177.
[66] Ibid s 182.
[67] Andrew Stafford and Stewart Richie, *Fiduciary Duties: Directors and Employees* (Jordans, 2nd ed, 2008) 2.60.
[68] *Guinness plc v Saunders* [1990] 2 AC 663, HL.
[69] *Companies Act 2006* (UK) c 46, s 177, 182.
[70] Although not defined, the terms 'transaction or arrangement' have been the subject of discussion in cases. The meaning of 'transaction', in terms of the *Insolvency Act 1986* (UK) c 45, s 436 (*Clement v Henry Hadaway Organisation Ltd* [2008] 1 BCLC 223; *Feakins v DEFRA* [2007] BCC 54). The understanding of 'arrangement' as much broader than 'transaction' (*Murray v Leisureplay plc* [2004] EWHC 1927 (QB); *Re British Basic Slag Ltd's Agreements* [1963] 1 WLR 727).
[71] *Neptune (Vehicle Washing Equipment) Ltd v Fitzgerald* [1996] Ch 274 ('*Neptune*').
[72] *Ball v Eden Project Ltd* [2002] 1 BCLC 313.

director for a rival outfit[73], subject to board approval, they must not prioritise the one interest over the other.[74]

A contract that is voidable because of a directors interest may be ratified in a general meeting[75], and a director need not be included in an arrangement for this duty to apply.[76] Personal profits obtained through conflicts of interest as a director are forbidden, even if that profit would not have accrued to the company.[77] The mere fact that a profit could have been made by misuse of a director's position is enough to render him liable.[78]

A director will not be automatically interested in a transaction because of an interest of someone connected to him within the meaning of Section 252.[79] It would be prudent to declare any interests to ensure nothing falls within the remit of Section 177.[80] Director ratification is not permitted in cases where directors have profited at the expense of the company.[81] Even minor, personal conflicts that lead to profits are forbidden[82], and the duty to account for such profits extends beyond resignation.[83] The 2006 Act's phraseology changed, requiring directors to state the nature *and* extent of their interest, rather than just the nature previously required by the 1985 Act, which may reflect the complex conflicts that can arise in certain circumstances.

B. Conflicts of Interest in Groups of Companies

Financial service conglomerates attract specific instances of conflicts of interest by virtue of their structure and business operations. In *Kuwait Asia Bank EC v National Mutual Life Nominees*[84], in the liquidation of a money-broking company, the directors appointed

[73] In *Bristol and West Building Society v Mothew* [1998] Ch 1 [18], CA, Millett LJ stated, in relation to fiduciaries in this set of circumstances, 'A fiduciary who acts for two principals with potentially conflicting interests without the informed consent of both is in breach of the obligation of undivided loyalty; he puts himself in a position where his duty to one principal may conflict with his duty to the other. This is sometimes described as 'the double employment rule'. Breach of the rule automatically constitutes a breach of fiduciary duty'.
[74] *Co-operative Wholesale Society Ltd v Meyer* [1959] AC 324, HL.
[75] *North-West Transportation Co Ltd v Beatty* (1887) 12 App Cas 589.
[76] *Coleman* (n 59).
[77] *Gulliver* (n 21).
[78] *Gencor ACP Ltd* [2000] 2 BCLC 734.
[79] Definition of persons 'connected' with a director.
[80] *Re Dominion International Group plc (No 2)* [1996] 1 BCLC 572.
[81] *Cooks v Deeks* [1916] 1 AC 554.
[82] *Towers v Premier Waste Management Ltd* [2011] EWCA Civ 923.
[83] *Cooley* (n 20).
[84] *Kuwait Asia Bank EC v National Mutual Life Nominees* [1991] 1 AC 187 PC.

by the bank who had interests in the company were bound by their duties as directors to ignore the interests of the bank. They could not rely upon instruction from the bank to excuse breaches of their duties as directors.[85]

The same problem can arise where the company forms part of a group. Group structure is a reality in the UK and the Australian financial services industry and a particular issue for financial service conglomerates. Directors must not prejudice the company to benefit the whole group. In *Charterbridge Corporation v Lloyds Bank*[86] the test was outlined as 'the proper test, in the absence of actual separate consideration must be whether an intelligent and honest man in the position of a director of the company concerned could have reasonably believed that the transactions were for the benefit of the company'.[87] In this case, securities afforded to the parent company by the subsidiary were essential to prevent the collapse of the parent company and the subsequent devastating effect upon the subsidiary.

Australian Securities and Investments Commission v King[88] provided much-needed clarity for the role of directors in groups of companies. The High Court of Australia determined that an officer of a corporation need not be named as such to fall within the scope of Section 9(b)(ii) of the *Corporations Act*. Instead, emphasis will be placed on their overall influence in the group's affairs, rather than the strict role they have been assigned. Directors of the parent company, allowed to act in other companies in the group, would expose creditors and shareholders to obvious risk if they could avoid responsibility for the conduct by abstaining from any formal designation of responsibility.[89] This decision is essential for directors in financial service conglomerates as it extends the definition of an officer of a corporation. This extension is required because placing too much emphasis on the phrase 'of a corporation' ignores the overall influence that person may have in the group of companies.[90]

[85] Hollander (n 36) 340.
[86] *Charterbridge Corporation v Lloyds Bank* [1970] Ch 62.
[87] Ibid 74.
[88] *Australian Securities and Investments Commission v King* [2020] HCA 4.
[89] Ibid [46].
[90] Ibid [73].

This decision is also important for financial service conglomerates, as the size of a corporation, the corporate structure, the management structure, and the identity of those involved are likely to affect who is an officer of a corporation at any point in time.[91] The size of financial service conglomerates is also important as:

> The traditional focus of corporate law in relation to responsibility for corporation actions has been on the role of directors. In smaller companies especially, this may still reflect the way they are in fact run. However, the reality in most medium to large enterprises is that operational decision-making devolves to managers and other individuals below board level who conduct the ongoing business of the company subject to higher level supervision by the board of directors.[92]

This decision may be helpful to assign accountability for wrongdoing in financial service conglomerates to those who give the orders, as well as those who swing the axe. The decision may reflect the complex structure of financial service conglomerates and the need to appropriately determine liability for wrongdoing, not allowing directors to escape the consequences of their actions, hiding behind a strict interpretation of their role in an entity.

Financial service conglomerates' rise has meant a one-stop-shop for financial services and products that gives rise to conflicts. The *Financial Services and Markets Act*[93] and FSA Rule SYSC 10 deals with conflicts of interest and Chinese walls. The guidance identifies conflicts of interest and requires records and maintenance to prevent a potential conflict of interest, damaging clients' interests. The conglomerate's organisational structure gives rise to conflicts due to the diverse portfolio of products and services on offer, the composition of the customer base, and the differing capacities in which it undertakes business. However, there is a clear distinction between conflicts that arise due to structure and conflicts entered by directors. The Law Commission guides the UK on the most common conflicts of interest that arise in financial services. ASIC performs the same role in Australia.[94]

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[91] Ibid [92].
[92] Ibid [93].
[93] *Financial Services and Markets Act 2000* (UK) c 8.
[94] Consultation Paper 73, Managing conflicts of interest in the financial services industry, April 2006; ASIC Regulatory Guide 181: Managing Conflicts of Interest; ASIC Regulatory Guide 193: Notification of Directors' Interests in Securities: Listed Companies.

C. *Breaching Conflicts of Interest Rules*

Breach of the 'no conflict' and 'no profit' rules at general law and statute attracts penalties. A director who has engaged in conflicts of interest may have unlimited liability for any loss suffered by the company, even if a profit has not been made.[95] Directors who breach their statutory duty to avoid conflicts of interest may face removal from office, civil or criminal penalties, personal liability, disqualification, or voluntary undertakings.[96] Ignorance is not a defence[97], so situations where directors' do not understand their legal obligations are problematic. Civil penalties apply for the breach of the statutory statement of general duties. Numerous cases contain instances where directors have had conflicts of interest or failed to disclose those conflicts to the board.[98] Silence or inactivity from a director will not constitute a defence as participation in decision-making is a requirement.[99] The court has the power to grant exemption from an action in negligence[100], although relief is not always forthcoming.[101] 'Any individual who undertakes the statutory and fiduciary obligations of being a company director should realise they are inescapable personal responsibilities'.[102]

It is important to note that the duty to avoid conflicts of interest at both general law and statute applies to shadow directors 'to the extent that they are capable of so applying'.[103] Courts have established anyone who exercises a real influence over the company can be disqualified for breach of duty.[104] The same applies to *de jure* directors deemed unfit under the *Company Directors Disqualification Act*[105] for violating duties.[106] Directors may volunteer to abstain from acting in such a capacity or being involved in management for a period. Directors must also provide a statement of unfitness setting out their admission of misconduct.[107] This can often be an alternative to lengthy and costly legal

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[95] *Companies Act 2006* (UK) c 46, s 178.
[96] Bruce (n 35) 77.
[97] *Grupo Torras SA v Al Sabah (No 5)* [2001] 1 CL 75.
[98] *Clark v Cutland* (2003) All ER (D) 228 (Jun); *Midland Tool* (n 43); *Fassihi* (n 42).
[99] *Lexi Holdings plc (in administration) v Luqman* [2009] EWCA Civ 117.
[100] *Companies Act 2006* (UK) c 46, s 1157.
[101] *Globalink Telecommunications Ltd v Wilmbury Ltd* [2002] EWHC 1988 (QB).
[102] *Re Westmid Packaging Services Ltd* [1998] 2 BCLC 646 [654].
[103] *Companies Act 2006* (UK) c 46, s 170(5).
[104] *Secretary of State for Trade and Industry v Deverell* [2001] Ch 340; *Secretary of State for Trade and Industry v Jones* [1999] BCC 336.
[105] *Company Directors Disqualification Act 1986* (UK) c 46.
[106] *Secretary of State for Trade and Industry v Nuthall* [2006] EWHC 1995 (Ch); *Re Sykes (Butchers) Ltd (in liquidation), Secretary of State for Trade and Industry v Richardson* [1998] 1 BCLC 110.
[107] *Secretary of State for Trade and Industry v Davies* [2001] All ER (D) 27 (Sep), CA.

proceedings.[108] The decision rests with the Secretary of State[109] , who will consider any related circumstances or matters. The minimum penalty term is two years, and the maximum is fifteen.[110]

III. Conflicts of Interest in Australia

There is a general understanding that a director is to act with undivided loyalty to the corporation. As stated, a key difference between the UK and Australia is the difference between proscriptive and prescriptive duties. The High Court of Australia has noted the distinction between proscriptive and prescriptive duties, recognising only the prohibitive.[111] This imposes a duty upon directors not to obtain unauthorised profits or engage in conflicts of interest. Directors do not have a fiduciary duty to act in the beneficiary's best interests, although they have a general duty to exercise care and diligence.[112] The exclusive recognition of prohibitive or proscriptive duties has led to the rejection of the duty of disclosure as fiduciary in Australia. English law takes a different approach; a fiduciary's non-disclosure of breach of duty is a potential breach of fiduciary duty itself.[113]

As a rule, Australia has more case law on conflicts of interest cases than the UK. The dual federal and state system has led to a particular interest in fiduciaries. *Bolkiah v KPMG*[114] serves as a precedent where firms who have acted for one client act for another without prioritising their interests.

The duty to avoid conflicts of interest is to be taken literally, as a duty to avoid rather than manage.[115] This would be very demanding if strictly applied, as it would extend to all conflicts. As it stands, this application has been relaxed over time to whether the 'reasonable man looking at the relevant facts and circumstances of the particular case

[108] *Re Carecraft Construction Ltd* [1994] 1 WLR 172.
[109] *Company Directors Disqualification Act 1986* (UK) c 46, ss 7(2A) - 8(2A).
[110] Ibid s 1A(2).
[111] *Breen v Williams* (1996) 186 CLR 71.
[112] *Corporations Act 2001* (Cth) s180(1).
[113] *Fassihi* (n 42) [53]; *Hanco ATM Systems Ltd v Cashbox ATM Systems Ltd* [2007] EWCH 1599 (Ch); *GHLM Trading Ltd v Maroo* [2012] 2 BCLC 369; *McTear v Engelhard* [2014] EWHC 1056 (Ch).
[114] *Prince Jefri Bolkiah v KPMG (A Firm)* [1999] 2 WLR 215.
[115] *Blaikie Bros* (n 56).

would think that there was a real sensible possibility of conflict'.[116] There is also debate on whether liability is further confined in the corporate law context regarding the pursuit of conflict.[117] Generally, liability arises not from being in a position of conflict, but rather in pursuing that conflict.[118] Such a statement casts doubt on the scope of conflicts of interest and suggests that breach is the pursuit of conflict, rather than the existence. In terms of the Hayne Royal Commission in Australia, this begs the question of whether conflicts themselves must be removed or managed[119] or just the ability to pursue them.

In many cases, conflicts of interest are unavoidable. In *Re Colorado Products*[120] a director of the company was also the controller of a company in China that produced the goods that were imported. They were also the controller of another company which leased the business premises to it. In these circumstances, one would consider the active pursuit of a conflict as the trigger for the breach. It was held that merely being a director on multiple companies will not violate the 'no conflict' rule, as many analogous cases of non-executive directors on numerous boards were not found to amount to breach.[121] Again, begging the question of whether a conflict must be pursued to amount to a breach of fiduciary duty.[122] The reference to a 'real or substantial possibility of conflict' eluded to in both *Hospital Products Ltd v United States Surgical Corp*[123] and *Pilmer v Duke Group Ltd*[124] seems inappropriate as leading guidance in this area.

Sometimes this lack of clarity can be problematic. For example, directors have claimed no breach of the conflict rule as it cannot be established, they preferred their interests over a client's.[125] In *Agricultural Land Management Ltd v Jackson* ('*Jackson (No) 2*')[126] the defendants claimed that a breach would only arise if the directors preferred their interests,

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[116] *Boardmann v Phipps* [1967] 2 AC 46 [124].
[117] *Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* (2008) 39 WAR 1 ('*Bell Group*').
[118] Ibid [4503].
[119] Royal Commission (n 3) 45.
[120] *Re Colorado Products Pty Ltd (in prov liq)* [2014] NSWSC 789.
[121] *On the Street Pty Ltd v Cott* (1990) 3 ASCR 54; *Streeter v Western Areas Exploration Pty Ltd (No 2)* (2011) 278 ALR 291.
[122] *See generally* Rosemary Langford and Ian Ramsay, 'Directors' conflicts: Must a conflict be pursued for there to be a breach of duty?' (2015) 9 *Journal of Equity* 281.
[123] *Hospital Products Ltd v United States Surgical Corporation* [1984] HCA 64 [97] ('*Hospital Products*').
[124] *Pilmer v Duke Group Ltd (in liq)* (2001) 207 CLR 165.
[125] *Agricultural Land Management Ltd v Jackson (No 2)* [2014] WASC 102 [268] ('*Jackson (No 2)*').
[126] Ibid.

citing *Bell Group Ltd v Westpac Banking Corporation*[127], stating that '[c]onflict per se is not actionable. A breach of duty arises where a fiduciary acts in a position of conflict and pursues (or prefers) the personal interest'.[128] This was rejected as 'the 'conflict rule' is not limited merely to situations where a fiduciary prefers their personal interest.[129] It also includes 'situations involving a *potential* for personal interest to be preferred or a *potential* for breach of duty to one principal where conflicting duties are owed to different principals'.[130] The same principles apply where, as in this case, the relevant conflict rule concerns two potentially conflicting duties'.[131] Edelman J stated that the 'no conflict' rule extends to situations where a 'potential' for personal interest to be preferred exists. 'There are many authorities which emphasise that the underlying duty upon the fiduciary is not circumscribed by whether actual advantage has been taken or whether the fiduciary has actually pursued the conflict'.[132]

In equity, the scope of the 'no conflict' rule has a significant limitation. The duty to avoid conflicts of interest will arise only in the part of a relationship between a fiduciary and the beneficiary that is fiduciary in character.[133] This applies to the scope of directors' duties[134], determined by relationship, agreement, and the party's dealings. The scope of the 'no conflict' rule for directors was questioned recently[135], but Bryan et al wrote that 'the scope of fiduciary duty generally in relation to conflicts of interest must accommodate itself to the particulars of the underlying relationship which will give rise to the duty so that it is consistent with, and confirms to, the scope and limits of that relationship'.[136]

[127] *Bell Group* (n 117).
[128] *Jackson (No 2)* (n 125) [265].
[129] Ibid [266].
[130] Ibid.
[131] Ibid.
[132] Ibid [268].
[133] *Birtchnell v Equity Trustees, Executors & Agency Co Ltd* (1929) 42 CLR 384.
[134] *Howard v Federal Commissioner of Taxation* [2014] HCA 83.
[135] *Coope v LCM Litigation Fund Pty Ltd* [2016] NSWCA 37.
[136] Michael Bryan et al, *A Sourcebook on Equity and Trusts in Australia* (Cambridge University Press, 2nd ed, 2019) 253.

A. *Disclosing and Authorising Conflicts of Interest*

Breach of general law directors' duties can be authorised by the company[137], in the same way those to whom fiduciary duties are owned may release those who owe them from their obligations.[138] This may take the form of a shareholder meeting, or by provision of the company's constitution, but full and frank disclosure is required to be effective.[139] Herein lies a point of debate.

Directors may escape liability for breach of fiduciary duty by disclosing their interests and obtaining fully informed consent. The degree of the disclosure required is unclear, unlike the UK which details this in statute[140] and case law.[141] This is because the courts have not always clearly articulated the relevant factors or requirements.[142] Consent may be obtained prior or be subsequent shareholder ratification. The efficacy of ratification is questionable, and not effective in situations of statutory breach.[143] In some cases, disclosure of interest and informed consent have avoided breach of duty[144], but disclosure of interest is a key baseline requirement.[145] Some cases have found directors who have failed to disclose their interests adequately in breach of their 'no conflict' obligations.[146] Some have required directors to take positive steps beyond disclosure to ensure the transaction does not go ahead, and found inaction insufficient in excusing them from liability.[147]

The key issue is the quality and degree of disclosure. 'There is no precise formula that will determine the extent of detail that is called for when a director declares his interest or the nature of his interest'[148], the amount depends on the nature and context of the contract. The other directors need to be fully informed, not just about the existence of a

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[137] Rosemary Langford, 'Statutory duties and ratification: Untangling the maze' (2021) 15 *Journal of Equity* 126, 128.
[138] *Angas Law Services Pty Ltd (in liq) v Carabelas* (2005) 226 CLR 507 [32] ('*Angas*').
[139] *Winthrop Investments Ltd v Winns Ltd* [1975] 2 NSWLR 666.
[140] *Companies Act 2006* (UK) c 46, s 177.
[141] *Neptune* (n 71).
[142] Rosemary Langford and Ian Ramsay, 'Conflicted directors: What is required to avoid a breach of duty?' (2014) 8 *Journal of Equity* 108, 108.
[143] *Forge v Australian Securities and Investments Commission* [2004] NSWCA 448.
[144] *Centofanti v Eekimitor Pty Ltd* (1995) 65 SASR 31.
[145] Langford (n 142) 113.
[146] *Permanent Building Society (in liq) v McGee* (1993) 11 ACSR 260.
[147] Langford (n 142) 108.
[148] *Gray* (n 59) [14].

conflict, but what it is and how far it goes. Disclosure should contain the nature and the extent of the interest in a transaction[149], and be sufficient to allow the provision of fully informed consent.[150]

Disclosure of conflicts of interest and the mis-selling of financial products has been a cause for concern in Australian financial services.[151] There are a range of policy solutions for managing conflicts of interest, but the most frequently recommended[152] and implemented policy in the financial industry and associated professions is disclosure. If people were rational, disclosure would be an effective remedy for conflicts of interest, and advisers would attempt to manage conflicts to increase the likelihood that their advice is trusted.[153] Research has shown that disclosure is quite ineffective at dealing with unavoidable conflicts of interest and rather than giving better advice, advisors give *more* biased advice than without.[154] This is particularly true in domains such as financial advice, where the provision of self-interested advice[155] was more the norm.[156] Depending on the culture, advisor bias can increase or decrease.[157] The disclosure itself can activate norms of self-interest, if the culture of the institution or person providing the advice is to put profits before people. Australia has had problems with these types of situations.[158] In financial service conglomerates, conflicts are often unavoidable due to organisational structure and remuneration practices. Disclosure can significantly decrease advisers bias if their culture is focussed on positive consumer outcomes and putting customers first.[159]

[149] *Short v Crawley (No 30)* [2007] NSWSC 1322 [692].
[150] *Woolworths v Kelly* (1991) 22 NSWLR 189 [211].
[151] Royal Commission (n 3) 74.
[152] Sunita Sah, 'Policy solutions to conflicts of interest: the value of professional norms' (2017) 1(2) *Behavioural Public Policy* 177, 182-185.
[153] George Loewenstein et al, 'The Limits of Transparency: Pitfalls and Potential of Disclosing Conflicts of Interest' (2011) 101(3) *The American Economic Review* 423, 423.
[154] George Loewenstein et al, 'When sunlight fails to disinfect: Understanding the perverse effects of disclosing conflicts of interest' (2011) 37(5) *Journal of Consumer Research* 836, 836; George Loewenstein et al, 'The dirt coming on clean: Perverse effects of disclosing conflicts of interest' (2005) 34(1) *The Journal of Legal Studies* 1, 2.
[155] Sunita Sah, 'Conflict of interest disclosure as a reminder of professional norms: Clients first' (2019) 154 *Organisational Behaviour and Human Decision Processes* 62, 62.
[156] Typically financial advisers receive different commissions for different products and services, so have an incentive to sell certain products to maximise their commission.
[157] Sah (n 152).
[158] Royal Commission (n 3) 74.
[159] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Research Paper, Conflicts of Interest and Disclosure, Sunita Sah, November 2018, 14.

B. *Conflicts of Interest in Groups of Companies*

In Australian financial service conglomerates, it is not just directors that are subject to fiduciary duties. Roles such as financial advisors, who are not status-based fiduciaries, can find that their relationship amounts to fiduciary due to their relationship with the client. Roles such as a financial advisor will be subject to the 'no profit' and 'no conflict' rule[160], and the courts have recognised this to be so.[161]

These relationships have been deemed 'vertical' fiduciary relationships due to the greater access to resources, skill or information of one party.[162] The broad test for this relationship was identified in *Hospital Products Pty Ltd v United States Surgical Corporation*.[163] Such relationships have a critical feature where 'the fiduciary undertakes or agrees to act for or on behalf of or in the interests of another person in the exercise of a power or discretion which will affect the interest of that person in a legal or practical sense'.[164] Adversely, 'horizontal' relationships are where the parties have committed to a high degree of trust to pursue their goals.[165] In these horizontal relationships, the *Hospital Products* test is inappropriate, and the level of trust is the deciding factor in whether the relationship exists.[166] Financial advisors' role in the Australian financial system and their legal obligations are discussed in Chapter Nine, due to serious misconduct uncovered by the Hayne Royal Commission. Chapter Nine demonstrates that financial service licensees are to engage in the efficient, honest, and fair provision of services, remain impartial, act in the customer's best interests, and avoid conflicts of interest. There is a distinction between personalised financial advice, which requires a license, and general advice, which does not impose the same obligations.

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[160] *John Alexander's Clubs Pty Limited v White City Tennis Club Ltd* (2010) 241 CLR 1.
[161] *ABN Amro Bank NV v Bathurst Regional Council* (2014) 309 ALR 445; *Bathurst Regional Council v Local Government Financial Services Pty Ltd* (No 5) [2012] FCA 1028; *Wingecarribee Shire Council v Lehmen Brothers Australia Ltd (in liq)* (2012) 301 ALR 1; *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 160 FCR 35; *Aequitas Ltd v Sparad No 100 Pty Ltd (formerly Australian European Finance Corp Ltd)* (2001) 19 ACLC 1006; *Commonwealth Bank of Australia v Smith* (1991) 42 FCR 390.
[162] *News Ltd v Australian Rugby League Ltd* (1996) 64 FCR 410.
[163] *Hospital Products* (n 123).
[164] Ibid 97.
[165] *United Dominion Corporation Ltd v Brian Pty Ltd* (1985) 157 CLR 1.
[166] Ibid.

C. Breaching Conflicts of Interest Rules

There is a difference between the directors' duties in Australia based in general law, and those based in statute. The duties to avoid improper use of position[167] and information from position[168], and the duty to disclose material personal interests[169] are contained within the *Corporations Act*.[170] Consequences for breach may range between a minor fine to disqualification from being a director.[171] Contravention of a director's statutory duty not to misuse their position to gain an advantage for themselves or others, for example, attracts civil remedial consequences. These might be a declaration of contravention[172], disqualification[173], pecuniary penalty[174], and compensation orders.[175] The general law duties to manage conflicts of interest and not to make secret profits are discussed above, in Section Three of this Chapter. If a company suffers loss as a result of a director's breach of their general law fiduciary duties, they can seek damages or compensation, but other remedies include injunction, entitlement of profits, order for property and recission.

The statutory duties that relate to conflicts and profits differ markedly from their general law equivalents. Unlike fiduciary duties, to prove a breach of Section 182 and 183 it must be shown that the defendant made improper use of their position or information arising from their positions, *and* they had a purpose of gaining for themselves or causing detriment to the corporation.[176] This was introduced in fears that the general law equivalent was adequate in ensuring the company real remedy against those who abused their positions.[177] The statutory duties contained in the *Corporations Act* in general were originally introduced to protect public interest and establish minimum standards of organisational behaviour.[178] General law duties protect the interest of the corporation itself.

[167] *Corporations Act 2001* (Cth) s 182.
[168] Ibid s 183.
[169] Ibid s 191.
[170] *Corporations Act 2001* (Cth).
[171] Ibid s 206(A).
[172] Ibid s 1317J.
[173] Ibid s 206(A).
[174] Ibid s 1317G.
[175] Ibid s 1317H.
[176] *Chew v R* (1992) 173 CLR 626 [633-634].
[177] *Angas* (n 138) [16].
[178] *Australian Securities and Investments Commission v Cassimatis (No 8)* (2016) 336 ALR 209 [447].

Enforcement in Australia differs to the UK, statutory directors duties are part of the civil penalty regime, and their enforcement rests with the Australian Securities and Investments Commission. It is a public body, so faces challenges like budgetary constraints, and has regularly been criticised by the press for failing to undertake its role more effectively. Shareholders may exercise certain powers to enforce directors' duties too. Directors can be removed from their position by resolution, shareholders can choose to utilise statutory courses of action such as unfair prejudice, winding up and statutory derivative actions, and Australian shareholders can apply for statutory injunctions. UK shareholders cannot.

IV. A CODE V. A PENALTY REGIME

A. An English Code

The key difference between the UK and Australia's legislative approach to conflicts of interest is that the UK adopts a code, and Australia adopts a penalty regime. The *Companies Act*[179] forms a code, setting out behavioural expectations but not dictating what to do. Instead, it addresses the possibility of directors prioritising their interests ahead of the company's and acting negligently. Duties derive from equity and common law.

The *Companies Act*[180] codifies common law rules and equitable principles. This is not just a matter of transforming judgements into legislative propositions, nor is it exhaustive. In company law, many principles will be influenced by other areas, such as agency and trusts.[181] These connections must not be lost, so company law may continue to evolve in line with other areas. However, legislation is formal. Therefore, the codification of directors' duties has been to balance precision with the flexibility needed for continuous development. Through codification, the Act preserves existing civil consequences for breach of directors' duties and allows for remedies the same as those flowing from a breach of the equitable principles and common law rules that the duties replace.

[179] *Companies Act 2006* (UK) c 46.
[180] Ibid.
[181] Luh Luh Lan, 'Rethinking Agency Theory: The View from Law' (2010) 35(2) *Academy of Management Review* 294, 294.

One of the outdated elements of the previous law was that directors had to disclose any interests that conflict directly or indirectly with the company's interests in any transaction requiring board approval.[182] This element was both too broad and too narrow. It was too broad as it involved declaring all interests, no matter how trivial.[183] It was too narrow as the actual extent of that interest need not be disclosed.[184] Section 177 of the *Companies Act* was introduced to combat this by widening the scope of required disclosure to include the nature and extent of interest. As it stands, the board's ability to approve conflicted interests in a transaction means the law may be insufficient in ensuring directors act appropriately. It allows for corporate backscratching, especially in service contracts. The time limits applied to contracts prevent long-term abuse of power but do not give shareholders the short-term right to veto service contracts. The *Companies Act* removes many of the complicated and unclear rules in the 1985 Act, providing a more coherent and intelligible method of ensuring that directors do not line their own pockets by way of their position.[185]

The codification of directors' duties clarifies what duties are owed, what those duties mean and how to discharge them. This reduces the chance that duties are breached in ignorance and reduces instances in smaller companies where directors fail to distinguish the company from themselves, conducting affairs for their own benefit rather than the company's. However, the codification has been slammed, as adequate shareholder protection has been forfeited due to a lack of clarity on which group's interests to consider, and a lack of enforceable remedies. Furthermore, the framework of duties and restrictions for directors has fallen short of a useful measure by allowing the board to approve transactions in which directors may have unscrupulous interests. The statutory code has led to more uncertainties and anomalies and represents a failed attempt to remedy English company law inadequacies.[186]

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[182] *Companies Act 1985* (Cth) s 317.
[183] Ibid s 317(1).
[184] Ibid s 317(3).
[185] Fraser Dobbie, 'Codification of Director's Duties: An Act to Follow' (2008) 11(1) *Trinity College Law Review* 13, 23.
[186] Ibid 28.

B. Australia's Penalty Regime

In Australia, the *Corporations Act* came as a package of bills.[187] The Act contains civil and criminal penalties for breaches. The civil penalty regime allows ASIC to bring proceedings for director's breach of their duties. These can have a lower standard of proof, leading to a broader range of sanctions and remedies. Criminal sanctions are usually fining and imprisonment, but alternatives may include a community service order. Civil penalties are generally fines, but may also be injunctions, banning orders, licence revocations and orders for reparation and compensation. Civil penalties can be defined as 'punitive sanctions that are imposed otherwise than through the normal criminal process'.[188] These sanctions are often financial in nature, 'and closely resemble fines and other punishments imposed on criminal offenders'.[189] However, the imposition process of these penalties 'is decidedly non-criminal, lacking many of the procedural safeguards built into the criminal process to protect the citizen from arbitrary use of State power'.[190]

The rationale for a civil penalty regime was to introduce a flexible set of sanctions tailored to the circumstances of a director's contravention, and give primacy to civil enforcement over criminal enforcement. The penalty regime was meant to reduce the time taken to complete enforcement and increase the success rate of litigation brought by the regulator. The introduction represents a 'conscious attempt by the Legislature to protect community interest by enhancing shareholder protection, and not unnecessarily burdening the vast majority of company directors who are honest and competent'.[191] When a director breaches their duties, without dishonest or fraudulent intent, they should not be exposed to criminal sanctions. At the same time, shareholders should be protected against breach by the appropriate civil penalties, including pecuniary penalties and disqualification.[192] Civil penalties exist to balance competing interests.

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[187] Australian Securities and Investments Commission Bill 2001 (Cth); Corporations (Fees) Bill 2001 (Cth); Corporations (Securities Exchanges Levies) Bill 2001 (Cth); Corporations (Futures Organisations Levies) Bill 2001 (Cth); Corporations (National Guarantee Fund Levies) Bill 2001 (Cth); and Corporations (Consequential Provisions) Bill 2001 (Cth).
[188] Michael Gillooly and Nii Lante Wallace-Bruce, 'Civil Penalties in Australian Legislation' (1994) 13(2) *University of Tasmania Law Review* 269, 269.
[189] Ibid.
[190] Ibid.
[191] Ibid 287.
[192] Ibid 288.

The appropriateness of the penalty system and the penalties has been reviewed more recently. The Senate Standing Committee on Economics said it is 'important that the penalties contained in legislation provide both an effective deterrent to misconduct as well as an adequate punishment, particularly if the misconduct can result in widespread harm. Insufficient penalties undermine the regulator's ability to do its job: inadequately low penalties do not encourage compliance, and they do not make regulated entities take threats of enforcement action seriously. The committee considers that a compelling case has been made for the penalties currently available for contraventions of the legislation ASIC administers to be reviewed to ensure they are set at appropriate levels'.[193]

In ASIC Report 387, penalties were considered consistent with other countries. Still, they found significantly higher prison terms in the US and a broader and higher range of civil and administrative penalties in other jurisdictions. Soft punishments and shorter sentencing might have contributed to Australia's reputation as a paradise[194] for white-collar criminals. This might well be why the misconduct in some banks, as evidenced by the Hayne Royal Commission, has been allowed to continue. In March 2019, widespread amendments to the penalty regime significantly increased the maximum penalties for civil and criminal contraventions and provided a new objective meaning of 'dishonesty', including consequential amendments.[195] Until this, ASIC's sanctions and remedies in undertaking enforcement actions included 'punitive, protective, preservative, corrective or compensatory actions'.[196] They could also resolve matters through negotiation or infringement notices.[197]

Types of action are summarised below. The additional amendments to the penalty regime have given ASIC more power to promote investor and financial consumer trust while ensuring fair conduct in financial markets and supporting the financial system's security.

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[193] Senate Standing Committee on Economics, Lifting the fear and suppressing the greed: Penalties for white-collar crime and corporate and financial misconduct in Australia, March 2017, 8.
[194] 'Australia 'paradise' for white-collar criminals, says ASIC chairman Greg Medcraft', *Sydney Morning Herald* (online, 11 December 2020) <https://www.smh.com.au/business/australia-paradise-for-whitecollar-criminals-says-asic-chairman-greg-medcraft-20141021-119d99.html>.
[195] Lifting the fear and suppressing the greed (n 193) 7.
[196] Ibid 17.
[197] Ibid.

Type of actions	Description
Punitive	Criminal penalties (terms of imprisonment, fines, community service orders) prosecuted by the Commonwealth Director of Public Prosecutions, with the exemption of minor regulatory offences, which ASIC prosecutes. Civil monetary penalties, all of which are payable to the Commonwealth.
Protective	Disqualification from managing a corporation Ban on providing financial services or engaging in credit activities. Revocations, suspension, or variation of conditions of a license Public warning notices. Application to court for a disqualification order.
Preservative	Court action to protect assets and encourage compliance (injunctions, freezing order).
Corrective	Court ordered corrective disclosure.
Compensatory	Representative actions in the court to recover damages or property (ASIC Act s50, Corporations Act s1317J).
Negotiated or agreed outcome	Enforceable actions Payment of infringement notices.[198]

Table 3. Penalties for Corporate Wrongdoing in Australia, Administered by ASIC

The two primary acts discussed have different intent, the UK's approach being a code, and Australia's penalty regime. This is the key difference between the UK and Australia in regulating financial services. An appropriately set penalty regime can be a great tool in deterring contravention and promoting the financial system's resilience. Until recently, the penalties in legislation had not been reviewed, so may not be as appropriate as they were when initially created. In recent years, it appears that shortcomings in penalty consistency and size created gaps between community expectation and regulatory response, particularly in instances of misconduct [199], hence the developments demonstrated by the Hayne Royal Commission.

[198] Adapted from ASIC Report 387: Penalties for Corporate Wrongdoing, March 2014, 9-10.
[199] Australian Securities and Investments Commission, *Submission 49*, 12.

Conclusively, there is a lack of a comprehensive definition of conflicts of interest in financial services. This may be due to its rapidly evolving nature, and the various new emerging conflicts that have accompanied the conglomeration of financial services since deregulation. It may be that the law struggles to keep pace with business in this sector. The current conflicts of interest frameworks cast a wide net over situations and uses disclosure as a tool to mitigate improper resolution, although the disclosure and approval process might be ineffective in tightly knit boards or those with poor corporate culture. Therefore, non-executive directors play a more critical role than ever before, as their independent role may help mitigate such behaviour.

It appears that defining circumstances where transactions breach conflict rules is a better option than strictly defining what constitutes a conflict. This way, the new conflicts that emerge with conglomeration are captured. The law is not perfect, and conflicts still occur. A potential reason for this is that boards of financial service conglomerates are selected for their expertise in finance rather than in law. The law can be complex and confusing, and directors are not always fully aware of their obligations to the corporation.[200] An opportunity for simplification of duties and obligations exists here.

Ethical dilemmas are commonplace in financial service conglomerates, as demonstrated thus far in this thesis, and the law may occasionally struggle to keep pace with business. Still, a solution to overcome the issues of complexity should be considered. An anti-conflict culture should be adopted by the boards of financial service conglomerates to ensure duties are not breached purposely. Measures to clarify the obligations of directors should also be taken to ensure duties are not breached in ignorance. No matter how thorough the framework to manage conflicts of interest in financial service conglomerates, a strong corporate culture is an effective tool in ensuring compliance. It also serves as a safety net of accountability and responsibility in situations where the conflict or circumstance may circumvent the traditional legal boundaries.

[200] Robert Goddard, 'Directors' Duties' (2008) 12(3) *Edinburgh Law Review* 468, 469.

CHAPTER 5: RELATED PARTY TRANSACTIONS

This chapter examines and compares the regulatory frameworks that govern related party transactions in the UK and Australia. It does this by:

- Considering UK and international definitions of related party transactions, and the lack of a formal definition appropriate for financial services, a commonality in both countries;
- Comparing the *Companies Act 2006*[1] and Listing Rules Chapter 11[2] and the *Corporations Act 2001*[3] and Regulatory Guide 76[4] and outlining any shortcomings in the frameworks; and
- Examining the applicable elements of the ASX Listing Rules 10 in Australia to related party transactions.

Related party transactions can harm the financial system and wider economy when abused. The stock market crash of the late 1980s exposed numerous instances of self-dealing, where the rules had been circumvented by using family members or related companies.[5] These transactions included loans to directors, inter-company loans, excessive remuneration, service charges and other uncommercial arrangements. Some companies saw significant transfers of wealth from shareholders to management.[6] Loans made to directors in some parts of the world have been seen as a 'manifestation of looting'[7], showing that weak governance arrangements and culture among board members has allowed abuse of these transactions. This chapter focuses on entities and board members as related parties.

Related party transactions can create conflicts of interest.[8] Persons abusing their position of responsibility could benefit from favourable terms at the expense of shareholders by contracting with the corporation on less favourable terms than could be achieved through

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[1] *Companies Act 2006* (UK) c 46.
[2] FCA Handbook, Listing Rules 11: Related Party Transactions.
[3] *Corporations Act 2001* (Cth).
[4] ASIC Regulatory Guide 76: Related Party Transactions.
[5] John Farrar and Pamela Hanrahan, *Corporate Governance* (LexisNexis Butterworths, 2017) 208.
[6] Ibid.
[7] Steven Balsam, Richard Gifford and John Puthenpurackal, 'Related Party Transactions, Corporate Governance and CEO Compensation: Related Party Transactions and Corporate Governance' (2017) 44(5-6) *Journal of Business Finance and Accounting* 854, 858.
[8] Ibid.

arm's length negotiation.[9] This could lead to the entity paying more for related party services, or providing services to the related party at below market rates.[10] Financial advisors have preferred their own interests in pursuit of financial incentives[11], and are more likely to prefer the institution's own products, which may include related party products and services.[12] Conflicted remuneration is a problem uncovered by the Hayne Royal Commission.[13] However, this is not a recent phenomenon.

Related party transaction rules are important in financial service conglomerates; the more entities in a group, the more opportunity for related party transactions abuse. Money is often moved between subsidiaries and parent groups, and between subsidiaries themselves. The Qintex Group was an intermediate holding group of about 170 companies, involved in a diverse range of business activities. *ANZ Executors & Trustee Co Ltd v Qintex Ltd & Anor*[14] demonstrated that 'the essential principle is that the powers, and the funds, of a company may be used only for the purposes of the company'.[15] 'They can only spend money which is… the company's if they are spending it for the purposes which are reasonably incidental to the carrying on of the business of the company. That is the general doctrine. Bona fides cannot be the sole test; you might have a lunatic conducting the affairs of the company, paying away its money with both hands in a manner perfectly bona fides yet perfectly irrational. The test must be what is reasonably incidental to, and within the reasonable scope of carrying on, the business of the company'.[16]

More recent cases have demonstrated that corporate powers must be used for corporate purposes in groups of companies.[17] Related party transactions without benefit or potential

[9] Ibid.
[10] Ibid.
[11] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Final Report, Volume 1, 74.
[12] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Background Paper 7, Legal Framework for the Provision of Financial Advice and Sale of Financial Products to Australian Households, Pamela Hanrahan, April 2018, 4.
[13] Royal Commission (n 7) 14.
[14] *ANZ Executors & Trustee Co Ltd v Qintex Ltd & Anor* [1990] QSC 198.
[15] *Advance Bank Australia Ltd & Ors v FAI Insurances Ltd & Anor* (1987) 5 ACLC 725 [748]; *Ngurli Ltd v McCann* (1953) 90 CLR 425 [438].
[16] *Hutton v West Cork Railway Co* (1883) 23 Ch D 654 [671].
[17] *Reid Murray Holdings Ltd (in liq) v David Murray Holdings Pty Ltd* (1972) 5 SASR 386.

advantage are beyond directors' authority.[18] This context is useful when exploring related party transactions in terms of financial service conglomerates. The question remains of whether related party transactions undermine the legal and regulatory system designed to protect financial service conglomerates. When efficient, related party transactions are useful in transferring value as legitimate transactions. When inefficient, they are used to hide excessive compensation and are methods for personal gain and nepotism.[19] The law is concerned about the point at which exploitation of the relationship goes beyond cost reduction.

Increased scrutiny of related party transactions arose throughout the ten years preceding the global financial crisis, along with the litigation resulting from audits of those transactions.[20] Research confirms a limited understanding of the nature of related party transactions and their economic consequences. The research also fails to address and understand these transactions' complexity or diversity.[21]

I. RELATED PARTY TRANSACTIONS IN THE UK

The potential for self-benefit through related party transactions is governed differently across the globe. The UK Listing Rules impose procedural safeguards and disclosure requirements for companies with a premium listing who engage in substantial related party transactions.[22] The Listing Rules operate alongside the *Companies Act 2006*[23] and are complemented by periodic disclosure requirements for related party transactions under International Accounting Standard 24 (IAS 24).

IAS 24 defines a related party transaction as a transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged.[24]

[18] *Kinsela & Anor v Russell Kinsela Pty Ltd (in liq)* (1986) 4 ACLC 215; *West Mercia Safetywear Ltd v Dodd* (1988) BCLC 250 [252-253].
[19] Sunwoo Hwang and Woochan Kim, 'When Heirs Become Major Shareholders. Evidence on Pyramiding Financed by Related-Party Sales' (2016) 41 *Journal of Corporate Finance* 23, 24.
[20] Craig Fields, 'State Challenges to Related Party Transactions Continue to Rise' (2000) 19(1) *Journal of State Taxation* 8, 8.
[21] Elizabeth Gordon et al, 'Related Party Transactions and Corporate Governance (2004) 9 *Advances in Financial Economics* 1, 8.
[22] FCA Handbook, Listing Rules 11: Related Party Transactions, LR 11.1.2.
[23] *Companies Act 2006* (UK) c 46.
[24] IAS 24 Related Party Disclosures, IAS 24.9 (25 September 2020) Deloitte <https://www.iasplus.com/en/standards/ias/ias24>.

The Standard defines related parties under IAS 24.9 and unrelated parties under IAS 24.11.[25] The premise of IAS 24 means that no related party transaction exists without the corporation and a related party on opposite sides of the transaction.

The UK Listing Rules take a broader stance on a definition to include transactions 'between a listed company and any person the purpose and effect of which is to benefit a related party'.[26] The focus on related party transactions may be that compliance and enforcement are much more manageable. As the previous chapter demonstrated, conflict of interest situations are highly subjective, giving rise to interpretation issues. This thesis suggests that 'legislative porridge'[27] causes confusion among directors regarding their duties, and this subjectivity compounds that confusion.

The Financial Conduct Authority offers guidance on related party transactions[28] in the UK, but it remains merely guidance. Therefore, the regulatory framework includes the *Companies Act*[29] and the Listing Rules.[30] The law applies to all companies, but there are additional rules for listed companies. English law promotes the classic concept of fiduciary duty and is reluctant to assess the transaction's substantive fairness as a test for its legality. Consequently, it relies heavily on internal company and auditing procedure.[31] The problem is that the general law has struggled to be effective in terms of shareholders, or directors acting in a shareholder capacity. Secondly, the private-ordering model led to the shift of procedural controls from shareholders to the board.[32]

The UK has long since insisted on related party transaction declarations, and in the past decade, Italy[33], India[34], Hong Kong, Malaysia, and Singapore[35] have followed suit. The

[25] Ibid 24.11.
[26] FCA Handbook LR11 (n 22) 11.1.5.
[27] *Wingecarribee Shire Council v Lehman Brothers Australia Ltd (in liq)* [2012] FCA 1028 [948].
[28] FCA Handbook LR11 (n 22) 11.1.
[29] *Companies Act 2006* (UK) c 46.
[30] Listing Rules 11: Related Party Transactions.
[31] Paul Davies, 'Related Party Transactions: UK Model' (February 2018) ECGI Working Paper Series in Law, Working Paper Number 387/2018.
[32] Ibid 12.
[33] Luca Enriques et al, 'Enforcing Rules on Related Party Transactions in Italy: One Securities Regulator's Challenge' European Corporate Governance Institute (ECGI) – Law Working Paper No 409/2018.
[34] *Companies Act 2013* (India) s 188.
[35] Dan Puchniak, 'Related Party Transactions in Commonwealth Asia: Complicating the Comparative Paradigm' (2019) 12 *Berkeley Business Law Journal* Working Paper 2019/001.

mere presence of a disclosure requirement demonstrates that these transactions may be harmful to financial service conglomerates and the economy. The law of conflicts of interest has remained mostly unchanged for a long time. Until 1998, the leading precedent was an 1854 House of Lords decision.[36] This might signify why related party transactions are regulated rather than governed by statute; business operations evolve quicker than legislation

A. Listing Rules 11 and the Companies Act 2006

Related party transactions in the UK are governed by the *Companies Act*[37] and Chapter 11 of the Listing Rules (LR11).[38] The purpose of LR11 is to provide safeguards to transactions and arrangements between listed companies and related parties, and the transactions between listed companies and the recipient of related party benefit.[39] These safeguards also ensure that a related party does not take advantage of their position. The Listing Rules apply to transactions or arrangements entered by a listed company and apply to transactions by its subsidiary undertakings.[40]

Unlike Australia, the Listing Rules define related parties and related party transactions. A related party is a substantial shareholder, director, or shadow director of the listed company, or of a subsidiary, parent, or fellow subsidiary company. This definition extends to any person exercising significant influence or an associate of a related party.[41] This is the same as in Australia. A substantial shareholder is any person entitled to exercise 10% or more of the votes that can be cast on all, or substantially all, matters at general meetings of the company[42], or the parent or subsidiary. A related party transaction is defined as:

- a transaction (other than a transaction in the ordinary course of business) between a listed company and a related party; or
- an arrangement (other than an arrangement in the ordinary course of business) pursuant to which a listed company and a related party each invests in, or provides finance to, another undertaking or asset; or

[36] *Aberdeen Railway Co v Blaikie Bros* [1854] UKHL 1.
[37] *Companies Act 2006* (UK) c 46.
[38] FCA Handbook LR11 (n 22).
[39] Ibid LR11.1.2.
[40] Ibid LR11.1.3.
[41] Ibid LR11.1.4.
[42] Ibid LR11.1.4A.

- any other similar transaction or arrangement (other than a transaction in the ordinary course of business) between a listed company and any other person the purpose and effect of which is to benefit a related party.[43]

The exception to this definition and the Listing Rules is that they do not apply to transactions executed in the 'ordinary course of business'. The Financial Conduct Authority notes the size and nature of transactions and the terms and conditions when assessing if this exemption applies, much like ASIC do in Australia. It is not clear how much rigour these transactions will be subject to.

If a listed company enters a related party transaction, they must submit a Class 2 Transaction Notification[44] detailing the name of the related party and the nature and extent of the interest. Shareholders must be notified, and the transaction must be approved before it is entered in completed. The related party must not vote on the resolution, nor can any related party associates[45], similar to the Australian approach. Material changes to the transaction mean that a new Class 2 Transaction Notice must be submitted.[46] The Financial Conduct Authority considers a 'material change' an increase of 10% or more in consideration payable.[47] If the listed company has been called to approve a transaction but becomes a related party before that date arrives, they must not vote on the relevant resolution.[48]

There are some instances of transactions to which related party transaction rules do not apply. Listing Rules 11 Annex 1 states that related party transaction rules do not apply to small transactions[49], employee share schemes and long-term incentive schemes[50] (something prominent in financial service conglomerates), credit[51], directors' indemnities

[43] Ibid 11.1.5.
[44] Ibid LR10.4.1.
[45] Ibid LR11.1.7.
[46] Ibid LR11.1.7A.
[47] Ibid LR11.1.7B.
[48] Ibid LR11.1.8.
[49] Ibid LR11 Annex 1.1.
[50] Ibid LR11 Annex 1.3.
[51] Ibid LR11 Annex 1.4.

and loans[52], underwriting[53], joint investment arrangements[54] and insignificant subsidiary undertakings.[55]

The Listing Rules feature two principal limitations. Firstly, they do not apply to transactions executed in the 'ordinary course of business', outlined above. Secondly, small transactions are exempt from the remit of the rules, even if they are not executed in the ordinary course of business. Reference to one of four ratios determines whether a transaction is small. Transactions not covered by the Listing Rules could be significant for a related party, and the lack of the need to obtain shareholder approval could undermine shareholder interests.

The *Companies Act* requires shareholder approval for situations in which directors are conflicted and treats related party transactions as conflicts of interest. The Act deals with and requires shareholder approval for long term service contracts, substantial property transactions, loans, quasi-loans and credit transactions and payments for loss of office.[56] These specific provisions are a narrow application of conflicts of interest obligations in the Act. History has shown that board approval is not enough to ensure that such transactions are in good faith and the company's best interests. As such, shareholder approval is required. These areas are covered by Chapter 4 of Part 10 of the Act, with an overview of provisions contained within Section 9.2.2. Quasi-loans, credit transactions and loans to persons connected with directors apply only to public companies and companies associated with them. This inclusion means that companies in a genuinely related group setting will be subject to the provisions. Before 2006, there was no reason why the Articles of Association might not permit related party transactions, even without board disclosure. However, it seems they rarely did.[57]

Chapter 4 of Part 10 of the Act entitled 'Transactions with Directors Requiring Approval of Members' is the provision extending to group arrangements between holding

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[52] Ibid LR11 Annex 1.5.
[53] Ibid LR11 Annex 1.6.
[54] Ibid LR11 Annex 1.8.
[55] Ibid LR11 Annex 1.9.
[56] *Companies Act 2006* (UK) c 46 s 188, 190, 197, 215.
[57] Davies (n 30) 12.

companies and subsidiaries.[58] Body corporates currently not registered as UK companies are exempt from the provisions[59], but shadow directors are not.[60]

The categories of people connected to a director include members of the director's family, body corporates, trustees, and firms. Directors associated with a body corporate and directors controlling a body corporate are covered by Sections 254 and 255. Section 253 details the people considered family members. The definition of a connected person is broad and contained within Schedule 1 of the *Companies Act*.[61] The definition restricts the interpretation of Sections 254[62] and 255[63] (directors connected with or controlling a body corporate) to those interested in shares or debentures. The broad definitions in the UK contrast with the restrictive approach taken in Australia.[64]

Section 188 of the *Companies Act*[65] *contains* the requirements for directors' long-term service contracts. Section 188(5) stipulates that any resolution approving the provision cannot be passed unless a memorandum containing the proposed contract is made available to all members. Contravention attracts civil consequences[66] and will render the provision void or entitle the company to terminate with notice.[67]

Section 190 of the *Companies Act*[68] deals with substantial property transactions, which require members' approval. This section prohibits the company from entering into arrangements with directors, or persons connected with directors, to acquire 'substantial non-cash assets' unless shareholder approval is obtained. The Act defines a 'non-cash asset' as 'any property or interest in property, other than cash'.[69] Any reference to the transfer or acquisition of a non-cash asset includes 'the creation or extinction of an estate

[58] *Companies Act 2006* (UK) c 46, s 188(1), 190(1), 197(1), 198(2), 200(2), 201(2), 203(1).
[59] Ibid s 188, 190, 197, 198, 200, 201, 203, 217, 218, 219.
[60] Ibid s 223(1).
[61] *Companies Act 2006* (UK) c 46.
[62] Ibid s 254.
[63] Ibid s 255.
[64] Rosemary Langford, *Company Directors' Duties and Conflicts of Interest* (Oxford University Press, 2019) 279.
[65] *Companies Act 2006* (UK) c 46, s 188.
[66] Ibid s 189.
[67] *British Racing Drivers' Club Ltd v Hextall Erskine & Co* [1996] 3 All ER 667 (Ch).
[68] *Companies Act 2006* (UK) c 46, s 190.
[69] Ibid s 1163.

or interest in, or a right over, any property, and the discharge of a liability of any person, other than a liability for a liquidated sum'.[70]

The Act also defines the term 'substantial'.[71] An asset is substantial 'if its value exceeds 10% of the company's asset value and is more than £5,000, or exceeds £100,000'.[72] An 'asset value' is the value of the company's net assets determined by reference to its most recent statutory accounts, or if no statutory accounts have been prepared, the amount of the company's called-up share capital.[73] 'Statutory accounts' are annual accounts prepared under Part 15[74], and its 'most recent' statutory accounts are those which have been communicated to members most recently.[75]

Exceptions are made for transactions with members or other groups of companies.[76] Approval for substantial property transactions is not required for a transaction between a company a member of that company, or for a transaction between a holding company and its wholly-owned subsidiary, or two wholly-owned subsidiaries of the same holding company.[77] This is particularly important for financial service conglomerates, as it negates the need for a third-party assessment of a transaction's value. Exceptions to shareholder approval also apply to companies being wound up or administration.[78] Companies that are being wound up (unless winding up is voluntary by the members') or are in administration[79] are not required to obtain approval under Section 190[80] for substantial property transactions.

The Act also covers exceptions for transactions on recognised investment exchanges.[81] Section 190 approval is not necessary for a transaction on a recognised investment exchange effected by a director, or a person connected with him, through the agency of a

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[70] Ibid.
[71] Ibid s 191.
[72] Ibid s 191.
[73] Ibid s 191(3).
[74] Ibid s 191(4).
[75] *Corporations Act 2001* (Cth) s 424.
[76] *Companies Act 2006* (UK) c 46, s 192.
[77] Ibid s 192.
[78] Ibid s 193.
[79] Within the meaning of Schedule B1 to the *Insolvency Act 1986* or the *Insolvency (Northern Ireland) Order 1989*.
[80] *Companies Act 2006* (UK) c 46, s 190.
[81] Ibid s 194.

person who acts as an independent broker in the transaction.[82] The Act defines 'independent broker' as a person who, independently of the director or any connected person, selects the person with whom the transaction is to be effected.[83] 'Recognised investment exchange' has the same meaning as Part 18 of the *Financial Services and Markets Act*[84]; an investment exchange in relation to which a recognition order is in force.[85] Contravention of Section 190[86] attracts civil consequences which are contained within Section 195.[87] With contravention, the arrangement and any transaction entered is voidable at the company's instance. A company will not be subject to any liability because of a failure to obtain the approval required by Section 190.[88]

The next set of provisions in the Act deal with loans, quasi-loans, and credit transactions. Under Section 197 of the Act, a company may not make a 'loan to a director of the company or of its holding company or give a guarantee or provide security in connection with a loan made by any person to such a director, unless the transaction has been approved by a resolution of the members of the company'.[89] The term 'loan' is undefined, but assumedly an amount of money is borrowed and repaid. Interest is not essential.[90] 'If the director is a director of the company's holding company, the transaction must also have been approved by a resolution of the members of the holding company'.[91] A resolution approving a transaction must be made available to all members. It must include the nature of the transaction, the amount of the loan and its purpose, and the extent of the company's liability under any transaction connected with the loan.[92] This is particularly pertinent in financial service conglomerates, where directors may hold multiple roles. Non-UK registered companies or wholly owned subsidiaries of another body corporate do not require approval under this section.[93]

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[82] Ibid.
[83] Ibid s 194(2)(a).
[84] *Financial Services and Markets Act 2000* (UK) c 8.
[85] *Companies Act 2006* (UK) c 46, s 194(2)(b).
[86] Ibid s 190.
[87] Ibid s 195.
[88] *NBH Ltd v Hoare* [2006] EWHC 73 (Ch); *Murray v Leisureplay plc* [2005] EWCA Civ 963; *Re Duckwari Plc (No 2)* [1999] Ch 253 (Ch).
[89] *Companies Act 2006* (UK) c 46, s 197.
[90] *Currencies Direct Ltd v Ellis* [2002] EWCA Civ 779; *Ciro Citterio Menswear plc v Thakrar* [2002] EWCH 662 (Ch); *Champagne Perrier-Jouet SA v HH Finch Ltd* [1982] 1 WLR 1359.
[91] *Companies Act 2006* (UK) c 46, s 197(2).
[92] Ibid s 197(4).
[93] Ibid s 197(5).

Section 198[94] deals with quasi-loans[95] to directors, such as a company paying for goods on behalf of a director and allowing a director to use a company credit card for expenditure. This section only applies in limited scope to public companies and their associated companies.[96] Much like Section 197[97], a resolution approving this type of transaction must not be passed unless a memorandum discussing the transaction's nature, the amount and the purpose, and the extent of the company's liability under any transaction connected with the quasi-loan[98] has been circulated.[99] No approval is required from the members of a body corporate that is not a UK-registered company, or is a wholly-owned subsidiary of another body corporate.[100] The same requirements also apply to loans or quasi-loans to persons connected with directors.[101] Section 198's[102] scope and approval steps are almost identical.

Credit transactions[103] are governed by Section 201[104] and apply only to public companies or companies associated with them.[105] A transaction must not be approved unless a memorandum containing details on the nature of the transaction, the value of the credit transaction and the purpose has been circulated.[106] The extent of the company's liability under any transaction connected with the credit transaction[107] must also be circulated to members.[108] Again, no approval is required from a body corporate that is not a UK-

[94] Ibid 198.
[95] A "quasi-loan" is a transaction under which one party ("the creditor") agrees to pay, or pays otherwise than in pursuance of an agreement, a sum for another ("the borrower") or agrees to reimburse, or reimburses otherwise than in pursuance of an agreement, expenditure incurred by another party for another ("the borrower") on terms that the borrower (or a person on his behalf) will reimburse the creditor; or in circumstances giving rise to a liability on the borrower to reimburse the creditor: *Companies Act 2006* (UK) c 46, s 199.
[96] Ibid s 198(1).
[97] Ibid s 197.
[98] Ibid s 198(5).
[99] Ibid s 198(4).
[100] Ibid s 198(6).
[101] Ibid s 200.
[102] Ibid s 198.
[103] A "credit transaction" is a transaction under which one party ("the creditor") supplies any goods or sells any land under a hire-purchase agreement or a conditional sale agreement, leases or hires any land or goods in return for periodical payments, or otherwise disposes of land or supplies goods or services on the understanding that payment (whether in a lump sum or instalments or by way of periodical payments or otherwise) is to be deferred: *Companies Act 2006* (UK) c 46, s 199.
[104] Ibid s 201.
[105] Ibid s 201(1).
[106] Ibid s 201(5).
[107] Ibid.
[108] Ibid s 201(4).

registered company or is a wholly owned subsidiary of another body corporate.[109] The same requirements apply to related arrangements.[110]

Exceptions apply for business expenditure[111]; expenditure on defending proceedings[112] of a certain nature[113]; expenditure in connection with regulatory action or investigation[114]; minor and business transactions[115]; intra-group transactions[116]; and money lending companies.[117] Section 210[118] provides details for determining what constitutes ‘other relevant transactions or arrangements’ for obtaining an exception to Sections 197, 198, 200 and 201. This part of the Act also determines the value of transactions and arrangements[119] and for whom a transaction or arrangement is entered.[120]

Civil consequences apply for contravention of Sections 197, 198, 200, 201 and 203[121], leaving the transaction or arrangement voidable at the company’s discretion unless certain exceptions apply.[122] Liability for infringement of the above sections applies to the company’s director or director of its holding company. Connected persons, authorising directors, and any person who entered the contravened arrangement are liable too. A person is not liable if they can demonstrate they took all reasonable steps to secure the company’s compliance and show that they did not know about the infringement when the transaction was entered.[123] Subsequent affirmations of transactions or arrangements contravening the discussed sections are found in Section 214.[124]

The final set of provisions are related to payments for loss of office.[125] ‘Payment for loss of office’ is defined as a payment made to a director or past director to compensate for

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[109] Ibid s 201(6).
[110] Ibid s 203.
[111] Ibid s 204.
[112] Ibid s 205.
[113] Ibid s 205(1)(a).
[114] Ibid s 206.
[115] Ibid s 207.
[116] Ibid s 208.
[117] Ibid s 209.
[118] Ibid 210.
[119] Ibid s 211.
[120] Ibid s 212.
[121] Ibid s 213.
[122] Ibid s 213(2).
[123] Ibid s 213(7).
[124] *Neville v Krikorian* [2006] EWCA Civ 943; *Queensway Systems Ltd v Walker* [2006] EWHC 2496 (Ch).
[125] *Companies Act 2006* (UK) c 46, s 215.

loss of office as director.[126] It also includes consideration for, or in connection with, their retirement from his office as director of the company or as consideration for their retirement.[127] The amounts must be outlined[128], and payments must not be made unless a memorandum is circulated to members.[129] Once again, approval is not required for a non-UK-registered company, or a wholly-owned subsidiary of another body corporate.[130] Exceptions exist for payments in discharge of legal obligations[131] and small payments[132], but any unapproved payments attract civil consequences.[133]

In situations where Section 175[134] and 177[135] have been complied with, the transaction or arrangement cannot be set aside by common law or equitable principle.[136] General duties remain unaffected if the case requires member approval, except where consent is given, or the matter does not require permission.[137] Compliance with general and statutory obligations does not negate the need for approval under the relevant provisions.[138]

Related party transactions can be considered as potentially harmful when carried out by directors to serve their own interests by diverting or extracting wealth or value away from the corporation or its shareholders.[139] Legal tools serve to prevent related party transactions from being used for tunnelling purposes, but the challenge is to minimise that risk without stifling value-creating transactions or imposing excessively high costs. For prohibition to be effective, tunnelling more broadly should be addressed. However, the prohibition of related party transactions would ineffectively tackle tunnelling, where such transactions are efficient and legal.

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[126] Ibid s 215(1).
[127] Ibid.
[128] Ibid s 216.
[129] Ibid s 217(3).
[130] Ibid s 217(4).
[131] Ibid s 220.
[132] Ibid s 221.
[133] Ibid s 222.
[134] Ibid s 175.
[135] Ibid s 177.
[136] Ibid s 180(1).
[137] Ibid s 180(2).
[138] Ibid s 180(3).
[139] Michele Pizzo, 'Related Party Transactions Under a Contingency Perspective' (2013) 17 *Journal of Management & Governance* 309, 311.

Though the United Kingdom and Australia share some similarities, the structure of financial service conglomerates in each country is unique. As a result, the potential risks for related party transactions are difficult to compare.

II. RELATED PARTY TRANSACTIONS IN AUSTRALIA

The Governance Institute of Australia provides guidance and a basic framework for related party transactions alongside the *Corporations Act*[140], ASIC Regulatory Guide 76[141], and ASX Listing Rules. This harmonised set of documents ensures a financial service conglomerate's compliance. The emphasis is on reducing corporate risk and protecting members' interests by managing these transactions.[142] In some areas, the law fails to serve that purpose. Related party transactions are defined in Australian Accounting Standards (AASB)[143] but may not account for financial institutions' diverse nature. The guidance provided by the Australian Securities and Investments Commission (ASIC) defines a related party transaction as 'any transaction through which a public company or registered managed investment scheme provides a financial benefit to a related party (such as a director, their spouse and certain other relatives)'.[144] However, the legal framework exists to protect the interest of members of public companies and registered schemes in Australia by requiring member approval for giving potentially damaging financial benefits.[145] In corporate opportunity cases, related parties take business opportunities that should go to their companies instead.[146]

There are 83 banks, credit unions and building societies that Australians could bank with.[147] Still, the Australian banking sector is dominated by an oligopoly of four banks, which control over 80% of owner-occupier home loans and 85% of all investor housing

[140] *Corporations Act 2001* (Cth).
[141] ASIC RG 76 (n 4).
[142] *Corporations Act 2001* (Cth) Chapter 2E; Corporations Regulations 2001, RED 2E.1.01; ASX Listing Rules, Chapter 10; ASIC RG 76 (n 4).
[143] Australian Accounting Standards (AASB) 124 Related Party Disclosures.
[144] ASIC RG 76 (n 4).
[145] Ibid RG 76.7.
[146] *Guth v Loft Inc* 5 Atlantic Reporter 2d 303 (Delaware Supreme Court 1939).
[147] 'Why the Big Four Still Have a Stranglehold Post-GFC', *Sydney Morning Herald* (online, 8 March 2018) <https://www.smh.com.au/opinion/banking-inquiry-why-the-big-four-still-have-a-stranglehold-post-gfc-20171126-gzsygu.html>.

loans.[148] As a result, related party transactions are commonplace due to the concentration and complexity of the industry. For simplification, the term 'banking' in this chapter represents the spectrum of products and services a person may use, from opening a bank account to completing a mortgage.

Related party transactions are a vital issue for directors of financial service institutions. As the Supreme Court of New South Wales Court of Appeal noted, '[t]he postulated reasonable person in Section 180(1) embraces any special skill or expertise the director or officer possesses'.[149] Director' roles are linked to related party transactions, and some relevant cases in the paragraph below have outlined ASIC's stance on this. RG 76 cites disclosure documents[150], member approval process[151], arm's length dealings[152] and director's meetings[153] as processes where the most significant risk of a related party influence exists.

A. ASIC Regulatory Guide 76 and the Corporations Act 2001

Related party transactions are governed in Australia by the *Corporations Act*[154] and RG 76. These provisions protect public company's[155] members' interests by requiring approval before giving financial benefits to related parties that may endanger their interests.[156] As stated, related party transactions involve conflicts of interest.[157] Legislation and guidance in Australia ensure these transactions are not uncommercial or anti-competitive.

What constitutes a financial benefit is imprecise but intended to be interpreted broadly, even if criminal or civil penalties apply.[158] The Act provides examples of giving a financial benefit to a related party[159], but assesses whether a benefit has been given rather

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[148] 'The big four banks are getting even more powerful at Australian's expense', *The Guardian* (online, 8 March 2018) <https://www.theguardian.com/business/grogonomics/2018/feb/08/the-big-four-banks-are-getting-even-more-powerful-at-australians-expense>.
[149] *Morely v Australian Securities and Investments Commission* (2010) 274 ALR 205 [358].
[150] ASIC RG 76 (n 4) 33.
[151] Ibid 22.
[152] Ibid 15.
[153] Ibid 8.
[154] *Corporations Act 2001* (Cth).
[155] Ibid s 9.
[156] Ibid s 208(1).
[157] ASIC RG 76 (n 4) RG 76.1.
[158] *Corporations Act 2001* (Cth) s 229(1).
[159] Ibid s 229(3).

than whether it satisfies the definition. A financial benefit need not involve actual money. The transaction's economic and commercial substance is considered to keep pace with the changing nature of financial services and conglomeration. This shows that there is value in intangible assets and opportunities.

A related party[160] is any person or entity that can influence the company's decision to offer a financial benefit either as a controlling or controlled entity and are listed in Section 228(2)-(7).[161] Related party transactions are not forbidden and are commonplace in financial service conglomerates due to market concentration and group structure. For a public company to give a financial benefit to a related party, the company's members must approve the transaction in the way set out in Sections 217-227[162] and ensure the benefit falls within an exception contained in Section 210-216.[163] This rule's exception pertains to three broad categories; transactions carried out on arm's length terms[164]; reasonable remuneration or reimbursement of officers and employee expenses[165]; and transactions or financial benefits given under court order.[166] Any financial benefit to be given to a related party must be accompanied by at least 14 days' notice and lodged with ASIC.[167] This period can be shortened in some cases[168] but comes with various other requirements.[169]

The proposed explanatory statement[170] to satisfy Section 219 (requirements for explanatory statements to members) is the opportunity to explain that the proposed financial benefit is in the entity's best interests. The transaction's impact is to be framed in dollars[171], accompanied by the reasons for doing so.[172] Alternative options must be considered, including reasons for choosing the related party and implications of not.[173] This is not to be taken lightly; advantages and disadvantages must be weighed up clearly

[160] Ibid s 228.
[161] Ibid s 228(2)-(7).
[162] Ibid s 208(a)(i).
[163] Ibid s 208(b).
[164] Ibid s 210.
[165] Ibid s 211.
[166] Ibid s 212-216.
[167] Ibid s 218(1).
[168] Ibid s 218(2).
[169] ASIC RG 76 (n 4) RG 76.118.
[170] *Corporations Act 2001* (Cth) s 218(1)(b).
[171] ASIC RG 76 (n 4) RG 76.98.
[172] Ibid RG 76.101.
[173] Ibid.

to communicate the more suitable option.[174] Overall the transaction's impact is of utmost importance.[175]

When benefits are hard to demonstrate or value, expert reports are commissioned.[176] Significant barriers to understanding can arise when transactions are complex, involved in changing business activities, strategic direction, board composition or substantial dilution of existing members.[177] This is not an express requirement under Ch 2E of the *Corporations Act*.[178] Still, ASIC considers that for directors to discharge their fiduciary obligations, the board should have everything necessary to inform themselves about transactions, particularly whether they be advantageous or onerous.[179] An independent expert opinion may also be required under Ch 10 of the ASX Listing Rules where a company or related party transaction is governed by Ch 6 of the *Corporations Act*[180], or the entity is commissioning a report for member approval under Section 611 [181] (exceptions to the prohibition).

Any meeting seeking approval to enter into a related party transaction must be communicated to a company's members with notice.[182] The documentation served with this notice must contain the same information lodged with ASIC[183] and should not contain anything else.[184] Any comments received from ASIC should also be included.[185] Directors are obliged to act justly to ensure total transparency and fairness.[186] Documents not accompanying this notice, but given at or before the meeting must be materially the same as anything lodged prior with ASIC.[187] The same applies to the resolution that

[174] *Fraser v NRMA Holdings Ltd* (1995) 55 FCR 452.
[175] ASIC RG 76 (n 4) RG 76.101.
[176] Ibid RG 76.104.
[177] Ibid RG 76.112.
[178] *Corporations Act 2001* (Cth).
[179] Ibid RG 76.109; *ENT Pty Ltd v Sunraysia Television Ltd* (2007) 61 ACSR 62.
[180] *Corporations Act 2001* (Cth).
[181] Ibid s 611.
[182] Ibid s 221(b)-(c).
[183] Ibid s 221(a).
[184] Ibid s 221(e).
[185] Ibid s 221(d).
[186] *Darvall v North Sydney Brick & Tile Co Ltd* (1988) 14 ACLR 717; *TNT Australia Ltd v Poseidon Ltd (No 2)* (1989) 52 SASR 38; *Devereaux Holdings Pty Ltd v Pelsart Resources NL (No 2)* (1985) 9 ACLR 956.
[187] *Corporations Act 2001* (Cth) s 222.

approves the giving of the financial benefit; it must be the same as the proposed resolution lodged with ASIC.[188]

There are shortcomings in this approach. The information sent to members can contain defects, obscuring the effectiveness of the outlined procedure. Common errors include a failure to provide an adequate valuation of the benefit, including potential conflicts of interest, assumptions, and values; failure to disclose complete details of the benefit and the related party and the reasons for doing so; inadequate information about the related party itself; failure to disclose essential information regarding securities; and a failure to disclose the total value of the remuneration package to be offered. RG 76 exists to counter these potential pitfalls[189] by facilitating informed member decisions.

When voting on proposed resolutions under Pt 2E.1 Div 3 of the *Corporations Act*[190], votes must not be cast, in any capacity, by a related party with interest in the benefit of the transaction or an associate[191] of such a related party.[192] There are some exceptions where the related party may vote by proxy, provided that the proxy appointment is in writing and specifies how the proxy is to vote on the resolution.[193] The vote cannot be cast on behalf of a related party to whom the resolution would permit financial assistance to be given to or an associate of this party.[194] If ASIC is satisfied that the declaration will not unfairly prejudice the interests of the public company's members[195], it can declare that Section 224(1)[196] does not apply.

The focus is on the transaction's effect rather than the transaction itself. On occasion, a declaration will be made if the company can demonstrate no real conflict of interest occurs. For example, when the associate has no interest in the transaction outcome or the related party's interests are the same as the company.[197] In granting relief, ASIC will consider the effect of relief on an entity's members' interests.[198] If a poll was demanded

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[188] Ibid s 223.
[189] ASIC RG 76 (n 4) RG 76.3.
[190] *Corporations Act 2001* (Cth).
[191] Ibid s 10-17.
[192] Ibid s 224(1).
[193] Ibid s 224(2)(a).
[194] Ibid s 224(2)(b).
[195] Ibid s 224(4); See ASIC form CF11 at Pr 140.105.
[196] *Corporations Act 2001* (Cth) s 244(1).
[197] ASIC RG 76 (n 4) RG 76.130–76.131.
[198] Ibid RG 76.132.

whether the resolution be passed, all votes for and against in person, by proxy, or by an authorised representative must be recorded.[199] Failure to do so will incur strict liability penalties.[200]

The Australian system provides for situations where the approval of related party transactions is not required. Benefits that fall within the exceptions of arm's length dealings; remuneration or reimbursement of expense; indemnification of officers; intra-group benefits; and other exceptions will not be subject to member approval.[201]

Membership approval is not required for transactions that confer a financial benefit if the terms are the same as dealing at arm's length, or less favourable to the related party than if the parties were dealing at arm's length.[202] What constitutes arm's length requires comparing the transaction in question and a hypothetical scenario in which the parties are dealing at arm's length. The circumstances of the former should align with the latter[203], and all circumstances are relevant. This includes whether transactions from non-related parties are available, current economic conditions and their impact on industry, and any special value attributed to the transaction in question.[204]

As a term, 'arm's length' is not defined by the *Corporations Act 2001*, nor is there definition or guidance in the related party rules of what constitutes 'dealing at arm's length'. Case law serves as guidance in this concept. It refers to a relationship between the parties that does not import any special duty or obligation where the parties are unrelated. As a result, the parties are impartial and act in their interests.[205] It has also been suggested that the relationship involves a dealing which is a matter of real bargaining.[206] The court pays particular consideration to several factors when deciding whether transaction terms would differ if the parties were unrelated, free from influence, control or pressure, sufficiently knowledgeable about the transaction, experienced in business

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[199] *Corporations Act 2001* (Cth) s 225(2)-(4).
[200] Ibid s 225(6).
[201] ASIC RG 76 (n 4) RG 76.13.
[202] *Corporations Act 2001* (Cth) s 210.
[203] *Westgold Resources NL v Precious Metals Australia Ltd* (2002) 41 ACSR 672.
[204] ASIC RG 76 (n 4) RG 76.67–76.69.
[205] *Orrong Strategies Pty Ltd v Village Roadshow Ltd* (2007) 207 FLR 245 ('*Orrong*'); *Australian Securities and Investments Commission v Australian Investors Forum Pty Ltd (No 2)* (2005) 53 ACSR 305 ('*Australian Investors*').
[206] *Trustee for the Estate of the Late AW Furse (No 5) Will Trust v FCT* (1990) 21 ATR 1123.

and well informed and advised, and able to achieve the best commercial outcome in all the circumstances.[207] Relevant considerations in this sense will involve how the terms are comparable with overall transactions on arm's length terms.[208] Companies should consider the terms that prevail in the open market. Onerous or generous terms are less likely to be deemed reasonable.[209]

Dealings are more likely to be considered arm's length if the parties have engaged in a genuine bargaining process. Transactions with evidence of negotiation, professional advisors' involvement, company protocols followed, and the entire process adequately documented are considered more favourably than those without.[210] Companies must also consider the transaction's potential adverse effects and ensure they are balanced with the benefits. The contract should protect business interests, and the transaction should be analogous with their business plan.[211] Alternative options to the transaction[212] and independent or expert advice obtained is also considered.[213] If members are unsure whether a transaction was at arm's length, they can seek an independent expert's report. However, a positive report may not be sufficient to mount a defence against a claim for damages arising from any infringement of the *Corporations Act*.[214] However, it may demonstrate that the contravention was accidental and relieve the director from negligent liability in civil proceedings.[215]

Another area exempt from the process of member approval is the reimbursement and remuneration of expenses to a related party as an officer or employee of the public company and companies controlled or under that company's control.[216] The amount of remuneration must be reasonable[217] in the circumstances[218] and can include contributions, superannuation and other benefits received by an employee or officer

[207] ASIC RG 76 (n 4) RG 76.64; *Australian Investors* (n 205).
[208] ASIC RG 76 (n 4) RG 76.75–76.79.
[209] Ibid; *Orrong* (n 205).
[210] Ibid; *Australian Investors* (n 205); *Granby Pty Ltd v Federal Commissioner of Taxation* (1995) 129 ALR 503.
[211] ASIC RG 76 (n 4) RG 76.86–76.88.
[212] Ibid RG 76.89.
[213] Ibid RG 76.90–76.91.
[214] *Corporations Act 2001* (Cth).
[215] Ibid s 1318.
[216] Ibid s 211.
[217] Ibid s 211(1)-211(2).
[218] *Australian Investors* (n 205).

ceasing to be employed.[219] Options offered to a person accepting a directorship do not fall under this exception.[220] Once again, the lack of formal approval could encourage less ethical transactions to take place.

Similarly, the giving of benefits to a related party that is an officer in the form of an indemnity, exemption or insurance premium or an agreement to do so does not require board approval provided that doing so is reasonable.[221] The same applies to the making of payments to officers regarding legal costs incurred in defending an action for liability sustained as an officer of that company. Whether the benefit is reasonable will depend on whether it was reasonable at the time to give the benefit. Any other financial benefit given or made payable to the officer must be disregarded.[222] Giving financial benefits to a 'closely-held subsidiary' does not require member approval either.[223] Finally, member approval is not required for the giving of financial benefits to members, in their capacity as members, that do not discriminate unfairly[224] against other members[225]; the giving of small amounts totalling no more than AUD5,000 to a related party in a financial year[226]; or the giving of a benefit ordered by the court.[227] Small amounts paid to related parties no requiring approval are divert value from the corporation and are damaging in that sense.

There are consequences for failing to obtain membership approval. A company or controlled entity that engages in a related party transaction without consent contravenes Section 208 of the *Corporations Act*.[228] Related parties might be subject to civil penalties if they involved in the contravention.[229] Involvement constitutes aiding, abetting, counselling, or procuring the contravention or inducing the infringement. Involvement also includes knowingly or indirectly knowingly contravening or conspiring with others to commit the contravention.[230] As a result, liability for participation in a breach of Section 208[231] can extend beyond the directors and other company insiders. If any

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[219] *Corporations Act 2001* (Cth) s 211(3).
[220] *Mott v Mount Edon Gold Mines (Aust) Ltd* (1994) 12 ACSR 658.
[221] *Corporations Act 2001* (Cth) s 212.
[222] Ibid s 212(3).
[223] Ibid s 214(1).
[224] *Leawell Pty Ltd as Trustee for Garton Smith Trust v Watershed Premium Wines Ltd* [2009] FCA 26.
[225] *Corporations Act 2001* (Cth) s 215.
[226] Ibid s 213.
[227] Ibid s 216; *Re Summit Resources (Aust) Pty Ltd* (2012) 261 FLR 365.
[228] *Corporations Act 2001* (Cth) s 208.
[229] Ibid s 209(2).
[230] Ibid s 79.
[231] Ibid s 208.

involvement is intentionally dishonest, then a maximum penalty of five years' imprisonment or 2000 penalty units or both may be imposed.[232] A director of a holding company that exercises significant influence in a subsidiary's decisions can be treated as a director of the subsidiary, and subsequently involved in a contravention of the provisions.[233]

Knowledge of the facts constituting the infringement is required. This can be fulfilled by either exposure to the facts, or where the defendant had some actual knowledge but sought to avoid knowing more.[234] The fact that a related transaction is approved in line with the relevant provisions in the Act in no way relieves any person of their duties under the Act, including their general law and equitable fiduciary duties. This is the same in the UK.[235] A court retains the power to restrain an entity from giving a benefit to a related party.[236]

1. *ASX Listing Rules Chapter 10*

The ASX Listing Rules Chapter 10 is also an essential document for financial service conglomerates and other listed corporations in Australia. Chapter 10 deals with transactions between an entity, and people in a position to influence that entity. It also deals with participation by directors in employee incentive schemes, payments to directors and termination benefits.

An entity must ensure that no part of the group acquires or disposes of substantial assets from or to a person in a position of influence. Such transactions require shareholder approval or the grant of a waiver from ASX. Examples include related parties, subsidiaries, substantial shareholders, an associate of any of these, or a person in a relationship that the ASX considers requires approval.[237] This does not apply to wholly owned subsidiaries, a related party only of the proposed transaction or an issue of securities for cash.[238]

[232] Ibid s 209(3), Sch 3 Item 50.
[233] *ASIC v Adler* (2002) 41 ACSR 72.
[234] *Richardson & Wrench (Holdings) Pty Ltd v Ligon No 174 Pty Ltd* (1994) 123 ALR 681; *Pereira v Director of Public Prosecutions* (1988) 82 ALR 217.
[235] *Corporations Act 2001* (Cth) s 230.
[236] Ibid s 1324.
[237] ASX Listing Rules Chapter 10.1.
[238] Ibid 10.3.

Chapter 10 operates under the premise that a person in a position of influence is likely to influence the terms on which the acquisition or disposal of assets takes place. It aims to stop this party from exercising their influence to benefit themselves at the entity's expense, associates are excluded from voting on its approval.[239] The approval processes address conflicts of interest and minimises harm to the entity and the counterparty to the transaction.

Listing Rule 10 operates alongside the *Corporations Act*[240] to protect member interests when financial benefits are given to related parties. However, the guidance is scoped differently. It only applies to substantial assets rather than all forms of financial benefits but applies to a broader range of connected parties rather than just related parties and does not exclude transactions on arm's length terms.[241] In some senses, this is too narrow for financial service conglomerates, as a wide range of financial benefits can harm the contracting parties. Still, a broader range of connected parties accounts for the various individuals and companies that form the group structure of financial service conglomerates, casting the net wider for capturing rogue related party transactions.

The lack of formal definition in Australia may be both positive and negative; strict definitions can be less flexible. In the constantly evolving industry of financial services, flexibility may be vital in capturing related party transaction abuse. That does not mean that a definition is bad; the regulatory complexity directors of financial service conglomerates face is considerable, and clarity to spot abuse of related party transactions may be welcomed.

Despite the opportunities for related party transactions in financial service conglomerates, the current framework in the UK can be too general. The same applies in Australia; the current definitions and frameworks may not account for the diverse nature of financial service conglomerates, undermining the regulation's efficacy. The same rules apply to financial services as they do to other industries, despite the peculiarities that can make ethical dilemmas such as related party transactions more common in financial service conglomerates. This thesis has demonstrated that these conglomerates are different to

[239] ASX Listing Rules Guidance Note 24, 3.
[240] *Corporations Act 2001* (Cth).
[241] ASX Listing Rules Guidance Note 24, 4.

other industries due to their group structure, complexity, and interconnectedness. For these reasons, a distinct category of related party transactions rules may be more effective at mitigating misconduct in this area. Here lies an opportunity to simplify the law to equip directors of financial service conglomerates better to fulfil their obligations. Once again, there should be an emphasis on strong corporate culture to champion such ethical behaviour.

The focus on arm's length dealings is logical and should ensure that the terms acquired for a transaction are fair and reasonable. Member approval is not required for transactions that satisfy the criteria, but like conflicts of interest, the emphasis on approval could see members approve uncommercial related party transactions. Unfortunately, the UK Listing Rules and Section 213 of the *Corporations Act* do not apply to small transactions[242] and those carried out in the ordinary course of business.[243] These transactions may be significant and could undermine shareholder interests as their approval is not required. Approval is a valuable tool in mitigating ethical predicaments such as conflicts of interest and related party transactions in both the UK and Australia.

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[242] *Corporations Act 2001* (Cth) s 213.
[243] FCA Handbook LR11 (n 22) LR11.1.2.

CHAPTER 6: THE FIDUCIARY CONCEPT AND ITS RELEVANCE TO BANKS AND FINANCIAL INSTITUTIONS

This chapter examines the relevance of the fiduciary concept in banking and financial services more specifically to outline shortcomings in the frameworks which manage ethical dilemmas. It does this by:

- Analysing the principles that apply in the relationship between the bank and the customer;
- Exploring the leading cases that underpin fiduciary theory; and
- Demonstrating that financial service conglomerates are peculiar and require special governance considerations.

I. THE BANK AS FIDUCIARY

'My trust in a motor vehicle mechanic may, in fact, greatly exceed my trust in a lawyer yet only the latter is likely to be found a fiduciary'.[1]

Relationships between banks and their service users are fiduciary in at least some aspects[2], with Australian and Canadian authority[3] supporting this. The relationship between a customer and the bank can be fiduciary. In the ordinary case of banker and customer, the relationship depends entirely or mainly on implied contract.[4] The bank is not obliged to account for monies received in deposits, so the trust and trustee relationship is non-existent. The mutual obligations of the parties are determined on a 'running account' basis.[5]

Historically, bankers were not considered fiduciaries as the banker was not intended to be the trustee of specific deposits. Instead, the banker is only obliged to return the value of money deposited.[6] The way a bank conducts itself in its financial dealings or its dealings with a customer's guarantor can also constitute a fiduciary relationship.[7]

[1] Paul Finn, 'Contract and the Fiduciary Principle' (1989) 12 *University of New South Wales Law Review* 76, 93.
[2] John Glover, 'Banks and Fiduciary Relationships' (1995) 7(1) *Bond Law Review* 50, 53.
[3] *Commonwealth Bank of Australia v Smith* (1991) 102 ALR 453 ('*Smith*'); *McBean v Bank of Nova Scotia* (1981) 15 BLR 296; *Hayward v Bank of Nova Scotia* (1984) 45 OR (2d) 542.
[4] *N Joachimson v Swiss Bank Corporation* [1921] 3 KB 110 [117].
[5] *Re Metway Bank Ltd* [1991] 1 Qd R 120.
[6] Glover (n 2) 50.
[7] *National Westminster Bank plc v Morgan* [1985] 1 AC 686 ('*Morgan*').

Certain relationships are undeniably fiduciary, but it is hard to say if a particular circumstance qualifies beyond those categories. Fundamentally, the relationship between banker and customer is founded within contract, and equitable doctrines have little involvement. Introducing these doctrines into such a relationship could result in 'doing infinite mischief and paralysing the trade of the country'.[8] When considering the traditional banking activities of deposit-taking and lending, this makes sense, but banks are no longer merely deposit takers or lenders. Increasingly, with conglomeration and diversification, banks are acting as advisors, an area where a fiduciary relationship is likelier to arise if they are providing personalised advice.

Courts have found fiduciary relationships in diverse commercial situations such as joint venture relationships[9], an old relative and young man he advises on how to clear debts[10], and the errand boy and person who sends him to make a purchase.[11] Just because a relationship is commercial does not mean it cannot be fiduciary. Different tests exist which confirm defining features of fiduciary relationships. One comprises undertaking to act in the interests of another person[12]; another is the expectation that the fiduciary will not use his position in a manner opposed to the beneficiary's interests.[13] Another looks at the beneficiary's vulnerability as an important indicator[14], and sometimes defining characteristic.[15] All have been present when courts have found the bank to owe fiduciary duties[16] and even a duty of care.[17]

Many customers rely on banks, and that reliance may inject an equitable element into the relationship. The 'limits of a banker's business cannot be laid down as a matter of law. The nature of such a business must in each case be a matter of fact'.[18] In *Woods v*

[8] *Governor and Company of the Bank of Scotland Ltd v A Ltd and Others* [2001] EWCA Civ 52 [25]; *Manchester Trust v Furness* [1895] 2 QB 539 [545].
[9] *United Dominion Corporation Ltd v Brian Pty Ltd* (1985) 157 CLR 1.
[10] *Tate v Williamson* (1866) LR 2 Ch App 55 ('*Tate*').
[11] *Coomber v Coomber* [1911] 1 Ch 723.
[12] *Bristol and West Building Society v Mothew* [1998] Ch 1.
[13] *Arklow Investments Ltd v Maclean* [2000] 1 WLR 594.
[14] *Hodgkinson v Simms* [1994] 3 SCR 377.
[15] *Ng Eng Ghee and others v Mamata Kapildev Dave and others (Horizon Partners Pte Ltd, intervener) and another appeal* [2009] 3 SLR(R) 109.
[16] *Woods v Martin's Bank Ltd* [1954] 1 QB 55 ('*Woods*').
[17] *Lloyds Bank Ltd v Bundy* [1975] QB 326 ('*Bundy*').
[18] *Woods* (n 16) [70].

Martin's Bank Ltd[19], due to the 600+ branches in operation, Salmon J concluded that 'it was and is within the scope of the defendant's bank's business to advise on all financial matters'[20], cementing the presence of reliance. Customer reliance may also occur where financial advice is taken in connection with a loan.[21] Where a bank advises on financial affairs, the relationship between the customer and the bank, in addition to any contractual rights, may include a duty of care and fiduciary duties.[22]

Bankers who advise on business acquisitions are like stockbrokers who give investment advice. Bankers and stockbrokers may enter a fiduciary relationship by assuming to advise a person known to rely on them.[23] A stockbroker acting as an investment advisor was found to be a fiduciary as he held himself out as having expertise in advising on investments.[24] 'The adviser stands in a fiduciary relationship to the person whom he advises'[25] if approached for advice on investments and gives it. A similar principle was applied to an advising banker. The judgement stated that 'a bank may be expected to act in its own interests in ensuring the security of its position as lender to its customer, but it may have created in the customer the expectation that nevertheless, it will advise in the customer's interest as to the wisdom of a proposed investment'.[26]

Transactional advice is undertaken by banks every day, whether issuing a loan or approving an overdraft. Fiduciary relationships are not the usual way that the law regulates this aspect of banking.[27] Prima facie and following the principle in *Shaddock & Associates Pty Ltd v Council of the City of Parramatta*[28], if a bank elects to explain the mechanics of a transaction to a customer, it is under a tortious duty of care not to misstate that position.[29] In these cases, customers may submit that the bank has acted unconscionably or has exercised undue influence. *James v Australia and New Zealand Banking Group*[30] claimed a fiduciary relationship in transactional advice given in a

[19] Ibid.
[20] Ibid [71].
[21] Glover (n 2) 54.
[22] *Halsbury's Laws of England* (Butterworths, 4th ed, 1989) 251.
[23] Glover (n 2) 56.
[24] *Daly v Sydney Stock Exchange* (1986) 160 CLR 371
[25] Ibid [385].
[26] *Smith* (n 3).
[27] Glover (n 2) 58.
[28] *Shaddock & Associates Pty Ltd v Council of the City of Parramatta* (1981) 55 ALJR 713.
[29] Glover (n 2) 58.
[30] *James v Australia and New Zealand Banking Group* (1986) 64 ALR 347.

broader investment advice context.[31] It underlined the importance of demonstrating a customer's reliance before any fiduciary element can be established.[32] After the bank manager recommended an unlicensed and incompetent broker, the customers sought recompense.

The use of fiduciary duties to regulate the relationship between the banker and the customer in the UK was challenged in *National Westminster Bank Plc v Morgan*.[33] A consumer was allowed to avoid a mortgage, as the banker breached their fiduciary duty of care by pressuring her to sign. Lord Scarman stated that the 'Lord Justices were led into a misinterpretation of the facts by their use, as is all too frequent in this branch of law, of words and phrases such as 'confidence', 'confidentiality', 'fiduciary duty''.[34]

The nature of fiduciary duties and their application in commercial relationships have been problematic in the UK and Australia. This raises the question of which fiduciary relationships should be allowed to supplement those bargained for in commercial contracts[35], and what should be made of fiduciary notions to achieve good faith and fair dealing in contracts.[36] The role of fiduciary law in regulating financial service conglomerates, potentially poisoned by confidentiality, secrecy and elaborate loyalties, is still inconclusive.[37] Many issues surround the lack of a definition and the use of the term 'fiduciary' to fill gaps in other doctrines. This includes the dilution of fiduciary duties to exact a duty of good faith and fair dealing[38], findings of fiduciary relationships to extract equitable, but profit-based remedies[39], uncertainty of what fiduciary duties are and whether they encompass undue influence[40], breach of confidence[41], and a negligence-like

[31] Glover (n 2) 58
[32] Ibid.
[33] *Morgan* (n 7).
[34] Ibid [703].
[35] *E Pfeiffer Weikellerei-Weineinkauf GmbH & Co v Arbuthnot Factors Ltd* [1988] 1 WLR 151; *Noranda Australia Ltd v Lachlan Resources N L* (1988) 14 NSWLR 1.
[36] This was historically more of an issue for Australia than the UK given the relative disfavour showed by the courts in the UK on the imposition of duties of good faith and fair dealing on contracting parties.
[37] *Re a firm of Solicitors* [1992] 1 All ER 353; *MacDonald Estate v Martin* [1991] 1 WWR 705; *National Mutual Holding Pty Ltd v Sentry Corp* (1989) 87 ALR 539.
[38] *Pacific Industrial Corp SA v Bank of New Zealand* [1991] 1 NZLR 386*; Plaza Fibreglass Manufacturing Ltd v Cardinal Insurance Co* (1990) 68 DLR (4th) 586.
[39] *English v Dedham Vale Properties Ltd* [1978] 1 WLR 93.
[40] *Tate* (n 10); *Bank of Credit and Commerce v Aboody* [1990] 1 QB 923.
[41] *Lac Minerals Ltd v International Corona Resources Ltd* [1989] 2 SCR 574.

duty of care for advisors.[42] When these have been acknowledged, the laws of the United Kingdom and Australia hold most closely to the old orthodoxies.[43]

A. Misconceptions About the Relationship

The relationship between the bank and the customer comprises numerous elements of the law. The focus is on the obligations and duties arising from the unique relationship between the two. The relationship is a contractual one, and its uniqueness comprises many implied terms giving the contract the requisite degree of commercial or business efficacy. All dealings between customers and the bank are governed primarily by contract.[44] However, the courts have often considered 'special incidents'[45] where a duty of care exists, owed to the customer by the bank. This is particularly prevalent when offering financial advice. Case law suggests that courts should be wary of 'finding the existence of a duty of care' in relationships governed by contract.[46] There are other misunderstandings about the bank's role as a fiduciary.

A misunderstood aspect of this relationship is when money is deposited with a bank, it is owned by the bank. Deposits are received as a debt to the customer, therefore not held by the bank in a fiduciary capacity.[47] There is no restriction on what the bank does with that money, nor is there an obligation to account for any profits made due to its use; the money deposited is an asset of the bank, which it may use as it pleases.[48] Regarding a fiduciary duty of care mentioned in the paragraph above, the House of Lords has been reluctant to extend more than a duty to act honestly to anyone the bank is not under a fiduciary or contractual obligation to. Lord Hodson approved the passage of Pearson LJ in the Court of Appeal, where His Honour noted in *Hedley v Byrne*:

> [a]part from authority, I am not satisfied that it would be reasonable to impose upon a banker the obligation suggested, if that obligation really adds anything to the duty of giving an honest answer. It is conceded by [the plaintiff] that the banker is not expected to make outside inquiries to

[42] *Giradet v Crease & Co* (1987) 11 BCLR (2d) 361.
[43] *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41 ('*Hospital Products*').
[44] *Bank of Queensland Ltd v Wright* [2014] QSC 67; *National Australia Bank Ltd v Hokit Pty Ltd* (1996) 39 NSWLR 377 [384]; *Tai Hing Cotton Mill Ltd v Liu Chong Hing Bank Ltd* [1986] AC 80 ('*Tai Hing*').
[45] *Bank of New South Wales v Laing* [1954] AC 135.
[46] *Akpata v Minister for Immigration and Citizenship (*2012) 206 FCR 120; *Politarhis v Westpac Banking Corp* (2009) 262 LSJS 31; *Tai Hing* (n 35).
[47] *Foley v Hill* (1848) 2 HL Cas 28.
[48] *Croton v R* (1967) 117 CLR 326.

> supplement the information which he already has. Is he then expected, in business hours in the bank's time, to expend time and trouble in searching records, studying documents, weighing and comparing the favourable and unfavourable features and producing a well-balanced and well-worded report? That seems wholly unreasonable. Then, if he is not expected to do any of these things, and if he is permitted to give an impromptu answer in the words that immediately come to his mind on the basis of the facts which he happens to remember or is able to ascertain from a quick glance at the file or one of the files, the duty of care seems to add little, if anything, to the duty of honesty.[49]

The bank's liability depends on their response to an individual inquiry, but they have to provide an opinion with a degree of skill, competence, and diligence.[50] Negligence has been established in cases of a deceitful reply to a credit inquiry, and the fact that there existed 'no responsibility' did not amount to a defence.[51] Non-disclosure of a customer's 'temporary' financial difficulty by the bank has also been assessed negatively.[52] The *Hedley Byrne* principle stated above has been extended to negligent statements made by bank managers[53] and negligent investment advice.[54]

It has been argued that due to the alleged fiduciary relationship, banks must disclose information of which they are aware to their customers with regards to specific investments. This has been rejected because banks and their clients do not enjoy a fiduciary relationship. Such a notion would be contrary to the settled position in Australia where fiduciary duties are proscriptive, and not prescriptive.[55]

Just because the banker and customer relationship does not fall into the traditionally recognised category of fiduciary relations, it does not mean that a fiduciary relationship may not arise in a particular factual scenario.[56] In *Lloyd's Bank v Bundy*[57], a father had guaranteed his son's overdraft at the bank. When the son ran into difficulties, the bank asked the father for more security, and he gave it upon the advice of the bank manager. It

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[49] *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465 [512].
[50] *Mutual Life & Citizens' Assurance Co Ltd v Evatt* [1971] AC 793.
[51] *Commercial Banking Co of Sydney Ltd v R H Brown & Co* (1972) 126 CLR 337; *Rise Home Loans Pty Ltd v Dickinson (No 2)* [2010] VSC 29.
[52] *Compafina Bank v Australia & New Zealand Banking Group Ltd* (1982) 1 NSWLR 409.
[53] *Box v Midland Bank Ltd* [1979] 2 Lloyd's Rep 391.
[54] *Woods* (n 16).
[55] *Breen v Williams* (1996) 186 CLR 71.
[56] *Australian Competition & Consumer Commission v Oceana Commercial Pty Ltd* [2003] FCA 1516 ('*Oceana*'); *Smith* (n 3).
[57] *Bundy* (n 17).

was alleged that the bank manager knew if the son's money issues were to continue, then the father would end up broke. The Court of Appeal found that the extra security was obtained with undue influence[58] in breach of the fiduciary duty of care resulting from the special relationship between the bank and the customer. Sir Eric Sachs stated:

> [i]t not infrequently occurs in provincial and country branches of great banks that a relationship is built up over the years, and in due course the senior officials may become trusted councillors of customers of whose affairs they have an intimate knowledge. Confidential trust is placed in them because of a combination of status, goodwill and knowledge.[59]

This situation was contrasted with the ordinary confidence 'between trustworthy persons who in business affairs deal with each other at arm's length'.[60] 'The situation was thus one which to any reasonable person cried aloud the defendant's need for careful, independent advice'.[61] Instances such as this are rare and might be framed as misleading or deceptive conduct. Still, it is essential to remember that facts of each scenario are crucial to arriving at a decision.[62]

The traditional view that banks are not fiduciaries remains true. As time goes on and regulators continue to use fiduciary-type language, banks strive to forge longer-term, close relationships with their customers and conglomerates continue to move towards giving advice, the courts may see more instances where a bank is indeed a fiduciary. The industry is changing, and maybe the law needs to get on board. The time may be coming when one must call a spade a spade.

Fiduciary principles in banking law are distinct from the other fiduciary principles in equity. Financial conglomerates accept deposits, make loans, underwrite securities, and perform investment banking activities, including advising on mergers and acquisitions and facilitating securities trading. They also participate in functions outside of the commercial or investment banking sphere[63], including offering advice, a recognised

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[58] *Garcia v National Australia Bank Ltd* (1998) 194 CLR 395.
[59] *Bundy* (n 17) [344].
[60] Ibid 341.
[61] Ibid 342.
[62] *Oceana* (n 56).
[63] Andrew Tuch, 'Financial Conglomerates and Information Barriers' (2014) 39(3) *Journal of Corporation Law* 563, 577.

fiduciary category in certain circumstances.[64] Chapter Nine discusses the implications of this relationship in Australia.

B. Fiduciary Principles in Commercial Banking

1. Loans

The relationship between bank and customer is contractual, 'creditor-debtor', and typically non-fiduciary. The bank may, however, owe fiduciary duties when acting as lender and agent or trustee.[65] The majority of jurisdictions recognise the existence of a fiduciary relationship when circumstances exist[66], such as operating beyond their usual arm's length role, and the courts look for the presence of trust, reliance, and informational inequality. Fiduciary duties arise when a bank encourages a customer to repose a special trust or confidence[67] in their advice, giving rise to the element of reliance. This reliance often results in an advantage for the bank.[68] A bank may, for example, have unconscionably shifted a bad risk from itself to the customer[69]; 'a position of disadvantage or vulnerability on the part of one of the parties which causes him to place reliance on the other and requires the protection of equity'.[70] Special circumstances may arise outside the contractual relationship[71], but a bank that does no more than give advice or receive confidential information will not be a fiduciary.[72] Creditor-debtor relationships are generally arm's length. In exceptional circumstances, the court may impose a duty on the bank to disclose information, even if that breaches another customer's confidence.[73]

2. Deposits

A central element of a bank's business model is the receipt of deposits, securities or other assets from customers, and these relationships are not fiduciary.[74] As with loans, special

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[64] *SEC v Capital Gains Research Bureau Inc*, 375 US 180, 194 (1963).
[65] *Broadway National Bank v Barton-Russel Corp* 585 NYS2d [944-945]; *Olmeca SA v Mfrs Hanover Trust Co* 629 F Supp 214 [223] (SDNY 1985).
[66] Cecil Hunt, 'The Price of Trust: The Examination of Fiduciary Duty and the Lender-Borrower Relationship' (1994) 29(1) *Wake Forest Law Review* 719, 768.
[67] *Deist v Wachholz* 678 P 2d 188 [193] (1984).
[68] *Woods* (n 16).
[69] Donovan Waters, 'Banks, Fiduciary Obligations and Unconscionable Transactions' (1986) 65 *Canadian Bar Review* 37, 43.
[70] *Hospital Products* (n 43) [142].
[71] *Weiner v Lazard Freres & Co*, 672 NYS 2d 8 [14] (NY App Div 1998).
[72] *Umbaugh Pole Bldg Co Inc v Scott*, 390 NE 2d 320 [323] (Ohio 1979); *Groob v Keybank*, 843 NE 2d 1170 [1175] (Ohio 2006).
[73] Andrew Tuch, 'Fiduciary Principles in Banking' in Evan Criddle et al (eds), *The Oxford Handbook of Fiduciary Law* (Oxford University Press, 2019) 129.
[74] *Curtis-Shanley v Bank of America*, 970 NYS 2d 830 [832] (NY App Div 2013).

circumstances may give rise to the existence of a fiduciary relationship.[75] Although the economic relationship is reversed, courts rely heavily on authorities in both situations. A bank does not become a fiduciary by conducting loans and deposits. Without something more[76], the relationship will remain non-fiduciary.

This section has assessed the bank as a fiduciary and in what circumstances it is so. The legal principles that govern this area predate the evolution of financial service conglomerates by some time, but are useful as banking is at the core of these institutions. Trust and reliance, particularly in the provision of advice, are essential elements of the fiduciary relationship.

II. The Peculiarities of the Bank

This thesis suggests that financial service conglomerates are peculiar and unique due to their structure, regulatory inconsistencies and arbitrage, complexity, and the existence of moral hazard. As such, approaches to governance should be unique for these conglomerates. Some material differences peculiar to banks will be discussed throughout this chapter to highlight the distinction between financial and non-financial firms. Most commentary on bank governance has arisen since the global financial crisis, and therefore focuses on the US and the UK and Europe. Throughout this chapter, the US will be compared with the UK, as studies focus upon the US as a significant contributor to the crisis, and far more authoritative sources exist with a US basis.

A. Bank Governance

The term 'corporate governance' has been around since the 1960s, but more recently, the term comprises a more fashionable concept, 'and like many fashionable concepts, it is somewhat ambiguous'.[77] Corporate governance approaches and descriptions vary globally, highlighting the differences created by changing legal, economic and socio-cultural demands. In the UK, corporate governance is 'the system by which companies are directed and controlled'.[78] It is also 'about what the board of a company does and how

[75] *Price v Wells Fargo Bank*, 213 Cal App 3d 465 [478] (1989).
[76] For instances of circumstance giving rise to fiduciary duties, *see generally Morris v Resolution Trust Corp* 622 A 2d 708 (Me 1999); *Buxcel v First Fidelity Bank* 601 N W 2d 593 (SD 1999).
[77] John Farrar and Pamela Hanrahan, *Corporate Governance* (LexisNexis Butterworths, 2017) 3.
[78] Financial Reporting Council, The UK Corporate Governance Code, July 2018 1.

it sets the values of the company and is to be distinguished from the day to day operational management of the company by full-time executives'.[79] In Australia, the ASX Corporate Governance Council describes it as a 'framework of rules, relationships, systems and processes within and by which authority is exercised and controlled within corporations. It encompasses the mechanisms by which companies, and those in control are held to account'.[80] A simple, American definition is 'how investors get the managers to give them back their money'[81], reaffirming that corporate governance is concerned with facilitating profit making.

Financial service conglomerates are large, complex[82] and highly connected[83] through highly complex contracts.[84] Complexity can defined as a function of the interpretive difficulty experienced by an individual in transforming raw information about a financial institution into usable information about its operations.[85] Due to this complexity, financial service conglomerates are often treated as a 'black box'. Their assets and liabilities interact in non-transparent ways and involve large numbers of individuals with differing agendas, often with complex contracts.[86] This complexity makes it difficult for investors, regulators, and managers to identify, acquire and understand information.[87] In the past, this created a smokescreen behind which governance, risk management and compliance was ineffective or ignored, and financial service conglomerates became unaccountable. This unaccountability fuelled misconduct which contributed to the Global Financial Crisis (GFC). The build-up to the crisis has since been portrayed as full of excess and profit at any cost; a grotesque account of the vices of modern finance.[88]

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[79] Financial Reporting Council, The UK Corporate Governance Code, September 2012, 1.
[80] What is Governance? (1st December 2019) Governance Institute of Australia <https://www.governanceinstitute.com.au/resources/what-is-governance/>.
[81] Andrei Shleifer and Robert Vishny, 'A Survey of Corporate Governance' (1997) 52(2) *Journal of Finance* 737, 737-83.
[82] Gary Gorton and Andrew Winton, *Financial Intermediation,* Working Paper 8928 (2002 National Bureau of Economic Research) 57.
[83] Joao Cocco et al, 'Lending Relationships in the Interbank Market' (2009) 18 *Journal of Financial Intermediation* 24, 25.
[84] Steven Schwarcz, 'Regulating Complexity in Financial Markets' (2009) 87 *Washington University Law Review* 211, 231; Frank Partnoy and David Skeel, 'The promise and Perils of Credit Derivatives' (2007) *University of Cincinnati Law Review* 1019, 1020-1021.
[85] Manuel Utset, 'Complex Financial Institutions and Systematic Risk' (2011) 45 *Georgia Law Review* 779, 797.
[86] Ibid 799.
[87] Ibid.
[88] Robert Pickel, 'Ten Years After: Identifying the Deadliest Sin of the Financial Crisis' (2017) 36 *Banking and Financial Services Policy Report* 1, 2.

The GFC was the most severe economic event since the Great Depression.[89] Investment banks collapsed, mutual and hedge funds faltered, and financial giants became insolvent.[90] The actual value of the total consolidated loss[91] is challenging to comprehend. Chapter Two demonstrated that deregulation and governmental policies since the mid-1980s encouraged financial institutions' consolidation and conglomeration. Domestic and international mergers led to a significant rise in the number of large, complex, financial institutions which have dominated markets for securities underwriting, syndicated lending, asset-backed securities, over-the-counter derivatives, and collateralised debt obligations.[92] The world is fully aware that 'this crisis began in regulated entities…[and] This happened right under our noses'.[93] 'The lessons we have to learn from the financial market crisis are clear; we need a new regulatory framework for financial markets that contributes to more responsible behaviour on the part of all financial market participants'.[94] The Hayne Royal Commission findings support this and advocate reducing the complex and overlapping regulatory frameworks applicable to financial service conglomerates.[95]

The GFC reflected failings in banks' corporate governance and prudential regulation.[96] Banks are different from non-financial firms due to their financing, business model and balance sheets. As highly leveraged institutions, the bank's primary business model is to transform short-term deposits into long-term loans. Therefore, capital is raised through debt. Shareholders may gain at the creditor's expense from increased risk, but creditors suffer if things go badly. The potential for risk-shifting rises with the level of leverage.

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[89] Markus Brunnermeier, 'Deciphering the Liquidity and Credit Crunch, 2007-08' (2009) 1 *Journal of Economic Perspectives* 77, 77.
[90] AIG, Freddie Mac, Fanny Mae, IndyMac, Lehman Brothers and Washington Mutual collapsed in the US, Northern Rock collapsed in the UK while the Royal Bank of Scotland, Lloyds and HBOS had to be bailed out with UK taxpayer's money. Greece and Ireland received bailouts as the crisis hit the Eurozone and even two years after the recognized end of the global financial crisis, high street chains and big stores were still collapsing in the US and the UK.
[91] 'Total global losses from financial crisis: $15 trillion', *Wall Street Journal* (online, 5 August 2019) <https://blogs.wsj.com/economics/2012/10/01/total-global-losses-from-financial-crisis-15-trillion/>.
[92] Arthur Wilmarth, 'The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis' (2009) 41(4) *Connecticut Law Review* 963, 964.
[93] Paul Atkins, former member, US Securities and Exchange Commission, 2008.
[94] Wolfgang Schauble, Federal Minister of Finance, Germany, May 19, 2010.
[95] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Final Report, Volume 1, 16.
[96] OECD, Corporate Governance and the Financial Crisis: Key Findings and Main Messages (2009) 41; European Banking Authority, EBA Guidelines on Internal Governance (2011) 3.

A significant difference between financial and non-financial firms is opacity; outsiders' ability to understand the quality in a bank rather than a non-financial firm.[97] This, and the considerable impact on society should anything go wrong, means banks must be kept under close watch. Prudential regulation ensures capital and liquidity requirements to minimise the risk of failure in a bank. Deposit insurance helps reduce the risk of a run on the bank[98], and if all else fails, bank bailouts protect the system from folding entirely. High risk, high reward opportunities and this safety net promotes risk taking in banks and undermines market discipline.[99] If banks were more like other institutions, depositors and creditors would notice the risks and insist on more robust governance and control.[100]

Banks' peculiarities stem from their balance sheet and externalities. Prudential regulation was meant to force banks to internalise their activities' full social cost, meaning maximised shareholder value would be in society's best interests.[101] In reality, the tighter relationship between shareholders and managers encouraged the banks to test regulatory controls' limits, and regulators have been wary of introducing any regulation that disrupts the 'golden goose' of financial sector accumulation.[102] A lack of transparency makes it challenging for regulators to determine whether risks are appropriately controlled.[103]

In recent years, financial institutions failed to take account and manage the risks associated with diverse practices. A crisis in the sub-prime mortgage sector arose from one of the 'worst miscalculations in the annals of risk management'. [104] These miscalculations were the work of high-paid executives, lauded as the best minds in the business, backed by supercomputers, who still managed to lose tens of billions of dollars

[97] Liangliang et al, 'Competition and Bank Opacity' (2016) 29(7) *The Review of Financial Studies* 1911, 1911-1912.
[98] Belen Diaz Diaz, Samuel Idowu and Philip Molyneux, *Corporate Governance in Banking and Investor Protection* (Springer, 2018) 12.
[99] Enrico Onali, 'Moral Hazard, Dividends, and Risk in Banks' (2014) 41(1) *Journal of Business Finance and Accounting* 128, 130-132.
[100] Douglas Baird and Robert Rasmussen, 'Private Debt and the Missing Lever of Corporate Governance' (2006) 154 *University of Pennsylvania Law Review* 1209, 1210.
[101] Bank of England, The Prudential Regulation Authority's approach to banking supervision, October 2018, 5.
[102] Emily Jones and Alexandra Zeitz, 'The Limits of Globalizing Basel Banking Standards' (2017) 3 *Journal of Financial Regulation* 89, 101.
[103] Angelo Borselli, 'Keeping Watch on Giants: The Supervision of Insurance Group and of Insurance Undertakings within Financial Conglomerates in European Law' (2012) 3 *Insurance Law Review* 26, 28.
[104] Norman Sheehan, 'A risk-based approach to strategy execution' (2010) 31(5) *Journal of Business Strategy* 25, 27.

through ‘exotic products and services’ built on sub-prime mortgages.[105] The banks that had the most ‘pro shareholder’ boards and had the closest alignment between executive returns and stock price took the most considerable risks before and suffered the most significant losses during the crisis.[106]

Elements of culture such as a poor approach to risk management in financial institutions is discussed in Chapter 7, 8 and 9. The Hayne Royal Commission demonstrated that all financial service providers need to analyse and review their culture.[107] The link between poor culture and conduct has damaged the Australian financial system.[108] As a result, a review of banks’ governance and their risk management processes should be undertaken to address failures and begin to rebuild public trust in the financial sector. A lack of effective governance was a key factor in the crisis; the crisis can be ‘attributed to failures and weaknesses in corporate governance arrangements’.[109] In the build-up to the crisis, governance and risk management systems were ineffective. Governance is essential in any industry, and banks are no exception.

The conventional approach to governance ensures that managers run their firm in the best interests of shareholders. Shareholders can appoint directors, and directors can appoint managers.[110] This gives directors their significance. Several mechanisms temper the actions of directors, some of which are particularly relevant to financial service conglomerates.

Executive pay is one of these mechanisms and is an issue for the industry[111], particularly in the US.[112] Performance-related pay burdens managers with the bank’s underperformance, leading to riskier behaviour to sustain favourable figures. An efficient performance-related pay structure can be a powerful tool for aligning the institution’s,

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[105] ‘Wall Street’s money machine breaks down’, *Fortune Magazine* (online, 1 February 2018) <http://archive.fortune.com/magazines/fortune/fortune_archive/2007/11/26/101232838/index.htm>.
[106] Jeffrey Gordon and Wolf-Georg Ringe, *The Oxford Handbook of Corporate Law and Governance* (Oxford University Press, 2018) 1108.
[107] Royal Commission (n 95) 388.
[108] Ibid 382-388.
[109] Grant Kirkpatrick, ‘The Corporate Governance Lessons from the Financial Crisis’ (2009) *Financial Market Trends* 2, 1 (February 2018) Organisation for Economy Co-operation and Development <https://www.oecd.org/finance/financial-markets/42229620.pdf>.
[110] Kraakman et al, *The Anatomy of Corporate Law* (Oxford University Press, 3rd ed, 2017) 1110.
[111] Andrew Johnston, ‘Preventing the Next Financial Regulating Bankers’ Pay in Europe’ (2014) 41(1) *Journal of Law and Society* 6.
[112] Lucien Bebchuk, ‘Regulating Bankers’ Pay’ (2010) 98(2) *Georgetown Law Journal* 247, 250.

shareholders, and the executive's interests and objectives. These pay contracts are not the result of structured negotiations by owners and managers. Instead, they are an outcome of a bargaining process with 'board members on both sides of the pay bargain, or, in case of a two-tier system, the result of a bargaining process between executive directors and supervisory directors in which the latter might not be independent'.[113]

There is no generally accepted matrix for deciding appropriate remuneration for banking executives. The market usually becomes the benchmark.[114] In Australia, paying directors a reasonable amount of compensation is an exception to the rule requiring shareholder approval for financial benefits to a related third party. Special payments beyond salary have been regarded as a 'golden handshake' or 'golden parachutes'. These are any payments made to a senior executive officer for departure from a company for any reason, except for payments for services performed or benefits accrued.[115] An example of a substantial package was detailed in *GIO Australia Holdings Ltd v AMP Insurance Investment Holdings Pty Ltd & Anor*, where the CEO of Southcorp Keith Lambert received AUD4.4 million despite losing 40% of its share value.[116]

The Australian government introduced the new 'golden handshake' law to combat such instances, which requires shareholder approval for such payments. This tool is used alongside tax policy to curb the use of 'golden handshakes'.[117] Corporate governance guidance in the UK and Australia appreciates the temptation for self-interest in remuneration arrangements but are by no means a perfect solution. Since the global financial crisis, both the UK and Australia have made changes to suggested governance arrangements including changes to ensure diversity in remuneration committees, alignment with long term shareholdings, culture, clarity, appropriateness, and predictability.[118] Chapter Eight deals with governance changes post-global financial

[113] Tom Dijkhuizen, 'The EU's Regulatory Approach to Bank's Executive Pay: From Pay Governance to Pay Design' (2014) 11(1) *European Company Law* 30, 31.
[114] Ruth Bender, 'How Executive Directors' Remuneration is Determined in Two FTSE 350 Utilities' (2003) 11(3) *Corporate Governance: An International Review* 206.
[115] Kym Sheenan, 'The Regulatory Framework for Executive Remuneration in Australia' (2009) 31(2) *Sydney Law Review* 273, 274.
[116] *GIO Australia Holdings Ltd v AMP Insurance Investment Holdings Pty Ltd & Anor* [1998] FCA 1486.
[117] Sheenan (n 115).
[118] UK Corporate Governance Code (n 79) 14-15; ASX Corporate Governance Council, Corporate Governance Principles and Recommendations, 4th ed February 2019, 29.

crisis in detail, as this event was a catalyst to make some governance changes, particularly in the UK.

B. How Are Banks Different?

There are some characteristics that are peculiar to banks. Banks are highly leveraged. Capital is raised through short and long-term debt, which makes up most of their liability. Due to the risks involved, creditors should ensure these institutions are monitored effectively. However, depositors are usually widely dispersed and do not have enough exposure or desire to do this.[119]

Governments have a history of injecting money into troubled banks to curb failures while stimulating lending, maintaining liquidity, maintaining capital, and protecting depositors, in both the UK[120] and Australia[121], not to mention the US.[122] Strangely this is the very thing that can cause a bank to fail in the first place. The more critical a financial institution to the national or global economy, the more likely a government will ensure it does not fail. This provides an incentive to structure banks as 'too big to fail'. Both deposit insurance and 'too big to fail' policies create the standard moral hazard problem; an incentive for common bank shareholders to gamble with the bank's assets at the government's expense.[123] Thanks to this guarantee, creditors' incentive to monitor firms is weakened.

Many financial products and assets are challenging to observe and measure. The data collected by banks throughout the lending process is not available to others for numerous

[119] Gordon (n 106) 1112.
[120] Federico Mor, *Bank rescues of 2007-09: outcomes and cost,* House of Commons Briefing Paper Number 5748, October 2018, 3; 'Bank reforms: how much did we bail them out and how much do they still owe?', *The Guardian* (online, 4 June 2019) <https://www.theguardian.com/news/datablog/2011/nov/12/bank-bailouts-uk-credit-crunch>.
[121] Naoise McDonagh, 'The evolution of bank bailout policy: two centuries of variation, selection and retention' (2021) 31(3) *Journal of Evolutionary Economics* 1065, 1066; 'Bank bailouts: it's now taxpayers who need protection' *ABC News* (online, 4 June 2019) <https://www.abc.net.au/news/2014-11-10/verrender-bank-bailouts-its-now-taxpayers-who-need-protection/5878418>.
[122] McDonagh (n 121); 'Bailed out banks. The treasury Department has invested about $200 billion in hundreds of banks through its Capital Purchase Program in an effort to prop up capital and support new lending', *ABC News* (online, 4 June 2019) <https://www.abc.net.au/news/2014-11-10/verrender-bank-bailouts-its-now-taxpayers-who-need-protection/5878418>.
[123] Bebchuk (n 112) 249.

reasons. As a result, their loan portfolio's value may not be subject to scrutiny from third parties due to the sensitive information contained within.[124]

Due to these factors, the regulators are tasked with monitoring and controlling the risk-taking of banks. The most significant difficulty is monitoring the bank's financial assets effectively.[125] Many institutions seek to avoid regulation and instead influence regulators rather than adopt protocols to reduce the risks of failure.[126]

It is for these reasons that governance in financial service conglomerates should be unique. The rest of this chapter will analyse why the board of directors and executive pay arrangements in these conglomerates deserve attention.

C. Bank's Board of Directors

Directors are subject to numerous legal duties to avoid or manage conflicts of interest amongst themselves and others. This is one of the most prominent mechanisms in controlling their significance. These are enforced by statutory derivative or class actions. It is unlikely that claimants will be as knowledgeable about the business as the managers, making litigation futile. There are typically checks concerning good faith decisions that grant considerable discretion to management, leaving shareholders to focus purely on conflict of interest situations.[127]

Multiple derivative actions are useful for minority shareholders in common law jurisdictions, especially against financial conglomerates with numerous entities in their group structure. In *Universal Project Management Services Ltd v Fort Gilkicker Ltd* ('*Gilkicker*')[128], English law clearly stated that multiple derivative actions were allowed for the first time.[129] As a result, shareholders of holding companies can bring derivative

[124] Basel Committee on Banking Supervision (BCBS), Enhancing Corporate Governance for Banking Organizations (1999) 6-7.
[125] Bruce Arnold et al, 'Systemic risk, macroprudential policy frameworks, monitoring financial systems and the evolution of capital adequacy' (2012) 36 *Journal of Banking & Finance* 3125, 3125.
[126] Gordon (n 106) 1112.
[127] Ibid.
[128] *Universal Project Management Services Ltd v Fort Gilkicker Ltd* [2013] EWCH (Ch) 348 ('*Gilkicker*').
[129] Ibid 44.

actions against subsidiaries despite not owning any shares at that level.[130] Common law jurisdictions recognised multiple derivative actions long before this decision. In the US, *Holmes v Camp*[131] and *US Lines Inc v US Lines Co*[132] recognised this over a hundred years ago and over eighty years ago respectively. *Gilkicker* ensures that 'English company law runs in this respect in harmony with the laws of Hong Kong, Singapore, Canada, Australia and New Zealand, all of which have, albeit by different methods, ensured that injustice of the type described can be properly addressed'.[133] This development is undoubtedly spurred by the injustice that could arise if multiple derivative actions were prohibited. Lord Millet said that had they 'come before an English court, the case must have been dismissed in limine, and for the first time for more than 150 years, an alleged injustice would be without redress. The moral for would-be fraudsters is simple; choose an English company and be careful to defraud its subsidiary and not the company itself'.[134]

Banks in the UK and the US were larger and had more independent directors than non-financial institutions.[135] In the decade before the crisis, these board sizes were shrinking.[136] Those institutions with strong corporate governance now blame their failure on the very same measures intended for their safety.[137] 'Shareholder-orientated' boards with higher levels of risk pre-crisis experienced the most significant losses after.[138] The two reasons for this are that the potential payouts associated with substantial risks were very high, encouraging riskier investments, and that independent directors assumed that the regulators in Australia[139], the US and the UK were more effective than they were.

[130] "[C]ases in which the court recognized the conferral of locus standi to pursue the company's cause of action not upon one of its members, but upon one or more members of its holding company, where the holding company was itself subject to the same wrongdoer control as the company". *Gilkicker* (n 128) [21].
[131] *Holmes v Camp* 180 A.D 409 (N.Y App Div 1917).
[132] *US Lines Inc v US Lines Co* 96 F.2d 148 (2d Cir 1938).
[133] *Gilkicker* (n 128) [49].
[134] Ibid 40.
[135] Renee Adams et al, 'Bank Board Structure and Performance: Evidence for Large Bank Holding Companies' (2012) 21 *Journal of Financial Intermediation* 243, 243.
[136] Marco Becht et al, 'Why Bank Governance is Different' (2012) 27 *Oxford Review of Economic Policy* 437, 440.
[137] Renee Adams, 'Governance and the Financial Crisis' ECGI – Finance Working Paper No 248/2009, 4.
[138] Andrea Beltratti and Rene Stulz, 'The Credit Crisis Around the Globe: Why Did Some Banks Perform Better?' (2012) 105(1) *Journal of Financial Economics* 10, 10; David Erkens et al, 'Corporate Governance in the 2007-2008 Financial Crisis: Evidence from Financial Institutions Worldwide' (2012) 18 *Journal of Corporate Finance* 389, 392.
[139] 'Banking royal commission: How ASIC went missing in action with the banks', *ABC News* (online, 14 June 2019) <https://www.abc.net.au/news/2018-04-23/banking-royal-commission-how-asic-went-mia/9685792>.

The board should be concerned with overseeing the internal controls of the bank. These controls relate directly to the overall strategy of the institution. As financial service conglomerates are concerned with risk allocation, risk management should be prioritised. In recent years, financial service conglomerates failed to take account and manage the risks associated with diverse practices. Such failures threatened macroeconomic performance and contributed to the financial crisis. The risk management systems in banks can be divided into four elements[140] which must be managed continuously. The complexity of financial service conglomerates make risk unmeasurable and risk-exposure inaccurate. Evidence suggests that the level of resources assigned to risk management directly impacts returns. Companies that were less risky in the build-up to the crisis enjoyed more favourable returns throughout.[141]

Another problem is the conflict that exists between risk management and performance-related financial incentives. Directors set targets and approve schemes which offer financial incentives to perform, pursuing profit above all else. The greater the incentive, the higher the desire to achieve it. These employee incentives get so out of hand that people resort to fraudulent or damaging strategies to exploit the incentive for as much personal gain as possible. The Hayne Royal Commission has shown that conflicting pay arrangements are likely to exacerbate conflicts of interest and misconduct[142], damaging the financial system.

D. Executive Pay in Banks

Performance-related pay is a recent phenomenon; historically, bank executives received a higher fraction of fixed remuneration than was expected in non-financial institutions.[143] Following deregulation in the banking sector, equity compensation[144] rose sharply and

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[140] Gordon (n 106) 1115.
[141] Andrew Ellul and Vijay Yerramilli, 'Stronger Risk Controls, Lower Risk: Evidence from US Bank Holding Companies' (2013) 68 *Journal of Finance* 1757, 1759.
[142] Royal Commission (n 95) 27.
[143] Joel Houston and Christopher James, 'CEO Compensation and Bank Risk: Is Compensation in Banking Structured to Promote Risk Taking?' (1995) 36 *Journal of Monetary Economics* 405, 412; Lazarus Angbazo and Ranga Narayanan, 'Top Management Compensation and the Structure of the Board of Directors in Commercial Banks' (1997) 1 *European Financial Review* 239, 239.
[144] A non-cash payment representing firm ownership, including options, restricted stock and performance shares.

soon, bank executive pay looked similar to other industries.[145] Before the crisis, performance-related pay was a favourite among financial service conglomerates. Typically, CEO's of US banks received far more variable compensation than their base salary was worth.[146]

At least two main questions arise concerning performance-related pay. The first is whether pre-crisis executive compensation and having 'skin in the game' restrained risk-taking. Studies found that in the US, remuneration was aligned with shareholder's long-term interests.[147] Similar studies are not yet available in Europe due to different approaches to disclosure, but there is a clear divergence between shareholder engagement and the board's role in the remuneration process and setting remuneration guidelines.[148]

Typically, bank executives held significant stock in their firms. Research into Standard and Poor's Execucomp found that the mean value of stocks held by CEOs in their firms was USD87.5 million, equating to roughly 0.4% of the outstanding stock[149], not including cash already made from selling these shares or from bonuses. The top five executives in Bear Stearns and Lehman Brothers received USD2.4 billion in aggregate cash flows throughout the time they held stock in their firms between 2000 and 2008.[150] Although these executives sustained losses totalling approximately USD1.4 billion, they were still in a favourable financial position of roughly USD1 billion over that timeframe.[151] These bank executives were still in a positive financial position after the losses in that period. Stock options gave managers an incentive to pursue risks beyond optimal levels. There is a lack of evidence linking the risk sensitivity of managers' portfolios and shareholder returns. In other words, there was no proof that compensation led managers to select

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[145] Robert DeYoung et al, 'Executive Compensation and Business Policy Choices at US Commercial Banks (2013) 48 *Journal of Financial Quantitative Analysis* 1, 1; Vicente Cunat and Maria Guadalupe, 'Executive Compensation and Competition in the Banking and Financial Sectors' (2009) 33 *Journal of Banking and Finance* 495, 495; David Becher et al, 'Incentive Compensation for Bank Directors: The Impact of Deregulation' (2005) 78 *Journal of Business* 1753, 1754.
[146] Rudiger Fahlenbrach and Rene Stulz, 'Bank CEO Incentives and the Credit Crisis' (2001) 99(1) *Journal of Financial Economics* 11, 17.
[147] Ibid 13.
[148] Guido Ferrarini *et* al, 'Understanding Directors' Pay in Europe: A Comparative and Empirical Analysis' (June 9, 2009) ECGI - Law Working Paper No. 126/2009 <https://ssrn.com/abstract=1418463 or http://dx.doi.org/10.2139/ssrn.1418463>.
[149] Fahlenbrach (n 146) 13.
[150] Lucien Bebchuk et al, 'The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008' (2010) 27 *Yale Journal of Regulation* 257, 257.
[151] Sanjai Bhagat and Brian Bolton, 'Financial Crisis and Bank Executive Incentive Compensation' (2014) 25 *Journal of Corporate Finance* 319, 322.

projects with lower expected values.[152] This suggests that options encouraged detrimental risk-taking.

The costs incurred when a firm collapsed were not absorbed entirely by shareholders. Government guarantees mean these costs are only partially priced into credit agreements.[153] Shareholders may benefit from strategies that increase risk but generate positive cash flow elsewhere in the world. Research shows a positive correlation between managerial equity compensation and default risk.[154] In other words, the firms with managers who had the most substantial incentive to maximise share price were the most likely to fail. This does not account for the fact that most bank shareholders are diversified in the UK and the US, and would not approve excessive risks.[155]

The second question is whether banking regulation should address the remuneration of banking executives to avoid unnecessary risk-taking. The consensus is that regulators should require, or at least recommend, relevant pay structures to combat the problems experienced in banks due to excessive performance-related pay.[156] It may not be wise for regulators to tackle this aggressively by replacing the remuneration committee's role, but approach this with a limited scope to maintain the flexibility enjoyed in setting these executive pay arrangements. Regulating pay too strictly would have limited and indirect effects on bank stability, making it preferable for supervisors to utilise powers granted to them under prudential regulation provisions.[157]

E. Liability Rules Concerning Banks

Judges may lack the capacity to review business decisions effectively. As a result, the fear of the liability imposed by the court may persuade less diversified managers to take

[152] *See generally* John Thanassoulis and Mika Tanaka, Bankers' pay and excessive risk, Staff Working Paper No 558, October 2015, 3.
[153] Gordon (n 106) 1120.
[154] Patrick Bolton et al, 'Executive Compensation and Risk Taking' (2015) 19(6) *Review of Finance* 2139, 2141.
[155] John Armour and Jeffrey Gordon, 'Systemic Harms and Shareholder Value' (2014) 6 *Journal of Legal Analysis* 35, 35.
[156] David Walker, 'Evolving Executive Equity Compensation and the Limits of Optimal Contracting' (August 1, 2009) Boston University School of Law Working Paper No. 09-34; NYU Law and Economics Research Paper No. 09-46
<https://ssrn.com/abstract=1443170 or http://dx.doi.org/10.2139/ssrn.1443170>.
[157] Guido Ferrarini and Maria Ungureanu, 'Economics, Politics and the International Principles for Sound Compensation Practices: An Analysis of Executive Pay at European Banks' (2011) 64(2) *Vanderbilt Law Review* 429, 435.

on less risk than shareholders want and vice-versa.[158] Diversified shareholding could potentially lose more in a case of default than stakes held in the firm through equity-based compensation. For banks with diversified share ownership and managers with equity-based pay, the fear of liability would not lead to risk-aversion, but it might curb the undesirable risks that managers may otherwise take.[159]

Generally, directors are shielded from litigation arising from errors or omissions in business decisions, so long as they can demonstrate that those decisions were made in good faith.[160] Civil procedure rules make litigation expensive, so action by public agencies is a more efficient route to recourse. Still, agencies tend to attempt to impose a regulatory regime rather than a private law obligation action. Here lies a lack of clarity between individual and organisational responsibility. Legislative reform seeks to hold reckless managers to account by way of criminal liability where misconduct causes failure.[161]

In Australia in September 2006, the Corporations and Markets Advisory Committee expressed concern at the tendency of legislation to impose criminal sanctions on individuals for corporate wrongs because of their position, unless the individual can provide a defence.[162] The committee believed that as a general principle, an individual should not be subject to criminal liability unless it can be shown that they have assisted or been privy to misconduct.[163] In 2009 the Council of Australian Governments agreed to a set of principles outlined by the Ministerial Council for Corporations upon which personal liability for corporate fault should be imposed. The *Personal Liability for Corporate Fault Reform Act*[164] amended Commonwealth legislation in line with these principles to remove liability for corporate fault when such liability is unjustified. It also removes the burden of proof upon defendants to establish a defence; replaces personal criminal liability for corporate fault with civil liability where a non-criminal penalty is appropriate and; where personal criminal liability is justified, clarifies the circumstances

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[158] Armour (n 155).
[159] Ibid.
[160] *Stone v Ritter* 911 A 2d 362, 370 (Del Sup 2006); *In Re Citigroup Inc Shareholder Derivative Litigation*, 964 A 2d 106 (Del Ch 2009).
[161] *Financial Services (Banking Reform) Act 2013* (UK) c 33, s 36.
[162] Corporations and Markets Committee, *Personal Liability for Corporate Fault Report* (2016) 5.
[163] Ibid 6.
[164] *Personal Liability for Corporate Fault Reform Act 2012* (Cth).

where such liability applies.[165] This encourages directors to take reasonable and necessary risks while holding them liable for their misconduct.

Banks are peculiar in numerous ways, and these peculiarities make them distinct from other industries. These peculiarities, particularly the complexity of their structure and product offerings, encourage dilemmas, challenge regulators, and endanger the financial system's integrity if things go wrong. Poor culture and governance mean that no safeguards exist to prevent this behaviour from blossoming. This chapter has shown that because banks are different, governance has been ineffective. Performance-related pay, remuneration arrangements and risk-management have shown that a failure like the global financial crisis of 2007 was inevitable.

[165] Harold Ford, *Ford's Principles of Corporations Law* (LexisNexis Butterworths, 17th ed, 2018) 16.3.

Chapter 7: The Importance of Governance and Culture in Light of the Financial Crisis and Prudential Inquiry into Commonwealth bank of Australia: Two Case Studies

This chapter explores the importance of corporate culture and governance in two financial service conglomerates. Firstly, it explores governance shortcomings in the Co-operative Bank which came to light after the introduction of revised capital adequacy ratios in response to the global financial crisis (GFC).[1] Secondly it considers the culture and governance shortcomings outlined by the Prudential Inquiry into Commonwealth Bank of Australia, and the culture and governance changes implemented by the bank after the Hayne Royal Commission. The timing of this thesis and the completion of the Hayne Royal Commission represents a unique opportunity to consider culture and governance at the bank before and after Commissioner Hayne's recommendations were published. This chapter:

- Provides an overview of the global financial crisis and the causes; and then
- Analyses culture and governance shortcomings in the Co-operative Bank which came to light after the revised capital adequacy ratios imposed after the GFC; and
- Analysing culture and governance shortcomings in Commonwealth Bank before and after the Hayne Royal Commission.

The Co-operative Bank and Commonwealth Bank have been chosen due to authoritative data availability. The two cases are an excellent illustration of the impact that governance and culture can have on a financial service conglomerate. The two cases highlight the importance of culture and governance in institutional stability and promoting consumer confidence and trust in the financial services industry.

Corporate governance describes the framework of rules, relationships, systems, and processes within and by which authority is exercised and controlled in corporations.[2] Often the rules, relationships and systems are concerned with the alignment or adjustment of conflicting objectives in the management of company affairs.[3]

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[1] Basel Committee on Banking Supervision, An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements, BIS, August 2010.
[2] Justice Owen in the HIH Royal Commission, The Failure of HIH Insurance Volume 1: A Corporate Collapse and its Lessons, Commonwealth of Australia, April 2003, xxxiv; ASX Corporate Governance Council, Corporate Governance Principles and Recommendations, 4th ed February 2019, 1.
[3] John Farrar and Pamela Hanrahan, *Corporate Governance* (LexisNexis Butterworths, 2017) 4.

Culture in financial services is widely accepted as a root of the major conduct failings in recent history that has harmed both consumers and markets.[4] It is the glue that binds an organisation, and impacts its effectiveness, ethics, and governance.[5] Creating and maintaining culture requires good governance[6] and in this sense, the two are intertwined.

Culture has always been important in boards and is central to good governance.[7] Boards must be satisfied that the correct culture exists within their organisation, and that it promotes the right behaviours and identifies and holds wrongdoers to account. The Hayne Royal Commission has cast a spotlight on some aspects of culture, giving financial service conglomerates in Australia time to reflect on the importance of culture and what culture means for them in the future. Pre-Hayne organisational culture in Australian financial service conglomerates still had shortcomings, as the rest of this chapter shows.

The Co-operative Bank was chosen because of the Kelly Review[8] and the Myners Review[9] which followed the bank's period of failure. Both reviews became paramount in cementing the importance of culture and governance in financial service conglomerates. The Commonwealth Bank of Australia was chosen based on the Australian Prudential Regulation Authority's independent inquiry into governance, culture, and accountability.[10] The Hayne Royal Commission believes that this particular inquiry was critical in drawing attention to the importance of culture and governance in Australian financial service conglomerates.[11] The self-assessments for governance, accountability,

[4] Financial Conduct Authority, Transforming Culture in Financial Services, Discussion Paper DP18/2, March 2018, 3.
[5] City Values Forum, A Guide to Board Leadership in Purpose, Values and Culture, 6.
[6] Ibid 25.
[7] Tony Featherstone, Boards getting to grips with company culture, 16 March 2020, Australian Institute of Company Directors <https://aicd.companydirectors.com.au/advocacy/governance-leadership-centre/practice-of-governance/boards-getting-to-grips-with-company-culture>.
[8] Christopher Kelly, An Independent Review of the Co-operative Bank (The Kelly Review), 30 April 2014.
[9] Paul Myners, The Co-operative Group: Report of the Independent Governance Review (The Myners Review) 7 May 2014
[10] Australian Prudential Regulation Authority, Prudential Inquiry into the Commonwealth Bank of Australia, April 2018.
[11] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Final Report, Volume 1, 395.

and culture[12] that followed were paramount in gaining insight into these themes in Australian financial service conglomerates.

I. THE GLOBAL FINANCIAL CRISIS

The GFC is an important point in time to discuss, as it had far reaching consequences for financial systems across the globe. In terms of this chapter and the Co-operative Bank, the aftermath of global financial crisis represents a moment of regulatory change when capital adequacy ratios were increased for banks. The Co-operative Bank's inability to meet these new ratios[13] led to various governance and culture problems at the bank coming to light. The Co-operative Bank's financial collapse was attributed to the shortfall against the higher regulatory capital requirements set out in Basel III.[14] Had it not been for these new ratios, introduced in response to the GFC, these shortcomings may have not come to light for some time.

The GFC is an important theme in this thesis, and it is discussed in some detail here with emphasis on some of the characteristics peculiar to financial service conglomerates that have been discussed thus far, including interconnectedness, moral hazard, too big to fail, and culture and governance promoting risky behaviour. It is intended that this provides context for the discussion, rather than repeating the extensive literature base on this subject.

Prior to the Covid-19 recession, GFC[15] was considered the most severe economic downturn since the Great Depression. The two events, however, are entirely different.

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[12] Australian Prudential Regulation Authority, Information Paper: Self-assessments of governance, accountability and culture, 22 May 2019.

[13] The Basel III accord increased capital requirements from 2% to 4.5% of common equity, as a percentage of the bank's risk-weighted assets. There is also an extra 2.5% buffer capital requirement that brings the total minimum requirement to 7% to be compliant. This buffer can be used when banks face financial stress, in times such as the Covid-19 recession for example.

[14] Project Verde, Treasury, The Financial Collapse of the Co-operative Bank (1st January 2021) <https://publications.parliament.uk/pa/cm201415/cmselect/cmtreasy/728/72807.htm>.

[15] The global financial crisis (GFC) refers to the period of extreme stress in global financial markets and banking systems between mid 2007 and early 2009.Many banks around the world incurred large losses and relied on government support to avoid bankruptcy. Millions of people lost their jobs as the major advanced economies experienced their deepest recessions since the Great Depression in the 1930s. Recovery from the crisis was also much slower than past recessions that were not associated with a financial crisis. – Reserve Bank of Australia <https://www.rba.gov.au/education/resources/explainers/the-global-financial-crisis.html>.

The GFC was the result of numerous factors including speculative lending and substantial risk-taking by financial institutions.[16] This made it a crisis resulting from human behaviour. The Covid-19 recession resulted from the shock to world economies from responses in handling a global pandemic. It is important to mention that without the GFC, the Covid-19 recession may have reached unimaginable levels. After a decade of banking regulations, most notably Basel III[17], banks were better capitalised and more liquid than they were in the GFC. This allowed for capital to be extended to parts of the economy which needed it, something not possible in the GFC. The GFC is important and relevant to the discussion due to the aspects of human behaviour that led it to be.

The GFC was a long time in the making. At the start of the 2000s, financial intermediation was growing at a much faster rate than underlying credit to the economy.[18] Banks became increasingly interconnected through a web of financing, investment and hedging operations that undermined risk-assessment. When asset prices fell, interconnections worked in reverse and brought down entire conglomerates.[19] This interconnectedness is a structural factor that became a liability in the crisis.

Interconnectedness is also a key measure of systemic importance.[20] It exposes different business areas to risks in unrelated markets that may not sustain instability within. The Financial Crisis Inquiry Report[21] mentioned the role of interconnectedness in the financial crisis succinctly. It stated that the crisis reached seismic proportions with the failure of Lehman Brothers.[22] The panic, fuelled by a lack of transparency of major financial service institutions, coupled with a 'tangle of interconnections among financial institutions' deemed too big to fail, caused credit markets to seize.[23] Trading ground to a halt, stocks plummeted, and the economy plunged into deep recession.[24] Distress in one

[16] Mark Williams, *Uncontrolled Risk* (McGraw-Hill, 2010) 213.
[17] Basel Committee on Banking Supervision, Basel III leverage ratio framework and disclosure requirements, January 2014.
[18] Jacopo Carmassi et al, 'The Global Financial Crisis: Causes and Cures' 47(5) *Journal of Common Market Studies* 977, 981.
[19] Ibid.
[20] Mathias Drehmann and Nikola Tarashev, 'Measuring the Systemic Importance of Interconnected Banks' (2013) 22 *Journal of Financial Intermediation* 586, 587.
[21] The Financial Crisis Inquiry Report, Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, January 2011.
[22] Ibid xvi.
[23] Ibid.
[24] Ibid.

area of the economy spread and led to failures in others due to interconnections.[25] There was no plan for containment due to a lack of understanding of the risks and interconnections in financial markets.[26] The crisis showed just how troublesome interconnectedness in financial services was.

The first signs appeared in 2007 when real estate prices began to collapse, and subprime mortgages began to spike in the US. The leveraged credit market dried up, and billions of dollars of pending buy-out deals collapsed. Billions more in mortgage-backed securities and collateralised debt obligations were written down.[27] The following timeline shows how the GFC unfolded in the UK. In the years leading up to the crisis, Northern Rock had been expanding aggressively with funding from international money markets. When the problems in the US sub-prime mortgage market started to spread to Europe, the financing relied on by Northern Rock dried up and left the bank facing severe liquidity problems. Major US events are included in this timeline due to this interconnectedness.

[25] Ibid 27.
[26] Ibid xxi.
[27] Randall Guynn, 'The Global Financial Crisis and Proposed Regulatory Reform' (2010) 2 *Brigham Young University Law Review* 421, 423.

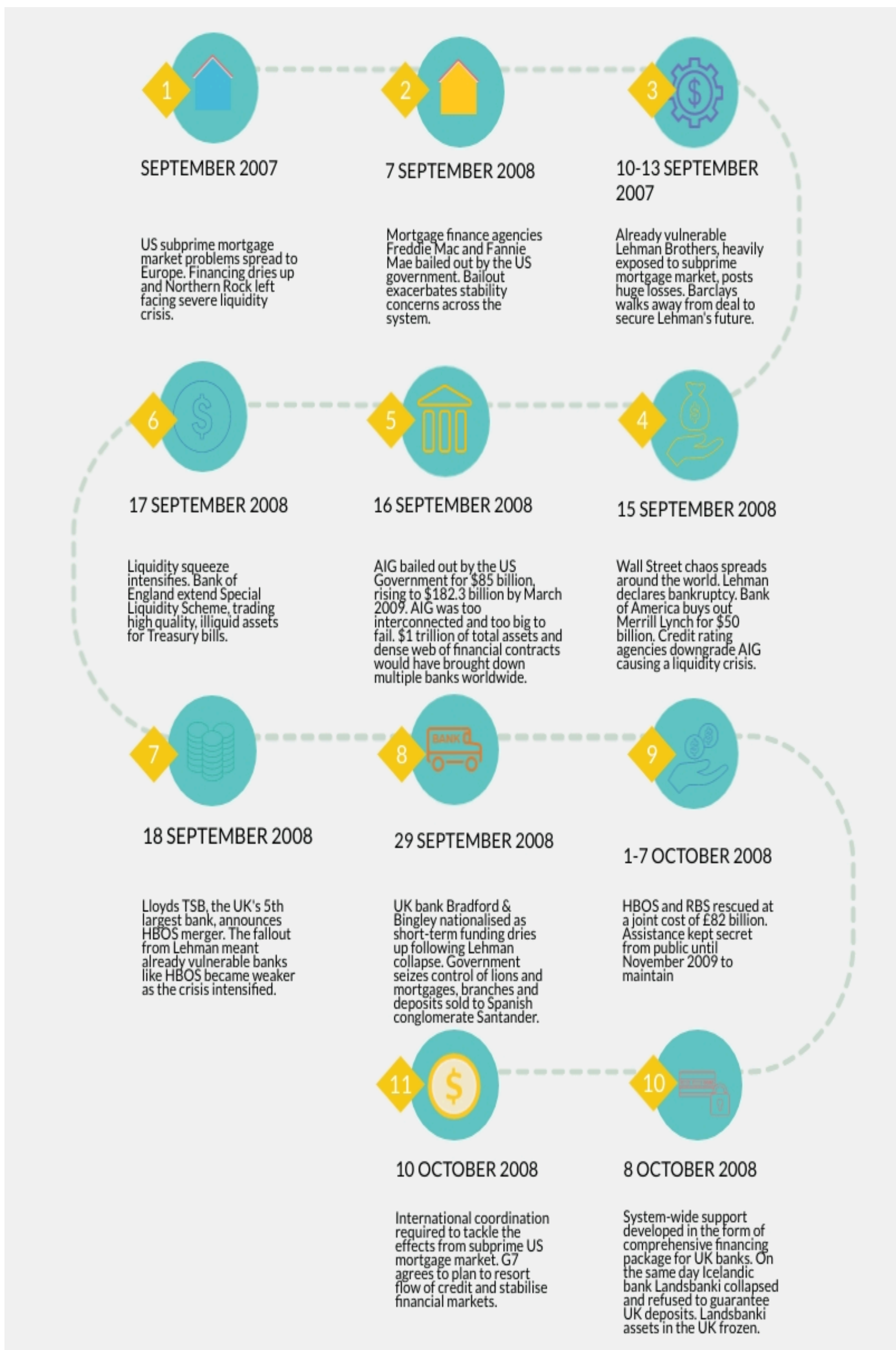

Figure 8. Timeline of how the GFC Unfolded and Important Events in the UK's Experience of the Crisis

Although numerous factors precipitated the GFC, the general agreement amongst economists is that it comes down to reckless risk-taking.[28] The subprime mortgages were a product of reckless risk-taking in the form of predatory lending, as mortgages were sold to borrowers with poor and impaired credit risk status.[29] Despite the relatively small size of the US subprime mortgage market, as borrowers defaulted on loans they couldn't afford to repay, the value of asset backed securities plummeted.[30] After the housing boom in the US burst, shockwaves spread to the rest of the world. Wholesale market funding became scarce and 'bank liquidity decreased, forcing banks to rely on central bank funding'.[31] The liquidity crisis[32] was further compounded as consumer confidence dropped, and the first run on a British bank since the 19th century commenced.[33] US monetary policy was primarily domestic and paid no attention to global interconnectedness[34], but it was clear from the fallout that US and UK financial markets and institutions were linked.

As the crisis gained momentum it became clear that Lehman Brothers was failing, and a buy-out from Barclays seemed the only chance of avoiding bankruptcy. The buy-out never occurred, as the Financial Services Authority would not approve the deal.[35] The US wanted Barclays to guarantee Lehman's future obligations, and the FSA declined. The FSA was the other key interest to the deal to acquire Lehman. The FSA stated they would not sanction the deal unless Barclays got a guarantee for funding when markets opened.[36] The funding would have to come from the US. Such a guarantee would put US taxpayers money at stake, and the FSA were not prepared to risk UK taxpayers money for a private deal by Barclays.[37] Without a guarantee, Lehman would be left to fail, and it did. The lack of market transparency, the sudden downgrade of credit ratings and the US

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[28] Claire Cregan et al, 'Economic Crime and the Global Financial Crisis' 5(4) *Law and Markets Review*, 276, 276.
[29] Etay Katz, 'The Credit Crunch: The Regulatory Way Forward' (2008) 2(3) *Law and Financial Markets Review* 234, 234.
[30] Ibid.
[31] Ibid.
[32] This liquidity crisis was also referred to as the credit crunch or credit squeeze. The Cambridge Dictionary defines 'credit crunch' as 'economic conditions that make financial organisations less willing to lend money, often causing serious economic problems' - Cambridge Dictionary (Online at 2 October 2021) 'credit crunch' <https://dictionary.cambridge.org/dictionary/english/credit-crunch>.
[33] Katz (n 28) 234.
[34] Jacopo Carmassi et al, 'The Global Financial Crisis: Causes and Cures' 47(5) *Journal of Common Market Studies* 977, 979.
[35] Tony Ciro, *The Global Financial Crisis: Triggers, Response and Aftermath* (Taylor and Francis, 2012).
[36] Vicky Ward, *The Devil's Casino* (2010) 205.
[37] Ibid 206.

government's decision to let Lehman fail led to a breakdown of trust in the financial system that shut down inter-bank money markets and created a large-scale liquidity crisis.[38] This shook Wall Street and marked the point at which the crisis spun out of control.[39]

Research shows that the interconnectedness of Lehman with international markets was via the liquidity Lehman provided to numerous investments.[40] This interconnectedness, still seen in financial service conglomerates, was the reason why the fall of Lehman made the crisis worse. Bailing out Lehman Brothers would not have saved the US from a recession because they were already in one, but it might have spared the rest of the globe the most severe effects of the crisis resulting from its collapse.[41] As soon as Lehman fell, credit and debt markets seized and devastated the real economy.

Interconnectedness is responsible for the speed at which the initial events of the crisis spread and engulfed institutions worldwide. This demonstrated the interconnected nature of financial services globally. At the time of a crisis, interconnectedness resulted in adverse effects for asset portfolios held by financial institutions because it increased the likelihood that banks will fail simultaneously.[42] Banks' interconnectedness at a national and global level propagated shock throughout different parts of the financial system.[43] This is difficult to contain once shock starts to spread. Financial crises are not always preventable, but what should have been prevented were the kind of systemic and interconnected vulnerabilities that existed and carried such contagious effects.[44] If interconnectedness is a characteristic of financial service conglomerates, then these conglomerates inherently endanger the financial system's stability.

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[38] The de Larosière Group, The High-Level Group on Financial Supervision in the EU Report, Brussels, 25 February 2009, 12.

[39] 'Lehman Brothers: When the financial crisis spun out of control', *CNN News* (online, 28 January 2021) <https://edition.cnn.com/2018/09/30/investing/lehman-brothers-2008-crisis/index.html>.

[40] Umar Burkhanov, 'The Big Failure: Lehman Brothers' Effects on Global Markets' (2011) 2 *European Journal of Business and Economics* 17, 20.

[41] 'Would saving Lehman have saved us from the Great Recession?', *The Washington Post* (online, 28 January 2021) <https://www.washingtonpost.com/business/2018/09/20/would-saving-lehman-have-saved-us-great-recession/>.

[42] Marco Espinosa-Vega and Steven Russell, 'Interconnectedness, systemic crises, and recessions' (2020) 1 *Latin American Journal of Central Banking* 1, 2.

[43] Gael Hauton and Jean-Cyprien Heam, 'Interconnectedness of Financial Conglomerates' (2015) 3 *Risks* 139, 140.

[44] The de Larosière Group (n 37) 6.

Opacity causes problems with risk management and regulation, and in the GFC, it skewed the perception of real risk exposure in the financial services market. Financial service conglomerates benefit from economies of scale and scope due to their size and structure. The potential rewards associated with selling banking customers other financial products and services was almost irresistible. The institutions were paying the credit rating agencies and the auditors, who were subsequently accused of maximising profits in exchange for inaccurate ratings[45], and financial institutions themselves were outsmarted by the innovators who designed the complex products they were selling.[46] The GFC undermined consumer trust in the system, leading to a slower recovery. The UK financial industry was already experiencing a 'fundamental loss of trust' following deregulation[47] which was exacerbated by the crisis. A similar situation is taking place in the Australian financial services industry; until changes are made, the financial industry will lack the public respect and trust that is necessary in the sector.[48]

After the crisis, the question arose whether the excessive financial market intervention detailed in the figure above would exacerbate the moral hazard problem. Moral hazard refers to insurance protection's ability to alter an individual's attitude towards loss prevention.[49] In the GFC, the biggest moral hazard problem was the existence of the central bank as a lender of last resort. Although the lender of last resort has an important function in the financial system, its existence creates moral hazard as institutions expect to be protected if a crisis occurs.[50] Depositors and foreign lenders have little incentive to monitor banks, knowing government bailouts will likely protect them[51], and banks engage in risky behaviour in pursuit of growth and profits. The concept of too big to fail exacerbated risk-taking, and the government intervened. Moral hazard must be confronted and represents a unique feature of the crisis.

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[45] Council on Foreign Relations, The Credit Rating Controversy (1st March 2021) <https://www.cfr.org/backgrounder/credit-rating-controversy>.
[46] 'Outsmarted: Human Nature v High Finance', *The New Yorker* (online, 3 March 2021) <https://www.newyorker.com/magazine/2009/06/01/outsmarted>.
[47] Sue Jaffer et al, 'Why Trustworthiness is Important' in Nicholas Morris and David Vines (eds), *Capital Failure: Rebuilding Trust in Financial Services* (Oxford, 2014) 4.
[48] Royal Commission (n 11) 134.
[49] Steven Shavell, 'On Moral Hazard and Insurance' (1979) 93(4) *The Quarterly Journal of Economics* 541, 541.
[50] Frederic Mishki, 'The International Lender of Last Resort: What are the Issues?' July 2000, 12, prepared for the Kiel Week Conference, 'The World's New Financial Landscape: Challenges for Economic Policy' Kiel Institute of World Economics, Kiel, Germany, June 19-20, 2000.
[51] Ibid 2.

This thesis has stated that Australia escaped the GFC relatively unscathed. Australia did not experience the large economic downturn seen in the UK, but unemployment rose[52], growth slowed[53] and there was a period of heightened uncertainty. Australia's experience of the crisis was influenced by the fact Australian banks had small exposures to US banks and housing markets, thanks to profitable domestic lending.[54] The historical focus on lending standards by APRA meant subprime lending was only a small share of lending in Australia, and the economy was buoyed by exports to China whose economy rebounded quickly after the initial shock of the crisis.[55] These factors were bolstered by strong policy responses. The Reserve Bank lowered the cash rate, the government undertook expansionary fiscal policy and guaranteed deposits and bonds issued by Australian banks.[56] Australia used the crisis to strengthen lending standards and implement stronger global banking standards.[57]

Although Australia weathered the crisis well, some people still lost a lot of money. Australian hedge fund Basis Yield Alpha Fund brought legal action against Goldman Sachs for misleading statements and omissions about collateralised debt obligations.[58] They claimed Goldman sold securities as a way to offload toxic subprime mortgages and sought to profit by shorting the securities.[59] When the crisis hit, hundreds of Australians lost their investments. Goldman settled with Basis Yield Alpha over the securities which caused the Australian firm to become insolvent. This case showed one instance of unethical behaviour, as Goldman chose to deceive as they tried to save their own skin in the face of the impending crisis, leading to Basis Yield Alpha's insolvency.

One of the critical lessons from the crisis is that people have tended to analyse corporate governance issues in financial service conglomerates through a narrow lens, without

[52] Between early 2008 and mid 2009, unemployment in Australian increased by about 1.75%, from around 4% to 5.75% - Reserve Bank of Australia Bulletin, March Quarter 2010.
[53] GDP fell by 0.5% - Australian Bureau of Statistics, Australian National Accounts: National Income, Expenditure and Product, December 2008.
[54] Reserve Bank of Australia, The Global Financial Crisis Explainer, 4 <https://www.rba.gov.au/education/resources/explainers/pdf/the-global-financial-crisis.pdf?v=2021-09-21-10-14-17>.
[55] Ibid.
[56] Ibid.
[57] Ibid.
[58] *Basis Yield Alpha Fund (Master) v. Goldman Sachs Group Inc et al*, New York State Supreme Court, New York County, No. 652996/2011.
[59] 'Goldman sued for $1.07 billion over Timberwolf CDO', *Reuters* (online, 21 September 2021) <https://www.reuters.com/article/us-goldman-basisalpha-idUSBREA0T1VN20140130>.

accounting for their peculiarities, detailed throughout this thesis. Corporate governance is better understood when we account for the structure and complexities of financial service conglomerates and the beliefs, cultures, ideologies, and conventions of those who make up the board and senior executive.[60] By exploring culture, we can better understand how governance failed. This thesis suggests that culture may be a powerful tool for managing ethical dilemmas, thereby mitigating the potential consequences of their abuse in financial service conglomerates.

The following case studies demonstrate the importance of good governance and culture in financial conglomerates. Corporate governance represents one of the most important failures of the crisis[61], and failures in risk assessment and risk management were aggravated by corporate governance failures.[62] The GFC cast a spotlight on financial risk in the UK and Australia, but until the Hayne Royal Commission, too little attention had been paid on the evident connections between remuneration practices and regulatory, compliance and conduct risks in Australia.[63] This led to large reputational consequences before and during the Commission.[64]

II. Corporate Governance Failure Case Study – The Co-operative Bank

The UK has experienced large-scale corporate governance failures, and this section focuses on those of the Co-operative Bank. The Co-operative Bank was subject to regulatory enforcement investigations by the Financial Conduct Authority, the Prudential Regulation Authority, and the Financial Reporting Council, in the wake of the GFC. Afterwards, a Treasury Select Committee and 'Project Verde'[65] were formed to ascertain governance at the bank was failing.

The failings of the Co-operative Bank can be categorised into three separate events:

[60] William Sun et al, 'Introduction: rethinking corporate governance – lessons from the global financial crisis' in William Sun et al (eds), *Corporate Governance and the Global Financial Crisis: International Perspectives* (Cambridge, 2011) 18.
[61] The de Larosière Group (n 37) 29.
[62] Ibid 10.
[63] Royal Commission (n 11) 15.
[64] Ibid 15.
[65] House of Commons Treasury Committee, Project Verde, Sixth Report of Session 2014-15, Volume One.

- Losses of £634 million for the 2012 financial year;
- The Co-operative's takeover of the UK's second biggest bank at the time, Britannia, which led to the exit from a deal with Lloyds Banking Group to buy 632 of its branches; and
- The downgrade of the bank's credit rating by six notches, taking its bonds down from 'investment grade' to 'junk status'.[66]

Multiple factors contributed to these three events, including the economic environment during and after the GFC, and the introduction of greater capital adequacy ratios in Basel III. Non-financial risk factors such as weak governance, poor risk management and a flawed culture undermined the stability of the Co-operative Bank.[67] This highlights the vital role culture can play in financial service conglomerates.

The Co-operative Bank had some key differences to other banks at the time. The Co-operative was much smaller than the other UK banks. Their problems did not compromise any consumer deposits and as a result, did not require the substantial taxpayer bailout that the other banks did. Their problems were caused primarily by a lack of board experience, but other UK banks had considerable amounts of experienced leadership, and still ran into problems. This event suggests that there is something more important than box ticking and due diligence at the board level, and there are structural issues that require attention.[68] Two important elements of non-financial risk at the Co-operative Bank are governance and culture, and board accountability, and these will be explored now.

A. Governance and Culture

Governance is the system by which companies are directed and controlled.[69] The Co-operative operated a unique governance model.[70] Although a public limited company, the Co-operative Bank was part of the wider 'Co-operative Banking Group' (known as 'Co-operative Financial Services' until September 2011).[71] The banking group was wholly

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[66] What went wrong for the Co-op Bank? (1st January 2020) The Conversation <https://theconversation.com/what-went-wrong-for-the-co-op-bank-14308>.
[67] The Kelly Review (n 8) 4.
[68] Newsnight: Lord Turner on the Co-op Bank Saga, November 26 2013 (27 September 2021) <https://www.youtube.com/watch?v=Gq35VNmxaW4>.
[69] Financial Reporting Council, The UK Corporate Governance Code, July 2018, 1.
[70] Project Verde Sixth Report (n 64) 57.
[71] Ibid 9.

owned by the mutual Co-operative Group. Co-op Group was the bank's sole shareholder and had a substantial influence and interest in the bank's affairs.[72]

The financial crisis did not hit the Co-operative Bank hard because funding came predominantly from depositors. The increased regulation on capital requirements after the crisis, however, did. In the merger with Britannia Building Society in 2009 which demonstrated the Co-operative's ambition and expansion, cultural and operational differences were blamed for failure. Britannia's financial position deteriorated, and the institution was placed on the Financial Services Authority's watchlist. The Co-operative's due diligence turned out to be substandard, and it acquired financial products with a much higher risk profile than they had expertise in. Many of the loans it had acquired were of poor quality, and when assessed accurately, they lost the Co-operative £469 million in value, contributing heavily to the losses posted in 2012. This was the first clue that governance was not appropriate for the Co-operative's business operations.

In 2013 the bank withdrew from planned purchases of Lloyds Banking Group branches. The Treasury blamed the deal's failure on the Co-operative Bank's board, its regulators, and auditors at KPMG.[73] Prolonged negotiations on selling TSB[74] to the Co-operative Bank also ended after it came to light the bank was facing a shortfall of £1.5 billion of Common Equity Tier 1 capital to be compliant with Basel III capital adequacy standards, confirmed by the Prudential Regulation Authority.[75]

In the same year, Moody's downgraded the Co-operative bank's debt ratings six levels.[76] The downgrade came after the bank's announcement of their regulatory capital shortfall. Moody's view was that the bank could only return to full solvency through a substantial

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[72] Ibid.
[73] 'Co-op Bank Managers blamed for doomed Lloyds branches deal', *The Financial Times* (online, 7 May 2021) <https://www.ft.com/content/6d00fab0-59f2-11e4-9787-00144feab7de>.
[74] The TSB name was used previously by the Trustee Savings Bank prior to its merger with Lloyds Bank in 1995, resulting in the name Lloyds TSB in 1999. TSB began operation as a separate business within the Lloyds Banking Group in 2013, and was floated on the stock market in 2014, after the failure of the Project Verde deal with the Co-operative Group: Bernardo Batiz-Lazo and Douglas Wood, 'Effects of regulatory change on European banks: A case study on the strategy and stock market performance of Lloyds Bank (1980-1993)' (2003) Economic History 0301004, University Library of Munich, Germany, 23.
[75] Christine Mallin, *Handbook on Corporate Governance in Financial Institutions* (Elgar, 2016) 48.
[76] Moody's downgrades Co-operative Bank's rating following announcement of exchange offer, Moody's Investor Service Reports, 18 June 2013.

recapitalisation and a significant restructuring of the bank's operations.[77] This downgrade stemmed from a report one month earlier, where the bank faced risks of further losses from its non-core portfolio, vulnerability to losses heightened by the low level of provisions held against its lending portfolio, and slow progress in realising merger-related revenue and cost benefits[78], highlighted by the merger with Britannia Building Society.

The Kelly Review[79] uncovered failings in management and governance, particularly with the Co-operative's board structure between 2008 and 2014. By 2012 the bank's financial statements recognised they were not meeting the recommendations in the UK Corporate Governance Code regarding the proportion and experience of independent, non-executive directors on the board.[80] They were also struggling to fulfil diversity recommendations in the board's composition. It was clear that the board did not understand the requirements for a regulated bank.[81]

The Kelly Review highlighted fifteen lessons to be learned from corporate governance failures, including 'tolerating – as the bank did – a culture of underperformance, weak transparency and a lack of accountability' which undermined their 'ability to respond quickly and robustly to any challenges'.[82] The review stated that 'culture is pervasive. The tone is set by leaders and reinforced by management systems. In the bank, the culture did too little to discourage the wrong behaviours or potential issues, work collaboratively with the regulator, or address issues as soon as they became apparent'.[83] Several aspects of the bank's culture contributed to the challenges it faced. Those particularly important aspects include the acceptance of mediocrity[84], weaknesses in accountability[85], failure to address poor performance[86], tendency to discourage challenge[87] and a good news culture.[88]

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[77] Ibid.
[78] Moody's downgrades Co-operative Bank; on review for further downgrade, Moody's Investor Service Reports, 9 May 2013.
[79] The Kelly Review (n 8).
[80] Ibid 10.
[81] Ibid 9.
[82] Ibid 129.
[83] Ibid.
[84] Ibid.
[85] Ibid 130.
[86] Ibid.
[87] Ibid.
[88] Ibid.

The review ends poignantly; 'these lessons have come at a great cost to the Co-operative Bank, its staff, its customers, and the members of the Co-operative Group. The failings are… basic. The circumstances which led to them being set out here must pain all who care about the co-operative movement'.[89] This is an early example of how culture was deemed an aggravating factor for failure in a financial institution. It is a possible reason why culture became important in corporate governance recommendations and further evidence that poor culture is harmful in financial service conglomerates.

The Kelly Review provides a conclusive summary of the effectiveness of governance at the Co-operative Bank. It concludes that:

> The Bank Executive failed to exercise sufficiently prudent and effective management of capital and risk. The Banking Group Board failed in its oversight of the executive. The Group Board failed in its duties… to provide effective stewardship of an important member asset. Collectively, they failed to ensure that the Co-operative Bank consistently lived up to its ethical principles. In all these things they badly let down the Group's members.[90]

The lack of skills and expertise demonstrated by the board were remarkable. It was stated that:

> It is hard to avoid the conclusion that the Group Board, as constituted, was never likely to be able to exercise any form of effective shareholder oversight of its banking subsidiary. The [Co-op Banking Group] Board did include some experienced and capable individuals, but it was greatly handicapped by the lack of banking experience of its Chair, by poor process and by inadequate information. If the executive had been more capable, that might not have mattered so much. The combination of poor decisions by the executive and weak governance proved very damaging.[91]

B. Problems with the Board

The group was led by a board of twenty, non-executive representatives elected as one member, one vote from Co-op Regional Boards and Independent Co-operative Societies.[92] Underneath the board was the Group Chief Executive, who oversaw the Co-

[89] Ibid 130.
[90] Ibid 4.
[91] Ibid 122.
[92] The Myners Review (n 9) 8.

operative's underlying businesses, including the bank and supermarket chain.[93] The Co-operative Banking Group had a board of fourteen members who were heavily integrated with the group board.[94] The banking group Chairman who was Deputy Chairman of the wider group, and two other Co-op Group board members sat on the banking group board.[95] This is a perfect example of directors' conflicting duties in conglomerates and precisely the type of arrangement that governance changes in the UK Corporate Governance Code have attempted to tackle post-crisis.[96]

The varied experience of board members influenced the Co-operative Bank's governance structure greatly. The group board and the executive had limited financial experience and limited understanding of their relationship with the regulators, and the non-executives on the banking group board fared little better.[97] This included the Chairman, Paul Flowers.[98] The board was already lacking the composition requirements of The UK Corporate Governance Code in terms of experience and diversity suggestions.

The Myners Review[99] was released in 2014 after the Co-operative Group appointed Lord Paul Myners to conduct a comprehensive and independent investigation into governance. He stated that recent years 'have been the most tumultuous and challenging for the Co-operative Group in its entire 150-year existence. It was brought to the brink of collapse in 2013 by the emergence of near-catastrophic losses at the Co-operative Bank and a £1.5 billion capital shortfall'.[100] Lord Myners drew similarities between the Kelly Review and his findings. While the Kelly Review was completely independent from the Myners Review[101], his findings and recommendations provided compelling evidence of the depth of governance shortcomings. In particular, that 'failures in board oversight are inevitable if the criteria used to elect its members do not require those elected to have the necessary skills… Sustained success requires effective governance. Effective governance requires a high performing board. The composition of the Co-operative board, and the limited pool

[93] Project Verde Sixth Report (n 64) 10.
[94] Project Verde Sixth Report (n 64) 10.
[95] The Co-operative Bank Financial Statements 2011, 10.
[96] UK Corporate Governance (n 68) 6-7.
[97] The Kelly Review (n 8) 10, 114-116, 127.
[98] Project Verde Sixth Report (n 64) 10.
[99] The Myners Review (n 9).
[100] Mallin (n 74) 55.
[101] The Kelly Review (n 8) 2.

from which its members were drawn, made a serious governance failure almost inevitable'.[102]

In 2014, the Treasury Committee conducted an inquiry into the collapsed bid for 632 branches of Lloyds Banking Group, otherwise known as 'Project Verde'.[103] The inquiry reported several shortfalls in corporate governance at the Co-operative Group and the Co-operative Bank, and outlines that:

> There were considerable links between the governance of Co-operative Group and Co-operative Bank. At the end of 2008, when Co-op was deliberating on the Britannia merger, seven of the thirteen non-executive members of the bank board— including the Chairman—were sourced from the elected members of the group board.[104] By 2011, when Co-op was first considering a bid for Verde, this figure had fallen to four out of twelve, though two group executives also sat on the board.[105] The remaining group representation was senior, including the group Chairman, Len Wardle, the group Chief Executive, Peter Marks, and the group Deputy Chairman, Paul Flowers, who was Chairman of the bank.[106]

Further, 'the Co-op Bank Chief Executive had, until early 2011, a single reporting line to the banking group board. This changed with the introduction of Project Unity, which required the bank Chief Executive to report to the Group Chief Executive.[107] The governance of the bank and group thus became further intertwined'.[108]

The report framed the Co-operative Bank as an oversized board with insufficient financial experience.

> In its June 2012 Risk Assessment letter to the bank, the FSA stated that the current Board structure "does not provide sufficient oversight, coverage, depth of debate and challenge to management", particularly given the large number of projects underway at that time. In the same letter, the regulator said that it had observed over-reliance on just a few [independent professional non-

[102] The Myners Review (n 9) 15.
[103] Project Verde (20 July 2019) UK Parliament <https://www.parliament.uk/business/committees/committees-a-z/commons-select/treasury-committee/inquiries1/parliament-2010/project-verde/>.
[104] The Kelly Review (n 8) 118.
[105] Ibid.
[106] Project Verde Sixth Report (n 64) 57.
[107] Letter from Andrew Bailey, Deputy Governor of Prudential Regulation Authority (1 July 2019) <https://publications.parliament.uk/pa/cm201314/cmselect/cmtreasy/writev/verde/pv16.pdf>.
[108] Project Verde Sixth Report (n 64) 56.

executive directors], and that the balance between [independent professional non-executive directors] and group [non-executive directors] on the [Co-op Banking Group] board needed to change. The bank was very slow to make the necessary changes'.[109]

On 10 August 2015, after the release of the Kelly Review and the Myners Review, the Financial Conduct Authority issued a statement confirming that the Co-operative Bank had contravened Sections 91 and 205 of the *Financial Services and Markets Act*.[110] They stated:

> The serious failings in this case merits a substantial financial penalty. However, in the circumstances of this case, the Authority has decided not to impose a financial penalty. The Authority has given serious consideration to the impact of a substantial financial penalty. This includes, in particular, that Co-op Bank is currently engaged in a turnaround plan with the aim of ensuring that it meets its Individual Capital Guidance on a sustainable basis and has adequate capital to withstand a severe stress. The Authority considers that it is of great importance that this plan is successful and that Co-op Bank's capital resources are directed towards improving its resilience. In the exceptional circumstances of Co-op Bank, a public censure is considered appropriate and proportionate.[111]

In the same month, the Prudential Regulation Authority stated the Co-operative Bank had also contravened Principles 3[112] and 11[113] of the Principles for Businesses.[114] They stated the Co-operative Bank breached Principle 3 because they did not have adequate control frameworks in place[115], did not have sufficient risk management[116] or corporate lending policies[117], and did not produce appropriate management information.[118] For contravention of Principle 11, the Prudential Regulation Authority stated that:

> During the relevant period, Co-op Bank also failed to deal with its regulators (the FSA and subsequently the PRA) in an open and co-operative way, and to disclose appropriately matters

[109] The Kelly Review (n 8) 121.
[110] *Financial Services and Markets Act 2000* (UK) c 8.
[111] Financial Conduct Authority, Final Notice, 10 August 2015, 1.3-1.4.
[112] A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems: FCA Handbook, PRIN 2.1: Principle 3.
[113] A firm must deal with its regulators in an open and cooperative way and must disclose to the appropriate regulator appropriately anything relating to the firm of which that regulator would reasonably expect notice: Ibid Principle 11.
[114] FCA Handbook, PRIN 2.1: The Principles.
[115] The Kelly Review (n 8) 126.
[116] Project Verde Sixth Report (n 64) 208.
[117] The Kelly Review (n 8) 12.
[118] Project Verde Sixth Report (n 64) 202.

> relating to Co-op Bank of which the regulators would reasonably expect notice, in breach of Principle 11. From 25 April 2012 to 9 May 2013, Co-op Bank failed to notify the regulators of two intended personnel changes in senior positions at the Firm, and the reasons for those intended changes. Where a firm forms a view in relation to the members, structure, or effectiveness of its senior management, this is a matter of which the PRA would reasonably expect to be notified without delay as part of its day-to-day supervision of the firm. This is to enable the PRA properly to consider and assess the management at the firms which it regulates and the risks to safety and soundness which may arise from changes to the management team.[119]

The Prudential Regulation Authority also found that the bank's control framework was flawed in design and operation, with inadequacies in its risk management framework and capital management policies.[120] The bank had a culture of encouraging short-term financial positions[121] at the cost of prudent and sustainable long-term actions. The PRA also decided against a penalty of £121.86 million as it would not promote safety and soundness and would not advance their objectives.[122]

Weak corporate governance, exercised by a large and inexperienced board, poor risk management processes, and poor strategic decisions, exacerbated by the GFC, resulted in enormous losses for the Group, and the higher capital ratios in Basel III almost caused the bank to fail.[123] The bank repeatedly failed to live up to its ethical principles.[124] The culture of the institution was not appropriately prepared for market instability. The story is a vital example of the importance of corporate governance and strong culture in financial institutions.

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[119] Prudential Regulation Authority, Final Notice to The Co-operative Bank PLC, 10 August 2015, 1.5 (9 July 2019) Bank of England <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/enforcement-notice/en110815>.
[120] PRA censures Co-operative Bank for serious risk management and transparency failings (3 March 2021) Bank of England <https://www.bankofengland.co.uk/news/2015/august/pra-censures-cooperative-bank-for-serious-risk-management-and-transparency-failings>.
[121] The Kelly Review (n 8) 91.
[122] Bank of England (n 119).
[123] The Rise and Fall of the Ethical Bank (20 September 2021) The Ecologist <https://theecologist.org/2019/jan/15/rise-and-fall-ethical-bank>.
[124] The Kelly Review (n 8) 4.

III. Corporate Governance Failure Case Study – The Commonwealth Bank of Australia

Australian banks have been resilient but still experience governance failures. A week after the Hayne Royal Commission was ordered, the Commonwealth Bank of Australia's (CBA) CEO apologised for the misconduct of his financial advisors and the distress they caused. This showed how important good governance and culture is in financial service conglomerates. It also shows that banks require closer supervision and constant challenge.[125] The Australian Prudential Regulation Authority subsequently launched an independent inquiry into governance, culture, and accountability within CBA.[126] The outcomes spurred the self-assessments of governance, accountability and culture,[127] released by APRA later that year.

Weaknesses, serious misbehaviour, ethical lapses, and compliance failures have amounted to substantial losses and record penalties for the financial service conglomerates involved.[128] The instances of poor governance, culture and conflicts of interest uncovered in the APRA Prudential Inquiry into CBA will be explored in this case study analysis.

Trust in the bank had been low, both domestically and globally. Their continued financial success 'dulled the senses of the institution'[129] and meant that the numerous tell-tale markers[130] of governance failings became apparent only recently. Within the six month timeframe provided, the panel could not extensively audit CBA's activities.[131] As a result,

[125] 'Commonwealth Bank: A Case Study in Failure', *Sydney Morning Herald* (online, 9 July 2019) <https://www.smh.com.au/business/commonwealth-bank-a-case-study-in-failure-20140704-zsw83.html>.
[126] Prudential Inquiry into Commonwealth Bank (n 10).
[127] Self-assessments of governance (n 12).
[128] Prudential Inquiry into Commonwealth Bank (n 10) 3.
[129] Ibid 6.
[130] The Panel of the Inquiry into the Commonwealth Bank of Australia identified various signs of failing at the bank, including 'inadequate oversight and challenge by the Board of emerging non-financial risks; unclear accountabilities, starting with a lack of ownership of key risks at the Executive Committee level; weaknesses in how issues, incidents and risks were identified and escalated through the institution and a lack of urgency in their subsequent management and resolution; overly complex and bureaucratic decision making processes that favoured collaboration over timely and effective outcomes and slowed the detection of risk failings; an operational risk management framework that worked better on paper than in practice, supported by an immature and under-resourced compliance function; and a remuneration framework that, at least until the AUSTRAC action, had little sting for senior managers and above when poor risk or customer outcomes materialised (and, until recently, provided incentives to staff that did not necessarily produce good customer outcomes)': Prudential Inquiry into Commonwealth Bank (n 10) 3.
[131] Ibid 6.

the panel confined the scope of the Inquiry to focus on recent business practices and the prevailing culture at the institution.[132] This focus perhaps reflects the importance of culture in financial service conglomerates to ethical behaviour. The importance of financial risk is not disputed, but this case study focuses on non-financial risks at the bank.

Non-financial risks have globally accepted definitions.[133] Operational risk is defined as 'the risk of loss resulting from an inadequate or failed internal process, people, systems, or external events. This definition includes legal risk but excludes strategic and reputational risk'.[134] Compliance risk is 'the risk of legal or regulatory sanctions, material financial loss, or loss to reputation a bank may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organisation standard, and codes of conduct applicable to its banking activities'.[135] CBA's non-financial risk can be categorised into governance and culture, and board accountability. Governance and culture will be the focus of this case study, as they have been a recurring theme in this thesis so far. Both themes are essential factors in mitigating conflicts of interest and misconduct in the future.

A. *Governance and Culture*

Sound corporate governance is crucial to a company's long-term viability.[136] As noted above, the GFC highlighted the potentially catastrophic outcomes resulting from poor governance. In banks, effective corporate governance overlays every risk parameter's management and instils confidence in the bank's ability to manage assets and liabilities prudently.[137] Ultimately the board is tasked with ensuring prudent risk-management. CBA did not prioritise the governance and management of non-financial risks to the standard expected of a systemically important bank.[138] CBA also had issues around their

[132] Ibid.
[133] Prudential Inquiry into Commonwealth Bank (n 10) 7.
[134] Basel Committee on Banking Supervision, Principles for the Sound Management of Operational Risk, June 2011, 3.
[135] Basel Committee on Banking Supervision, Compliance and the Compliance Function in Banks, April 2005, 7.
[136] Prudential Inquiry into Commonwealth Bank (n 10) 10.
[137] Ibid.
[138] Ibid 11.

use of the Three Lines of Defence (TLOD) model.[139] The investigation found that despite the model's relative simplicity, CBA failed to implement it properly.

The TLOD provides a simple way to enhance risk management by clarifying essential roles and duties.[140] It has been accepted as best practise for listed entities and as a required organisational model by banking regulators in response to poor risk-management during the global financial crisis.[141] The model was intended to be generally applicable, although it did not recognise the peculiarities of regulated financial institutions.[142] The use of the TLOD model allows for the effective coordination of control responsibilities and is summarised below.

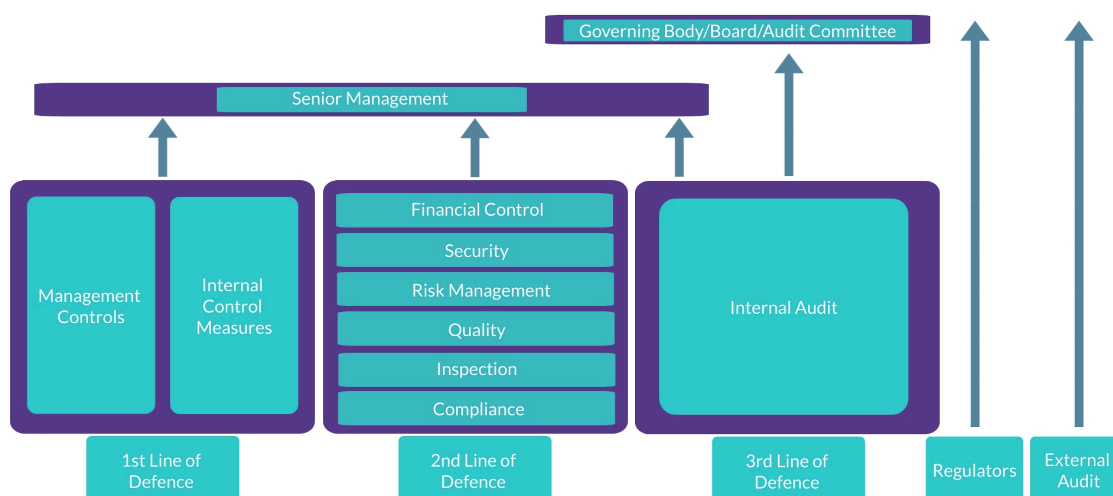

Figure 9. The Three Lines of Defence Model

In CBA, significant variability in the resourcing, roles and responsibilities of Line 1 and Line 2 had been uncovered. Line 2's involvement in CBA's Risk in Change process was highlighted as an issue of concern.[143] Principally, Line 2 staff must be 'structurally and

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[139] The Three Lines of Defence model is a system of best practice to enhance communications on risk management and control by clarifying essential roles and duties. In the model, management control is the first line in risk management, the various risk control and compliance oversight functions established by management are the second line, and independent assurance is the third. All three play a distinct role within the wider governance framework: Institute of Internal Auditors Position Paper: The Three Lines of Defence in Effective Risk Management and Control, January 2013, 2.
[140] Ulrich Bantleon et al, 'Coordination challenges in implementing the three lines of defense model' (2021) 25(1) *International Journal of Auditing* 59, 59.
[141] Ibid.
[142] Financial Stability Institute, 'The Four Lines of Defence Model for Financial Institutions', Occasional Paper 11, December 2015, 4.
[143] Prudential Inquiry into Commonwealth Bank (n 10) 29.

functionally independent of the business'.[144] There should be 'no conflicts of interest' that impede Line 2 staff from 'providing impartial advice' to the bank.[145] Despite reviews of conflicts of interest at the bank by Line 2 staff, there was significant scope for improving this process.[146] This means the bank poorly managed ethical quandaries like conflicts of interest, and the potential for negative impacts arising from those dilemmas became a genuine possibility. The TLOD model is easy to use and implement, yet this governance measure remained unenforced and unchecked. This could suggest a culture of non-compliance with governance measures, or a poor attitude to risk management at the bank. The management of conduct risk was also a cause for concern at CBA.

Conduct risk is defined by the Australian Securities and Investments Commission (ASIC) as:

> The risk of inappropriate, unethical, or unlawful behaviour on the part of an organisation's management or employees. Such conduct can be caused deliberately or inadvertently caused by inadequacies in an organisation's practices, frameworks, or education programs. Conduct risk can have significant ramifications for an organisation, its shareholders, clients, customers, counter-parties and the financial services industry.[147]

Conflicts of interest are a typical example of conduct risk and require intense scrutiny in any financial institution. Until 2017 CBA applied a narrow definition of conduct risk, primarily focused on product development and distribution.[148] A broader and more appropriate definition was applied to a newly formed Conduct Risk Strategy.[149] It is unknown what impact the previous approach to conflict of interest-based conduct risk had on the bank's operations. The inquiry found areas that needed prioritisation at the bank, including an enhanced analysis and reporting of commercial property exposures against underwriting standards. More importantly, the introduction of a group-wide system for managing conflicts of interest[150] was required. This reflects the failing standards in this critical area of governance.

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[144] Ibid.
[145] Ibid.
[146] Ibid 34.
[147] Australian Securities and Investments Commission, *Market Supervision Update Issue 57 – Conduct Risk*, March 2015.
[148] Prudential Inquiry into Commonwealth Bank (n 10) 36.
[149] Ibid.
[150] Ibid 51.

The board of the bank is responsible for setting risk appetite through delegation to the CEO. The growing complexity of financial service conglomerates can lead to gaps in the risk framework and as such, these conglomerates should organise their risk governance structure around the TLOD model. The board, assisted by committees, oversee all three lines. The board and committees in CBA had struggled to effectively implement the simple system over many years and numerous attempts.[151] Their governance of non-financial risks also left significant room for improvement.[152] There was an unclear tone at the top and a lack of rigorous oversight and detailed reporting. There was a lack of accountability for risk management and remuneration at the Executive Committee level, which led to attitudinal weaknesses. Overconfidence from financial success meant risks were overlooked.[153] CBA's focus on financial risk was not met with an equivalent focus of operational, compliance and conduct risk. A 'tick box' approach to governance meant that risk frameworks were dangerously under-developed.[154] A clear culture demonstrated from the top can be a valuable tool in setting positive attitudes towards compliance and accountability. This could have mitigated the shortcomings in CBA's approach to risk, alongside solid governance at the bank.

A robust governance framework alone may not ensure a bank responds effectively and appropriately to the risks it faces. Formal mechanisms only go part way to effective risk management.[155] The culture of the bank is crucial in interpreting and applying the relevant laws, regulations, and standards. A dynamic definition of culture is:

> The accumulated shared learning of that group as it solves its problems of external adaptation and internal integration; which has worked well enough to be considered valid and, therefore, to be taught to new members as the correct way to perceive, think, feel, and behave in relation to those problems. This accumulated learning is a pattern or system of beliefs, values, and behavioural norms that come to be taken for granted as basic assumptions and eventually drop out of awareness.[156]

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[151] Ibid 28.
[152] Ibid 11.
[153] Ibid.
[154] Ibid 11.
[155] Ibid 81.
[156] Edgar Schein, *Culture and Leadership* (Wiley, 5th ed, 2017) 6.

Once dominant, culture can be difficult to change, and positive culture needs reinforcement. As the financial crisis demonstrated, culture can make or break a bank. Despite well-established prudential frameworks, poor practice bloomed in financial institutions, including CBA. The subsequent institutional failures and scandals demonstrated the weaknesses in banking culture across Australia.[157] CBA's dominant culture of complacency and reactivity was encouraged by a pervasive sense of 'chronic ease'[158] and remained unchallenged. This was corroborated by poor leadership, a skills gap, and a lack of reflection.

After analysis, it was found that CBA actively inhibited effective risk-management at the institution.[159] Widespread complacency at the bank numbed risk-management senses by allowing staff to accept substandard outcomes in the bank's day-to-day operation. It allowed for repeated avoidance of outcome ownership[160], and fostered a culture lacking in accountability. The inquiry found significant opportunities to address numerous weaknesses in CBA's culture, starting with altering the tone at the top.

Outcome ownership is not regularly discussed in terms of corporate culture and as such has no solid definition. This thesis suggests that ownership is a concept that embodies initiative, accountability, and ethical behaviour. For example, ownership is about taking the initiative to bring about positive results, not waiting to act, and acting in a way that shows you care about the outcome of your actions. It is about being accountable for those outcomes and showing others that they can trust you to do the right thing. Outcome ownership is an element of corporate culture that would benefit financial service conglomerates by promoting ethical behaviour and restoring some trust in the industry that has been eroded by the types of behaviours discussed in this section and those uncovered by the Hayne Royal Commission.

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[157] Prudential Inquiry into Commonwealth Bank (n 10) 81.
[158] Ibid.
[159] The Inquiry outlined nine cultural themes inhibiting sound risk-management, These are 'widespread complacency; reactivity rather than pre-emption regarding risk; uneven influence of the risk function; not fully 'walking the talk' when it comes to risk management; less tendency towards reflection, introspection and learning (from mistakes); collegial, high trust environment, leading to some over-confidence and over-collaboration; striving to balance empowerment with challenge, although not well executed; aiming to be a values-led institution, but an over-reliance on good intent; and self-perceived, but incomplete, focus on the customer': Ibid 83.
[160] Ibid 84.

The scope for improvement at the bank is vast, and their history of delivering against risk is chequered. The road to rectification is a long one, and the bank continues to pay for its poor past performances,[161] despite a focus on reform.[162]

B. Problems with the Board

Much like the Co-operative Bank in the UK, CBA's board played an intrinsic role in corporate governance failure. The APRA inquiry identified several problems with the board. These included inadequate oversight, lack of accountability, over-confidence, poor reporting standards, and an emphasis on process rather than outcomes.[163] The inquiry also found evidence of poor communication despite overlapping committee membership, overconfidence in the board, immature oversight of risk and a lack of candour from management.[164]

There was a lack of oversight from senior leadership. The inquiry stated that 'the Executive Committee was not an effective vehicle for addressing group-wide risks and issues. Its mandate did not include oversight of the group's risk profile, and its dynamics did not encourage collective accountability for group risk outcomes or constructive challenge of Committee members'.[165] This lack of oversight led to shortcomings in risk management and compliance. The inquiry criticised the bank's management of operational and compliance risks[166], its control environment[167], its compliance function, and its conduct risk profile and strategy.[168] The findings reflect the persistence of issues

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[161] Prudential Inquiry into Commonwealth Bank (n 10) 16; Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Interim Report, Volume 1, 297; 'CBA pleads guilty to criminal breaches', *Sydney Morning Herald* (online, 2 March 2020) <https://www.smh.com.au/business/banking-and-finance/cba-pleads-guilty-to-criminal-breaches-20191119-p53bw7.html>; 'Commonwealth Bank profits slump as compliance bill surges by $1bn', *The Guardian* (online, 2 March 2020) <https://www.theguardian.com/news/2019/aug/07/commonwealth-bank-profits-slump-compliance-bill-surges-by-1bn>.

[162] Why changing culture at the Commonwealth Bank is the new CEO's top priority (2 March 2020) Business Insider <https://www.businessinsider.com.au/why-changing-culture-at-the-commonwealth-bank-is-the-new-ceos-top-priority-2018-1>.

[163] There was 'insufficient rigour and urgency by the Board and its Committees around holding management to account in ensuring that risks were mitigated, and issues closed in a timely manner; gaps in reporting and metrics hampered the effectiveness of the Board and its Committees and; a heavy reliance on the authority of key individuals likely weakened the Committee construct and the benefits that it provides': Prudential Inquiry into Commonwealth Bank (n 10) 14.

[164] Ibid.

[165] Ibid 22.

[166] Ibid 103.

[167] Ibid.

[168] Ibid.

over time. The bank struggled to implement its Three Lines of Accountability model and risk management frameworks appropriately and consistently.[169]

Issue identification and escalation are a priority for financial service conglomerates as they face many potential risk implications. These institutions need to be able to identify and address issues early. 'This is critical for achieving business objectives and limiting damage from problems that inevitably arise'.[170] The inquiry found shortcomings in CBA's handling of issues escalated from staff, customers, and regulators.[171] They had difficulty resolving identified issues due to organisational complacency, low senior-level oversight, and weak project execution capabilities.[172]

Banks are heavily focused on financial objectives and are the cornerstone of a competitive financial system. Banks must balance short-term profits and long-term viability objectives while attempting to satisfy a myriad of stakeholders. In a large financial service conglomerate like CBA, trade-off decisions are made every day, balancing shareholder value, risk management and customer outcomes. The inquiry observed imbalances between these elements[173] as risk and compliance were only addressed once they became 'high rated' issues, and financial objectives were regularly prioritised above all else.[174]

Conclusively, APRA's inquiry into CBA found that continued financial success dulled its ability to comprehend risk.[175] The investigation also uncovered several prominent cultural themes, including a widespread sense of complacency[176], a reactive approach to risk, overly collegial and collaborative working environments and a lack of willingness to learn from mistakes.[177] In 2019, APRA called on all APRA-regulated institutions to undertake the same task, hoping to build on the lessons learned in the CBA inquiry.[178]

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[169] Ibid 27.
[170] Ibid 37.
[171] Ibid 44.
[172] Ibid 39.
[173] Ibid 47.
[174] Ibid.
[175] Ibid 3.
[176] Ibid 4.
[177] Ibid.
[178] Self-assessments of governance (n 12) 4.

The issues uncovered in CBA were present in other financial service conglomerates, evidenced by the responses to APRA's self-assessment of governance. Reported issues were classified as either governance, accountability, or culture. A need for more robust measures in all three areas was evident, but institutions largely rejected the suggestion that complacency towards risk was prevalent in their organisations.[179] Despite the varied responses received, some central themes were clear for the industry. These included non-financial risk management, misunderstood risk culture, and unclear, ineffectively enforced accountabilities.[180]

There is no single approach to culture, but there are some common elements. These include setting a clear tone at the top and role modelling good behaviours and attitudes toward financial and non-financial risk.[181] When teamed with other elements of good culture, these can promote effective risk management within a strong governance framework.[182]

The Co-operative Bank and Commonwealth Bank of Australia's failures demonstrate the importance of good governance and culture in financial service conglomerates. The Co-operative Bank's near miss with financial collapse, and the Prudential Inquiry into Commonwealth Bank demonstrate that governance and culture arrangements have fallen short of influencing the way it which these financial service conglomerates have acted. The emphasis on self-regulation through voluntary governance standards may have contributed to financial service conglomerates falling victim to their own success.

IV. COMMONWEALTH BANK AFTER THE HAYNE ROYAL COMMISSION

The timing of this thesis and the completion of the Hayne Royal Commission represents a unique opportunity to explore governance and culture in CBA before and after Commissioner Hayne's report. This will begin to help ascertain whether the Hayne Royal Commission has had any effect on Australian financial service conglomerates. A key question answered in Chapter Nine of this thesis.

[179] Ibid.
[180] Ibid.
[181] Prudential Inquiry into Commonwealth Bank (n 10) 95.
[182] Ibid.

Consumer trust in the Australian banking sector is at an all-time low considering a series of scandals in recent years, such as fees for no service[183], misleading regulators[184], charging dead people[185], and the sale of worthless, junk insurance policies.[186] Poor financial advice, dubious lending practices, mis-selling of financial products and compliance breaches have seriously undermined consumer confidence.[187] It was hoped that the Hayne Royal Commission might spur some changes in the Australian financial industry.

The Hayne Royal Commission has become a catalyst for change, according to the CEO of CBA, Matt Comyn.[188] The bank's share price outperformed the competition, and the new tech-based strategy made it the poster child for post-Hayne renovation and reconstruction.[189] CBA has documented its dedication to reform, and many changes are linked to the themes of this thesis, and the Hayne Royal Commission recommendations. For financial advice recipients, CBA has committed to an annual review of ongoing advice[190]; disclosure of lack of independence[191]; review of measures to improve quality of advice and reconsider exemptions to conflicted remuneration[192]; review life insurance commissions[193]; reporting compliance concerns[194]; zero tolerance towards unethical behaviour and misconduct[195]; and the implementation of a disciplinary system for

[183] Royal Commission Interim Report (n 161) 124.
[184] 'AMP could face criminal charges for misleading ASIC, banking inquiry hears', *The Guardian* (online, 4 February 2021) <https://www.theguardian.com/australia-news/2018/apr/27/amp-could-face-criminal-charges-for-misleading-asic-banking-inquiry-hears>.
[185] Royal Commission Interim Report (n 161) 121; 'Banks still charging dead people months after royal commission, Banking Code Compliance Committee finds', *ABC News* (online, 4 February 2021) <https://www.abc.net.au/news/2020-08-31/banks-still-charging-the-dead-bccc-finds-royal-commission/12614758>.
[186] Royal Commission Interim Report (n 161) 17; Watchdog oversee $160m in payouts from Australian banks that sold junk insurance', *The Guardian* (online, 4 February 2021) <https://www.theguardian.com/australia-news/2020/may/14/watchdog-oversees-160m-in-payouts-from-australian-banks-that-sold-junk-insurance>.
[187] Royal Commission (n 11) 120.
[188] 'Inside CBA's post-Hayne strategy', *Australian Financial Review* (online, 27 August 2020) <https://www.afr.com/chanticleer/inside-cba-s-post-hayne-strategy-20200203-p53x95>.
[189] 'Life after Hayne: CBA banks on technology', *Australian Financial Review* (online, 27 August 2020) <https://www.afr.com/companies/financial-services/life-after-hayne-cba-banks-on-technology-20200206-p53yjo>.
[190] Royal Commission (n 11) Recommendation 2.1, 25.
[191] Ibid 2.2.
[192] Ibid 2.3, 2.6.
[193] Ibid.5.
[194] Ibid 2.8.
[195] Ibid 2.9.

advisors amidst serious compliance or conduct concerns.[196] This shows that the Hayne Royal Commission may have impacted corporate governance measures in Australian financial service conglomerates, particularly their culture.

Post-Hayne, CBA is dedicated to strengthening and reforming culture and governance and improving supervision in line with APRA guidance.[197] CBA has committed to strengthening culture by lifting executive accountability through the Banking Executive Accountability Regime's[198] (BEAR) product accountability measures[199] and the extension of BEAR to its broader leadership team[200], going beyond minimum compliance. The reform of governance and culture is assisted by reviewing remuneration practice in line with Financial Stability Board guidance[201], reviewing remuneration standards and non-financial risk[202], remunerating front line staff[203] and implementing the Sedgwick recommendations[204] more broadly.[205]

In late 2019, CBA responded to the findings of the Hayne Royal Commission. Implementation of the recommendations was said to be 'crucial' for the bank in becoming a better, simpler bank.[206] They cited a AUD900 million investment to enhance their practices. A new internal Code of Conduct hoped to achieve significant cultural change, along with improved remuneration practices.[207] These changes demonstrate that governance and culture are at the heart of misconduct at this bank, and possibly other

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[196] Ibid 2.10.
[197] CBA Action on Royal Commission Recommendations (3 March 2021) Commonwealth Bank of Australia <https://www.commbank.com.au/guidance/newsroom/cba-action-on-royal-commission-recommendations-201911.html>.
[198] The BEAR, discussed in Chapter 2 VII, was introduced to was introduced to improve accountability and culture in Australian financial service conglomerates. It aimed to strengthen culture, governance and accountability by clarifying remuneration expectations and the higher level of accountability now expected of authorised deposit-taking institutions, their directors, and senior executives. The BEAR is soon to be superseded by the Financial Accountability Regime (FAR). The FAR extends the standards of conduct established by the BEAR to all APRA-regulated entities.
[199] Royal Commission (n 11) Recommendation 1.17.
[200] Ibid 3.9, 4.12 and 6.8.
[201] Ibid 5.1.
[202] Ibid 5.2, 5.3.
[203] Ibid 5.4.
[204] The Sedgwick Recommendations from the 2017 Retail Banking Remuneration Review by Stephen Sedgwick are that retail banks review their approach to tasking and managing staff performance, the way they structure variable rewards and incentives and the workplace experience of retail staff. The recommendations serve to promote ethical behaviour, clear and constant leadership and the removal of incentives based directly or solely on sales.
[205] Ibid 5.5.
[206] Commonwealth Bank of Australia (n 196).
[207] Ibid.

financial service conglomerates. The speed of these changes also suggests that culture and governance could have been improved before now. The published Commonwealth Bank Code of Conduct[208] does not feature the word 'culture', and the governance measures discussed are very limited.

CBA has made significant changes to simplify the structure of its business during the writing of this thesis. They have sold their insurance arms and their global asset management business, and are committed to exiting their aligned financial advice, wealth management and mortgage broking businesses.[209] This allows the bank to focus on core banking business and meeting customer expectations. This represents an acknowledgement that their diversified operations have conflicted with their ability to perform their core functions. It also appears that a range of aggravating factors, such as culture, governance, and remuneration, have contributed to misconduct at the bank.

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[208] Commonwealth Bank Code of Conduct 2020 (8 August 2021) Commonwealth Bank of Australia <https://www.commbank.com.au/content/dam/commbank-assets/about-us/2018-09/CBA-code-of-conduct.pdf>.
[209] Commonwealth Bank of Australia (n 17).

Chapter 8: Corporate Governance Changes After the Global Financial Crisis

This chapter analyses corporate governance reform in the UK and Australia to assess the key governance changes after the global financial crisis. The changes discussed align with the themes raised in this thesis and are predominantly cultural. This comparison serves to further understand the role and importance of culture and governance in financial service conglomerates in the management of ethical dilemmas. It goes further to understand if the lessons from the global financial crisis have had a positive impact on governance measures in these conglomerates. It does this by:

- Comparing versions of the Corporate Governance Code in the UK[1] before and after the global financial crisis; and
- Comparing versions of the Corporate Governance Principles and Recommendations in Australia[2] before and after the global financial crisis.

The global financial crisis harmed financial markets, and everything intertwined with them. The crisis revealed substantive risk-taking, regulatory weakness and unethical behaviour by financial service conglomerates. Despite strategies to increase accountability and legitimacy, the rules overwhelmingly failed.[3] Global finance and soft law, unchecked for decades, proved weak in the face of international financial institutions, and led to the downfall of the economy.[4]

Failings of corporate governance received less attention in the wake of the global financial crisis than the failings in organisational culture and compensation arrangements.[5] The crisis was seen as being precipitated by compensation practices and culture problems, but these days it is recovering more of the attention it deserves.[6]

[1] Financial Reporting Council, The UK Corporate Governance Code, July 2018.
[2] ASX Corporate Governance Council, Corporate Governance Principles and Recommendations, 4th ed February 2019.
[3] Michael Barr and Geoffrey Miller, 'Global Administrative Law: The View from Basel' (2006) 17(1) *The European Journal of International Law* 15, 21.
[4] Michael Barr, 'Who's in Charge of Global Finance?' (2014) 45(4) *Georgetown Journal of International Law* 972, 972.
[5] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Final Report, Volume 1, 394.
[6] Ibid.

The corporate governance requirements in banks and financial institutions have always been different from other industries[7], and the years following the crisis have been characterised by an increase in financial regulation and tightening supervision. Emphasis has been placed on the regulatory oversight of governance and the accompanying supervision and enforcement.[8] The financial crisis places complex financial conglomerates under the spotlight, as a problem area of the industry.[9]

The United States has been a focus of the debate, as many believe poor corporate governance led to the failure of multiple financial institutions across the globe[10], although this claim remains hotly contested.[11] The conversation was stimulated in Europe in the wake of the crisis[12] as policymakers on both sides of the Atlantic recognised the inevitability of financial reforms and the need to consider the adequacy of the existing corporate governance framework.[13] The European Commission concluded that the 'non-binding nature of a substantial part of the corporate governance framework, based essentially on voluntary codes of conduct, did not facilitate the effective implementation of sound corporate governance practices by institutions'.[14]

Governance has become important in the restructuring of financial supervision. Large, complex financial institutions are plagued by problems[15] including their complexity, transparency, culture, and regulatory challenges. These problems contribute to the ethical issues that have become more common in these conglomerates. Effective culture and corporate governance in these institutions may help manage these dilemmas more effectively.

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[7] Luc Laeven and Irving Levine, 'Bank Governance, Regulation and Risk Taking' (2009) 93 *Journal of Financial Economics* 259, 259.
[8] John Armour and Jeffrey Gordon, 'Systemic Harms and Shareholder Value' (2014) 6 *Journal of Legal Analysis* 35, 64.
[9] Henry Paulson, *On the Brink: Inside the Race to Stop the Collapse of the Global Financial System* (Business Plus, 2010) 74.
[10] William Sun et al (eds), *Corporate Governance and the Global Financial Crisis: International Perspectives* (Cambridge University Press, 2011) 29.
[11] *See generally* Brian Cheffins, 'Did Corporate Governance Fail during the 2008 Stock Market Meltdown – The Case of the S&P 500' (2009) 65(1) *Business Lawyer* 2.
[12] *See generally* Peter Mulbert, 'Corporate Governance of Banks' (2009) 10 *European Business Organization Law Review* 411.
[13] *See generally* Edyta Dorenbos, 'Corporate Governance of Banks: Is More Board Independence the Solution' (2013) 2013(2) *Dovenschmidt Quarterly* 46.
[14] Ibid 46.
[15] Barr (n 4).

I. CORPORATE GOVERNANCE CHANGES FOR FINANCIAL SERVICE CONGLOMERATES IN THE UK

The UK admitted they would have experienced the crisis without Lehman Brothers' fall because they were already failing to enforce their regulatory powers.[16] After one of the worst financial crises in history, the UK's financial regulation approach has been more of the same; higher, complex capital ratios, liquidity ratios, and low leverage ratios. The Walker Report came in the wake of the global financial crisis and recommended changes to the governance of big financial institutions. Unfortunately, the report was a 'crashing disappointment', with Walker missing his chance to rewrite the rulebook, and opting for minor changes instead.[17] Unsurprisingly the 39 recommendations were well-received by the banks.[18] There is some similar sentiment in the Hayne Royal Commission's wake; Hayne missed his chance to rewrite the rulebook on financial service conglomerates, especially financial stability.[19]

One argument that solidifies corporate governance's commercial importance is that corporate governance laws affected the trajectory of the crisis in the UK. Understanding this relationship clarifies the role of corporate governance in financial stability. It has been said that corporate governance functioned 'tolerably well' in the financial crisis.[20] It has also been said that it must be rethought from the ground up.[21] To draw a link between corporate governance and economic outcome, one must comprehend how behaviour affects instability, and how governance affects that behaviour.

[16] Gerard Caprio Jr, 'Financial Regulation After the Crisis: How Did We Get Here, and How Do We Get Out?' (2013) Special Paper 226 *LSE Financial Markets Group Special Paper Series* 15.
[17] 'Walker report a 'crashing disappointment'', *The Guardian* (online, 2 July 2020) <https://www.theguardian.com/business/2009/nov/26/walker-report-banking-comment>.
[18] UK banks respond to the Walker Review (2 July 2020) CMS Law Firm <https://www.cms-lawnow.com/ealerts/2018/12/uk-banks-respond-to-the-walker-review-into-the-complaints-and-adr-landscape-for-the-uks-sme-market?cc_lang=en>.
[19] Steve Kourabas, 'Prudential Regulation in Australia and the Banking Royal Commission: A Missed Opportunity for Reform?' (2020) 31(1) *Journal of Banking and Finance Law and Practice* 1, 11 (Monash University Faculty of Law Legal Studies Research Paper No 3613506).
[20] Brian Cheffins, 'Did Corporate Governance Fail During the 2008 Stock Market Meltdown? The Case of the S&P 500' (2009) 65(1) *Business Lawyer* 1, 3.
[21] Allen Hutchinson, 'Hurly-Berle: Corporate Governance, Commercial Profits, and Democratic Deficits' (2011) 34(4) *Seattle University Law Review* 1219, 1219.

In the UK, the Corporate Governance Code sets the standard for board composition and development, remuneration, shareholder relations, accountability, and audit in listed companies.[22] The Code is published by the Financial Reporting Council (FRC). The FRC promotes integrity and transparency in business. It does this by setting the UK Corporate Governance and Stewardship Codes and UK standards for accounting and actuarial work; monitoring and promoting corporate reporting quality; and operating independent enforcement arrangements for accountants and actuaries.[23]

The Cadbury Committee introduced the initial version of the Code in 1992, which defined corporate governance as 'the system by which companies are directed and controlled'.[24] There have been numerous revisions over the years, but the debate about the extent of the framework has intensified considering financial crises and high-profile abuse. Ultimately, a wide range of stakeholders has paid the price for these instances of poor governance. This section details the changes made after the financial crisis in the UK. At the heart of The Code are principles for different areas of governance, much like the Australian equivalent. Achieving good corporate governance hinges on applying these principles. Regardless of the contents, efficacy will always be limited when such things are voluntary. The elements of The Code that are important to the themes of this thesis will be extracted.

A. Board Leadership and Company Purpose

Before the financial crisis, UK corporate governance focused on collectively effective and responsible directorship. Directors were to act prudently, in the company's interests, manage risk and meet objectives, mirroring their statutory obligations. Non-executive directors were championed as monitors for reasonable remuneration.[25] The crisis taught us that directors' duties were not sufficiently observed, and the role of directors in the stability of financial service institutions was underestimated.

Post-crisis governance changes noted that a successful company is guided by an entrepreneurial board, charged with promoting its success, generating value, and

[22] The UK Corporate Governance Code 2018 (n 1).
[23] Ibid Preface.
[24] Report of the Committee on the Financial Aspects of Corporate Governance, 1992, 2.5
[25] Financial Reporting Council, The Combined Code on Corporate Governance, June 2006, 3.

contributing to society.[26] The board should establish a purpose, the values, culture and strategy of a company and act with integrity, promoting company culture by example.[27] Boards should ensure necessary resources to achieve goals and establish a prudent and effective control framework.[28] This should lead to effective risk management. The board should monitor and assess culture to ensure that corrective action is taken when behaviour is misaligned with its purpose, values, and strategy.[29] The crisis demonstrated that this did not happen. Culture is clearly a significant factor influencing ethical dilemma abuse in financial service conglomerates. Post-crisis governance reforms have linked culture to effective risk management. Culture should not form part of the voluntary principles, but rather be mandated to ensure that financial service conglomerates act appropriately and appreciate the role culture can play in resolving ethical predicaments.

The board should be aware of shareholder and key stakeholder views and explain how their interests have been considered in decision-making.[30] This is essential to financial service conglomerates. The board should take action to identify and manage conflicts of interest, including those arising from significant shareholdings and ensure that the influence of third parties does not compromise their independent judgement. Any concerns regarding this should be recorded in the minutes of meetings.[31] These measures increase directors' accountability, something that the implementation of BEAR[32] in Australia is looking to achieve.

Both history and the most recent crisis taught us that the cost of a failing bank is high.[33] The previous chapter demonstrated how poor governance and culture almost brought the Co-operative Bank to insolvency. The changes in The Code reflect the importance of culture in the resolution of ethical quandaries such as conflicts of interest, misconduct, and ethical behaviour generally. The previous requirements were general and not

[26] The UK Corporate Governance Code 2018 (n 1) 4.
[27] Ibid.
[28] Ibid.
[29] Ibid.
[30] The Companies (Miscellaneous Reporting) Regulations 2018 (UK) require directors to explain how they have had regard to various matters in performing their duty to promote the success of the company in section 172 of the *Companies Act 2006*. The Financial Reporting Council's Guidance on the Strategic Report supports reporting on the legislative requirement.
[31] The UK Corporate Governance Code 2018 (n 1) 4-5.
[32] Banking Executive Accountability Regime (4 March 2021) APRA <https://www.apra.gov.au/banking-executive-accountability-regime>.
[33] Ari Kang et al, 'The Costs of Closing Failed Banks: A Structural Estimation of Regulatory Incentives' (2015) 28(4) *The Review of Financial Studies* 1060, 1061.

particularly onerous. Governance should be tailored to financial service conglomerates due to the high frequency of ethical dilemmas and systemic importance.

B. Division of Responsibilities

Pre-crisis corporate governance understood the need for a clear division of responsibilities between the running of the board and the running of the company, and that no one person should have unfettered powers of decision.[34] It was well understood that the potential for self-interest is a threat if one person can act without accountability or fear of reprimand. Changes to The Code recognise that this was not enough to maintain board integrity and that more board independence was required. Competing directorships were warned against both before[35] and after the crisis.[36]

The chair of the board is responsible for steering the company and should be independent.[37] They should demonstrate objective judgement, promote a culture of openness, and ensure a constructive relationship between directors. The board should have a mix of executive and non-executive directors to ensure no one group dominates decision making.[38] The focus on a more significant proportion of non-executive directors could be an attempt to ensure ethical predicaments such as self-interested transactions are dealt with appropriately. Their ability to do this effectively hinges on the amount of time they can dedicate to learning the inner workings of the board and the greater organisation.[39] This is why non-executives are recommended not to take on more than one significant non-executive appointment.[40]

The board should identify each independent, non-executive director and any factors that may impair their independence.[41] At least half of the board should comprise independent,

[34] The Combined Code (n 25) 4.
[35] Ibid 6.
[36] The UK Corporate Governance Code 2018 (n 1) 7.
[37] Ibid.
[38] Ibid.
[39] Niamh Brennan et al, 'Accountability processes in boardrooms' (2016) 29(1) *Accounting, Auditing and Accountability* 135, 141.
[40] The UK Corporate Governance Code 2018 (n 1) 7.
[41] Circumstances than could affect a non-executive directors ability to remain independent include, but are not limited to; 'is or has been an employee of the company or group within the last five years; has, or has had within the last three years, a material business relationship with the company, either directly or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company; has received or receives additional remuneration from the company apart from a director's fee,

non-executive directors.[42] One of these non-executive directors should be appointed to a senior role and serve as an intermediary.[43] Non-executive members should engage in the selection and removal of executive directors. There should be a thorough level of scrutiny employed to ensure executive directors comply with performance objectives.[44] Full-time executive directors should not take on more than one non-executive director role in a FTSE 100 company or another significant appointment.[45] This is not strictly enforceable as The Code is only guidance. The recommendations tackle conflicting directorships and interests in other companies. These measures break up the potential back-scratching and cronyism that could form without independent directors' presence. This represents the knowledge that misconduct, and unethical behaviour can originate at board level.

The financial crisis taught us that board composition should ensure no one *group* has unfettered power, rather than no one *person* as the Combined Code stated.[46] This demonstrates that ethical dilemmas such as conflicts of interest were allowed by entire boards in some instances, and entire boards could be untrustworthy.

C. *Composition, Success and Evaluation*

In 2006 board appointments were formal, rigorous, and transparent. Appointments ensured enough time could be devoted to the job, and the board had an appropriate balance of skills and experience.[47] These principles were simplistic and asked little of directors. Changes to The Code promotes diversity, succession, and response to weaknesses in the board.

The Code states that board appointments should be subject to a formal, transparent, and rigorous procedure alongside an effective succession plan.[48] Appointments should be

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participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme; has close family ties with any of the company's advisers, directors or senior employees; holds cross-directorships or has significant links with other directors through involvement in other companies or bodies; represents a significant shareholder; or has served on the board for more than nine years from the date of their first appointment': The UK Corporate Governance Code 2018 (n 1) 6-7.

[42] Ibid 7.

[43] Ibid 6.

[44] Ibid 7.

[45] Ibid 6-7.

[46] The Combined Code (n 25) 4.

[47] Ibid 7.

[48] The UK Corporate Governance Code 2018 (n 1) 8.

based on merit and objective criteria[49] and promote gender, ethnic and social diversity.[50] The board should comprise a combination of skills, experience and be refreshed often. An annual evaluation should consider its composition and diversity and assess how effectively members work towards objectives on a group and individual level.[51]

All directors should be subject to annual re-election and the reasons for doing so should be recorded and conducive to the company's long-term success.[52] The chair should serve no more than nine years in the role unless an extension is required to facilitate the board's effective succession planning and diversification. Non-executive directors should be found using open advertising or external search consultancy to ensure a diverse applicant base.[53] This approach may well promote the independence that non-executive directors are required to have.

The board's performance should be regularly assessed internally and externally. This should take place every three years in FTSE 350 companies.[54] Full and open disclosure about this process should be provided in the company's annual report. The chair is ideal for identifying strengths and weaknesses amongst the board and taking appropriate action to manage these.[55]

The financial crisis demonstrated that the board should be as diverse as possible. A diverse board might run the business more effectively and minimise ethical problems and corporate misconduct. There is a link between long-term goals and succession planning at the board level. This suggests financial service conglomerates may have breached good governance principles pursuing short-term profits. There is a new onus on communicating accurate information about the company to ensure outsiders are not misled, and any instability can be acted on quickly.

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[49] Which protect against discrimination for those protected under *Equalities Act 2010* (UK) c 15.
[50] The UK Corporate Governance Code 2018 (n 1) 8.
[51] Ibid 8-9.
[52] Ibid 8.
[53] Ibid.
[54] Ibid 9.
[55] 'The definition of 'senior management' for this purpose should be the executive committee or the first layer of management below board level, including the company secretary': The Combined Code (n 25) 14.

D. Audit, Risk and Internal Control

Directors pre-crisis were to establish transparent arrangements for applying financial reporting and maintain an appropriate relationship with auditors. They also had to keep an internal control system to safeguard assets and shareholders' investments.[56] There was no emphasis on risk or risk management, which is entirely inappropriate for financial service conglomerates.

The Code now asks the board to establish formal and transparent policies to ensure that auditing is undertaken with a degree of integrity and independence.[57] Any reflection of the company's position should be fair, honest, and presented in an understandable format. The board should also explore the risks the company is willing to take to achieve long-term strategic objectives.[58] This reflects the failings of auditors in the run up to the financial crisis. KPMG was accused of 'reckless and grossly negligent audits', and a 'cosy cabal which cocoons management and auditors'. 'Auditors have got away with murder', to the point where the European Commission began to question the 'conflicts of interests and seemingly cosy self-regulatory structures that govern what is a pivotal financial function'.[59] The functions intended to protect the public failed, leaving financial service conglomerates to make risky decisions to pursue short-term profits at the expense of financial stability.

An audit committee of executive and non-executive members should be formed to ensure auditing integrity. In larger companies such as financial service conglomerates, a minimum of three members is suggested. One member should have relevant financial experience, and the committee should be competent in the banking sector.[60] The committee is primarily charged with monitoring the integrity of financial statements; advising on the accuracy of financial statements; reviewing audit functions; developing

[56] Ibid.
[57] 'The board's responsibility to present a fair, balanced and understandable assessment extends to interim and other price-sensitive public records and reports to regulators, as well as to information required to be presented by statutory instruments': The UK Corporate Governance Code 2018 (n 1) 10.
[58] Ibid 10-12.
[59] 'Auditors face being called to account for their role in the global financial crisis', *The Guardian* (online, 19 January 2021) <https://www.theguardian.com/business/2009/oct/25/auditors-role-financial-crisis>.
[60] The UK Corporate Governance Code 2018 (n 1) 10-12.

appropriate auditing policy in line with UK requirements; and reporting how responsibilities have been discharged.[61]

Directors should state their role in producing financial statements and attest they are fair, balanced, and understandable. They should also demonstrate how independence and integrity have been maintained. The information is necessary for shareholders to assess the company's position, performance, and strategy[62], and a valuable tool for intervention in times of instability.

The board should assess risks[63] to the institution and describe the process for management and mitigation. The risk management controls should be monitored to assess efficacy, and any material uncertainties in the company's ability to remain a going concern should be disclosed often.[64] This measure may have been introduced considering recent instances, such as the Co-operative Bank, where insolvency remained undetected until deals began to fall apart.

The biggest lesson from the financial crisis is that financial and non-financial risk is a real threat to the system's integrity. The management and mitigation of risk is now a key role for the board, and accountable persons should ensure independence and integrity in audits. The audit procedure in financial service conglomerates failed. The conflicts of interest between a conglomerate and its auditors must be removed. KPMG believed that HBOS had no corporate governance concerns, but the conglomerate collapsed just seven months later[65] and cost the taxpayer £28 billion in a bailout.[66] This cannot be repeated.

[61] Ibid 10-12.
[62] Ibid.
[63] 'Principal risks should include, but are not necessarily limited to, those that could result in events or circumstances that might threaten the company's business model, future performance, solvency or liquidity and reputation. In deciding which risks are principal risks companies should consider the potential impact and probability of the related events or circumstances, and the timescale over which they may occur': The UK Corporate Governance Code 2018 (n 1) 12.
[64] Ibid 10-12.
[65] The FRC's enquiries and investigation of KPMG's 2007 and 2008 audits of HBOS, November 2017, 4.
[66] 'KPMG faces investigation over HBOS audits in UK', *The Irish Times* (online, 15 March 2020) <https://www.irishtimes.com/business/financial-services/kpmg-faces-investigation-over-hbos-audits-in-uk-1.1355866>.

E. Remuneration

Pre-financial crisis, remuneration was not scrutinised as it is now. Levels of remuneration were sufficient to motivate directors, but companies should avoid paying more than necessary.[67] A significant proportion of director's remuneration was to be linked to corporate and personal performance.[68] The global financial crisis showed that pay arrangements substantially incentivised imprudent and excessive risk-taking. Bebchuk and Fried warned about this in their book Pay Without Performance[69], yet no serious action was taken. The level of pay, the way it is set, and its complexity became significant after the crisis.

Post-crisis governance shows remuneration has been a systemic problem for financial service conglomerates. The Code suggests that executive remuneration policies be designed to align with the institution's purpose and values and promote the company's long-term success.[70] This can be particularly tricky as the best talent demand the most significant pay checks. No director should decide their own remuneration. All directors should exercise independent judgement when authorising remuneration based on personal and company performance.[71] These suggestions attempt to steer away from directors approving each other's excessive remuneration.

Similar to auditing, the board should establish a committee of independent, non-executive directors.[72] The committee should determine the policy for setting executive director remuneration and setting remuneration for the chair, executive directors, and senior management.[73] All executive director remuneration should be in line with company values and culture.[74] The level of remuneration should reflect the time and commitment invested in the role.[75] Any remuneration consultant should exercise integrity and independence, and their decisions should be detailed in the company's annual report.[76]

[67] The Combined Code (n 25) 11.
[68] Ibid.
[69] Lucian Bebchuck and Jesse Fried, *Pay Without Performance: The Unfilled Promise of Executive Compensation* (Harvard, 2014).
[70] The UK Corporate Governance Code 2018 (n 1) 13-15.
[71] Ibid.
[72] Ibid.
[73] Ibid.
[74] Ibid.
[75] Ibid.
[76] Ibid 13-15.

Remuneration schemes should align with shareholder interests. Remuneration committees should use discretion to override formulaic outcomes and allow the recovery or withholding of sums or share awards.[77] Only basic salary should be pensionable for executive directors and be in line with industry benchmarks. The committee should ensure that directors are not rewarded for poor performance.[78] Directors should consider the associated risk, alignment to culture, clarity, appropriateness, and predictability when setting pay.[79] This shows the new focus on culture in financial service conglomerates as a tool for mitigating improper ethical dilemma resolution.

The crisis demonstrated that remuneration was a catalyst for conflicts of interest and excessive risk-taking, undermining the financial system's integrity. The Code reflects the lessons learned about director's remuneration, but no single body or organisation is responsible for reforming director's pay. Various sources have contributed to reform[80], but this may not be the most effective method for a substantial overhaul. Conflicted remuneration will be discussed in the next chapter, as it has been a significant factor in the misconduct in Australian financial service conglomerates. This thesis believes that conflicted remuneration arrangements have encouraged unethical behaviour in financial service conglomerates.

II. CORPORATE GOVERNANCE CHANGES FOR FINANCIAL SERVICE CONGLOMERATES IN AUSTRALIA

Australia has focussed on financial stability and prudential regulation since the global financial crisis. This has been more evolution than revolution, as Australia did not replicate other jurisdictions' significant changes. The Australian regulatory landscape changed in four primary ways: 'enhancing oversight and supervision; improving crisis management and resolution arrangements; strengthening the resilience of core prudentially regulated institutions; and increasing the transparency and resilience of

[77] Ibid.
[78] Ibid 13-15.
[79] Ibid 14-15.
[80] Tim Edmonds and Phil Abraham, *Banking executives' remuneration in the UK,* House of Commons Briefing Paper Number 06204, June 2017, 3.

major wholesale markets and the shadow banking sector'.[81] This indicates that shortcomings in these areas exacerbated crisis effects. The Hayne Royal Commission has shown that reform on issues such as integrity, trust and transparency need to be more than rhetoric.[82] Still, stringent regulation is at odds with financial innovation.[83]

Financial institutions must comply with a swathe of regulation aimed at reducing systemic risk and protecting consumers, namely depositors.[84] The Hayne Royal Commission's revelations are yet another example of what has gone wrong in so many countries. When it comes to financial service conglomerates, you can only trust some people, some of the time.[85] Whether they are capable of self-regulation was a question posed at the time of the global financial crisis[86], and did not serve as a warning for Australia. The same question still exists today in the wake of the Hayne Royal Commission.[87]

The Hayne Royal Commission recognised that organisational culture is critical in shaping behaviour.[88] It was critical of corporate governance standards in financial institutions[89], and the recommendations focus on internal governance reforms.

Internal governance refers to the processes which ensure the board's objectives are met. These include remuneration, risk management, performance indicators and collective accountability. External governance is concerned with the ownership-control relationship.[90] The outcomes of the Hayne Royal Commission underline the role of governance in assuring best practices in the industry.[91] The document ensuring best

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[81] Ian Beckett, 'Financial Regulation in Australia since the GFC' (2012) 3 *JASSA The Finsia Journal of Applied Finance* 20, 20.
[82] Royal Commission (n 5) 265.
[83] Michael Drew, 'The Future of Financial Regulation: Lessons from the Global Financial Crisis' (2010) 19(1) *Griffith Law Review* 1, 5.
[84] Joao Santos, 'Bank capital regulation in contemporary banking theory' (2001) 10(2) *Financial Markets, Institutions and Instruments* 41, 46.
[85] 'Flaws of self-regulation', *Sydney Morning Herald* (online, 25 October 2019) <https://www.smh.com.au/business/banking-and-finance/flaws-of-self-regulation-trust-some-of-the-people-some-of-the-time-20180504-p4zdda.html>.
[86] 'Can banks self-regulate?', *New York Times* (online, 25 October 2019) <https://www.nytimes.com/2008/01/25/business/worldbusiness/25iht-wbdavos.1.9497014.html>.
[87] Royal Commission (n 5) 105.
[88] Ibid 341.
[89] Ibid 395.
[90] Kevin Davis, 'The Hayne Royal Commission and financial sector misbehaviour: Lasting change or temporary fix?' (2019) 30(2) *The Economic and Labour Relations Review* 200, 203.
[91] Royal Commission (n 5) 202.

practices in Australia is the Corporate Governance Principles and Recommendations (Principles and Recommendations).[92]

The Principles and Recommendations are not mandatory, and do not seek to prescribe a governance framework for corporations.[93] With that being said, any decision not to adopt a Recommendations must be explained. The 'if not, why not' approach is a fundamental aspect of the Recommendations.[94] They apply to every entity listed on the ASX, all of whom are under disclosure obligation to disclose the details of their corporate governance regime.[95] They were initially introduced in 2003 and have undergone several revisions leading to the latest version of February 2019. The latest revision was spurred by the emergence of issues surrounding culture, values, and trust in the financial sector,[96] highlighted further by the Hayne Royal Commission. The Principles and Recommendations utilise the term 'corporate governance' to describe the 'framework of rules, relationships, systems and processes within and by which authority is exercised and controlled within corporations. It encompasses the mechanisms by which companies, and those in control, are held to account'.[97] Corporate governance is essential in promoting investor confidence.[98] Investor confidence is more crucial now than ever in financial service conglomerates, as trust is at an all-time low. Good governance could be a method to restore trust in the Australian financial system.

The style of governance an institution adopts is a matter for the directors. Directors are bound to exercise due care and diligence[99] in their roles, and appropriate governance arrangements help discharge these duties. As with the UK, if a board decides not to adopt a recommendation, it must explain under the 'if not, why not' approach. This element is fundamental as it ensures the market receives an appropriate level of information. This information is used to make informed decisions about the institution's nature in times of instability or uncertainty. There are nine Principles, some of which are strikingly like the

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[92] Principles and Recommendations (n 2).
[93] Ibid 4.
[94] Ibid.
[95] Ibid.
[96] Ibid 1.
[97] Justice Owen in the HIH Royal Commission, The Failure of HIH Insurance Volume 1: A Corporate Collapse and Its Lessons, Commonwealth of Australia, April 2003 xxxiv.
[98] Principles and Recommendations (n 2) 1.
[99] Sections 180 (in the case of a listed company) and 601FD(1)(b) (in the case of a listed trust) of the *Corporations Act*.

UK Code. As with the UK, only sections relevant to managing potential ethical dilemmas such as conflicts of interest and related party transactions have been selected for analysis.

A. Management and Oversight

The 2003 version of the Principles and Recommendations was a simpler document. Governance aimed to lay solid foundations for management and oversight by recognising and publishing board and management's roles and responsibilities.[100] Any deviation from best practice was to be explained.[101] The purpose of this role was to outline responsibilities and accountabilities and not much more. The current document provides a more stringent framework.

The current version states that a listed entity should delineate its board and management roles and responsibilities and regularly review performance. Roles and responsibilities should be disclosed in a charter.[102] Generally, the executive will implement strategic directives, promoting culture, values, and codes of conduct.[103] The executive team will also be responsible for providing the board with accurate and timely information to enable the board to perform its duties.[104] This extends to legal and regulatory compliance and not just financial information.[105] The board will generally be responsible for:

- demonstrating leadership;
- defining the purpose and setting strategic objectives;
- approving the entity's values and code of conduct to underpin the desired culture;
- appointing the chair and the deputy chair and/or the 'senior independent director';
- appointing and replacing the CEO;
- appointing and replacing other senior executives and the company secretary;
- overseeing management's implementation of strategic objectives;
- instilling the entity's values and performance generally; and
- approving operating budgets and major capital expenditure.[106]

[100] ASX Corporate Governance Council, Principles of Good Corporate Governance and Best Practice Recommendations, 2nd ed March 2003, 17.
[101] Ibid.
[102] Principles and Recommendations (n 2) 7.
[103] Ibid 6.
[104] Ibid 6.
[105] Ibid 6.
[106] Ibid 7.

The board should undertake appropriate checks[107] before appointing or recommending directors. The board should also ensure they provide relevant information on directors for voting purposes. This information includes biographical details, relevant qualifications, experience, and other material directorships.[108] Any potential conflict of interest regarding their capacity as a director or their independence should be explored and disclosed.[109] If standing for re-election, the board should assess their independence and state if they approve of re-election. Directors should agree to resign if they do not meet independence and conflict of interest requirements, as they can generally only be removed by shareholder resolution.[110] Australian institutions should have a diversity policy with measurable objectives for achieving diversity across the board and workplace in line with relevant legislation.[111] Diversity has been linked to success in business due to a better understanding of the marketplace and more innovation[112], but it may also reduce comradery and back-scratching on boards, tackling potential unethical behaviour.

Policies and procedures for assessing and reviewing the performance of the board and individual directors should be developed.[113] They should disclose the process of evaluation at least once every reporting period.[114] These measures should help ensure no one person or class of people dominates decision-making, aiding in the correct management of ethical predicaments faced by directors and the board.

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[107] 'Appropriate checks would usually include checks as to the person's character, experience, education, criminal record, and bankruptcy history'. Listed entities may consult Australian Standard AS 4811-2006 *Employment screening* to understand the types of checks that may be undertaken and how best to undertake them: Principles and Recommendations (n 2) 7.
[108] Ibid 7.
[109] Ibid.
[110] *Corporations Act 2001* (Cth) s 203E.
[111] 'The Workplace Gender Equality Act 2012 applies to non-public sector employers with 100 or more employees in Australia. The Act requires such employers to make annual filings with the Workplace Gender Equality Agency ("WGEA") disclosing their "Gender Equality Indicators". These reports are filed annually in respect of the 12-month period ending 31 March. For an entity which chooses to follow recommendation 1.5(c)(3)(B), publishing the URL of the webpage on the WGEA website where its latest "Gender Equality Indicators" are available will be taken to meet that recommendation': Principles and Recommendations (n 2) 9.
[112] David Carter et al, 'Corporate Governance, Board Diversity, and Firm Value' (2003) 38 *The Financial Review* 33, 36.
[113] Principles and Recommendations (n 2) 11.
[114] Ibid.

B. Board Structure

In the 2003 Principles and Recommendations, board structure aimed to add value through effective composition, size, and commitment to discharging duties.[115] The board was to understand and deal with the company's issues by reviewing and challenging management's performance.[116] The current version still champions an independent director majority to ensure the integrity of the corporation. This can be problematic in financial service conglomerates as independent directors may not have the necessary skills and experience required in this industry.

According to the latest version, the board should be of an appropriate size and have the skills, commitment, and knowledge to discharge its duties effectively.[117] The board should have a nomination committee with at least three members, most of whom are independent directors, chaired by an independent director.[118] The board should disclose the processes to address succession issues and ensure it has the appropriate balance of skills, knowledge, experience, independence, and diversity to effectively discharge its duties and responsibilities.[119] This diversity is key in ensuring rogue directors do not exploit ethical dilemmas.

The entity should have a skills matrix setting out the skills that the board has or is looking to achieve, and disclose the names of independent directors.[120] If a director has an interest elsewhere, the board should agree it does not compromise their independence.[121] This is important for potential conflicting interests in financial service conglomerates, as directors may have roles in other entities or competitors. The protocol should exist to induct new directors and periodically review any need for existing directors to undertake professional development needed to perform their role as directors effectively.[122]

[115] Principles of Good Corporate Governance (n 100) 19.
[116] Ibid.
[117] Principles and Recommendations (n 2) 12.
[118] Ibid.
[119] Ibid 12-13.
[120] Ibid 13.
[121] Ibid.
[122] Ibid 15.

C. Culture

Culture was not mentioned in the 2003 version of the Principles and Recommendations. The inclusion in recent years may reflect the effect that poor culture can have in corporations, particularly in financial service conglomerates, where misconduct has shifted focus towards organisational culture. Poor culture has proved to be an aggravating factor for exploiting ethical dilemmas, particularly opportunistic and self-interested behaviour.[123] It seems logical that an emphasis on appropriate culture may aid the management of such dilemmas in these conglomerates.

Culture has been recognised more recently as a problem in Australia's financial sector and is linked to public trust in the system. The House of Representatives Standing Committee on Economics stated in 2016 that 'the culture of Australia's financial sector also needs to be reformed. While significant changes have been announced that will better protect consumers, not enough has been done to force banks' senior leaders to change their behaviour. When consumers are continually let down, senior executives should go'.[124] 'There are certainly individuals… who have had some consequences relating to remuneration… we have not had individuals terminated'.[125] This has undermined public trust in the Australian financial system. Governance principles in Australia now reflect this knowledge.

The most recent version of the Principles and Recommendations emphasises culture, stating a listed entity should instil and continually reinforce a culture across the organisation of acting lawfully, ethically, and responsibly[126] and articulate and disclose its values.[127] It should also create and disclose a code of conduct for directors and senior executives, and ensure a committee exists to investigate material breaches of that code.[128] The institution should also have a whistle-blower policy, an anti-bribery and corruption

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[123] Xiaoding Liu, 'Corruption culture and corporate misconduct' (2016) 122 *Journal of Financial Economics* 307, 308.
[124] House of Representatives Standing Committee on Economics, Review of the Four Major Banks: First Report, November 2016, iv.
[125] Mr Ian Narev, CEO of CBA, Parliamentary Debates, Senate Official Hansard, 4 October 2016, 16.
[126] Managing Culture: A good practice guide, 1st ed 2017 - Institute of Internal Auditors - Australia, The Ethics Centre, the Governance Institute of Australia and Chartered Accountants Australia and New Zealand.
[127] Principles and Recommendations (n 2) 16.
[128] Ibid.

policy, and provide a committee to investigate allegations of wrongdoing.[129] One can see how such a provision would be beneficial to institutions pre-GFC.

Culture has gained momentum considering crisis and scandal, and appears to be a powerful tool in managing ethical predicaments. Financial service conglomerates might find unethical behaviour changes if they create and reinforce an organisational culture that emphasises core values of honesty, integrity, and ethical behaviour.

There are some issues associated with the above statement. The characteristics of good culture as a concept proposed by this thesis[130] are straightforward and easy to understand. Regulating good culture is not so easy. There are some solutions to the regulation of culture, most notably proposed by Wishart & Wardrop in 2018.[131] This thesis believes that a mixture of some of their proposed solutions may be likelier to have a greater effect on the promotion of good culture in financial service conglomerates.

One option is to enhance enforcement, moving from reliance on criminal sanctions to more easily satisfied civil penalties.[132] These penalties allow for greater workability by the regulators due to a reduced burden of proof and the relaxation of the rules of evidence.[133] Penalising conduct has rarely worked in the past[134], but the introduction of deterrent measures may help promote consumer confidence in the financial industry if people see a greater number of individuals and entities prosecuted for their misconduct.

A second option is the development of a code of ethics or enforceable codes of conduct by the banking and finance industry.[135] There is scope for a document or set of documents of this nature, such as a regulatory instrument that clearly outlines the obligations of financial service conglomerates for common ethical issues. This document should be created with the regulators and not the financial service industry. Such a document would

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[129] Ibid 17.
[130] Positive culture includes things like honesty, integrity, and good customer outcomes. It is a culture that rewards compliance with the regulatory frameworks that exist. Circumventing the rules or pursuing personal gain are characteristics of negative culture, and a positive culture ensures such things do not take place. Positive corporate culture embodies accountability, responsibility for actions and ethical behaviour.
[131] David Wishart and Ann Wardrop, 'What can the Banking Royal Commission achieve: Regulating for good corporate culture?' (2018) 43(2) *Alternative Law Journal* 81, 82-85.
[132] Ibid.
[133] Ibid.
[134] Ibid.
[135] Ibid 83.

explain the ethical dilemmas that can arise in financial service conglomerates and the associated obligations in plain and unambiguous language. This would achieve clarity by simplifying and condensing the existing regulatory landscape. The same document should also detail mandatory expectations of behaviour, particularly regarding culture, governance, and ethical behaviour. This must be created with the appropriate regulators to ensure monitoring and enforcement are within their remit, or their remit should be extended.

Another solution put forth by Wishart and Wardrop is the creation of accountability frameworks and mapping of responsibilities.[136] 'If something goes wrong, those accountable are held responsible'.[137] Australia has made progress on this in recent years with the Banking Executive and Accountability Regime and the soon to be introduced Financial Accountability Regime. These measures are a welcome step towards better culture in financial service conglomerates by promoting a heightened sense of accountability and responsibility among senior executives.

There appears to be no silver bullet solution on how to change culture in financial service conglomerates, but a multi-pronged initiative may have a good chance at initiating lasting change.

D. Report Integrity

The 2003 Principles safeguarded integrity in financial reporting through the audit committee. Much emphasis was placed on the committee and its charter to ensure integrity in reports.[138] The current requirements expand the task to other members of the corporation to ensure diversity in the process.

The institution should be able to verify the integrity of its reports.[139] Before approving the financial statements, the board should obtain declarations from the CEO and CFO that the records have been appropriately maintained, comply with the appropriate accounting standards, and give an accurate and fair view of financial position and performance.[140]

[136] Ibid 85.
[137] Ibid.
[138] Principles and Recommendations (n 2) 33.
[139] Ibid 19.
[140] Ibid 19-20.

The entity should disclose its process to verify the integrity of reports released to the market that an external auditor has not audited or reviewed.[141]

E. Disclosure

An entity should make timely disclosure of all matters expected to have a material effect on the price or value of its securities.[142] This is like the 2003 requirement[143] and not much has changed. The institution should have a written policy for complying with its obligations under Listing Rule 3.1[144] and ensure the board receives copies of all material market announcements promptly after being made.[145] The emphasis on disclosure aids third party intervention in times of adverse conditions.

F. Managing Risk

Risk is a huge factor for financial service conglomerates, and the 2003 Principles required a sound system of risk oversight and management and internal control.[146] The 2019 Principles form a similar requirement. This does not reflect the fact that financial service conglomerates are exposed to more significant and diversified risks than ever before.

The entity should establish a sound risk management framework that is reviewed periodically.[147] The board should have a committee to oversee risk, with at least three members, the majority of whom are independent.[148] The board or a committee should annually review the entity's risk management framework to ensure soundness and that the entity is operating with due regard to the company's risk appetite.[149]

A listed entity should disclose the structure and role of its internal audit function.[150] There must also be a process for evaluating and continually improving the effectiveness of governance and risk management.[151] There should also be disclosure of any material or

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[141] Ibid 20.
[142] Ibid 21.
[143] Principles of Good Corporate Governance (n 100) 35.
[144] ASX Listing Rules 3.1-3.1B: Continuous Disclosure.
[145] Principles and Recommendations (n 2) 21.
[146] Ibid 43.
[147] Principles and Recommendations (n 2) 26.
[148] Ibid 29.
[149] Ibid 27.
[150] Ibid.
[151] Ibid.

potential exposure to societal risks, and how the entity manages or intends to manage them.[152] The introduction of new governance requirements suggest corporate governance has been weak in recent years and must be strengthened to improve financial service conglomerates' resilience.

G. Remuneration

Remuneration was meant to attract and maintain talented and motivated directors and employees to maximise performance at the company.[153] This has changed in the last decade. Remuneration policy was to be managed by a committee and encourage long-term sustainable goals.[154] This was not taking place in the run-up to the financial crisis.

Directors' remuneration should be sufficient to attract and retain high-quality candidates, and remuneration structures should attract, retain, and motivate high-quality senior executives.[155] An independently balanced remuneration committee should be formed and disclose the relevant remuneration calculations, ensuring it is appropriate and proportionate and not excessive.[156] The process used to calculate remuneration should be rigorous, formal, and transparent. 'Remuneration is a driver of culture and a focus for investors'.[157] Incentives need to align with company culture and not reward risky behaviour. Remuneration should not interfere with a director's independence.[158] As discussed earlier, a lack of proper remuneration protocols is a challenge to effective corporate governance.

Two important themes emerge from the corporate governance changes in the UK; remuneration and culture. Remuneration guidelines now reflect that executives and employees have been afforded excessive and conflicting pay arrangements. Additionally, performance-related pay has not encouraged the pursuit of long-term and sustainable business practices. In Australia, culture, which was previously unmentioned before the

[152] Ibid.
[153] Ibid 29.
[154] Principles of Good Corporate Governance (n 100) 55.
[155] Principles and Recommendations (n 2) 29.
[156] Ibid 30.
[157] Ibid 29; Katerina Stachova et al, 'Influencing organizational culture by means of employee remuneration' (2015) 16(3) *Business: Theory and Practice* 264, 265.
[158] Ibid.

crisis, now is a key Principle demonstrating how important culture is to promote legal, ethical, and moral conduct, especially in financial service conglomerates.

Only in recent years have the Code and Principles reflected the importance of culture in attaining a company's long-term success. Poor culture can lead to a range of issues, such as low morale, regulatory intervention, loss of good faith, loss of reputation and misconduct. Good culture can reduce turnover and drive better business.[159] The governance changes in the UK and Australia show that this is being recognised and encouraged, underlining the important role culture can play in in the management of key issues in corporations.

[159] Kathleen Heycock, Insight: What has culture got to do with corporate governance? 1st January 2020 <http://www.farrar.co.uk/news-and-insights/what-has-culture-got-to-do-with-corporate-governance/#>.

Chapter 9: Lessons Learned from the Hayne Royal Commission

This chapter considers the lessons learned from the Hayne Royal Commission and explores whether the recommendations have had any impact on governance measures in financial service conglomerates. It also explores the role and importance of culture in financial service conglomerates in managing ethical dilemmas. It does this by:

- Exploring the lessons learned from the Hayne Royal Commission on simplification of the law, conflicts of interest, and culture and governance;
- Considering an alternative approach to corporate governance in financial service conglomerates; and
- Examining the changes, if any, in Australian financial services in the wake of the Hayne Royal Commission.

I. THE HAYNE ROYAL COMMISSION INTO MISCONDUCT IN THE BANKING, SUPERANNUATION AND FINANCIAL SERVICES INDUSTRY

A Royal Commission was confirmation that public confidence in the financial system was dwindling. Shortcomings in behaviour and governance have been exposed but treated as episodic rather than intrinsic. The Hayne Royal Commission was, at the very least, the distressed sound of the 'canary in the coal mine'.[1] The Hayne Royal Commission intended to serve two purposes; to confront misconduct in the financial sector and challenge the Australian regulator's weakness, but the inquiry was resisted for years.[2] The recommendations are separated into six different categories based on their subject. These are banking, financial advice, superannuation, insurance, regulators and culture, governance, and remuneration.[3] This chapter only examines key questions and some relevant themes that have emerged. This chapter is Australian focused and is placed towards the end of the thesis to continue the chronological structure of the two prior chapters.

[1] Joseph Healy, *Breaking the Banks* (Impact, 2019) xx.
[2] 'What we learnt from the Hayne inquiry', *Australian Financial Review* (online, 1st February 2021) <https://www.afr.com/companies/financial-services/what-we-learnt-from-the-hayne-inquiry-20200203-p53x8j>.
[3] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Final Report, Volume 1, 8.

The 76 final recommendations[4], 54 of which are directed at the government, were to be implemented entirely by mid-2020.[5] The recommendations are too many and too diverse to analyse succinctly. As a result, this chapter will consider three key themes in the Treasury's questions in response to the Interim Report.[6] The three themes arising from these questions are simplifying the law, conflicts of interest, and governance and culture.[7]

This thesis states that poor governance and culture have resulted in the mismanagement of ethical predicaments. They have also undermined compliance, as a culture of non-compliance has been found in some financial service conglomerates.[8] As a result, the Australian financial sector scandals are not just a one-off, but a reflection of their governance and culture. Deficiencies in culture and governance have meant entities paid too little attention to regulatory, compliance and conduct risk.[9] The law has not been obeyed, nor has it been enforced.[10]

The culture, values, and motivation of financial service conglomerates have not represented the sector's best interests. Banks are, to use a medical analogy, the heart that pumps blood around the body, by distributing finance around the economy. How they perform that task is as critical to the economy as a healthy heart is to any one of us.[11] There is nothing easier in life to sell than money, and there is potentially nothing more reckless.[12] It is for these reasons that our understanding of financial service conglomerates, and their role in society, must be refined.

This chapter now discusses lessons learned from the Hayne Royal Commission centred on three different themes. These themes are the simplification of the law, conflicts of interest, and culture and governance.

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[4] Ibid 19.
[5] 'Federal government reveals timeline to implement its 54 banking royal commission recommendations', *ABC News* (online, 5 May 2020) <https://www.abc.net.au/news/2019-08-18/banking-royal-commission-recommendations-implemented-by-2020/11425910>; Restoring Trust in Australia's Financial System, Financial Services Royal Commission Implementation Roadmap, August 2019, 8-9.
[6] Royal Commission (n 3) 5.
[7] Governance and culture encompass and affect leadership and compliance which was another key theme raised by the Royal Commission.
[8] Royal Commission (n 3) 12.
[9] Ibid.
[10] Ibid.
[11] Healy (n 1) 3.
[12] Ibid 4.

A. Simplification of the Law

The simplification of law has been problematic for some time; back in 1923, Harlan Stone wrote that:

> Any system of law in which legal rules are always created ad hoc must at its best lack form and symmetry. Its development is not systematic, its precedents which collectively are its substance, because of the very method of their creation, lack a foundation of scientific and philosophical generalisation on which all systems of law must ultimately rest if they are to ensure and do their appointed work.[13]

The law can be overengineered, and Australia is a prime example. Multiple legislation and thousands of pages of regulations at both state and federal levels are challenging to navigate. Little is done to communicate the law to ordinary people and instead offers them 'legislative porridge'[14], which fails to protect their interests. The Hayne Royal Commission presented a rare opportunity in time; to overhaul the regulation of the industry and tailor-fit law in response to recent and well-documented failures. The law could benefit from a simplification and clarification exercise, rather than a reduction.

Commissioner Hayne suggested the rules regulating financial institutions be consolidated into six requirements: obey the law; do not mislead or deceive; act fairly; provide services that are fit for purpose; deliver services with reasonable care and skills; and when acting for another, act in their best interests.[15] The current law is anything but simple, despite Australian financial legislation undergoing a significant simplification process in 2007. The *Financial Sector Legislation Amendment Act*[16] sought, amongst other things, to:

- amend financial regulation to streamline and simplify prudential regulation[17];

[13] Harlan Stone, 'Some Aspects of the Problem of Law Simplification' (1923) 23 *Columbia Law Review* 319, 321.
[14] *Wingecarribee Shire Council v Lehman Brothers Australia Ltd (in liq)* [2012] FCA 1028 [948] ('*Wingecarribe*').
[15] 'Banks say Hayne law simplification has its own challenges', *Australian Financial Review* (online, 5 May 2020) <https://www.afr.com/companies/financial-services/banks-say-hayne-law-simplification-has-its-own-challenges-20181108-h17nwv>; 'Understanding Hayne. Why less is more', *The Conversation* (online, 5 May 2020) <https://theconversation.com/understanding-hayne-why-less-is-more-110509>.
[16] *Financial Sector Legislation Amendment (Simplifying Regulation and Review) Act 2007* (Cth).
[17] By amending the *Banking Act 1959* (Cth), *Insurance Act 1973* (Cth), *Life Insurance Act 1995* (Cth), *Superannuation Industry (Supervision) Act 1993* (Cth) (collectively, the prudential Acts) and other related legislation, including the *Corporations Act 2001* (Cth) and *Financial Sector Collection of Data Act 2001* (FSCODA) (Cth), to implement Government commitments relating to prudential regulation in

- consolidate and rationalise prudential reporting requirements in the superannuation industry[18]; and
- close a regulatory gap for reporting contraventions of the market conduct and disclosure provisions in the *Corporations Act 2001*.[19]

By this time, however, Australian regulation was already too complicated. It required simplification back then as much as it does today:

> For many years all one had to know was that the elegantly simple s 52(1) of the *Trade Practices Act 1974* prohibited a corporation from engaging in conduct, in trade or commerce, that was misleading or deceptive or likely to mislead or deceive. For some purpose that is not evident the Parliament decided to remove elegant simplicity in its statutory drafting some years ago. Now the community and the Courts must grapple with a labyrinth of statutes, all prohibiting such conduct, in relatively general fields (such as s 18 of Sch 2 of the *Competition and Consumer Act 2010* and see s 131A of that Act itself) and also in particular fields, such as s 1041H(1) of the *Corporations Act* and s 12DA(1) of the *ASIC Act*.[20]

Australian legislation has been called 'a plethora of pointlessly technical and befuddling statutory provisions scattered over many Acts in defined situations'.[21] Research at the University of Melbourne found 'literally dozens of overlapping state and federal statutes'[22] in multiple areas, including financial services. Legislation has been moving away from the principle-based approach, resulting in an explosion of complexity and volume of relevant legislation, impenetrable for many lawyers.[23] Even NAB have

response to the Productivity Commission's Rethinking Regulation: The Report of the Taskforce on Reducing Regulatory Burdens on Business*,* 2006.

[18] By amending the *Superannuation Industry (Supervision) Act 1993* (Cth) and the *Financial Institutions Supervisory Levies Collection Act 1998* (Cth) so that, where a superannuation fund has suffered loss because of fraudulent conduct or theft, financial assistance is available on a more equitable basis.

[19] By amending the *Superannuation Industry (Supervision) Act 1993* (Cth), *the Superannuation (Self Managed Superannuation Funds) Taxation Act 1987* (Cth) (SMSF Taxation Act) and the *Income Tax Assessment Act 1936* (Cth) (ITAA 1936).

[20] *Wingecarribee* (n 14) [947].

[21] Ibid summary.

[22] Professor Elise Bant, Melbourne Law School, Submission to the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, 4 October 2018, 1-2.

[23] Ibid.

criticised the length of legislation[24], the volume of compliance obligations[25], the duplication, repetition, multiple layers of regulation and conflicting regulatory approaches and priorities.[26] Resolving disputes with banks in court is not a practical option. As a result, other methods of consumer protection have evolved. The Banking Code of Practice sets out what banks should do, and the Australian Financial Complaints Authority (AFCA) resolves disputes. In the resolution process, the AFCA must do what they consider is 'fair in all the circumstances', regarding the legal principles, applicable codes or guidelines, best practice, and previous decisions.[27] A return to overarching and straightforward prohibitions in financial services would be welcomed, as the law is too complicated, and the alternatives that have evolved are not.

The Hayne Royal Commission states that exceptions to norms of conduct in legislation governing financial service entities should be eliminated.[28] Essentially, 'the more complicated the law, the harder it is to see unifying and informing principles and purposes. Exceptions and limitations encourage literal application and focusing on boundary-marking and categorisation may promote uncertainty'.[29] The recommendation that mortgage brokers owe a best interests duty to their clients, which subjects them to the same laws as financial advisors, will ensure consistency of advice-givers and remove uncertainty. This clarifies and simplifies the obligations of advisors operating in different areas and protects consumers by facilitating their rights in redress situations.

It is intended that the law's 'intent is met, rather than merely its terms complied with'[30] in the financial services industry. Several recommendations apply to the removal of these exceptions.[31] As far as possible, legislation governing financial entities should expressly

[24] The *Corporations Act* has increased in length by 178 per cent since 1981: Chapter Five: External Constraints that impede ability to execute, 2016 (22 November 2021) Australian Government Treasury <https://treasury.gov.au/publication/fit-for-the-future-a-capability-review-of-the-australian-securities-and-investments-commission/report-12/chapter-5-external-constraints-that-impede-ability-to-execute>.
[25] ASIC state that regulatory red tape must be reduced, and that on occasion they grant relief where compliance costs would outweigh benefit: Ibid.
[26] Australian Financial Review (n 15).
[27] Australian Financial Complaints Authority Operational Guidelines A.14.2.
[28] Royal Commission (n 3) 43.
[29] Ibid.
[30] Ibid.
[31] The point-of-sale exemption for retail dealers under the NCCP Act (Recommendation 1.7); grandfathered commissions (Recommendation 2.4); life risk and general insurance commissions (Recommendations 2.5, 2.6 and 4.4); funeral expenses policies (Recommendation 4.2); insurance claims handling and settlement (Recommendation 4.8); and the definition of 'small business' in the 2019 Banking Code of Practice (Recommendation 1.10): *See generally* Royal Commission (n 3).

state the fundamental norms of behaviour expected when rules are developed on a particular subject matter.[32] It is hoped that the regulated community will understand the law's intentions if the relationship between rule and expectation is not clearly defined. It is sensible to question this notion.

Bringing forth or altering an Act is not a quick process and just because a bill is drafted does not guarantee its efficient enactment. Of the 625 bills introduced to the 45th Parliament of Australia, roughly 64% finally became Acts, and the consideration of legislation took up some 64% of the House's time.[33] One would hope that such amendments to legislation be considered 'urgent' and progress hastened as a result, but there is no guarantee of this.

Other challenges to simplification exist, and the biggest come from the banks. ANZ said that the six principles[34] of the Hayne Royal Commission are important, but likely 'to be lost if laws are overlapping, over-structured, ambiguous, or subject to frequent change'. They refute that 'radical simplification of the law is required, or that a principles-based approach, starting with the six ideas referred to at the outset of this section, would produce greater certainty or, importantly, contribute to improved compliance with the law'.[35] Commonwealth Bank also pushed back on an aggressive simplification, saying 'the uncertainty of a fundamental rewrite of financial services laws would … be too destabilising and risks unintended consequences'. It said simplifying the law is 'clearly desirable, but it is not essential and would be difficult to implement in practice'.[36] NAB stated that whilst 'simplification would not be a straightforward exercise', it welcomed 'a thoughtful and constructive effort to simplify the existing regime by addressing the features that contribute to complexity and placing greater emphasis on a core set of principles of the kind referred to in the interim report'.[37]

[32] Royal Commission (n 3) Recommendation 7.4, 42.
[33] Infosheet 7: Making Laws (5 May 2020) Parliament of Australia <https://www.aph.gov.au/about_parliament/house_of_representatives/powers_practice_and_procedure/00_-_infosheets/infosheet_7_-_making_laws>.
[34] Obey the law, do not mislead, or deceive; act fairly; provide services that are fit for purpose; deliver services with reasonable care and skills; and when acting for another, act in their best interests: Royal Commission (n 3) 8-9.
[35] Australian Financial Review (n 15).
[36] Ibid.
[37] Ibid.

Regarding overlap in the law, ANZ agreed there 'is scope for removing regulatory overlap and clarifying aspects of financial services law, particularly where this will make compliance simpler and remove barriers to competition'.[38] Westpac criticised 'the proliferation of laws, their complexity and sometimes their ambiguity'.[39] This 'can cause difficulties in designing and implementing systems and processes that manage conduct risk and ensure compliance, and can also cause difficulties for regulators in seeking to enforce those laws'.[40] They warned 'many applicable laws have been in place for some time and are well understood, and, if changed, would result in some uncertainty until the application of the new laws has been tested and judicially considered'.[41]

The Hayne Royal Commission encourages litigation where laws have been broken[42], and asking regulators to adopt the 'why not litigate?'[43] approach. The banks pushed back on pressuring regulators to resort to litigation as an enforcement tool. Commonwealth Bank said it is 'important that regulators maintain freedom to deploy the various enforcement procedures available to them, rather than having a particular form of enforcement (such as commencement of legal proceedings) mandated by legislation'.[44] Westpac said that while 'negotiation and settlement should not be the main approach for a regulator ... it would also likely be counterproductive for a regulator to adopt litigation as a default mechanism'. Westpac also said it 'does not see any compelling case for the scope of ASIC's remit to be reduced or reallocated'.[45] Commonwealth Bank called for ASIC to be 'given some time to embed' already-announced changes to its powers and enforcement approach before any more fundamental changes are made to its remit or powers.[46] The banks' reluctance to make changes in the industry is questionable, and their criticism of the frameworks governing their misconduct and discipline may be surprising to some. It was the banks who abused these frameworks in the first place. The banks are a significant hurdle to change in the industry. Without their support, any attempts to reimagine the industry are likely to be quashed.

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[38] Ibid.
[39] Ibid.
[40] Ibid.
[41] Ibid.
[42] Royal Commission (n 3) 432.
[43] Ibid 435.
[44] Australian Financial Review (n 15).
[45] Ibid.
[46] Ibid.

The Law Council of Australia welcomed the Hayne Royal Commission Recommendations for simplification and agreed that profit had been put before people[47], and in some instances, before the rule of law.[48] Central to the Law Council's submissions to the inquiry was a call for simplifying laws, making them easier to understand and implement[49] and that the intent of the law needs to be followed, if not exceeded, in the financial services industry.

B. *Conflicts of Interest*

The Final Recommendations contain several suggestions to deal with conflicts of interest. The Minutes of Evidence of the Royal Commission total 7598 pages. The term conflict(s) of interest(s) feature 173 times, suggesting that this is a common theme. Conflicts of interest is a regulated area, so the regulation of financial advice provision in Australia will be detailed first, then the mis-selling of financial products explored. Three issues will be chosen for discussion of the mis-selling of financial products. These issues are a best interests' duty, financial advisors lack of independence disclosure, and conflicted remuneration in financial product sales.

1. *The Regulation of Financial Advice in Australia*

Australia's ageing population have needed suitable and appropriate financial guidance to manage the wealth accumulated during 29 years of economic growth.[50] Recent scandals such as charging hundreds of millions of dollars of fees for no service[51], misleading

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[47] Law Council Submission, Interim Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (22 February 2021) The Law Council <https://www.lawcouncil.asn.au/resources/submissions/interim-report-of-the-royal-commission-into-misconduct-in-the-banking-superannuation-and-financial-services-industry>.

[48] 'Banking royal commission: AMP executive says company put profits before the law', *The Guardian* (online, 8 March 2021) <https://www.theguardian.com/australia-news/2018/apr/17/banking-royal-commission-amp-executive-says-company-put-profits-before-the-law>.

[49] 'Sweeping changes': Focus on simplified laws, consumer rights in Banking RC final report (5 May 2020) The Law Council <https://www.lawcouncil.asn.au/media/media-releases/sweeping-changes-focus-on-simplified-laws-consumer-rights-in-banking-rc-final-report>.

[50] 'Australia in first recession for nearly 30 years', *BBC News* (online, 1 October 2021) <https://www.bbc.co.uk/news/business-53994318>.

[51] 'Fees for no service payouts and offers approach $900m', *Business News Australia* (online, 4 February 2021) <https://www.businessnewsaustralia.com/articles/fees-for-no-service-payouts-and-offers-approach--900m.html>; ASIC Report 499: Financial Advice: Fees for No Service, October 2016, 5-7.

regulators[52], charging dead people[53], and the sale of worthless, junk insurance policies[54] have shaken trust in the financial advisory professions and presented challenges for financial service licensing laws.[55] Concerns have also arisen about the unclear distinction between comprehensive financial advice and basic advice, the blurring of which leads to a higher potential for regulatory breach.[56]

Recent research states that the term 'best interest' is commonly used and rarely understood; directors and trustees apply the phrase without understanding its proper use.[57] This is probably due to the multiple and differing interpretations in Australian legislation.[58] The heritage of a best interests duty lies in equity, and as such, 'is an 'umbrella duty'' embracing a large number of individual, well-recognised 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'.[59] The concept remains unclear in providing financial advice due to market concentration and the sales roles adopted by Australian financial service conglomerate employees. Too often, advisors have preferred their interests or those of the entity they represent over the clients, despite the law requiring that client interests be prioritised.[60] Financial advice is considered in this thesis as an ethical dilemma and conflict of interest, rather than an issue in Australian financial services in its own right.

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[52] 'AMP could face criminal charges for misleading ASIC, banking inquiry hears', *The Guardian* (online, 4 February 2021) <https://www.theguardian.com/australia-news/2018/apr/27/amp-could-face-criminal-charges-for-misleading-asic-banking-inquiry-hears>; Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Interim Report, Volume 1, 297.

[53] 'Banks still charging dead people months after royal commission, Banking Code Compliance Committee finds', *ABC News* (online, 4 February 2021) <https://www.abc.net.au/news/2020-08-31/banks-still-charging-the-dead-bccc-finds-royal-commission/12614758>; 'Charging Dead Clients is Dishonest. Really? Who Knew' University of Melbourne (1 June 2022) <https://pursuit.unimelb.edu.au/articles/charging-dead-clients-is-dishonest-really-who-knew>; Royal Commission Interim Report (n 52) xvii.

[54] Watchdog oversee $160m in payouts from Australian banks that sold junk insurance', *The Guardian* (online, 4 February 2021) <https://www.theguardian.com/australia-news/2020/may/14/watchdog-oversees-160m-in-payouts-from-australian-banks-that-sold-junk-insurance>.

[55] Robin Bowley, 'Regulating the Financial Advice Profession: An Examination of Recent Developments in Australia, New Zealand and the United Kingdom and Recommendations for Further Reform' (2017) 36(1) *University of Queensland Law Journal* 177, 177.

[56] Ibid.

[57] David Millhouse, 'Systemic and cyclical failure in Australian financial services and financial products sectors: have weaknesses in law contributed to these failures?' (PhD Thesis, Bond University, 2018) 191.

[58] Ibid.

[59] *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).

[60] Royal Commission (n 3) 74.

A person provides a financial service if they provide financial product advice[61], deal in a financial product[62], make a market for a financial product[63], operate a registered scheme, provide a custodial or depository service[64], provide a crowd-funding service[65] or engage in conduct of a kind prescribed by the relevant regulation.[66] Financial product advice means a recommendation or opinion intended to influence a person's decision about a financial product or class of products[67] or could reasonably be regarded as having such influence.[68] There are two types of financial product advice: personal advice and general advice.[69] Personal advice is financial product advice, given in circumstances where the provider has considered the person's objectives and financial needs[70], other than in compliance with anti-money laundering legislation[71], or a reasonable person might expect to have considered one of those matters.[72] General advice is financial product advice that is not personal and does not consider their financial needs or objectives.[73]

The Royal Commission found that poor advice given to customers left them in a worse financial position than if they received proper advice.[74] The Royal Commission listed four recurring points in this area that require attention:

- advisers proposing actions that benefited the adviser;
- advisers proposing actions that benefited the licensee either with whom the adviser was aligned or by whom the adviser was employed;
- advisers lacking skill and judgment; and
- licensees being unwilling to find out whether poor advice had been given and, if it had, to take timely steps to put it right.[75]

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[61] *Corporations Act 2001* (Cth) s 766B.
[62] Ibid s 766C.
[63] Ibid s 766D.
[64] Ibid s 766E.
[65] Ibid s 766F.
[66] Ibid s 766A(f).
[67] Ibid s 766B(1)(a).
[68] Ibid s 766B(1)(b).
[69] Ibid s 766B(2).
[70] Ibid s 766B(3)(a).
[71] *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (Cth).
[72] *Corporations Act 2001* (Cth) s 766B(3)(b).
[73] Ibid s 766B(4).
[74] Royal Commission (n 3) 119.
[75] Royal Commission (n 3) 165.

The provision of financial product advice is regulated under the *Corporations Act*.[76] Subject to some exclusions, all persons providing financial product advice to clients must hold an Australian Financial Services (AFS) license and comply with the Act. The Future of Financial Advice Acts[77] impose additional obligations on those providing personal advice. The existing requirements for personal advice provided to retail clients within Div 3 of Pt 7.7 of the *Corporations Act* apply only to AFS licensees and their authorised representatives.[78] In contrast, the best interests duty is set out in Div 2 of Pt 7.7A. It applies to an 'advice provider'[79], who is generally the individual providing personal advice, such as a financial advisor. The key obligations in Div 2 of Pt 7.7A are to:

- act in the best interests of the client[80] and be able to demonstrate they have met the safe harbour requirements[81];
- to provide appropriate advice[82];
- to warn the client if advice is based on incomplete or inaccurate information[83];
- to prioritise the interests of the client[84]; and
- to comply with the modified best interest duty.

Section 912(1) of the *Corporations Act*[85] applies to financial service licensees and requires the efficient, honest, and fair provision of services and for conflicts of interest to be managed. Improper conduct breaches this obligation.[86] AFS license holders must have adequate safeguards against conflicts of interest and efficient processes to address those which arise. The Act states that conflicts will be managed rather than avoided. This wording is equivalent to statutory and equitable directors' duties and potentially reflects the interconnected nature of Australian financial service conglomerates and the inherent conflicts that arise. Avoiding conflicts is not always possible, so effective management is required.

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[76] *Corporations Act 2001* (Cth).
[77] Corporations Amendment (Future of Financial Advice) Bill 2012 (Cth); *Corporations Amendment (Further Future of Financial Advice Measures) Act 2012* (Cth).
[78] *Corporations Act 2001* (Cth) s 994A.
[79] ASIC Regulatory Impact Statement, Future of Financial Advice: Best interests duty and related obligations, 2012, 6.
[80] *Corporations Act 2001* (Cth) s 961B.
[81] Ibid s 961B(2).
[82] Ibid s 961G.
[83] Ibid s 961H.
[84] Ibid s 961J.
[85] *Corporations Act 2001* (Cth) s 192(1).
[86] *Saxby Bridge Financial Planning Pty Ltd v ASIC* (2003) 46 ASCR 286; *R J Elrington Nominees Pty Ltd v Corporate Affairs Commission (SA)* (1989) 1 ACSR 93; *Story v NCSC* (1988) 13 NSWLR 661.

2. *The Mis-selling of Financial Products*

'The value of your investment may go up as well as down'[87] is a familiar phrase. The 'ordinary' person should know the potential risks involved in an investment, but what exactly constitutes a mis-sold financial product?

A product is mis-sold if it is sold on the basis of misleading advice. Its value may have dropped below an expected range, or a promise or guarantee made about its future performance may not be true.[88] Mis-selling is possible due to information asymmetry.[89] When conflicts of interest are discussed in terms of the Hayne Royal Commission, it is the seller's interest, conflicting with the customer's interest. Particularly in the case of advice givers, all too often advisors have preferred their interests or the interests of the entity they represent over those of the client[90], or have tried to balance the two. This bias may be due to conflicted remuneration arrangements.

Mis-selling is not a cause of action, and the most prominent case is *Derry v Peak*.[91] This case outlined the rationale underlying mis-selling cases as 'the public, seeing these names, may well say, 'These are respectable and intelligent men who think well enough of this scheme to adventure their money in it; we will do the same'. Little knowing that those thus trusted had made themselves save against loss if the thing turned out ill, while they might gain if it was successful'.[92] The first instance of the term 'mis-selling' in a reported decision was in *Cocking v The Prudential Assurance Co Ltd*[93] and the first substantive decision arising from mis-selling was in *J Rothschild Assurance plc v Collyear*.[94] The term featured exclusively in cases relating to pensions[95], before becoming more widely used in cases of regulated insurance products.[96]

[87] Jonathan Kirk, *Mis-Selling Financial Services* (Elgar, 2019) 1.01.
[88] Ibid 1.02.
[89] Ibid 1.03.
[90] Royal Commission (n 3) 74.
[91] *Derry v Peak* (1889) 14 App Cas 337.
[92] Ibid [346].
[93] *Cocking v The Prudential Assurance Co Ltd* [1996] Pens LR 235.
[94] *J Rothschild Assurance plc v Collyear* [1999] Pens LR 77.
[95] *Customs & Excise Commissioners v Century Life plc* (6 March 2000, unrep); *Glaiser v Greenwood* [2001] PNLR 25.
[96] *Re Allied Dunbar Assurance plc* [2005] EWHC 28 (QB).

The impact of mis-selling financial products can be wide-ranging and devastating, especially if people are mis-sold a mortgage or life-savings investment. This was the practice of certain financial institutions before the global financial crisis.[97] The historic, endemic mis-selling practices in banks across the world have shown that rectification can be costly, and mis-selling can also significantly impact the broader economy.[98] There has been an increase in claims for mis-selling in recent years, which has created jobs at claims management firms and solicitors firms, and increased workload for the courts, but has also had a devastating impact on trust and confidence in the financial services industry.[99]

(a) Best Interests Duty in Financial Advice

Clients seek advice for financial decisions because they cannot make them alone. Prioritising the client's best interest is an element of financial advice because the client is entrusting some aspects of decision making to the financial advisor.[100] 'Client's best interests' is akin to fiduciary duties in financial services, which have been discussed heavily throughout this thesis. They are subject to some limitations; this duty obscures the type of advice being provided and whether a client's best interest obligation is enacted, and a growing amount of research suggests that a client's best interest duty is not being met by financial advisors.[101] ASIC state that in 75% of the advice files they reviewed, 'the adviser had not demonstrated compliance with the best interests duty in section 961B of the *Corporations Act*'.[102] It was found that financial products were often replaced for others, despite the existing product meeting the client's needs and objectives.[103] This is likely encouraged by preferred product lists used in financial service conglomerates to push related party products. It may also be linked to incentives for selling certain

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[97] RBS took a £3.1 billion ($3.92 billion USD) provision to settle claims in the US that it mis-sold toxic mortgage-backed securities in the run up to the 2008 financial crisis. – 'RBS writes off $4 billion for US mortgage mis-selling cases', *CNBC News* (online, 29 March 2020) <https://www.cnbc.com/2017/01/26/rbs-writes-off-4-billion-for-us-mortgage-mis-selling-cases.html>.
[98] As of August 2012, the big five UK high-street banks (HSBC, Lloyds, RBS, Barclays and Standard Chartered) had set aside £9bn for compensation payments, resulting from the long-term, mis-selling of Payment Protection Insurance (PPI), and distributed over half to injured parties: 'PPI compensation payments could affect UK economy', *The Guardian* (online, 29 March 2020) <https://www.theguardian.com/money/economics-blog/2012/aug/07/ppi-compensation-payments-affect-uk-economy>.
[99] Kirk (n 87) 1.20.
[100] Daniel Richards et al, 'Conceptualising Financial Advice in Australia: The Impact of Business Models and External Stakeholders on Client's Best Interests Practice' (2019) 28(2) *Financial Services Review* 133, 138.
[101] Ibid.
[102] Royal Commission (n 3) 169.
[103] Ibid.

products. Bank's basic products do not make much money, so lenders push staff to cross-sell more profitable products and services.[104] Either way, the client's interests are often subservient to the seller, the institution, or both.

The *Corporations Act* governs the provision of financial advice in Australia.[105] Since the Wallis Report recommendations in 1997, APRA deals with prudential regulation and is responsible for regulating licensing, disclosure, consumer protection and since 2009, the provision of consumer credit. The Act provides for the licensing of financial services providers[106], financial services disclosure[107], and the requirements for personal advice to retail clients.[108] ASIC's regulatory guidance serves as a tool for interpretation of the law, and best practice. 'Financial product advice', and the exceptions to, are defined in Section 766B of the *Corporations Act*. The provision of advice is also governed by equity, imposing an obligation to act in the client's best interest. As stated earlier, there are two types of financial product advice: personal advice and general advice. It is the provision of personal advice that this part of the chapter is concerned with.

Section 961B of the *Corporations Act* requires financial advisors to take reasonable steps to act in their client's best interests, and place those interests ahead of its own while providing advice. To be compliant, an advisor must have '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'.[109] This requires advisors to demonstrate a level of understanding and competency in individual situations. This section is directly affected by Section 961B(2), which serves as a broader scope than Section 961B(1). Compliance with this section will not automatically fulfil the general law duty to avoid actual or real and sensible conflicts of interest.[110] However, efforts to comply may reduce the risk of breaching the 'no conflict' rule and subsequent penalties for breach.[111]

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[104] 'After PPI, what could be the next banking mis-selling scandal?', *The Financial Times* (online, 14 February 2020) <https://www.ft.com/content/2abb8482-c9b3-11e9-a1f4-3669401ba76f>.
[105] *Corporations Act 2001* (Cth).
[106] Ibid s 910A – 926B.
[107] Ibid s 940A – 953C.
[108] Ibid s 761G.
[109] Ibid s 961(1)(g).
[110] *Boardman v Phipps* [1967] 2 AC 46, [124].
[111] Stephen Corones and Kym Irving, 'Raising levels of awareness of rights and obligations in the provision of financial product advice to retail clients' 32(2) *Company and Securities Law Journal* 192, 198.

Prioritising client interest in Section 961J seems to be an alternative and less demanding standard than the duty to avoid conflicts of interest. Those who give financial advice must prioritise client interests where they know or ought to know that a conflict of interest exists.[112] This section's language is 'open textured' and applies in numerous cases, although the extent to what types of action or specific actions amount to giving priority is disputed. A new emphasis on Section 961J may uphold the Hayne Royal Commission's notion that conflicts of interest need to be managed more effectively.[113]

The Hayne Royal Commission states more can be done to manage conflicting advice and champion the best interests duty in financial advice provision.[114] One way would be to amend Section 961[115] to be more prescriptive. Another would be to remove the safe harbour defence in Section 961B(2).[116] The Hayne Royal Commission says that there is already a myriad of changes set to roll out through financial service regulation, and that right now is not the time. If changes are not made effectively, then this can be revisited.[117]

ASIC has said that financial services licensees who breach those sections of the *Corporations Act* that impose the best interests duty[118], oblige the provision of appropriate advice[119], warn of incomplete or inaccurate advice[120], and require giving priority to the client's interests[121], are liable to civil penalty. Licensees must take reasonable steps to ensure that representatives of the licensee comply with these sections. Authorised representatives are liable to civil penalty for breach of the above sections.[122] Compensation can be sought by clients who suffer loss or damage because of breach[123], and the court can make any of several other kinds of order under that section.[124]

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[112] *Corporations Act 2001* (Cth) s 961J(1).
[113] Royal Commission (n 3) 172, 179, 180.
[114] Ibid 131.
[115] *Corporations Act 2001* (Cth) s 961.
[116] Ibid s 961B(2).
[117] Royal Commission (n 3) 177.
[118] *Corporations Act 2001* (Cth) s 961B.
[119] Ibid s 961G.
[120] Ibid s 961H.
[121] Ibid s 961J.
[122] Idib s 961Q.
[123] Ibid s 961M.
[124] Royal Commission (n 3) 206.

The *Financial Sector Reform Act*[125] introduces a best interest duty for mortgage brokers.[126] This highlights the relationship between advisor and advisee and the associated information asymmetry. Perhaps this needs to be extended to a broader range of roles to promote integrity in the industry. It is clear how management might misunderstand which roles and services conglomerates offer are subject to legal obligations.

(b) Financial Advisers Impartiality

The scandals of Westpoint, Storm Financial[127] and Opes Prime[128] have shown that financial advisers have been salespeople rather than trusted and impartial advisors. The emergence of financial advisers as salesmen and women for certain financial products has been a concern. Whether regulation should improve the quality of financial advice or identify and restrict the sale of poor financial products has been asked.[129] In response to the Parliamentary Joint Committee inquiry spurred by these failings, the Future of Financial Advice reform package[130] was announced to improve financial advice[131], with amendments to the current legislation. The Explanatory Memorandum to the Corporations Amendment states that:

> The underlying objective of the reforms is to improve the quality of financial advice while building trust and confidence in the financial advice industry through enhanced standards which align the interests of the adviser with the client and reduce conflicts of interest. The reforms also focus on facilitating access to financial advice, through the provision of simple or limited advice.[132]

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[125] *Financial Sector Reform (Hayne Royal Commission Response – Protecting Consumers (2019 Measures)) Act 2020* (Cth).
[126] Ibid s 158LA.
[127] Parliamentary Joint Committee on Corporations and Financial Services, Inquiry into financial products and services in Australia, 2009, 18.
[128] Ibid 51.
[129] Ibid 79.
[130] Corporations Amendment (Future of Financial Advice) Bill 2012 (Cth); *Corporations Amendment (Further Future of Financial Advice Measures) Act 2012* (Cth).
[131] The Inquiry championed 'the introduction of an explicit legislative fiduciary duty on financial advisers requiring them to place their clients' interests ahead of their own. There is no reason why advisers should not be required to meet this professional standard, nor is there any justification for the current arrangement whereby advisers can provide advice not in their clients' best interests yet comply with section 945A of the Corporations Act': Parliamentary Joint Committee on Corporations and Financial Services, Inquiry into financial products and services in Australia, 2009, 110.
[132] Corporations Amendment (Further Future of Financial Advice Measures) Bill 2012 (Cth), Revised Explanatory Memorandum, 3.

It does this by banning conflicted remuneration where AFS licensees or their representatives provide financial product advice to consumers and introducing a statutory best interests obligation for AFS licensees providing financial advice.

Financial advisors play a dual role in sales and advice and have been subject to commission and performance-related pay structures, which are conflicts of interest. Conflicts of interest create an incentive for advisors to give biased advice, and it is inherent in some forms of advice. ASIC's report into retirement advice[133] submitted that 'remuneration structures in the financial advice industry can create conflicts of interest that may distort the quality of advice. These payments include commissions'[134] and conflicted remuneration. In these situations, disclosure is a popular remedy. Virtually all policies designed to mitigate the adverse effects of conflicts of interest include, or consist solely of, disclosure.[135] Disclosure is an attractive choice because it is relatively easy to implement and upholds the principles of transparency, empowerment, and free markets.[136] By reducing the information asymmetry between the advisor and the client, disclosure allows advisees to make better-informed decisions.[137] Although a common option for managing conflicts of interest, advisees generally do not use disclosures effectively.[138] Unsure of how to react, the disclosure is often ignored by advisees.[139]

The Hayne Royal Commission noted that the most obvious conflict of interest affecting financial advice is between an advisor's duty and financial interests.[140] Other conflicts may arise on an adviser's knowledge of financial products. For example, they may be expected to know more about in-house products than competitor's products, so may push products that are not as suitable for a customer as ones offered by a competitor.[141] As such, there should be a separation between the sale and provision of these goods. Hayne suggested several approaches this separation could take, all of which would reduce conflicts of interest in financial advice.[142] These are:

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[133] ASIC Report 279, Shadow shopping study of retirement advice, 2012.
[134] Ibid 3.
[135] Sunita Sah, 'Conflict of Interest Disclosure as a Reminder of Professional Norms: Clients First! (2019) 154 *Organizational Behavior and Human Decision Processes* 62, 62.
[136] Ibid.
[137] Ibid.
[138] Ibid.
[139] Ibid 62-63.
[140] Royal Commission (n 3) 190.
[141] Ibid 190.
[142] Ibid 191.

- Requiring all advisors to be independent, impartial, and unbiased within the meaning of Section 923A(2) of the Corporations Act;
- Requiring separation between any AFSL holder authorised to issue financial products and any AFSL holder authorised to provide financial product advice; and
- Prohibit advisors who are not independent from recommending any products associated with an entity the advisor is associated with.[143]

(c) Conflicted Remuneration

Conflicted remuneration is any benefit, monetary and non-monetary, given to AFS licensees, or their representatives, that could be 'expected to influence the choice of financial product' recommended to clients.[144] It includes both general and personal advice. Breaching this ban can result in civil or administrative sanctions for the licensee, or civil penalties for their representatives. The use of preferred product lists or incentives treads dangerously close to infringing this.

The best interests duty[145] and related obligations[146] apply when personal advice is provided to a client. Since 2012, Div 4 of Pt 7.7A of the *Corporations Act*[147] prohibits AFS licensees from accepting conflicting remuneration[148]; product issuers giving conflicted remuneration to licensees[149]; employers using conflicted remuneration as incentives for employees to work[150]; and licensees 'must take reasonable steps to ensure that [their] representatives… do not accept conflicted remuneration'.[151] The FOFA legislation recognised a broad range of benefits could be interpreted as influencing advice, and that remote influences should be excepted.

Despite clear guidance on conflicted remuneration, Australian banks abused the system, and such cases are coming to light. In June 2020, ASIC commenced civil penalty

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[143] Ibid.
[144] *Corporations Act 2001* (Cth) s 963A.
[145] Ibid s 961B.
[146] Div 2 of Pt 7.7A of the *Corporations Act 2001* (Cth).
[147] *Corporations Act 2001* (Cth).
[148] Ibid s 963E, 963G and 963H.
[149] Ibid s 963K.
[150] Ibid s 963J.
[151] Ibid s 963F.

proceedings against CBA, alleging more than AUD22 million was paid by Colonial First State Investments[152] to CBA to distribute its superannuation products between 2013 and 2019[153], breaching the ban on conflicted remuneration.[154] This is another action brought against a financial service conglomerate in the first six months of 2020[155], suggesting that ASIC are attempting to be more dominant in regulating the industry. Recently the Federal Court ruled that Colonial First State had engaged in false and misleading representations, and misleading and deceptive conduct when communicating with members.[156] The *Financial Sector Reform Act* bans conflicted remuneration for mortgage brokers and intermediaries[157], which goes some way to recognising the issue and the necessary change.

ASIC provides in-depth guidance for AFS licenses, their representatives, employers, and product issuers.[158] The legislation and guidance are clear cut. It appears that financial service providers have been furnished with precise and unambiguous tools to manage conflicts of interest within their operations, but they have failed to do so. As a result, any conflicts of interest that exist between duty and interest should be removed, as they can seldom be managed effectively.[159] This may be achieved through smaller measures, an outright ban on performance-related pay incentives linked to sales for example, or through much more drastic measures, such as forcing financial service conglomerates to shed their wealth management or financial advice arms. This would be the logical next step in further safeguarding the integrity of the financial system.

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[152] Colonial First State Investments Ltd provides investment, superannuation and retirement products to individual, as well as corporate and superannuation fund investors, and is a wholly-owned subsidiary of Commonwealth Bank (CBA).

[153] ASIC sues CBA and Colonial First State for payment of banned conflicted remuneration (12 September 2021) ASIC <https://asic.gov.au/about-asic/news-centre/find-a-media-release/2020-releases/20-143mr-asic-sues-cba-and-colonial-first-state-for-payment-of-banned-conflicted-remuneration/>.

[154] *Corporations Act 2001* (Cth) s 963E, s 963K.

[155] 'ASIC enforcement update January to June 2020', *Mirage News* (online, 9 October 2020) <https://www.miragenews.com/asic-enforcement-update-january-to-june-2020/>.

[156] Colonial First State liable for misleading superannuation members (12 September 2021) ASIC <https://asic.gov.au/about-asic/news-centre/find-a-media-release/2020-releases/20-143mr-asic-sues-cba-and-colonial-first-state-for-payment-of-banned-conflicted-remuneration/>.

[157] *Financial Sector Reform (Hayne Royal Commission Response – Protecting Consumers (2019 Measures)) Act 2020* (Cth) s 158NB, 158NC.

[158] ASIC Regulatory Guide 246: Conflicted and Other Banned Remuneration.

[159] Royal Commission (n 3) 3.

C. Culture and Governance

> Culture is the collective programming of the human mind that distinguishes one human group from another. Culture, in this sense, is a system of collectively held values.[160] It is the deeper level of basic assumptions and beliefs shared by members of an organisation, that make up the way an organisation views itself and its environment.[161]

Culture, as we know it, is 'one of the two or three most complicated words in the English language'.[162] As a result, our understanding and application of the term is problematic. Other definitions include 'the collective level of mental programming that is shared with some but not all other people', 'the software of the mind', and 'what goes with what'.[163] These definitions suggest that people possess an implicit knowledge of what may or may not be permissible in an organisation's culture.

Although helpful, these definitions fall short of providing a framework for comparative purposes. Other definitions state that culture 'denotes a historically transmitted pattern of meaning embodied in symbols, a system of inherited conceptions expressed in symbolic forms through which men communicate, perpetuate, and develop their knowledge about and attitudes towards life'.[164] What exactly constitutes a 'symbolic form' is unknown, but social scientists state that values, beliefs, and norms are major components of culture. As a result, culture can also be defined as 'the latent, normative value system, external to the individual, which underlies and justifies the functioning of societal institutions'.[165]

Culture is important because it can address the problems that governance seeks to solve. Still, culture is not transplantable, nor is it easily implemented or even available in a 'one size fits all' framework, unlike corporate governance.[166] Many corporate characteristics

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[160] Geert Hofstede: The Dimension Paradigm (5 April 2020) <https://hi.hofstede-insights.com/models>.
[161] Marc Epstein and John Lee, *Advances in Management Accounting* (Emerald, Vol 17, 2008) 352.
[162] Jeffrey Gordon and Wolf-Georg Ringe, *The Oxford Handbook of Corporate Law and Governance* (Oxford University Press, 2018) 131.
[163] Ibid.
[164] Ibid.
[165] Ibid.
[166] Whether or not that governance framework will lead to 'good governance' is subjective. 'The Organisation for Economic Co-operation and Development (OECD) has draft Principles of Corporate Governance. The proposed OECD Principles are intended to be a non-binding statement of the key elements which underlie good corporate governance. Australia is involved in the development of the Principles at both the public and private sector level. Australia's corporate governance framework essentially consists of a 'matrix' of legislation, accounting standards which have the force of law, Australian Securities Exchange (ASX) Listing Rules, and voluntary self-regulatory codes of practice':

will affect culture. At a fundamental level, the objectives of the corporation will influence the corporate culture. It is generally accepted that the corporation is run for the benefit of the shareholders, and fiduciaries are called upon to maximise value.[167] The risks associated with poor culture and governance could inflict more damage to the financial services industry than it has done in the past.[168] For this reason, a strong corporate culture may be valuable in managing ethical quandaries in financial service conglomerates effectively.

Culture and governance are recurring themes throughout this thesis. Case studies of the Co-operative Bank and Commonwealth Bank in Chapter Seven highlight the significance of culture and governance in financial institutions, especially in mitigating ethical predicaments which can lead to failings or reputation loss. Culture and governance represent two important themes of the Hayne Royal Commission.

The trigger for the Hayne Royal Commission was a series of scandals in the financial industry.[169] These, along with scandals around the world[170], have involved bad culture within financial institutions.[171] This culture has permitted and encouraged misconduct in ethical problems such as conflicts of interest. Governments have two options when it comes to culture; interfere or allow self-regulation. Both options are a minefield.[172] Culture, governance and leadership are considered interdependent, as culture is set at the top by leadership, and governance is the method by which an organisation operates.

Chapter Four: Corporate Governance Framework (6 March 2020) Australian Government Treasury <https://treasury.gov.au/publication/making-transparency-transparent-an-australian-assessment/chapter-4-corporate-governance-framework>.

[167] Edgard Waitzer, 'Rethinking the Purpose of the Corporation' (2018) 30(2) *Journal of Applied Corporate Finance* 17, 18.

[168] '$7b and counting: Bank culture, governance risks highest in 'many years'', *Sydney Morning Herald* (7 March 2020) <https://www.smh.com.au/business/banking-and-finance/7b-and-counting-bank-culture-governance-risks-highest-in-many-years-20190603-p51tyh.html>.

[169] Royal Commission (n 3) 1-2.

[170] *See generally* Mark Kantsukov and Darja Medvedskaja, 'From Dishonesty to Disaster: The Reasons and Consequences of Rogue Traders' Fraudulent Behaviour' in Tiia Vissak and Maaja Vadi (eds), *(Dis)honesty in Management: Manifestations and Consequences* (Emerald, 2013) 147; Rosa Abrantes-Metz et al, 'Libor Manipulation?' (2012) 36(1) *Journal of Banking and Finance* 136; Patrick John Ring et al, 'Taking notice of risk culture – the regulator's approach' (2016) 19(3) *Journal of Risk Research* 364.

[171] *See generally* The Salz Review: An independent Review of Barclay's Business Practices, April 2013; Johan Graafland and Bert van de Ven, 'The Credit Crisis and the Moral Responsibility of Professionals in Finance' (2011) 103 *Journal of Business Ethics* 605; Claire Hill, 'Bankers Behaving Badly? The Limits of Regulatory Reform' (2012) *University of Minnesota Law School, Scholarship Reserve*, 2012.

[172] David Wishart and Ann Wardrop, 'What can the Banking Royal Commission achieve: Regulating for good corporate culture?' (2018) 43(2) *Alternative Law Journal* 81, 81-82.

1. *Culture and Governance in the Hayne Royal Commission*

The role of culture in corporate governance has been explored increasingly since the late 1980's.[173] Recently, however, a strong belief has emerged that culture within banks is both a weakness and a potential systemic risk. The term 'culture' appears 818 times, and 'governance' appears 384 times in the Minutes of Evidence, gathered throughout the Hayne Royal Commission, suggesting that both require significant attention in response to shortcomings in the financial services industry.[174] Improving culture is crucial to restoring faith in the banking system[175], thereby promoting financial stability. Our relationships with banks mean that corporate culture is of public interest, and in recent years, banks have paid more than £200bn in fines and damages worldwide for inappropriate conduct.[176] This should not be allowed to continue; financial service conglomerates should not be able to pay their way out of misconduct, refusing to change their practises.

The importance of culture in financial service conglomerates was illustrated by Bob Diamond, Barclay's former chief executive, when questioned about the bank's role in the rigging of benchmark interest rates by a House of Commons Committee; 'Mr Diamond himself kept coming back to one lofty concept, directly referred to 50 times during the hearing… The shape and form of companies does contribute to their culture'.[177] This quote shows that organisational structure is important, and particularly the structure of financial service conglomerates, which has been discussed heavily in this thesis. This may well be because hundreds of legal entities are influenced by the culture of a relatively small group of people who sit atop the group's board. The culture of large groups such as financial service conglomerates possibly deserves more attention, due to the amount of companies influenced by the tone at the top, and their important relationship with clients and customers.

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[173] Edward Rock, 'America's Shifting Fascination with Comparative Corporate Governance' (1996) 74(2) *Washington University Law Quarterly* 367, 376.
[174] Royal Commission (n 3) 8.
[175] Paul Cox and Diandra Soobiah, 'An empirical investigation into the corporate culture of UK listed banks' (2018) 26(1) *Journal of Financial Regulation and Compliance* 120, 120.
[176] Conduct Costs Results International Results Table (5 March 2020) <http://conductcosts.ccpresearchfoundation.com/conduct-costs-results>.
[177] John Zinkin, *Rebuilding Trust in Banks: The Role of Leadership and Governance* (Wiley, 2014) 140.

The Hayne Royal Commission demonstrated that all financial services providers, no matter what size, need to analyse and review their culture and governance.[178] Recommendation 5.6[179] is not complicated, nor is it new; Prudential Standard CPS220 and equivalents already demand various things of corporations regarding risk culture.[180] The lesson to be learned from the Hayne Royal Commission concerning culture is that any assessments and implemented solutions should be assessed for efficacy.

Many institutions already have policies for risk culture in place. NAB, Commonwealth Bank, Westpac and ANZ all have governance and risk management frameworks in place and publicly available. The fact that many of these have been in place for many years[181] suggests that it is not the governance framework at fault, but the process by which that framework is administered. Governance administration can be considered a cultural issue, as a culture of non-compliance will undermine any governance measures imposed in a financial service conglomerate.

In Westpac's Corporate Governance Statement 2017, they state that the board of directors are responsible for 'approving our risk management strategy and frameworks, and monitoring their effectiveness'.[182] Their Delegated Authority Policy Framework allows for the board to 'balance effective oversight with appropriate empowerment and accountability of management'.[183] The internal Group Audit function provides 'the Board and Executive Management with an independent and objective evaluation of the adequacy and effectiveness of management's control over risk'.[184] The appropriate committee also receives regular reports from management on the effectiveness of…

[178] Royal Commission (n 3) Recommendation 5.6, 36.
[179] 'All financial services entities should, as often as reasonably possible, take proper steps to assess the entity's culture and its governance; identify any problems with that culture and governance; deal with those problems; and determine whether the changes it has made have been effective': Royal Commission (n 3) Recommendation 5.6, 36.
[180] APRA already requires that institutions have systems 'for identifying, measuring, evaluating, monitoring, reporting, and controlling or mitigating material risks that may affect its ability, or the ability of the group it heads, to meet its obligations to depositors and/or policyholders. These systems, together with the structures, policies, processes, and people supporting them, comprise an institution's or group's risk management framework': Prudential Standard CPS 220: Risk Management, 1.
[181] Westpac Group's Corporate Governance Statement is a 2017 document, whereas the other three big banks include their Corporate Governance Statement in their annual reports suggesting changes have already been made in light of the Royal Commission findings.
[182] Westpac Group Corporate Governance Statement 2017, 2 (7 March 2020) Westpac Australia <https://www.westpac.com.au/content/dam/public/wbc/documents/pdf/aw/ic/2017_Westpac_Corporate_Governance_Statement.pdf>.
[183] Ibid.
[184] Ibid 13.

management of Westpac's material risks'.[185] Effective risk management via the Three Lines of Defence model[186] means Westpac can accurately measure risk and risk appetite, protect depositors, and control excessive risk while meeting regulatory and compliance guidelines.[187] It would appear that the frameworks were in place but not implemented effectively at Westpac. The choice of strategy, the failure of managers to set the right 'tone at the top', and managers' failure to implement effectively in risk areas are the three ways risk and leadership interact.[188] On this basis, leadership and risk are linked.

The existence of this corporate governance structure at Westpac also poses questions about the quality of board monitoring. Even though all directors can fulfil this role, usually, monitoring falls to independent directors. The board of directors represents an integral function of a firm's corporate governance system, and independent directors bring important knowledge and information to the board.[189] Independent directors who are not necessarily bankers are charged with hiring, compensating and terminating the CEO, checking the company's auditing process and voting on conflict of interest transactions, amongst other responsibilities.[190] Relatively little is expected of these directors as they are usually drawn from other, top tier firms and have little time to give.[191] Although the requirements and incentives for non-executive directors to monitor exist, much hinges on their ability to perform this task adequately. It is essential to consider this because many academics and policymakers have questioned to what extent independent directors were responsible for corporate governance failures at many institutions.[192]

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[185] Ibid 14.

[186] The Three Lines of Defence model, discussed in Chapter 7 and represented in Figure 9 is a system of best practice to enhance communications on risk management and control by clarifying essential roles and duties. In the model, 'management control is the first line… in risk management, the various risk control and compliance oversight functions established by management are the second line… and independent assurance is the third. All three play a distinct role within the wider governance framework': Institute of Internal Auditors Position Paper: The Three Lines of Defence in Effective Risk Management and Control, January 2013, 2.

[187] Westpac Corporate Governance Statement (n 182).

[188] Zinkin (n 177) 132.

[189] Niamh Brennan et al, 'Accountability processes in boardrooms' (2016) 29(1) *Accounting, Auditing and Accountability Journal* 135, 144.

[190] Financial Reporting Council, The UK Corporate Governance Code, July 2018, 12.

[191] Ezra Mitchell, 'Corporate Governance and Income Inequality: The Role of the Monitoring Board' (2019) 3(1) *Business and Finance Law Review* 49, 69.

[192] Cong Wang et al, 'Industry Expertise of Independent Directors and Board Monitoring' (2015) 50(5) *Journal of Financial and Quantitative Analysis* 929, 930.

The traditional model of corporate governance ensured that 'the business and affairs of a corporation shall be managed by a board of directors', and 'outside directors – directors who hold no office with the corporation – play little role in its management'.[193] The justification for this norm was that outside directors 'lack not only the independence but also the intimate knowledge of the corporation, the time, and the information… necessary to manage'.[194] Contact time was 'much too little time to learn to manage a public corporation' and the 'minimal pay given… shows how insignificant their role is'. 'Outside directors are neither disposed nor able to play an active role in managing the corporation'.[195] The very reasons why independent directors are so important these days were considered weaknesses in the past. Their objective role in governance is valuable in ensuring legal and ethical behaviour in financial service conglomerates.

The Australian Banking Association (ABA) claim that remuneration culture is changing in Australia. Sales-based incentives for frontline staff have been abolished, bonuses for long-term goals such as risk management have been introduced, CEO bonuses have been deferred, and short-term variable remuneration for most bank executives have been cut.[196] The new Banking Code of Practice contains more than 200 commitments to improve customer's rights, meet the Hayne Royal Commission's requirements, and combat the 'fee for no service' scandal.[197] The banks are also paying back the money; more than AUD5.8 billion has been allocated for refunds and related remediation programs.[198] The ABA is an association of 21 member banks in Australia, including the big four financial service conglomerates of focus in this thesis. The ABA is governed by a Council of bank CEO's, with Matt Comyn, the CEO of Commonwealth Bank as chair.[199] The Banking Code of Practice is written by Australian banks, and although purports to strengthen consumer protections, and offer higher standards of behaviour than the law requires[200], may attract suspicion on its impartiality given, it is written by the banks for the banks.

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[193] George Dent, 'The Revolution in Corporate Governance, The Monitoring Board, and The Director's Duty of Care' (1981) 61 *Boston University Law Review* 623, 628.
[194] Ibid.
[195] Ibid.
[196] Royal Commission: One Year On (5 May 2020) Australian Banking Association <https://www.ausbanking.org.au/priorities/royal-commission/>.
[197] Ibid.
[198] Ibid.
[199] The ABA Council (1st September 2021) Australian Banking Association <https://www.ausbanking.org.au/about-us/aba-council/>.
[200] The Benefits of the Banking Code of Practice (1st September 2021) Australian Banking Association <https://www.ausbanking.org.au/banking-code/>.

The changes in remuneration practices should encourage better and more sustainable corporate culture at the banks. Short-term profit pursuit is rarely linked to long-term sustainability and appropriate risk appetite. Australia is also promoting accountability in banking executives in the form of the Banking Executive Accountability Regime.[201] Unfortunately it seems that two years on from the Hayne Royal Commission, culture may not have improved at all. If anything, it has gotten worse. Bank workers still insist pay is linked to hitting sales benchmarks and sales leader boards are the norm.[202] The lure of bonuses for hitting targets has been replaced with the fear of sacking for not. 'They used to offer us a carrot, and now they threaten us with a stick'.[203] Culture is often dealt with in a superficial sense[204], and senior level resistance to public criticism regarding the appropriateness of their behaviour is a sign of bad culture.[205] It may well be that Australian banks really are a law unto themselves, and after surviving a Royal Commission, may feel more empowered now to bend the rules but be smarter about it.

D. *Should We Overhaul the Board?*

The governance of financial service conglomerates is due for a change. The now-dominant public board model is a 40-year-old experiment, comprising part-time independent directors who are overly reliant on senior staff for information, and their performance judged by the stock market price.[206] All international financial institution boards are constituency boards, and their members have a dual role; they are all shareholder representatives by design, which the exception of some individual

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[201] The Banking Executive Accountability Regime (BEAR), discussed in Chapter Two has 1,400 senior executives on their register. Maximum penalties for BEAR breaches of AUD210 million apply, and higher fines and longer prison sentences apply for criminal behaviour. New investigation and intervention powers for ASIC give the regulators more power, and they are engaging in heightened surveillance of banks. The new Code and stricter regulation are a welcome introduction to the industry.

[202] ''Worse than ever': Australian bank culture has not improved since royal commission, staff say'', *The Guardian* (online, 1 July 2021) <https://www.theguardian.com/australia-news/2021/apr/07/worse-than-ever-australian-bank-culture-has-not-improved-since-royal-commission-staff-say>.

[203] Ibid.

[204] Tony Featherstone, Boards getting to grips with company culture, 16 March 2020. Australian Institute of Company Directors <https://aicd.companydirectors.com.au/advocacy/governance-leadership-centre/practice-of-governance/boards-getting-to-grips-with-company-culture>.

[205] 'ASIC shrink says corporate culture is broken', *Australian Financial Review* (online, 20 September 2021) <https://www.afr.com/work-and-careers/management/asic-shrink-says-corporate-culture-is-broken-20190619-p51z7r>.

[206] Ronald Gilson and Jeffrey Gordon, 'Board 3.0 – An Introduction' (2019) 74(2) *The Business Lawyer* 350, 351.

independent experts.[207] The issue is that the board struggles to keep on top of changes in the business they monitor. Public companies are challenged to stay astride of advancements and changes in the industry but also changes within the firm, and the board must be better equipped to take on this task. Gilson and Gordon argue that a new type of board model, Board 3.0, would promote the inclusion of directors who could credibly monitor managerial strategy and operational skill in circumstances where such an approach would be valuable.

Under the new model, directors could credibly defend managers to institutional owners in the face of shareholder activist challenges or insist that management take account of activist proposals that the board believe to warrant consideration. Informed, resourced, and motivated directors would be better suited to complex firms[208], such as financial service conglomerates, to deal with the issues peculiar to these types of institutions. Gilson and Gordon's work suggests that the established structure of oversight in corporations is not suitable for the financial service industry. A new style of oversight should exist, which considers financial service conglomerates' peculiarities, complex structures, exposures, and role in society.

Although their work is novel, the requirement for change was spurred by the global financial crisis. Numerous bodies took up various initiatives post-crisis to prevent the recurrence of such an event. These initiatives fall into two categories: governance and technical. Stakeholder expectations on governance have been changing, and many are explicitly related to banks and other financial institutions.[209] In addition to the changes in governance expectations, some technical modifications and advances are expected to amend business models and have implications for capital return. Some of these changes will affect the organisational structure of financial service conglomerates. These changes have consequences for risk oversight by the board and challenges the executive where appropriate.[210] The issue is that financial service conglomerate's governance has

[207] Stilpon Nestor, 'Board Effectiveness in International Financial Institutions: A Comparative Perspective on the Effectiveness Drivers in Constituency Boards' in Peter Quayle and Xuan Gao (eds), *Good Governance and Modern International Financial Institutions* (Brill, 2019) 5.
[208] Gilson (n 206) 353.
[209] Mark Laycock, *Risk Management at the Top: A Guide to Risk and its Governance in Financial Institutions* (Wiley, 2014) 5.
[210] Ibid 6.

followed a general approach, despite having distinctive characteristics.[211] The Hayne Royal Commission has reinforced financial service conglomerate's supervision must extend beyond financial risk, to non-financial risk such as culture and governance[212] due to the peculiarities mentioned in this thesis. Regulators must also play a role in supervision.

II. HAS THE ROYAL COMMISSION RESULTED IN RADICAL CHANGES?

It is more than two years from the start of the Hayne Royal Commission. During the process, the nation heard evidence presented to the Commission of hundreds of millions of dollars of fees for no service[213], misleading regulators[214], charging dead people[215], and the sale of worthless, junk insurance policies.[216] The government said they were committed to enacting change, but most recommendations have been abandoned or delayed. How much has really changed?

The banks who campaigned against a Royal Commission for years turned on a dime and requested a Royal Commission into their behaviour. The press surrounding their conduct had got so bad that they finally accepted a commission under a liberal national government. The Hayne Royal Commission showed banks ruthlessly ripping off their customers, their conduct proved by their own documentation. It has been suggested that the decision to allow a Royal Commission was a damage limitation exercise to ensure the process was quick and not too damning.[217] While it was certainly quick, it became apparent that Australian financial service conglomerates would have to make significant changes even before the final report was published. The Hayne Royal Commission exposed criminal behaviour, and a 'toxic culture based on greed and obsession with profit'.[218] Maybe it is time the banks were reigned in.

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[211] John Farrar, 'The global financial crisis and the governance of financial institutions' (2010) 24(3) *Australian Journal of Corporate Law* 227, 230.
[212] Royal Commission (n 3) 47.
[213] Business News Australia (n 51).
[214] The Guardian (n 52).
[215] ABC (n 53).
[216] The Guardian (n 54).
[217] 'Two years on from Australia's banking royal commission, why has progress stalled?', *The Guardian Podcast* (online, 4 February 2021) <https://www.theguardian.com/australia-news/audio/2021/jan/27/two-years-on-from-australias-banking-royal-commission-why-has-progress-stalled>.
[218] Senator McKim, Parliamentary Debates, Senate Official Hansard, 25 February 2021, 1583.

A few executives lost their jobs[219], a few resigned[220], evidence was heard that culture was not as robust as it should be, and shareholder interests were prioritised over clients and compliance with the law. The Hayne Royal Commission claimed the banks completely disregarded the law and favoured profits. The banks agreed.[221] Many of the changes proposed by Hayne were to change the loopholes and exceptions for financial services that allowed financial service conglomerates to circumvent the rules.

There were 24 referrals to the regulators to act over misconduct. All the big banks apart from Westpac were included in these referrals. The regulators had to mount their own investigations of these recommendations but had to meet a higher standard of proof to impose criminal charges. This undermined the efficacy of this process. ASIC shouldered the bulk of the burden of investigations from the Hayne Royal Commission, and a few cases were won, a few were lost, and a few are ongoing.[222]

The Hayne Royal Commission has thrust the regulators into the spotlight. Culture, governance, and remuneration are fundamentally important, intricately connected, and the regulators have an important role to play in the supervision of these matters. Supervision must extend beyond financial risk to non-financial risk, and take control of culture, governance, and remuneration.[223] Both ASIC and APRA have a history of ineffective enforcement[224], renowned for their inability to deal with or deter bad

[219] 'Larger numbers of sacked lower-level staff were reported – Hundreds of NAB staff sacked, docked pay over banking royal commission', *ABC News* (online, 4 February 2021) <https://www.abc.net.au/news/2018-10-19/nab-ceo-andrew-thorburn-fronts-parliamentary-committee/10395104>.
[220] 'NAB CEO Andrew Thorburn and chair Ken Henry resign in the wake of banking royal commission', *ABC News* (online, 4 February 2021) <https://www.abc.net.au/news/2019-02-07/nab-ceo-and-chairman-both-resign-after-royal-commission/10790670>.
[221] The Guardian (n 48).
[222] 'Banking royal commission recommendations flounder, two years on', *ABC News* (online, 8 July 2021) <https://www.abc.net.au/news/2021-02-04/banking-royal-commission-hayne-final-report-two-years-on/13110938>.
[223] Royal Commission (n 3) 47.
[224] 'After previous failures, doubts linger over the ability of APRA and ASIC to lift their game', *Sydney Morning Herald* (online, 16 October 2020) <https://www.smh.com.au/business/banking-and-finance/after-previous-failures-doubts-linger-over-the-ability-of-apra-and-asic-to-lift-their-game-20190205-p50vqc.html>.

behaviour.[225] These regulators have been toothless tigers[226] and need to be more willing to bite occasionally. Why not litigate indeed?

The Treasurer Josh Frydenberg said all of Hayne's 76 recommendations would be acted upon, including providing a regulatory framework to allow the banks to be held to account. Despite the significant changes that have taken place, much work remains, and some recommendations have been abandoned entirely. Josh Frydenberg has not kept his word.[227]

The Treasurer says over 70% of recommendations have been implemented, but more than half have been abandoned or are in progress.[228] The Consumer Action Law Centre suggests just 27 of the 76 recommendations have been implemented, two of those involved doing nothing at all.[229] Main changes have been low hanging fruit, or things so obviously bad they had to be changed. The Banking Executive Accountability Regime (BEAR)[230] is an example of a change in the industry, but Hayne wanted it to have an extended remit to increase its coverage to other parts of financial services and other entities. Unfortunately, it was left with a narrow scope.[231] The introduction of the Financial Accountability Regime[232] will address this, but the BEAR should have had a broader scope from its inception.

Some changes have not been made. No vital compensation schemes for misconduct victims have been developed, despite banks being notorious for the time they take to pay victims compensation.[233] ASIC has been active in this area, using press releases to shame the banks.[234] Considering this, the behaviour demonstrated by Australian financial service

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[225] 'Superannuation regulators ASIC, APRA unable to deter bad behaviour', *Australian Financial Review* (online, 16 October 2020) <https://www.afr.com/wealth/superannuation/regulators-unable-to-achieve-specific-or-general-deterrence-20180825-h14i0j>.
[226] 'ASIC pledges to get tough, but this week it has looked toothless', *The New Daily* (online, 16 October 2020) <https://thenewdaily.com.au/finance/finance-news/2018/11/23/asic-has-looked-toothless/>.
[227] Two years on Guardian podcast (n 217).
[228] 'Banking royal commission: most recommendations have been abandoned or delayed', *The Guardian* (online, 4 February 2021) <https://www.theguardian.com/australia-news/2021/jan/19/banking-royal-commission-most-recommendations-have-been-abandoned-or-delayed>.
[229] ABC (n 222).
[230] *Treasury Laws Amendment (Banking Executive Accountability and Related Measures) Act 2018* (Cth).
[231] The Guardian (n 228).
[232] Financial Sector Reform (Hayne Royal Commission Response No 3) Bill 2021 (Cth).
[233] Two years on Guardian podcast (n 217).
[234] Ibid.

conglomerates is an insult to victims of their misconduct across Australia. Australian financial service conglomerates may be too big to bring to heel, as a well as too big to fail.

The pandemic has slowed implementation of the recommendations. Many things that were meant to happen in the proposed timeline did not. The Australian Government has prioritised the pandemic over banking practices, and the financial services industry has seized the opportunity to drop the anchor on re-regulation. The laws on responsible lending have been scrapped, despite Hayne's request to keep them in place, risking a household debt disaster in Australia.[235] This act is contrary to the spirit of the Royal Commission and Hayne's recommendations. Most of the recommendations concerning the selling of loans have been scrapped, including trailing commissions for mortgage advisors, treating mortgage advisors as financial advisors and the development of a working group to scrutinise mortgage brokers has also been dropped.[236] Despite all of this, claims have been made in late October 2021 that the final tranche of legislation flowing from the Hayne Royal Commission has been introduced, seeing close to 90% of the recommendations in the final report enacted by the government.[237] There is a clear conflict between the rhetoric from the government, and the rhetoric from other commentators, making it difficult to establish a conclusive figure of the recommendations that have been implemented.

On a positive note, banking is becoming more straightforward. Banks offer standardised accounts with no fees or minimum deposits and are making banking more accessible. Several banks have sold or are selling their other businesses, such as wealth management, insurance, and financial advice to focus on core banking.[238] All these changes are what banks should have been doing anyway. It is almost bittersweet that a Royal Commission outlined such grave misconduct, and the outcome is that banks are working their way

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[235] 'Australia risks 'household debt disaster' if responsible lending laws scrapped', *The Guardian* (online, 4 February 2021) <https://www.theguardian.com/australia-news/2021/feb/04/australia-risks-household-debt-disaster-if-responsible-lending-laws-scrapped>; Alexander Mackey, 'Feature: Responsible Lending and Responsible Spending: What's with the push to rollback consumer protection?' (2021) 43(7) *Bulletin (Law Society of South Australia)* 8, 9.
[236] Two years on Guardian podcast (n 217).
[237] 'Final tranche of Hayne reforms a 'significant milestone'', *Australian Financial Review* (online, 28 October 2021) <https://www.afr.com/companies/financial-services/final-tranche-of-hayne-reforms-a-significant-milestone-20211027-p593km>.
[238] Two years on Guardian podcast (n 217).

towards a level of integrity that should have been demonstrated from the start. There is still much to do. Customer protection should be enshrined in legislation; this thesis has demonstrated that voluntary codes are insufficient in protecting consumers interests.

Has the Royal Commission led to radical changes? To the structure of Australian financial service conglomerates, to an extent. Executive pay has also seen significant changes, but the permanency of those changes is questionable. In institutions made of money, how long can executives resist the temptation to do something shady for a few extra dollars? Until the culture within these institutions is overhauled, history is due to repeat itself. Culture is key, and without a culture change, there is no change of behaviour. This thesis has also shown that culture and governance do not change overnight. Any victories claimed by the banks in overhauling culture and governance thus far are false. Consumers have a short memory and can be fickle when it comes to money. Banks might think that if they can convince everyone they have changed, this will soon be a distant memory. Prevention is better than cure, and illusion hides the issue. The more cynical might say banking will not change. Only time will tell. The proof will be in the pudding.

CHAPTER 10: CONCLUSIONS AND RECOMMENDATIONS

This thesis has considered ethical dilemmas in financial service conglomerates in the UK and Australia, and the legal, regulatory, and governance frameworks that manage them. It has also explored the role and significance of organisational culture in the correct management of these dilemmas. As a result of the research, this thesis draws four main conclusions from this topic. These will be discussed in turn.

I. Conclusion One

What ethical dilemmas, such as conflicts of interest and related party transactions, are common in financial service conglomerates?

Numerous ethical dilemmas are present in financial service conglomerates. These are exacerbated by certain factors which are peculiar to these institutions. Conflicts of interest and related party transactions are two ethical predicaments that are particularly common and important in financial service conglomerates. Their mishandling can damage the company, clients, stakeholders, or the economy.

Although conflicts of interest are governed primarily by statute and case law, recent events have shown that they are not managed effectively in financial service conglomerates.[1] Conflicts of interest are rife in Australian institutions[2] in particular, but their inevitability has been documented for some time in the UK.[3] They have become endemic due to the multifunctional aspects of these institutions[4], which have grown over time.

The broader the range of operations, the more potential conflict situations arise.[5] Financial service conglomerates provide a wide range of financial services and products, including commercial banking, investment management, private banking, financing, securities trading, insurance, corporate and investment banking, pensions, credit cards,

[1] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Final Report, Volume 1, 172.
[2] Ibid 135.
[3] The Law Commission, *Fiduciary Duties and Regulatory Rules*, Consultation Paper No 124, 1992, 61.
[4] *See generally*, Ingo Walter, 'Conflicts of Interest and Market Discipline Among Financial Service Firms' (2004) 22(4) *European Management Journal* 361.
[5] Gordon Smith and Andrew Gold, *Research Handbook on Fiduciary Law* (Edward Elgar, 2018) 360.

loans, mortgages, private equity, debt capital markets, research and CCIG.[6] Various conflicts can arise between the conglomerate's interests and its groups, directors, employees, and customers, and these multiply as more products and services are offered.

The improper resolution of conflicts of interest means a likelihood that the interests of one party will be unfairly subserved to the other. The ramifications of this can be vast. The correct management of conflicts of interest can ensure fairness in transactions in the financial services sector, restore trust and integrity in the financial system, ensure the efficient functioning of financial markets and support good outcomes for the clients of these conglomerates.

Related party transactions are a key ethical issue in financial service conglomerates. Improper related party transactions may damage company and shareholder value and harm stakeholder interests. Recent research states that improper related party transactions can be accompanied by deceptive and misleading conduct, dishonesty, conflicts of interest, breach of fiduciary duties, statutory directors' duties, best interest duties and breach of fairness requirements.[7] This suggests that improperly managed related party transactions also undermine the spirit of the law in many respects and can damage much more than contracts not executed at arm's length.

These conglomerates are subject to scores of different national regulatory and bankruptcy procedures, many of which conflict, stifling regulatory effectiveness.[8] From an internal perspective, directors and employees may be subject to various regulations depending on the nature of the product or service in question. Research has suggested that many company directors may be unaware of the fiduciary duties they owe and whom they are owed to.[9] This undermines the effectiveness of regulation and is particularly problematic in financial service conglomerates, as the improper management of ethical predicaments can damage the conglomerate and the broader economy. This shows that complex,

[6] The acronym CCIG is used to describe a broad range of products and services that Australian banks provide commercial, corporate, institutional and government bodies. These products and services include but are not limited to transactional banking, financial and debt capital markets, specialised capital, and alternative investment solutions.
[7] David Millhouse, 'Systemic and cyclical failure in Australian financial services and financial products sectors: have weaknesses in law contributed to these failures?' (PhD Thesis, Bond University, 2018) 144.
[8] Jacopo Carmassi and Richard Herring, 'The Corporate Complexity of Global Systemically Important Banks' (2016) 49(2-3) *Journal of Financial Services Research* 175, 176.
[9] Robert Goddard, 'Directors' Duties' (2008) 12(3) *Edinburgh Law Review* 468, 469.

conflicting, and voluminous regulation is counter-productive and may encourage unethical behaviour in resolving dilemmas.

Many of the ethical predicaments and aggravating factors in this thesis can be attributed to concentration. Concentration led to a highly interconnected financial services industry. This gave economies of scale, convenience, and the perception of stability. It also reduced competition, exacerbated ethical quandaries, and undermined consumers' best interests.

Multiple ethical dilemmas exist in financial service conglomerates. Conflicts of interest and related party transactions are two important classifications of these. Policy recommendations are made in Conclusion Four about improving this area.

II. Conclusion Two

What are the shortcomings in the legal frameworks for the management of ethical dilemmas, such as conflicts of interest and related party transactions, in financial service conglomerates, and how has supervision changed?

Chapter Two states that there are regulatory challenges posed by financial service conglomerates. This thesis concludes that one of the most significant shortcomings in the legal framework for managing ethical problems is the volume of documents and regulations that apply to all or some aspects of financial service conglomerates' operations. These conglomerates are subject to multiple legislation, regulations, guidance, standards, industry codes, information bulletins, reports, and policies. This problem is prominent in Australia, where vast amounts of legislation apply to authorised deposit-taking institutions, general insurance, life insurance and friendly societies, private health insurance, and superannuation.[10]

There is scope for simplifying and consolidating regulation governing ethical issues in financial service conglomerates. The range of responsibilities and duties may confuse, attract wilful ignorance, or be misunderstood by directors. Various documents such as The Corporate Governance Code go some distance towards clarifying obligations and

[10] *See generally* Professor Elise Bant, Melbourne Law School, Submission to the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, 4 October 2018.

expectations of financial service conglomerates. Still, without a culture of compliance or duties imposed on these institutions, such a document will always have a limited impact. A binding document that clarifies expectations of financial service conglomerates would help communicate regulatory objectives and simplify compliance. These principles would be championed without having to overhaul the legislation. In many situations, the regulation is well-intended but cluttered and complicated in its application.

One of the challenges facing this is the willingness of financial service conglomerates to comply. Chapter Nine demonstrated that in Australia, financial service conglomerates have almost been a law unto themselves. Despite the existence of good financial regulation, these conglomerates have done as they please without reprise. Even after a Royal Commission, not much has changed for these institutions, and the regulators have not brought them to justice. Post-Hayne, there is an onus on regulators to perform better, and time will show if that will be done. There is also scope for simplifying the law to ensure less falls through the cracks of ignorance and confusion. This is of limited effect, which is why culture needs to be championed to assert compliance and ethical behaviour in these institutions, specifically in Australia.

There is an opportunity in both the UK and Australia for the creation of a regulatory instrument to clarify the expectations, requirements, and obligations of directors of financial service conglomerates with regards to their current legal obligations, ethics, culture, governance, and the critical aspects of acting in a genuinely upstanding manner. Here lies an opportunity to tackle the issues discussed in this thesis.

Regulatory instruments are used to solve economic or social conflicts, and since they are binding, they can be implemented by force. The creation of this instrument in each country would help achieve clarity and aid accountability in financial services. It would also represent an opportunity to overhaul standards of behaviour in financial services. Such an instrument could be used to:

- Simplify and condense the existing legal and regulatory requirements for directors;
- Detail the expectations of financial service conglomerates, in line with public expectations;

- Contain both prescriptive and proscriptive requirements for directors which must be mirrored by employees in positions of accountability, responsibility, and trust;
- Use the misconduct demonstrated by the global financial crisis and the Hayne Royal Commission as examples of the types of behaviour that have no place in the future of financial services;
- Establish mandatory governance requirements for financial service conglomerates;
- Establish aspects of good culture such as honesty, compliance, integrity, fairness, ethical behaviour, and prioritising customer outcomes and interests, which directors should be mandated with striving to uphold; and
- Establish deterrent penalties for the infringement of duties beyond financial penalties and link liability for infringement to the accountable parties mapped out by financial service conglomerates in the Senior Managers Certification Regime in the UK, and the Banking Executive Accountability Regime and Financial Accountability Regime in Australia.

III. CONCLUSION THREE

What is the role and importance of culture in financial service conglomerates in the management of ethical dilemmas? Have the lessons from the global financial crisis and the Hayne Royal Commission recommendations had a positive impact on governance measures in financial service conglomerates?

Both the global financial crisis and the Hayne Royal Commission have drawn attention to the behaviour of financial service conglomerates. Both events have highlighted the importance of culture in managing ethical dilemmas, and both events have had different effects on governance measures in these conglomerates.

The global financial crisis emphasised the importance of culture in restoring trust and integrity in the financial system[11], and the Hayne Royal Commission has done the same. Hayne stated that the financial crisis provided the link between culture and financial

[11] Paul Cox and Diandra Soobiah, 'An empirical investigation into the corporate culture of UK listed banks' (2018) 26(1) *Journal of Financial Regulation and Compliance* 120, 120.

soundness and stability. Weak risk culture was a root cause of the global financial crisis[12], but immediate responses focussed on remuneration practices rather than culture failings.[13] This underlines the important role culture can play in managing ethical quandaries, which supports good outcomes for customers and restores trust and confidence in financial markets.[14]

Culture is not something that should be considered entirely distinct from corporate governance but rather the key to its implementation. A culture of non-compliance can undermine any governance measures an institution may wish to set. Without the correct culture, governance measures will be seen as loose principles that can be bent or abandoned entirely to pursue personal or institutional gain. Therefore we need to rethink the role culture plays in managing ethics in financial service institutions.

This thesis has concluded that culture is essential to the management of ethical quandaries in financial service conglomerates. Culture is influential because it can address the problems that governance seeks to solve. Still, culture is not transplantable, nor is it easily implemented or even available in a 'one size fits all' framework, unlike corporate governance.[15] The corporate governance requirements in banks and financial institutions have always been different from other industries.[16] As a result, governance in these institutions should have a strong cultural framework at the centre. This needs to be more than just a code of ethics, but rather a genuine belief in doing what is right for customers and markets, being compliant and being ethical. This needs to be at the centre of everything a financial institution does.

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[12] Managing Culture: A good practice guide, 1st ed 2017 - Institute of Internal Auditors - Australia, The Ethics Centre, the Governance Institute of Australia and Chartered Accountants Australia and New Zealand, 6.
[13] Royal Commission (n 1) 377-378.
[14] Managing Culture (n 12) 6.
[15] Whether or not that governance framework will lead to 'good governance' is subjective. 'The Organisation for Economic Co-operation and Development (OECD) has draft Principles of Corporate Governance. The proposed OECD Principles are intended to be a non-binding statement of the key elements which underlie good corporate governance. Australia is involved in the development of the Principles at both the public and private sector level. Australia's corporate governance framework essentially consists of a 'matrix' of legislation, accounting standards which have the force of law, Australian Stock Exchange (ASX) Listing Rules, and voluntary self-regulatory codes of practice': Chapter Four: Corporate Governance Framework (6 March 2020) Australian Government Treasury <https://treasury.gov.au/publication/making-transparency-transparent-an-australian-assessment/chapter-4-corporate-governance-framework>.
[16] Luc Laeven and Irving Levine, 'Bank Governance, Regulation and Risk Taking' (2009) 93 *Journal of Financial Economics* 259, 259.

A. Lessons in the UK

The Walker Report came in the wake of the global financial crisis and recommended changes to the governance of big financial institutions. Unfortunately, the report was a 'crashing disappointment', as a major overhaul was neglected in favour of minor changes, and part of wider group of inconsistent international reports.[17] Unsurprisingly the 39 recommendations were well-received by the banks.[18] There is some similar sentiment in the Hayne Royal Commission's wake; Hayne missed his chance to rewrite the rulebook on financial service conglomerates, especially financial stability.[19] The global financial crisis represents a missed opportunity to learn about the importance of governance and culture in financial service conglomerates. More attention was paid to compensation arrangements and attitudes to risk, as we believed these were the catalysts for misconduct in UK financial institutions. The Hayne Royal Commission has renewed interest in this topic[20], but the same mistake should not be repeated.

A shortcoming of governance is its voluntary character. The European Commission concluded that the 'non-binding nature of a substantial part of the corporate governance framework, based essentially on voluntary codes of conduct, did not facilitate the effective implementation of sound corporate governance practices by institutions'.[21] This suggests that more needs to be done to ensure governance measures are facilitated. Short of making governance measures mandatory, culture would be a useful tool in instilling and reinforcing governance.

This thesis has demonstrated that factors exacerbate ethical predicaments in financial service conglomerates. Large, complex financial institutions are plagued by problems[22],

[17] 'Walker report a 'crashing disappointment'', *The Guardian* (online, 2 July 2020) <https://www.theguardian.com/business/2009/nov/26/walker-report-banking-comment>; Jean Dermine, 'Bank Corporate Governance, Beyond the Global Banking Crisis' (2013) 22(5) *Financial Markets, Institutions and Instruments* 259, 259.
[18] UK banks respond to the Walker Review (2 July 2020) CMS Law Firm <https://www.cms-lawnow.com/ealerts/2018/12/uk-banks-respond-to-the-walker-review-into-the-complaints-and-adr-landscape-for-the-uks-sme-market?cc_lang=en>.
[19] Steve Kourabas, 'Prudential Regulation in Australia and the Banking Royal Commission: A Missed Opportunity for Reform?' (2020) 31(1) *Journal of Banking and Finance Law and Practice* 1, 11 (Monash University Faculty of Law Legal Studies Research Paper No 3613506).
[20] Royal Commission (n 1) 394.
[21] Edyta Dorenbos, 'Corporate Governance of Banks: Is More Board Independence the Solution' (2013) 2013(2) *Dovenschmidt Quarterly* 46, 46.
[22] Michael Barr, 'Who's in Charge of Global Finance?' (2014) 45(4) *Georgetown Journal of International Law* 971, 972.

including complexity, transparency, culture, and regulatory challenges. These contribute to the ethical issues that are common in these conglomerates. Effective culture and corporate governance in these institutions may help manage these dilemmas more effectively by managing internal attitudes and responses to external factors.

B. Lessons in Australia

Australia has focussed on financial stability and prudential regulation since the global financial crisis. The Australian regulatory landscape changed in four primary ways; 'enhancing oversight and supervision; improving crisis management and resolution arrangements; strengthening the resilience of core prudentially regulated institutions; and increasing the transparency and resilience of major wholesale markets and the shadow banking sector'.[23] Whether financial service institutions were capable of self-regulation was a question posed after the global financial crisis[24], and did not serve as a warning for Australia. The same question still exists today in the wake of the Hayne Royal Commission.[25] It is concerning that further evidence demonstrates that past lessons have not been learned.

In Australia, culture, which was previously unmentioned before the crisis, now is a key Principle demonstrating how influential culture is in promoting legal, ethical, and moral conduct, especially in financial service conglomerates. The terms 'culture' and 'governance' are themes throughout the Hayne Royal Commission's Minutes of Evidence. The final report recommends that culture and governance require significant attention in response to shortcomings in the financial services industry.[26] The culture within banks is both a weakness and a potential systemic risk.[27] Improving culture is crucial to restoring faith in the banking system[28], thereby promoting financial stability. The importance of financial stability makes culture and governance issues of public policy.

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[23] Ian Beckett, 'Financial Regulation in Australia since the GFC' (2012) 3 *JASSA The Finsia Journal of Applied Finance* 20, 20.
[24] 'Can banks self-regulate?', *New York Times* (online, 25 October 2019) <https://www.nytimes.com/2008/01/25/business/worldbusiness/25iht-wbdavos.1.9497014.html>.
[25] Royal Commission (n 1) 105.
[26] Ibid 8.
[27] Cox (n 11).
[28] Ibid.

In some senses, the Hayne Royal Commission has failed to positively impact the governance of financial service conglomerates. The inquiry was resisted for years[29] and the chance to overhaul the industry was hijacked by public policy, and the implementation of recommendations hampered by the global pandemic. Despite a culture of non-compliance found in some financial service conglomerates[30], more than half of the recommendations put forth by Hayne have been abandoned or are in progress.[31] The Consumer Action Law Centre suggests that two years on, just 27 of the 76 recommendations have been implemented, two of those involved doing nothing at all.[32] This opportunity to change how financial service conglomerates operate should not be wasted, and the evidence confirms that culture can be a tool in improving the conduct of these conglomerates.

Two years on from the Hayne Royal Commission, culture has not improved and may have got worse. Bank workers still insist pay is linked to hitting sales benchmarks and sales leader boards are the norm.[33] The lure of bonuses for hitting targets has been replaced with the fear of sacking for not.[34] This is not the type of behaviour that should be allowed to continue in this industry and is even more inappropriate in the recent wake of the Hayne Royal Commission. There is general agreement that this type of culture is toxic and undermines the purpose of regulation and the essence of fairness. This further supports the notion that culture can play an important role in managing ethical behaviour and dilemmas in financial service conglomerates.

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[29] 'What we learnt from the Hayne inquiry', *Australian Financial Review* (online, 1st February 2021) <https://www.afr.com/companies/financial-services/what-we-learnt-from-the-hayne-inquiry-20200203-p53x8j>.
[30] Royal Commission (n 1) 12.
[31] 'Banking royal commission: most recommendations have been abandoned or delayed', *The Guardian* (online, 4 February 2021) <https://www.theguardian.com/australia-news/2021/jan/19/banking-royal-commission-most-recommendations-have-been-abandoned-or-delayed>.
[32] 'Banking royal commission recommendations flounder, two years on', *ABC News* (online, 8 July 2021) <https://www.abc.net.au/news/2021-02-04/banking-royal-commission-hayne-final-report-two-years-on/13110938>.
[33] ''Worse than ever': Australian bank culture has not improved since royal commission, staff say'', *The Guardian* (online, 1 July 2021) <https://www.theguardian.com/australia-news/2021/apr/07/worse-than-ever-australian-bank-culture-has-not-improved-since-royal-commission-staff-say>.
[34] Ibid.

Setting the 'tone from the top' is essential to embed good culture in a firm.[35] Culture should be set at the top and flow down. Directors should demonstrate, implant, and reinforce the right culture throughout the institution. By understanding the importance of culture, senior executives and management can endorse and implement cultural change. It is essential to shape behaviour, facilitate official policy, and influence the decision-making processes to ensure compliance with the correct company culture. Not all decisions can be part of a documented process. Culture needs to be specific to the institution and reflect positive culture requirements.

Now is the time in Australia specifically to renew the focus on culture as a tool to manage ethical performance in financial service conglomerates. The Hayne Royal Commission has thrust the regulators into the spotlight. Culture, governance, and remuneration are fundamentally important, intricately connected, and the regulators have an essential role to play in the supervision of these matters. Supervision must extend beyond financial risk to non-financial risk and control culture, governance, and remuneration.[36] The Hayne Royal Commission demonstrated that all financial services providers, no matter what size, need to analyse and review their culture and governance.[37] The Hayne Royal Commission has also shown that reform on integrity, trust and transparency, all elements of effective and ethical culture, need to be more than rhetoric.[38]

Considering the evidence supporting culture's role in managing ethical dilemmas in financial service conglomerates, the design, implementation, and promotion of a positive culture of honesty, integrity, and fairness should be pursued by these institutions. Employees should readily adopt this at all levels of the institution to pursue effective dilemma management. Once again, this must be tailored to the institution to achieve successful implementation, but the general themes of a positive culture will be consistent across the industry; honesty, integrity, and fairness.

A positive corporate culture, championed from the top-down, would see appropriate decisions made by all members of financial service conglomerates when faced with

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[35] Nicholas Barnett, 'Governance in practice: What is the role of 'tone at the top' in setting culture?' (2019) 71(1) *Governance Directions* 25, 25.
[36] Royal Commission (n 1) 47.
[37] Ibid Recommendation 5.6, 36.
[38] Ibid 265.

ethical dilemmas. It would not matter whether these were concerning related party transactions at a board level or a conflict of interests between an advisor and a client of financial products. Positive culture would reward honesty, integrity, and good customer outcomes. It would reward compliance with the regulatory framework that exists to safeguard parties' interests in all transactions. Circumventing the rules or pursuing personal gain would be flagged, challenged, and reported, the way that regulation intends.

Australia does not lack financial regulation. Rules and frameworks exist to ensure ethical issues like conflicts of interest and related party transactions are managed correctly. The issue is that the rules are not being followed. Some of the conclusions and recommendations go some way to addressing situations where duty may be breached in ignorance or confusion. The only way to overcome wilful breach of the regulatory framework is to weed out the current culture in financial service conglomerates and replace it with one that echoes the values that these institutions should already embody. The process may be complicated, but the overarching message is quite plain; financial service conglomerates should be doing what is suitable for customers, and they are not. As the research has demonstrated, lessons are not always learned from critical events such as the global financial crisis or Hayne Royal Commission, and without a change, this will continue.

Culture and governance are recurring themes throughout this thesis. Case studies of the Co-operative Bank and Commonwealth Bank in Chapter Seven highlight the significance of culture and governance in financial institutions, especially in mitigating improper ethical dilemma resolution. The correct corporate culture can help manage ethical issues, avoiding failures or reputation loss, and supporting good customer outcomes, fairness, and integrity. Now is the time to prioritise culture in financial service conglomerates as a tool to manage the frequent ethical predicaments that can cause adverse effects on customers and the greater economy.

IV. Recommendations

How can the management of ethical dilemmas in Australian financial service conglomerates be improved by changes to the regulatory framework and self-regulation?

All the recommendations intend to improve regulation and self-regulation in financial service conglomerates, specifically regarding ethical predicaments. All the recommendations have a dual purpose; to enhance the management of ethical issues and promote and reinforce positive corporate culture at these institutions through education, monitoring, and improvement. Although the research question pertains to Australian financial service conglomerates, the recommendations have been expanded to be suitable for both Australia and the UK.

A. Recommendation One

As a new regulatory measure, a regulatory instrument should be created, based on the current regulatory landscape, that clearly outlines the obligations of financial service conglomerates for common ethical issues such as conflicts of interest and related party transactions. One simplified central document for each country, authorised and endorsed by the respective regulators, would explain the ethical dilemmas that can arise in financial service conglomerates and the associated obligations in plain and unambiguous language. This would achieve clarity by simplifying and condensing the existing regulatory landscape. The same document should also detail mandatory expectations of behaviour, particularly regarding culture, governance, and ethical behaviour. This must be created with the appropriate regulators to ensure monitoring and enforcement are within their remit. If the regulator's remit needs to be extended, then legislative change will be required to address these quite serious concerns. This must be created via an impartial process in consultation with consumers. This will mandate how banks are to behave, and must not be written by industry, like the Australian Banking Code of Practice. This will ensure impartiality and a balance of stakeholder interests.

This instrument would be tailor-made to the current financial service conglomerate landscape and account for the diverse nature of their operations. This document would serve as a guide to directors and other employees and mandate the behavioural standards expected of them. It would mandate directors and other employees to uphold aspects of

good culture such as honesty, compliance, integrity, fairness, ethical behaviour, and prioritising customer outcomes and interests. It will establish mandatory governance expectations, tailored to financial service institutions with emphasis on non-financial risk, and establish deterrent penalties for the infringement. It will utilise the relevant accountability regimes[39] in each country of duties beyond to impose liability for infringement to the correct, accountable parties mapped out by the financial service conglomerates themselves.

The current regulatory framework would stay in place. Australia already has more than enough financial regulation, and such a document would ensure financial service conglomerates have every opportunity to comply with their obligations. It is time that banks began to work for the consumer again.

B. Recommendation Two

The first stage for improved internal management of ethical predicaments starts with identification and understanding. Financial service conglomerates should ensure that all employees, executive or otherwise, can effectively identify ethical issues and understand that they are situations that may require escalation. They may also be subject to certain processes, which will be influenced by a corporate culture that embodies honesty, integrity and supports good outcomes for customers.

Directors must ensure that appropriate procedures and training with regular updates are in place so that all staff understand their obligations and how to manage ethical quandaries in this industry. This needs to be onerous enough to ensure a robust framework is in place while still promoting employees' independent judgment. Financial service conglomerates should focus on the following key areas to strengthen the self-regulation of ethical dilemma situations.

1. *Information Barriers*

Effective information barriers should be in place to manage ethical dilemmas that can arise from the flow of information between different areas of the conglomerate. These

[39] The Senior Managers Certification Regime in the UK, and the Banking Executive Accountability Regime and Financial Accountability Regime in Australia.

can include separation of premises, personnel, reporting, filing and IT systems. Access to sensitive or private information should be restricted to individuals who have a legitimate interest in the transaction between the institution and the client. This information should not be used for any other illegitimate purpose. Empirical evidence suggests that information barriers are ineffective and have failed to address the practical challenge of financial conglomeration, despite their legal effect.[40] As a result, more effective measures should be prioritised.

2. *Policies and Procedures*

Policies and procedures are essential in ensuring that personnel know their obligations, can refer to the details of their obligations, promote uniformity across the institution and communicate changes and updates timely and effectively. By having strong and effective policies and procedures in place, only the most significant dilemmas will require management intervention, as most questions can quickly be answered by referring to the correct document. These must be written clearly and succinctly and reviewed regularly to ensure their validity and practical working nature. These documents should be stored centrally and easily navigable and available.

Policies should not be developed for the sake of development and should reflect how the business operates. Internal procedures should reflect the law, regulation, industry codes of conduct, best practice and the spirit of honesty and integrity. This will mirror the cultural norms that are to be prioritised in financial service conglomerates.

3. *Training, Monitoring, Reporting and Improvement*

Training, monitoring, reporting, and improvement is essential to the continued effective management of ethical dilemmas in financial service conglomerates. A culture of training will promote a culture of awareness, guidance, reporting, monitoring and improvement of the processes by which dilemmas are managed. Training ensures that all personnel are aware of and have the right tools to perform effective dilemma management. Monitoring is the most significant improvement and ensures that the institution is compliant with its

[40] Andrew Tuch, 'Financial Conglomerates and Information Barriers' (2014) 39(3) *Journal of Corporation Law* 563, 585.

obligations. Reporting will allow the regulators to see this.[41] This step is crucial to ensure that policy, procedure, and training are streamlined and representative of the nature of business. The measures in place must be applicable and realistic. Measures that are overengineered, restrictive, complicated, or inappropriate will not promote the correct culture but encourage personnel to cut corners or skip actions entirely.

4. *Improved Oversight*

It is the responsibility of management to exercise effective oversight of line staff and other managers. Managers should also be aware of front-line employees' actions and responsibilities. Regular updates and debriefs should be the norm in financial service institutions, regardless of their impact on human resources. Through these measures, managers are well-positioned to escalate any potential conflict of interest situations that may have been overlooked. It is also an essential tool to aid reporting, ensuring compliance, and promoting a culture of sound ethical dilemma management and resolution within the institution.

5. *Disclosure*

Disclosure is an essential tool in effectively managing conflicts of interest in the provision of financial services. It should not be the last resort, which it has been until now, but should form part of the management process to ensure full and frank customer engagement. The negative image associated with financial service conglomerates needs to be repaired and encouraging a culture of honesty may help improve public trust in the industry. The discussion on disclosure shows that clients are not always aware of their rights. The proposed signposting document discussed in Recommendation One will go some way to address this. Consumer interests need to be upheld by financial service conglomerates, especially when disclosing conflicts of interest.

6. *Declining to Act*

When the measures in place are insufficient, or the dilemma cannot be managed effectively or avoided, the institution should decline to act. Not all institutions will be

[41] This relates to the regulatory instrument in Recommendation One. It is important that any new reporting obligations are developed with the appropriate regulator to ensure they fall within the regulator's scope and remit. Without this, such obligations will be unenforceable and the regulators will not be able to monitor and review reporting.

able to address and manage every dilemma that arises adequately. If this is the case, this scenario should be recognised, reported, and not acted on. The institution does not have to provide specific reasons for why it cannot act. It is crucial to ensure that institutions can decline business where action would be illegal, unethical, will negatively impact their image or compromise good customer outcomes.

C. Recommendation Three

Financial service conglomerates should be banned from further expansion and be forced to sell off fringe operations.

Ethical dilemmas are common in financial service conglomerates, and factors such as structural complexity and size have exacerbated them. Moral hazard promotes risk taking in banks and undermines market discipline[42] and a lack of transparency makes it challenging for regulators to determine whether risks are appropriately controlled.[43] Regulatory arbitrage encourages banks to circumvent regulatory compliance, meaning the risks they are exposed to become insufficiently regulated[44] and 'conflicts of interests and seemingly cosy self-regulatory structures that govern… a pivotal financial function'[45] have had severe repercussions when things go wrong. The damage to the UK economy in the GFC was vast, and consumer confidence in the Australian financial system post-Hayne Royal Commission has suffered. Former Barclays Chief Executive Bob Diamond was resolute when he said 'the shape and form of companies does contribute to their culture'.[46] It is time that the shape and form of financial service conglomerates was addressed, to save us from any catastrophe in the future.

Financial service conglomerates should be dissuaded from further expanding and diversifying to tackle structural complexity and too big to fail. The current model is not

[42] Enrico Onali, 'Moral Hazard, Dividends, and Risk in Banks' (2014) 41(1) *Journal of Business Finance and Accounting* 128, 130-132.
[43] Angelo Borselli, 'Keeping Watch on Giants: The Supervision of Insurance Group and of Insurance Undertakings within Financial Conglomerates in European Law' (2012) 3 *Insurance Law Review* 26, 28.
[44] Gaming the rules or ruling the game? – How to deal with regulatory arbitrage – Speech by Daniele Nouy, Chair of the Supervisory Board of the ECB, at the 33rd SUERF Colloquium, Helsinki, 15 September 2017.
[45] 'Auditors face being called to account for their role in the global financial crisis', *The Guardian* (online, 19 January 2021) <https://www.theguardian.com/business/2009/oct/25/auditors-role-financial-crisis>.
[46] John Zinkin, *Rebuilding Trust in Banks: The Role of Leadership and Governance* (Wiley, 2014) 140.

manageable. Recently we have seen conglomerates shedding their life insurance arms[47] and other fringe elements of their business.[48] This promotes foreign entry to the market, stimulating competition and allowing banks to focus on their core operations. Financial service conglomerates should be tasked with reviewing their current structure and shedding fringe operations. This would reduce the potential for ethical predicaments and allow for better provision of core services. This would also promote the stability of the financial system.

Conflicted remuneration arrangements have also compromised good customer outcomes by encouraging unethical behaviour and misconduct. Performance-related pay and incentives schemes have urged employees to favour transactions or financial products regardless of client suitability. They have also influenced how complaints are dealt with, undermining integrity. Many of these conglomerates claim to no longer offer incentive schemes or pay commissions to certain employees. Instead, they assess their performance on how satisfied customers are, and how well employees meet compliance requirements and uphold company values. Bank workers still insist this is not the case and that pay is linked to hitting sales benchmarks and topping leader boards.[49] The responsibility of reforming remuneration practices in financial service conglomerates rests with the boards and senior executives. The Hayne Royal Commission cast the spotlight on these arrangements and the damage they were doing.

The Hayne Royal Commission has suggested that changes are made to commission structures in conglomerates to eliminate the conflicts of interest. The mere presence of conflicted remuneration or performance-related pay is sufficient to cause conflicts of interest between advisors and clients. The use of conflicted remuneration and performance and incentive based-payment models across their product and service lines. Performance-related pay should be linked exclusively to long-term viability targets, customer satisfaction and compliance. Remuneration committees should submit

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[47] Australian Banks Almost Exited from Life Insurance (13 June 2020) Bond Advisor <https://www.bondadviser.com.au/blog/australian-banks-almost-exited-from-life-insurance/>.

[48] 'Australia's Suncorp sells smash repairs arm to focus on insurance, banking', *Reuters* (online, 13 June 2020) <https://uk.reuters.com/article/us-suncorp-divestiture-ama-group/australias-suncorp-sells-smash-repairs-arm-to-focus-on-insurance-banking-idUKKBN1WF2E2>.

[49] The Guardian (n 33).

applications for pay grades, incentive schemes and commission schemes to the regulator for approval.

Ethical dilemmas are inherent in financial service conglomerates by virtue of their design. In some instances, these dilemmas have been exploited to the customer's detriment, and some instances of unethical behaviour have caused greater economic turmoil. The current approach to regulating ethical dilemmas is useful when a culture of compliance exists. When it does not, the various frameworks governing conduct may be easily overlooked or wilfully disregarded. Herein lies the potential for harm.

This thesis has suggested some solutions to improve the management of ethical dilemmas in financial service conglomerates, some of which are cultural. These must be adopted by the conglomerates themselves to aid the effective management of ethical dilemmas. Unfortunately, past events have not been enough to make significant changes to the way financial service conglomerates operate. Therefore a tougher approach is required.

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