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Financial System Reform Taskforce
The Treasury
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By email: FSRconsultations@treasury.gov.au

To: FSR Team

Royal Commission Recommendations – Draft legislation February 2020

The Australian Financial Markets Association (AFMA) is commenting on selected aspects of the draft legislation relating to Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry recommendations issued on 31 January 2020.

The comments address the following selected measures from the package of measures released for consultation:

1. Recommendations 1.6 2.7 2.8 2.9 and 7.2 - Strengthening breach reporting (Breach reporting).
2. Recommendation 1.15 - Enforceability of financial services industry codes (Enforceable codes)
3. Recommendation 2.1 – Advice fees and Ongoing fee arrangements (Advice fee & OFAs) and
4. Recommendation 2.2 - Disclosure of lack of independence
5. Recommendation 6.14 - Financial Regulator Assessment Authority (Assessment authority)
6. Additional commitment in response to recommendation 7.2 – ASIC directions power (Directions power)

Yours sincerely

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1. Recommendations 1.6 2.7 2.8 2.9 and 7.2 - Strengthening breach reporting (Breach reporting)

1.1. General remarks

The legislation markedly expands the matters on which financial services licensees (AFSLs) will have to report to ASIC under s912D of the Corporations Act. The changes go beyond those foreshadowed in the ASIC Enforcement Review Taskforce in its December 2017 report (Taskforce) and the Royal Commission. This is likely to greatly increase the volume of breach reporting by large institutions.

For a long time AFMA has advocated the need for greater certainty and objectivity in determining what breaches need to be reported, given that the s912D threshold of significance is subject to interpretation, particularly when the interpretation has the benefit of hindsight. Despite the intention to create greater certainty and less subjectivity, the previous test of significance is left standing. A breach will be taken to be significant and reportable if it is punishable on conviction by imprisonment in excess of the prescribed terms, if it is a breach of a civil penalty provision, if it results in or is likely to result in loss or damage to clients, or it is a prescribed matter. These reportable breaches will be in addition to the obligation to report breaches that the AFSL considers significant having regard to the current matters about number and frequency, harm and so on.

1.1.1. Section 912D(2)(a) drafting

The Taskforce recommended that serious misconduct by employees and authorised individuals should be deemed to be significant. Section 912D introduces the concept of reportable situations. s912D(2) includes as reportable situations (a) in the course of providing a financial service a AFSL or representative has engaged in conduct constituting "gross negligence", or (b) the AFSL or representative has committed "serious fraud".

The breach reporting provision proposed under s912D(2)(a) refers to an AFSL or representative having engaged in conduct "*constituting gross negligence*". We note that the meaning of "gross negligence", which finds its source in the tort law duty of care to another and use in contractual relationships, will need to be given greater precision, as the term has proved to be of uncertain meaning in a range of commercial and legal contexts. There would need to be an assumption that the gross negligence or serious fraud has been determined by a court for the purposes of this section. If not, how is an AFSL supposed to know what constitutes either offence? While serious fraud may be easier to deal with, gross negligence is not so easily determined. Should an AFSL have to pre-empt a court concluding that either offence might be found against the AFSL or a representative? This would not be reasonable or fair to either the AFSL or representative. Accordingly, this section should be amended to make clear either that it is a court that has determined gross negligence or serious fraud, or that there are clear definitions for

what they are. Given that "gross" is a vague term, we suggest that it not be used, and the Taskforce report be looked to for drafting guidance.

There is also a problem with the drafting of s912D(4), where it says that a person is likely to breach a core obligation if, and only if, the person is no longer able to comply with the obligation. If a person is no longer able to comply then they would be *in breach* rather than likely to breach. The wording *"likely to breach"* does not work in this context.

In relation to s912D(5)(c) there is no materiality threshold for what constitutes *"loss or damage"* unlike the current s912D(1)(b)(iv) which includes advertence to the potential financial loss to clients of the AFSL. No explanation is given for this change and AFMA believes that such a test needs to be retained to provide a materiality threshold.

1.2. Section 912DAB - Reporting on investigations

1.2.1. Definition of investigation

The term "investigations" could be read broadly and cover a wide range of investigative actions taken by an AFSL. For example, it could cover a compliance department asking an employee a question on a particular matter, prior to a formal file being opened on a matter. As such it would be helpful if the term "investigations" was clearly defined.

1.2.2. Beyond recommendation

An AFSL will be required to report a range of *"reportable situations"*, including the traditional requirement to report where there is a breach or likely breach of certain "*core obligations*" and including where an investigation has been commenced into whether there has been a breach or likely breach, and the breach or likely breach is significant.

AFMA notes that the requirement to report investigations was not contemplated by the Taskforce, although it endorsed an objective test which would have required the early reporting of potential breaches in many situations.

1.2.3. Materiality

With regard to the drafting of s912D(1)(a), an investigation always needs to take place to confirm that a breach or likely breach has occurred and whether it is significant. Reporting will be required even though an investigation discloses no reasonable grounds to believe that the AFSL has breached a core obligation. s912D(1)(a)(ii) therefore serves no purpose and should be removed.

Breaches of civil penalty provisions which are deemed significant should be subject to a materiality test in a similar way to the breaches of offence provisions under section 912D(5)(a). If the more serious offence provisions are tested against a materiality

threshold for the purposes of deeming whether the breach is significant, then we see no reason why breaches of civil penalty provisions are not treated in the same manner.

Abandoning any materiality element for this purpose results in the potential for over-reporting of breaches that are minor and insignificant. Investigations should be only be reportable where there are reasonable grounds to believe that the AFSL has breached a significant core obligation. We believe there is no regulatory benefit in reporting investigations where no breach is found, and that there is no policy justification for imposing this unnecessary red tape on compliance systems.

1.2.4. Timing

In addition to the requirement to report investigations, the AFSL must also report the outcome of the investigation into whether there has been a breach of a core obligation, even if it concludes that there was no breach or no significant breach. This must be done within 10 days of the AFSL *"reasonably knowing"* that the investigation did or did not disclose reasonable grounds to believe that the AFSL or representative has breached the core obligation. We note that this is a shorter period than the 10 business days allowed under the current law. Current experience is that 10 business days is often a relatively short time to prepare an accurate summary of an issue, and the further reduction in time will pose an additional challenge for AFSLs.

It is also unclear when an AFSL attains a reasonable knowledge for the purposes of the reporting timeframe. For example, at what level would knowledge in an employee be deemed to be knowledge of the AFSL? The Explanatory Memorandum (EM) refers to an example where *"senior staff"* are made aware of the breach. Does this mean when the "accountable person" is notified? In the interest of consistency, there needs to be much greater effort on the part of the drafters to tie in language and statements with the package of laws being put forward, including elements of the Financial Accountability Regime.

The legal position is also unclear with regards to the terminology being used of "reasonable grounds", "substantial risk" and "justifiable risk". This cannot just be treated as mere lay descriptive language relating to judgments about factual circumstances. These terms are matters of legal interpretation. For example, would an AFSL be required to report a circumstance where it is of the view that a court considering the matter on a civil test would decide that, on the balance of probabilities, a breach did not occur? The Explanatory Memorandum (EM) needs to provide further interpretation of the legal meaning behind these terms.

1.2.5. Definition of investigation

Section 912DAB(2) deals with reporting of investigations conducted by the AFSL. "Investigation" has also not been defined and could be read broadly to cover a wide range

of investigative actions taken by an AFSL. For example, it could cover a junior compliance officer making enquiries and drafting an internal assessment of an issue to identify whether there has been any internal policy or regulatory breaches. Clarification is needed to ensure AFSLs know exactly what needs to be reported. Clarity is particularly important here as not only must the investigation be reported if there are reasonable grounds to believe a reportable situation has arisen, but also if there are *no* reasonable grounds to believe a reportable situation has arisen.

1.2.6. Section 912D(b) significance

Section 912D(b) refers to the need to make a significance determination with reference to s912D(5) and (6). The time to make the determination about significance is not time limited and therefore the question of whether a reportable situation exists is not time limited. This could lead to variability in how long it takes to report.

1.3. Section 912D(5)(c) - Breaches deemed significant – client loss or damage

Breaches resulting in client loss or damage should not be deemed to be significant under section 912D(5)(c). Instead, these breaches should be subject to the significance test in section 912D(6).

In the alternative, if our primary proposition is rejected, the subjectivity problem as to which breaches are reported needs to be addressed. Breaches resulting in client loss or damage should be subject to a materiality threshold, given that the Taskforce report specifically contemplated a materiality element. The Taskforce said that breaches of civil penalty provisions are deemed significant having regard to the loss suffered by clients relative to the amount invested and the circumstances of the client/s in question.

Abandoning any materiality element for this purpose results in the potential for over reporting of breaches that are minor and insignificant. For example, any breach resulting in a loss of 50 cents, even where these are isolated and / or have quickly been identified and remediated, would technically give rise to a reporting obligation as a reportable situation. This will drive up the costs of managing the compliance framework. Larger AFSLs with dedicated legal and compliance resources will need additional resources and external advice. Smaller AFSLs will need more external advice. The regulatory risk will be higher and AFSLs may want to be compensated for these administration costs and risks. This may lead to higher fees and charges being imposed on the recipients of more complex financial services (e.g. personal advice), further driving up the cost of advice and putting it out of reach of more Australians.

1.4. Section 912D - financial services law limitation

We have concerns with the drafting of section 912D(3)(a) and (b). The draft provisions seek to limit the application of breach reporting to paragraphs (a),(b),(ba) and (c) of the

definition of *"financial services law"*. This limitation is not replicated in relation to the obligation section 912D(1)(ca) regarding reasonable steps to ensure representatives comply with financial services laws, and s912(1)(b) concerning complying with the conditions of a licence. While there is some nuance between these provisions, the practical effect is that all "financial services law" without limitation may be subject to breach notification, regardless of whether there is customer loss, because while s912(1)(ca) is a civil penalty provision and any breach is deemed significant, the same does not apply to s912(1)(c).

The practical effect of this is will be to require breach reporting for any breach or mere investigation into a potential breach of a large majority of financial services laws. This will not be limited to just Chapter 7 of the Corporations Act but also Chapters 5C, 5D, 6, 6A, 6B, 6C or 8A, as well as Part 2 Division 2 of the ASIC Act. This means that there are a range of breaches of a minor technical nature that are not subject to civil penalties that would still be subject to mandatory reporting.

1.5. Infringement notices on suspicion

The reporting obligations will include administrative infringement provisions. ASIC will be able to issue a fine if it merely suspects an AFSL has breached its reporting obligations. AFMA is concerned with the statement in the draft EM which says: *"The use of an infringement notice is appropriate as it is expected that there will be a high volume of contraventions of the reporting provisions".* This statement is deeply concerning because it seems to suggest that despite the normal regulatory expectation that AFSLs must meet their obligations and are diligent in this purpose they will none the less be unable to comply with the law in practice.

An infringement notice must require ASIC to form a view on whether an AFSL has breached a reporting obligation, and certainly not on the basis of a mere suspicion.

1.6. Section 912DAC(1) - Obligation to report breach of other AFSL

Consistent with our view that the purpose of the legislation is to implement the Government's decision to implement the Royal Commission recommendations, AFMA considers that the obligation to report breaches of other AFSLs should be removed as it was not a recommendation put forward.

A reading of the EM suggests this obligation could be read broadly and not necessarily limited to situations where an AFSL has a close relationship with another. EM paragraph 2.72 says it is likely the obligation will arise in a situation where there is a relationship but does not limit this to situations where there is a formal relationship (e.g. contractual or distribution relationship). The EM also says that in practice, a reporting AFSL will likely develop reasonable grounds to suspect that a reportable situation has arisen in relation to another financial adviser through a relationship of proximity between the two entities.

For example, this may occur because of business dealings between the two entities or through mutual customers. According to paragraph 2.68 of the EM the reporting AFSL will also be required to lodge a report with ASIC if the AFSL has reasonable grounds to suspect that a reportable situation has arisen about an individual who:

- provides personal advice to retail clients about relevant financial products; and
- is operating under another financial services licence.

The broad nature of the proposed obligation on an AFSL when it comes to reporting on activities of other AFSLs is problematic. AFMA considers that the AFSL reporting obligations should be limited to the activities of the AFSL as they would not have full visibility of enough information to confirm whether there is in fact a breach at another organisation.

Additionally, it is difficult for a AFSL to determine that a reportable situation has arisen about another AFSL owing to limited or no access to the relevant information.

Without prejudice to our fundamental objection to this obligation, the test should be whether the AFSL itself has reasonable grounds to suspect and any investigation into whether an AFSL has breached this provision by not reporting another AFSL's breach. It should be focused on what the AFSL itself reasonably suspected at the time rather than an objective assessment of whether it should have suspected a reportable situation had arisen in relation to another AFSL. Accordingly, the drafting of the obligation to report breaches of other AFSLs. It could be expressed as follows.

A. Section 912DAC(1)(a) should be changed to "*it has* reasonable grounds to suspect" rather than "*there are* reasonable grounds to suspect"; AND

B. The obligation in this section to report breaches of other AFSLs should only apply to:

    a) the reportable situations mentioned in s912DAB(2) (gross negligence, serious fraud); and
    b) reportable situations which give rise to foreseeable material loss or harm to retail clients.

We also think the offence provision should be removed on the basis that it was not a Taskforce recommendation and is unreasonably onerous. It is unreasonable to subject AFSLs to this obligation to report the wrongdoing of others on the basis of a mere suspicion, without applying some level of seriousness to the types of reportable breaches. Otherwise, this obligation may trigger reporting obligations on AFSLs to report even very minor reportable situations of other AFSLs, failing which it will commit an offence.

1.7. Sections 912EB(5) and 912EB(6) – Notifying and compensating affected client

The 10-day notification and 30-day payment period are unduly short for situations where there are complex portfolios or large scale remediation involved. There should be an

element of proportionality included which takes into account the scale of the compensation exercise involved.

In some cases, there are complex portfolios (e.g. multi-currency share portfolios) and large volumes of transactions where it takes time to retrieve data and do the analysis. 30 days may not be enough time to perform this analysis and check calculations. This is even more so where there are long timeframes and lots of clients or there are complex fee schedules or fee and charge rates have changed over time.

The proposed legislation should also factor in large scale remediation projects. ASIC could be given the power to grant relief from complying with the timing requirements under this section where ASIC and the AFSL have agreed on a remediation plan. One way of addressing the concern about the need for timeliness in the case of a large scale remediation could be to give an AFSL the discretion to hold off from paying a client provided the AFSL compensates the client for delayed payment if that client is part of a broader ongoing investigation and ASIC has agreed to it.

2. Recommendation 1.15 - Enforceability of financial services industry codes (Enforceable codes)

AFMA considers that there are two points in the draft legislation for Enforceable Codes that require greater definitional certainty. The first concerns defining a code of conduct and the second relates to what is an enforceable provision. Given the significant consequences that will flow from making codes enforceable it is important that there now be much greater precision.

2.1. Defining code of conduct

As "code of conduct" is a generic term which is used in various ways for a range of purposes, it cannot be assumed that there is general understanding about what it means in the community. A financial services industry code has come to be understood as a promise by a subscribing organisation about how it will go about meeting a customer's legal rights under statutory or contractual law and to what extent additional legal rights may be conferred to benefit a retail consumer. The purpose of statutory enforceability is to provide a consumer with a statutory legal right additional to rights based in contract law.

The purpose of the RC Report Recommendation 1.15 was to deal with "industry codes". The RC Report said that they entail that *"promises can be enforced by those to whom the promises are made: the customer who acquires the product or service, and the guarantors of loans to individuals and small businesses"* [p12]. Clearly this does not encompass the types of codes commonly adopted by many industry associations, including those in the financial services industry, which give guidance on operational matters and set out accepted norms of professional behaviours when conducting business with peers.

Organisations have picked up the code concept for establishing internal organisational cultures. It is now accepted as part of current good corporate governance practice for a business organisation to have code of conduct that clarifies the organisation's mission, values and principles, linking them with standards of business conduct. Such a code articulates the values the organisation wishes to foster in its leaders and employees and, in doing so, defines desired behaviour. As a result, written codes of conduct or ethics can become benchmarks against which individual and organisational performance can be measured. Additionally, a code is a central guide and reference for employees or members to support day-to-day decision making. A code encourages discussions of ethics and compliance, empowering employees or members to handle ethical dilemmas they encounter in everyday work. It can also serve as a valuable reference, helping employees or members locate relevant documents, services and other resources related to ethics within the organisation.

None of these types of common codes should sit within the meaning of code for the purposes of the new s9 definition proposed in the draft legislation.

Because the codes of conduct referred to in the current s1101A of the Corporations Act rely on self identifying industry codes, with adherence by financial services organisations being voluntary and unilateral, there was no need to be more specific. The draft legislation in the proposed s9 definition does attempt to give some meaning and scope as follows

> *"code of conduct code means a code of conduct that relates to any aspect of the activities of:*
>
> *(a) financial services licensees; or*
>
> *(b) authorised representatives of financial services licensees; or*
>
> *(c) issuers of financial products;*
>
> *being activities in relation to which ASIC has a regulatory responsibility."*

However, this wording in practice does little to put a meaningful boundary around a code because it uses the term *"any aspect of the activities of"*. Evidently, "any aspect" of the activities of financial service providers enters the scope of industry codes.

It is proposed that a code of conduct code should mean a code of conduct that relates to a retail customer who acquires the product or service, and the guarantors of loans to individuals and small businesses from: (a) AFSLs; or (b) authorised representatives of AFSLs; or (c) issuers of financial products; being activities in relation to which ASIC has a regulatory responsibility.

2.2. Clarity on what is enforceable

Because of the serious legal consequences that flow from a provision being enforceable there should be clarity on what code provisions are enforceable to make clear to ASIC how it is to identifying such provisions under s1101A(2).

Code provisions should be clearly identified based on the following principles. Firstly, enforcement is not relevant to statements of the ethical principles underlying a code. Ethics are different to norms, as they are about how you tackle decision-making with regard to a norm. Secondly, in regard to norms, much of what was formerly in codes is now law rendering such norms redundant. Code enforcement should not duplicate what is required by statutory law, merely restating law in the code for reader guidance and contextual purposes. Enforcement of statutory requirements is fully dealt with in financial services regulation and ASIC is the proper and only arbiter on such matters.

Code enforcement should relate to the promises made by an organisation regarding standards going beyond meeting its statutory obligations to the customer. These are matters that could give rise to damage or loss to the customer, and an enforceable code will serve to ensure that a successful outcome for the customer is complied with by the organisation at fault.

3. Recommendation 2.1 – Advice fees and Ongoing fee arrangements (Advice & OFAs)

3.1. Frequency of obtaining written consent from clients:

AFSLs will need clarification on how frequently a client's written consent to deduct payment of fees relating to an ongoing fee arrangements (OFA) needs to be renewed. The EM suggests that such consent be renewed annually. However, the proposed drafting of the ED indicates that the consent only lapses when the client terminates it (s962U) or when the OFA is terminated or otherwise not renewed (s962V).

3.2. Definition of "account provider':

Clarification is needed as to which entity would be the "account provider" for the purposes of receiving the client's consent. For example, in an Investor Director Portfolio Services (IDPS) structure, would the "account provider" be the IDPS operator or the bank where the account is held? In a superannuation fund scenario, would the "account provider" be the superannuation trustee?

3.3. Estimation of asset-based fees

We seek clarification that disclosure of asset-based fees could be made based upon an assumption that the value of assets remains consistent through the next 12 months.

3.4. Penalties

We note that failure to keep appropriate records is intended to constitute a criminal offence with a penalty of up to one-year imprisonment. We feel that consideration should be given as to whether this is an appropriate penalty for isolated or immaterial record keeping errors or omissions.

4. Recommendation 2.2 – Disclosure of lack of independence

4.1. Commencement date query

Given the need to provide clients with new or supplementary Financial Services Guides (FSGs) by July 2020, we suggest that the proposed changes take effect one year from Royal Assent. In relation to updating of FSGs to comply with Recommendation 2.2 it is noted that ASIC will provide prescribed language. In this regard we question whether there is sufficient time before 1 July 2020 to enable an appropriate consultation period in relation to that prescribed language.

5. Recommendation 6.14 - Financial Regulator Assessment Authority (Assessment authority)

AFMA supports the proposal to establish the Financial Regulator Assessment Authority (FRAA). This development is consistent with the finding of the 2002 "Review of the Corporate Governance of Statutory Authorities and Office Holders" (Uhrig review) which found that "*the greater the independence of a statutory authority from government and the greater the power of that statutory authority, the greater is the need for governance."*

AFMA is largely supportive of the proposed structure as efficient and containing the correct balance between offering constructive review but without powers to direct the regulators.

We do raise concerns, however, in relation to two aspects of the design and drafting, specifically two limitations in the functions that we are concerned could adversely compromise the effectiveness of the authority. We believe while the authority would still be of some value it would be substantively restrained by these restrictions in relation to matters that are at the core of the regulators' responsibilities, particularly the making of legislative instruments

5.1. Regulator legislative instrument in scope of review

The foremost concern, which is fundamental importance, relates to the limitations that exclude the consideration of the regulators' powers to make a legislative instrument from the function of the authority. Related provisions exclude the consideration of matters relating to legislative instruments in defining the effectiveness of the regulators. The relevant sections are extracted below:

> *Division 3—Functions*
> *12 Functions*
> *(1) The Authority has the following functions:*
> *…*
> *(d) the effectiveness of APRA in exercising its powers (other than a power to make a legislative instrument);*
> *…*
> *13 Meanings of APRA's effectiveness and ASIC's effectiveness*
> *(1) APRA's effectiveness means the following:*
> *…*
> *(d) the effectiveness of APRA in exercising its powers (other than a power to make a legislative instrument);*
> *…*
> *(2) ASIC's effectiveness means the following:*
> *(c) the effectiveness of ASIC in exercising its powers (other than a power to make a legislative instrument);*

Many policy matters are directly related to the powers to make legislative instruments. As an example, at the moment ASIC is proposing to require foreign financial service

providers to gain a financial services licence to provide services to wholesale customers in Australia. This is a major change for the industry and may restrict the availability of services to Australian investors that is strongly opposed by AFMA and others. It is also a matter that is directly related to ASIC's power to make a legislative instrument granting relief to the licence arrangements.

The exclusion of matters relating to legislative instruments would exclude this key policy matter and many other similar matters from the consideration by the FRAA.

We do not consider it appropriate to restrict reviews of matters involving legislative instruments. ASIC in particular has many powers, with the power to make legislative instruments being one that is regularly used. There is nothing particular about the exercise of the legislative instruments power that should single it out for special exemption from FRAA review.

The argument given in the EM is that:

> *"APRA and ASIC also have policy-making powers to make legislative instruments. To avoid impinging on the regulators" independence in exercising these powers, the Authority is not empowered to review the effectiveness and performance of the exercise of these powers by the regulators."*

Regulators would still have complete independence in exercising their powers to make legislative instruments even if the exercise of these powers was subject to review and potentially reporting by the FRAA.

It simply does not follow that the existence of a review mechanism in relation to the regulators' actions with respect to what is their most significant power would compromise their independence. On the contrary, it is of paramount importance that the ability of regulators to make law is subject to professional review, particularly given its often complex nature.

The use of powers by regulators to make laws must be able to stand up to independent review. The use of proper processes in using these powers should give regulators confidence that their policy making functions will readily withstand review.

The current disallowance mechanisms have not proven to be effective in practice as they are rarely if ever used, and it is difficult for Parliament to intervene in technical and complex matters without the support of an independent review for support. The creation of the FRAA creates a rare opportunity to address the shortcomings of the disallowance system. If this is not addressed at this time then the question of *quis custodiet ipsos custodes*? may continue to go unanswered.

Further, as it is often open to regulators to approach matters via their legislative instrument powers instead of their other powers, there is a risk of creating incentives for regulators to take contentious policy implementations via this route to ensure they will

be outside of scope for FRAA review. This outcome would be inconsistent with objections of the FRAA and should be avoided.

5.2. Assessment single cases representing systemic issue

Our other area of concern is the one-dimensional approach to the exclusion of the assessment or reporting by the FRAA on single cases. The FRAA should not be an appeal dispute resolution body. However, we think the total exclusion of single cases would block the bringing forward of single cases which illustrates a systemic issue that should receive FRAA attention. The relevant provision is extracted below:

> *(2) However, the functions of the Authority do not include assessing or reporting on only a single case.*

We agree that the authority should not retry cases or comment on the final outcome of cases, as this could risk compromising the integrity of the process. However, this should not exclude consideration of the conduct of the regulator in relation to these individual cases.

And it is not sufficient to respond that these are matters for the ombudsman and similar channels of review for the interested parties. This is not a concern about the outcome of the cases but the process and practices that were used in the conduct of the case. There are often systemic issues that hang on the particular conduct of a regulator in a specific case.

While the great majority of individual cases will not be systemically important some cases will readily be so. These should not be excluded from consideration by the FRAA. Again, to design in such shortcomings is to risk limiting the capabilities of the FRAA in a manner that is inconsistent with its objectives.

As an example, it may be instructive to consider an example of one of ASIC's powers and how this might be relevant for review based on a single case. ASIC has the ability to apply for a search warrant and conduct raids. In the case of other commissions such as NSW's ICAC it was the specific conduct of the commission in relation to a single case that was associated with the similar powers being exercised that brought about wholesale review and change. While different single cases brought out different failures of conduct there was no pattern across the cases. Each single case demonstrated a particular deficiency that needed to be addressed.[1]

[1] One notable case involved ICAC officers going beyond a search warrant and videotaping pages of documents they did not have the power to seize. ICAC officers were reported as claiming this did not amount to seizure. In another single case the

While the outcome of these cases would be subject to court or administrative appeals and should not be reopened by any review body, the type of conduct in relation to each of these single cases could well be important from a systemic perspective, even though the issue raised are potentially present only in single cases.

We are concerned that the current one-dimensional exclusion of the consideration of single cases by the FRAA, instead of a more appropriate scope that will only exclude consideration of case outcomes, risks compromising the full effectiveness of the FRAA as an assessment authority.

Commission was found to have misinterpreted its powers in relation to the prosecution of the Deputy Senior Crown Prosecutor.

<https://www.theaustralian.com.au/nation/politics/nsw-icacs-own-gotcha-moment/news-story/101fab3cfb65956ff6bd1e7940f7d63e>

<https://www.theaustralian.com.au/nation/politics/caught-on-tape-another-icac-raid-goes-beyond-search-warrant/news-story/602df29584e4d7892f11adf9ec57667f>

6. Additional commitment in response to recommendation 7.2 – ASIC directions power (Directions power)

6.1. General

This proposal would allow ASIC to issue a direction on the basis of a mere suspicion of a contravention. This is fundamentally flawed, as it is contrary to Australian rule of law, and is too great a grant of arbitrary administrative power to ASIC.

The classic enunciation of the principles of the rule of law by jurists such as Dicey is the core principle of legality, which conveys the basic intuition that law should always authorise the use and constrain the risk of the arbitrary use of public power. The principle of legality restrains arbitrary power in three ways:

1) it constrains the actions of public officials;
2) it regulates the activity of law making; and
3) it seeks to minimise harms that may be created by law itself.

The legal system should guide the conduct of all legal subjects, including public officials. The principles that Australia's legal system follows include the need for transparency, non-retroactivity, clarity, generality, consistency, stability, capability of being obeyed, and declared rules constraining the administration of law as well as the discretion of public officials such as administrative decision-makers and law enforcement bodies. The benefit of formalised rules, controls and accountability requirements is that they permit individuals and entities to predict legal responses to their behaviour by public officials.

The growth of regulatory law has resulted in an expanded scope of discretion for public officials in interpreting standards and defining goals in various legislation and subordinate regulations. This development raises legitimate concerns with how accountability can be achieved in practice, because Parliament, the responsible minister, and the courts together cannot in a practical sense provide full oversight, given their lack of specialised policy knowledge and the sheer quantity of decisions that the administrative state generates.

The greatly enhanced powers that are handed to relatively independent administrative bodies, like the financial sector regulators, underlines the importance of administrative governance so that Australians and businesses can function normally without the risk of being frustrated by governmental arbitrariness or unpredictability. The principle of the rule of law in modern government requires an elaborate institutional complex staffed by competent and relatively impartial officials, using predictable and fair procedures in order to make reasoned and public decisions that, if an individual or entity wishes to dispute, can be argued by legal professionals and reviewed by an independent judiciary.

As the source of this proposal comes from the Taskforce their guiding words should be heeded in this context. They said:

> *ASIC's enforcement regime should be designed with checks and balances to ensure fair treatment and to safeguard against arbitrary exercise of powers. In considering how ASIC's enforcement regime may be strengthened, the focus should not be limited to desired regulatory outcomes. Due consideration should be given to protections afforded to the regulated population and how to best safeguard individual civil liberties and rights to ensure fair treatment by the regulator.* [p 12]

6.2. Not a RC Report Recommendation

The EM for the Directions power refers to Recommendation 7.2 of the Royal Commission Final Report (RC Report) as the basis for the Directions power draft legislation. Recommendation 7.2 says this:

> *The recommendation of the ASIC Enforcement Review Taskforce made in December 2017 that relate to self-reporting of contraventions by financial services and credit licensees should be carried into effect.*

This recommendation relates to the Breach reporting draft legislation. The RC Report made no recommendation regarding a directions power. This came from the Government's response to the RC Report recommendation in which it said:

> *The Government agrees to implement the outstanding ASIC Enforcement Review recommendations to improve the breach reporting regime. The Government also agrees to provide ASIC with powers to give directions to AFSL and ACL holders consistent with the recommendations of the ASIC Enforcement Review.* [p 37 Government Response February 2019]

The EM should be clear about the authority for this measure.

6.3. Reason to suspect

Section 918(1) would allow ASIC to make a direction where ASIC has a *"reason to suspect"* the AFSL is contravening a financial services law. While a "reason to suspect" is a legitimate basis for commencing an investigation such as under s13 of the ASIC Act it is not a legitimate basis for taking administrative action. The Taskforce provided only the most rudimentary rationale for the "reason to suspect" threshold which AFMA considers to be insufficient for such an important extension of administrative discretion to intervene in a commercial enterprise's activities. The Taskforce said it:

> *considers that a directions power could aid ASIC in graduated engagement, as the directions power can be triggered by a lower*

> *threshold of evidence and carries less serious consequences compared to a licence variation, suspension or cancellation [p 103].*

The threshold of suspicion is an ill defined low basis for administrative action. In *Goldie v Commonwealth* [2002] FCA 433 at [48-49] the Federal Court said that *"involves something more than mere speculation"* while in *Howarth v ASIC* (2008) 1010 ALD 602; [2008] AATA 278 at [134] it was said that it need not be a belief based on reasonable grounds.

Reasonableness is a fundamental basis for considering the legitimacy of an administrative decision. At the very least a decision by a public official to intervene in the activities of a business must be based on reasonable grounds. The Full Court's decision in *Minister for Immigration and Border Protection v Singh* [2014] FCAFC 1; 231 FCR 437 provides the following relevant principles concerning judicial review of the exercise of a discretionary power for unreasonableness in the legal sense:

1) *Legal unreasonableness "is invariably fact dependent" and requires a careful evaluation of the evidence. The outcome of any particular case raising unreasonableness will depend upon an application of the relevant principles rather than by way of an analysis of factual similarities or differences between individual cases.*
2) *There is a presumption of law that the Parliament intends an exercise of statutory power to be reasonable.*
3) *The concept of legal unreasonableness can be "outcome focused" such as where there is no evident and intelligible justification for a decision or, alternatively, it can reflect the characterisation of an underlying jurisdictional error.*
4) *Where reasons are provided, they will be the focal point for an assessment as to whether the decision is unreasonable in the legal sense, and it would be a rare case to find that the exercise of a discretionary power is legally unreasonable where the reasons demonstrated a justification.*
5) *The standard of legal unreasonableness applies across a wide range of statutory powers, but the indicators of legal unreasonableness are found in the scope, subject and purpose of the relevant statutory provisions, as well as being fact dependent.*

It is disappointing that the policy development process for such an important issue has involved so little legal analysis by the Taskforce before being taken forward into law. In summary, AFMA considers that "reason to suspect" should not be in s918(1) and that a higher threshold should apply. Where this threshold should be is a matter for further public consultation, with the views of the legal community being of particular weight in the consideration of the matter.

The principle of giving ASIC a graduated response power through the giving of directions that was important to the Taskforce in make their recommendation would still hold with a stricter threshold and be consistent with its recommendation in our view.

6.4. Procedural fairness not available in relation to interim directions

AFMA considers procedural fairness to be a central administrative law protection. It is noted that an AFSL or credit licensee is to be given the opportunity to appear at a hearing before ASIC and make submissions. However, this protection is undermined by s918F(1)(b) which allows ASIC to make an interim order without a hearing if ASIC consider that a delay would be prejudicial to the public interest.

An interim direction could be highly impactful on an AFSL or credit licensee and procedural fairness must be provided for in all circumstances. Not doing so would be inconsistent with the views of the Taskforce. The Taskforce noted that:

> *Public consultation on an ASIC directions power highlighted the importance of clear procedural fairness for licensees and assisted the Taskforce in arriving at its final recommendations. The Taskforce considers that ASIC should be able to require compliance with AFS or credit licence obligations in real time, and that the regulator should be given powers to direct licensees to take or refrain from taking actions where appropriate for this purpose, subject to procedural fairness.*

6.5. General conflicts of law protection required

There is no protection for an AFSL if ASIC gives a direction that conflicts with an AFSL's obligation to comply with other requirements in the law. The legislation needs to include a requirement for the ASIC direction to be consistent with the AFSL's other obligations under statute or general law in order to have legal effect. The obligation needs to be on ASIC to ensure that the direction is consistent in order for it to be valid.

6.6. S 918(6) Calculating compensation

The calculation of compensation is an important element of this measure. The calculation of compensation is a complex issue and there needs to be clarity and guidance on making such a calculation.