THE HON KENNETH HAYNE AC QC
COMMISSIONER
ROYAL COMMISSION INTO MISCONDUCT IN THE
BANKING, SUPERANNUATION AND FINANCIAL SERVICES INDUSTRY

24.10.2018

Dear Commissioner

Please find attached a submission from The Ethics Centre in response to your *Interim Report*.

We would be pleased to speak to our submission should there be value in our doing so.

Yours sincerely

Dr Simon Longstaff AO
Executive Director
The Ethics Centre
October 26th, 2018

LVL 2 LEGION HOUSE
161 CASTLEREAGH ST SYDNEY NSW 2000

WWW.ETHICS.ORG.AU

INTRODUCTION

This submission is made by The Ethics Centre in response to the *Interim Report* of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

The overarching theme of our submission is that, having offered compelling evidence that ethical failure lies at the heart of the matters it has investigated, the Royal Commission has underestimated the importance of strengthening the ethical foundations of the industries it has been examining.

While the community expects wrongdoing to be detected, remediated and punished, we argue that it would much prefer that misconduct not take place in the first place. Therefore, although enforcement of the law is necessary, it is not sufficient if the aim of public policy is to prevent wrongdoing and promote decisions and conduct that are right and good.

THE 'ETHICAL DIMENSION' REVEALED

The Commissioner refers to "basic standards of fairness and honesty" which he identifies with a number of "simple ideas" being to:

- Obey the law.
- Do not mislead or deceive.
- Be fair.
- Provide services that are fit for purpose.
- Deliver services with reasonable care and skill.
- When acting for another, act in the best interests of that other.

Each of these simple ideas has strong ethical content that should inform (if not direct) conduct irrespective of whether or not given legal effect by statute, regulation or in law made by judges.

Having identified these 'simple ideas', the Commissioner goes on to ask if the Law should be simplified to make it easier for them to be given practical effect. We would answer the Commissioner's question in the affirmative. The risk is that, in the hands of others, the Commissioner's simple ideas will be redrawn as detailed prescription – and that this will be done in the name of 'certainty'.

Legal history indicates that simple principles (rather than detailed rules) often give rise to the best law. For example, the Rules (or principles) of Equity are expressed in easy to understand aphorisms. Neither their brevity nor generality has limited their utility. It is worth noting that in the early Seventeenth Century, in the Earl of Oxford's case (1615) 21 ER 485, it was decided that in any contest between the Court of Chancery (Equity) and the King's Bench (the Common Law), equity must prevail. That is the most superior form of Law is that closest to its ethical foundations.

The Commissioner notes:

> The more complicated the law, the easier it is for compliance to be seen as asking 'Can I do this?' and answering that question by ticking boxes instead of asking 'Should I do this? What is the right thing to do?' And there is every reason to think that the conduct examined in this report has occurred when the only question asked is: 'Can I?'.
>
> The existing law has rightly been described, in at least some respects, as labyrinthine and overly detailed. In the blizzard of provisions, it is too easy to lose sight of those simple ideas that must inform the conduct of financial services entities.

We tend to agree – but would submit that the problem identified by the Commissioner is not just a product of complexity in the law. It is also a feature of systems that are over-reliant on compliance *per se*. Compliance often leads to unconscious conformance which, in turn, makes redundant the exercise of responsible judgement. Indeed, a system in which no person can choose to do anything wrong may seem to be the safest of all. However, an unintended consequence is that no person need choose to do what is right. Choice is redundant – there is mere compliance. Through lack of practice, the skill of responsible decision-making is weakened and eventually lost. Paradoxically, the habits of conformance increase, rather than reduce, risk – as, in practice, no system of rules can anticipate and control for every eventuality.

This not to say that rules, compliance and enforcement are unimportant. Our point is to draw attention to the need for a complementary 'principles based' approach that holds people accountable for the exercise of responsible judgement.

THE 'ETHICAL DIMENSION' JUSTIFIED

The principles invoked by the Commissioner are, in some sense, self-evident. One reason for the level and extent of public anger and disquiet in response to the conduct revealed by the Royal Commission is that it seems almost incomprehensible that anyone would think it acceptable to violate those principles for commercial or personal gain.

The Commissioner suggests that the unthinkable became acceptable because of the entities concerned:

- preferring profit to the pursuit of any other purpose; and
- treating regulatory compliance as a cost of doing business rather than as a foundation that informs and underpins how business must be conducted.

As to why this was so, the Commissioner reports:

> Too often, the answer seems to be greed – the pursuit of short-term profit at the expense of basic standards of honesty. How else is charging continuing advice fees to the dead to be explained?

We would submit that if this problem is to be addressed, then it will require something more than a reaffirmation of basic standards of honesty – or their articulation in the Law. Beyond this, we think that society, in general, and the industries involved, more particularly, need to delve a little deeper.

As a first step, we think it essential that attention be drawn to the reasons **why** the principles invoked by the Commissioner are so important. In our view, their binding force is derived from:

- a proper understanding of the intrinsic dignity of persons and the respect this requires;
- the ethical foundations of the free market; and
- the reasonable expectations of society – especially in return for its having granted the extraordinary privileges of incorporation and limited liability.

If the Commissioner's *Terms of Reference* allow for it, then we think that these issues should be addressed in his final report.

Respect for Persons

An unfortunate aspect of modern discourse about business and its responsibilities is its tendency to present all arguments in terms of utility. Thus, the case for good conduct is often framed as an appeal to 'enlightened self-interest' (avoid pain/secure gain).

This 'transactional' approach is reflected in the Commissioner's analysis of case studies and his conclusion that misconduct was often approved when the 'benefits' to the companies outweighed the potential 'costs'. The Commissioner implicitly adopts this form of reasoning when he argues that the solution to the problem of misconduct may lie in increasing the penalties to a point where they serve as a disincentive.

While we do not oppose the imposition of proportionate penalties for wrong-doing, we would argue that society should require businesses to act (as most people do) for reasons that go beyond 'enlightened self-interest'. As we argue below, such a requirement is not inconsistent with the commercial imperative in a free market.

Specifically, we think that businesses should recognise the intrinsic dignity of the natural persons with whom they deal – customers, employees, owners and shareholders, suppliers and members of the wider society in which they operate. The principal reason for treating people fairly, for not engaging in misleading and deceptive conduct, etc. is not that to do so might attract a penalty or secure a benefit. It is because a basic duty of honesty is owed to those who are ends in themselves.

Murder is not 'wrong' *because* it is illegal or *because* the police will investigate or *because* a successful prosecution will lead to punishment. Murder is wrong because it violates a person's fundamental right to life. Investigation, prosecution and punishment are merely the foreseeable consequences of committing murder.

Honest and fair business practice is not 'right' *because* it might reasonably be expected to build trust, confer benefits, avoid penalties, etc. Honesty and fairness enable persons to make informed decisions; to exercise their liberty unconstrained by force, fraud or fear. It is right *because* it is entailed in the principle of 'respect for persons' and their intrinsic dignity.

The intrinsic dignity of persons is the foundation stone on which stand all fundamental human rights. Both the Universal Declaration of Human Rights (UDHR; 1948) and the International Covenant on Economic, Social and Cultural Rights (ICESCR; 1966) include within their opening sentences:

> recognition of the inherent dignity and of the equal and inalienable rights of all members of the human family is the foundation of freedom, justice and peace in the world [...]

Intrinsic dignity underpins global relations of freedom, justice and peace. Across human rights literature this claim is often taken as self-evident. We think it deserves further consideration.

Intrinsic dignity is a property of 'personhood' – the 'state of being' to which the full range of fundamental rights and responsibilities apply. Personhood is generally ascribed to human beings – albeit for a variety of reasons that are not universally accepted. Intrinsic dignity is not contingent on the integrity of a person's material body, autonomy or health and well-being. It exists even if not recognised by others. It cannot be negated and endures regardless of the state of a person's being or the acts and attitudes to which they are subject.

By accepting the premise that all humans, irrespective of class, gender, race, ability, etc., possess intrinsic dignity, and that dignity is something that demands respect, we become subject to restrictions and demands on the ways in which we can and should act toward each other. Human rights instruments, such as the United Nations Declaration of Human Rights (UNDHR) translate these restrictions and demands into formal rights – which I some jurisdictions have the full force of law.

For example, Article 25 of the UNDHR states that:

> Everyone has the right to a standard of living adequate for the health and well-being of himself and of his family, including food, clothing, housing and medical care and necessary social services, and the right to security in the event of unemployment, sickness, disability, widowhood, old age or other lack of livelihood in circumstances beyond his control.

In Australian society, financial products like superannuation, loans and insurance help to underwrite security of health, well-being, food and shelter. Superannuation allows for a stable salary in retirement, loans allow access to homes that bring shelter, and insurance mitigates against risks of attendant financial and social

harms posed by illness and injury. Conversely, ethical failure in banking and finance can undermine intrinsic dignity – as evidenced in the case studies examined by the Royal Commission.

We would urge the Royal Commission to draw on these concepts – especially when considering how to resolve the tensions that inevitably arise when the interests of customers are at odds with the commercial priorities of a business or are not formally recognised at Law. For example, there will be some cases where the enforcement of a company's legal rights, in pursuit of its legitimate commercial interests, may have the effect of undermining one of the fundamental human rights of a person with whom it deals; say, a customer who may be made homeless through foreclosure or a community whose environment will be poisoned by activities funded by a bank. We would argue that the principles invoked by the Commissioner should anticipate such issues with a view to protecting fundamental human rights.

Free Markets

The work of the Royal Commission is set within the context of a market economy. As we have argued elsewhere[1], the philosophical basis for free markets has important implications for understanding the requirement for fairness and the application of other values and principles of the kind promoted by the *Interim Report*.

> Adam Smith was not an economist. Rather he was Professor of Moral Philosophy at the University of Glasgow. Although better known for The Wealth of Nations (a book frequently referenced but seldom read), his economic ideas can only be understood in the context of his other work – notably, The Theory of Moral Sentiments (in which the concept of the 'invisible hand' makes its first appearance).
>
> For Smith, as for other 'political economists', the market has no intrinsic value. Rather it is both an arena within which freedom of choice might be exercised and a tool for increasing the prosperity of all (and not just the few). Thus, 'the market' has a profoundly important moral purpose.
>
> The engine by which that purpose is realised is the legitimate pursuit of self-interest by economic actors. Smith reminds us that it is not through 'benevolence' that the butcher, brewer and baker make provisions for our dinner. Rather it is 'self-love' (self-interest – both theirs' and ours') that is the driving force. The 'invisible hand' ensures that self-interest is converted into an increase in the stock of common good.
>
> Often missed in Smith's work is the fact that his concept of a 'free market' is based on the acceptance and application of certain ethical norms. That is, he is not a proponent of unfettered competition of the 'let-it-rip' laissez-faire variety. Smith's market is not of the dog-eat-dog variety. Rather, he recognises that markets can only be truly free if they are not 'distorted' by various forms of corruption. So, a market cannot be 'free' if people lie or cheat or use power oppressively. All

[1] Longstaff, S. A. (2018) "On Equality" in CEDA (2018) *How Unequal: Insights on Inequality*, CEDA, Melbourne

such practices deny market participants the opportunity to make informed choices and thus, to exchange goods based on an accurate assessment of relative value. We see the principles of a free market in its ideal form.

Imagine a crossing point at a stream or river. On one side is a person with surplus wool. On the other a person with surplus wheat. One is hungry, the other cold. They exchange and move off – each better for the bargain.

A free market is built on the assumption that its participants are not subject to duress. An exchange is hardly 'free' if one of the parties has the equivalent of a 'gun at their head'. This simple truth has led to many social, legal and political reforms in which the aim has been to maintain some relative equality in bargaining power. For example, the creation of trade unions was in response to the exploitation of individual workers whose personal standing was grossly unequal when compared to the power of employers. The infamous status of the 'Hungry Mile' or children down mines, etc. reminds us of what happens when such asymmetry of power prevails as a structural factor in (not-so-free) markets.

In a similar fashion, we have seen changes in consumer law designed to even things up between producers and consumers. Notable examples of innovation include the Commonwealth Trade Practices Act which outlaws misleading, deceptive and unconscionable conduct – all in the name of maintaining a free market.

As with the link between equality of opportunity and justice as substantive fairness, there is an organic link between the concept of a free market and a basic equality between all of its participants. Specifically: all are equally entitled to make informed decisions; all are equally entitled to make genuine choices (subject to minimum constraint), all should be equally enabled to a reasonable benefit from the bargain.

This last point is especially interesting as it resonates with the findings of behavioural economists. Contrary to the assumptions of 'classical economics', human beings (across all cultures) are generally unwilling to make a bargain in return for what they know to be a minimal increase in utility. The classical model assumes (against the evidence) that an ideally rational person will prefer to have something (even a very little) rather than nothing. Instead, it turns out that real people choose to receive nothing rather than be treated unfairly. This human inclination to fairness was anticipated by Adam Smith who argued, in The Theory of Moral Sentiments, for the importance of the practices of sympathy (putting yourself into the shoes of the other person) and reciprocity (doing unto them what you would have them do unto you).

For Adam Smith self-interest explained why people would engage in the market. How they should exchange was a different matter! Again, one does not need to be a moralist to recognise the importance of Smith's insights and the evidence of the behavioural economists. A market that fails for lack of fairness and equality in its processes is no market at all. To ignore this basic reality is to be truly irrational.

We submit that there would be value in the Commissioner drawing attention to the ethical foundations of the market as part of intellectual framework that he draws upon in his final report.

The legal privileges of incorporation and limited liability

We think it important that corporations be reminded, from time to time, of their reliance on two extra-ordinary legal privileges – the granting of legal person-hood through incorporation and the limitation of the liability of owners and investors.

The development of these privileges was, at the time, a matter of considerable controversy. In debates ranging in time from the end of the Eighteenth until the middle of the Nineteenth Centuries it was widely objected that the severance of the bonds of personal responsibility would increase the risk of harm to individuals and society. Indeed, in 1844, a Report of a Select Committee enquiring into the provisions of the Joint-Stock Companies Bill (enacted later that year) had used headings such as “Form and Destination of the Plunder”, “Circumstances of the Victims” and “impunity of the Offenders”.

This older concern has re-emerged of late. For example, in 2016, the UK Government’s Green Paper on Corporate Governance specifically raised the question of limited liability as a privilege that risks being abused. In response to the Green Paper, the influential Institute for Business Ethics (IBE) submitted that: “We agree that reform should bring unlisted companies into the net. In this context we are struck by the reference to the “privilege” of limited liability. It occurs to us that limited liability should not be an inalienable right but one which is earned by recognition of responsibility. In cases of really egregious behaviour it should be possible to remove this right.”

The views expressed by IBE are certainly set at the more radical end of the spectrum. However, one can imagine people reading the volumes of the Royal Commission’s *Interim Report* being led to ask if the business community has lost sight of the privileges that it enjoys. Indeed, we think that this discussion may have particular relevance when businesses are thinking about the timing of reforms to practice that they know, deep down, to be necessary – but potentially costly. As the Commissioner notes:

> … there was the evidence that showed that even if doing business in a particular way was of actual or possible disadvantage to customers, the banks would not alter that way of doing business if unilateral change would bring significant competitive disadvantage.

We think that the Commissioner should consider reminding business of the fact that, without a measure of care, they could inadvertently undermine the legal foundations upon which they depend – especially in circumstances where politicians are exposed to popular outrage and disgust.

THE 'ETHICAL DIMENSION' APPLIED

There is a suggestion in the *Interim Report* that the Commissioner is sceptical of the role that ethics might play in remedying the deficiencies that he reports. For example, he writes in relation to the *Code of Ethics* being developed by the Financial Advisers Standards and Ethics Authority (FASEA):

> It is important to recognise the proper place of the proposed Code of Ethics. Professional codes are not laws. Codes of ethics are important to fostering public confidence and practitioner integrity in a profession. They are composed by industry practitioners according to agreed industry processes. Laws, by contrast, are the product of a public process conducted under the authority of democratic institutions. It is laws, and not codes of ethics, that are the proper repositories for basic norms of conduct. This qualitative disparity mandates a difference in approach to contraventions of each.
>
> While codes of ethics have a part to play in setting professional standards of behaviour, the industry must be conscious of their boundaries. The **investigation and punishment of breaches of law should not be outsourced to private bodies. Licensees and industry bodies should not try to resolve breaches of law by advisers internally, but must notify ASIC or other appropriate authorities.** A breach of the code of ethics must not be allowed to obscure, or be treated as more significant than, a breach of the law.

As a matter of fact, the FASEA *Code of Ethics* has been prepared by FASEA under Commonwealth legislation that requires the *Code* to be made. It will be promulgated by a Legislative Instrument of the Commonwealth Parliament. So, it will meet the Commissioner's basic requirement that it be a "product of a public process conducted under the authority of democratic institutions". That said, the Commissioner's point is correct in relation to most codes.

While we agree with the Commissioner that a breach of a code of ethics "must not be allowed to obscure ... a breach of the law" we do **not** agree that a breach of an ethical commitment is never more significant than a breach of the law. In some respects, this is a matter of jurisprudence – especially arguments about the sources and foundations of law.

On one view, laws are 'contingent' – they could be other than they are at any point in time. Furthermore, the mere fact that laws are the "product of a public process conducted under the authority of democratic institutions" does not make all laws, that meet that criterion, just, right or proper. For examples, Australian 'anti-miscegenation' laws – operating as late as the early Twentieth Century were clearly wrong – whatever their democratic pedigree. In that case, the intrinsic dignity of persons is violated by a democratic law enacted to prevent an Indigenous and Non-Indigenous couple from forming a loving relationship and starting a family.

We think that Codes of Ethics and Laws are both important. We also believe that occupational groups and members of the professions ought to be bound by obligations based on a framework of inter-personal accountability derived from a proper understanding of the purposes to be served by their organisation, association or profession. For example, it is difficult to see how any member of the legal profession could think that a concern for 'justice' was arbitrary or optional. The purpose of the legal profession gives rise to certain ethical obligations that are as compelling as any that might be sanctioned by a public process conducted under the authority of democratic institutions.

Given this, we would encourage the Commissioner to consider developing and expounding a more nuanced account of the relationship between ethics and the law. In doing so, we think that he could add to the strength of both – and thus their capacity to regulate conduct in a manner that realises the ends he promotes. As the Commissioner states:

> … penalising default is not the same as rewarding the right and proper performance of a task. Penalising default encourages hiding mistakes; it does not encourage doing the 'right thing'. It does not encourage the intermediary or the employee to ask, 'Should I, should the Bank, do this?'

We also think that the Commissioner should lend support to initiatives such as the *Banking + Finance Oath* (BFO) that establishes a common ethical foundation for the banking and financial services industry as a whole.

A practical commitment to ethics, rather than obedience to the law, leads and enables employees to ask about the 'right thing', to understand that, 'can does **not** imply ought'. That commitment requires:

- the development and articulation of an ethical framework of values, principles and purpose (all elements are required)
- a related program of education and training to build the capacity of individuals to make responsible decisions in line with the ethical framework,
- the forensic examination of systems, policies and structures to ensure that they are not driving behaviour that is inconsistent with the ethical framework
- routine assessment of monitoring of the experience of key stakeholders to ensure that it is consistent with what should emerge from the application of the ethical framework
- the establishment and effective implementation of processes by which examples and causes of misaligned behaviour can be reported and addressed.
- the provision of support to those who attempt to do what is right – rather than a sole focus on discipline those who do what is wrong.

SOME THOUGHTS ABOUT 'VERTICAL INTEGRATION'

The earlier sections of our submission have a bearing on the issue of 'vertical integration'. As the Commissioner observes:

> In particular, the second theme draws attention to consequences that appear to be related to, if not stem from, some entities being vertically integrated, in the sense that the entity manufactures and sells financial products while, at the same time, advising clients which products to use or buy.

We would submit that the risks of vertical integration are directly proportionate to the quality of the 'ethical skin' enveloping those working in such a structure. For example, there are many lawyers who work for corporations yet understand and accept that they are bound by professional obligations that set strict limits as to what they may or may not do.

The same is true of medical practitioners, engineers and accountants employed by corporations. No amount of commercial pressure would ever justify their acting in a manner that is inconsistent with their professional obligations. Society relies on members of the professions to do what is right – irrespective of the pressure placed upon them by colleagues with a narrower commercial focus.

Financial advisers are becoming subject to the same expectations as they move from the world of the market to that of the professions. The ideology of the free market legitimises the pursuit of self-interest through the satisfaction of wants. The ideology of the professions requires the subordination of self-interest. Rather than satisfy wants, the professions must discern and serve the interests of others. Most importantly, members of the professions are required to act in a spirit of public service – most often through the provision of public goods such as justice, health, safety, peace and prosperity.

The worlds of banking, superannuation and financial services will change in proportion to the number of true professionals that are employed in their ranks.

We invite the Commissioner to consider the question of vertical integration in this light.

CONCLUSION

Much of what we have written goes to questions of judgement and the ability to make responsible decisions.

With an abundance of caution, we should make it clear that we do not oppose the simplification of the law or its rigorous enforcement.

Rather, we think that the public interest will best be served by a more nuanced approach in which the ethical dimension of reform is given greater weight. We make this submission confident that much of what we argue is entailed in the observations and questions published in the *Interim Report*.

As the Commissioner notes, not everything of importance can be rendered precisely certain nor be measured:

> Management by measurement assumes, wrongly, that measurement can capture all that matters in dealings between bank and customer. It cannot and does not. So much was illustrated most clearly in the financial advice cases considered by the Commission. There are often circumstances where it is in the best interests of an adviser's client or a bank's customer to make no change to existing arrangements and take no new or different product. It is not easy to measure how often an employee is right to give advice to do nothing.

Our society has an unfortunate tendency to dismiss what cannot be measured or known with certainty.

We would urge the Commissioner to resist this tendency by asserting the primacy of principle so that the equivalent of equity prevails.

Dr Simon Longstaff AO
Executive Director
The Ethics Centre
October 26th, 2018