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Toothpaste for the toothless: why stricter rules are not enough for strata misconduct

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SNAPSHOT

- The strata management industry has been rocked by similar allegations to those investigated by the Hayne Commission with respect to the banking, superannuation and financial services industry.
- Since the Hayne Commission reforms, consumer confidence in the financial services industry has greatly improved.
- The Hayne Commission reforms, which include increased regulator enforcement and breach reporting, are a meritorious option moving forward for reform of strata management.

It was recently reported that a stalwart of a trusted industry, which has been awarded by the relevant professional association, was accused of conflicted and excessive charges in the form of product commissions. This was the story reported on 21 March 2024 with respect to strata manager, Netstrata, a founding member of the Strata Community Association ('**SCA**'). These allegations are still being investigated, with a commission of inquiry announced only recently, but this echoes the investigations of the Hayne Commission ('**Hayne**') into the financial services industry almost six years ago.

Beyond the superficial, there are also substantive similarities between the misconduct reported of financial advisers and those alleged against strata managers. Hayne found misconduct by financial advisers, including overcharging in the form of 'fee for no service' and 'giving advice that does not serve the client's interests but profits the adviser' (*Hayne Interim Report*, 73). Similar allegations have been made with respect to strata management: over-charging and conflicts of interest. The connection between the financial advice and strata management was expressly drawn in a 2022 report discussing strata insurance practices and the recommendations of Treasury's Quality of Advice Review ('**Levy**') with respect to strata management.

The Levy recommendations are in the process of being implemented and were a consequence of recommendations 2.3, 2.5 and 2.6 in the *Hayne Final Report*. However, it has been reported that, since Hayne, consumer confidence in financial advisers has already improved and a pathway towards restoration of consumer confidence in strata management could be found in those Hayne reforms. This article will consider the merits and applicability of those reforms to strata management. Specifically, it will consider increasing regulator enforcement and creation of a breach reporting regime.

Strata manager disclosure obligations

The current strata manager disclosure regime is governed by the *Strata Schemes Management Act 2015* (NSW) ('***SSM Act***'), regulations made under the *SSM Act* ('***SSM Regulations***'), the *Community Land Management Act 2021* (NSW) ('***CLM Act***') and regulations made under the *CLM Act* ('***CLM Regulations***'). It includes:

1. obligations of disclosure; and
2. fiduciary obligations with respect to owners corporations.

A strata managing agent has to disclose the following to owners corporations:

- third-party commissions and training services (s 60 of the *SSM Act* and s 64 of the *CLM Act*);
- connection or relationship with a service provider or a developer (s 71 of the S*SM Act* and s 75 of the *CLM Act*) and;
- a ban on receiving any gift over a very limited amount (s 57 of the *SSM Act*; r 63 of the *SSM Regulations*; s 61 of the *CLM Act* and r 38 of the *CLM Regulations*).

Contravention of these obligations carries a maximum penalty of 20 penalty units. For comparison, the maximum penalty for fraudulent appropriation is 20 penalty units. Additionally, a strata manager has a fiduciary duty to an owners corporation, with additional express obligations to act honestly and fairly and in the best interests of the client, and to avoid conflicts of interest.

The height of the bar for a fiduciary duty cannot be stressed enough. In *Ancient Order of Foresters in Victoria Friendly Society Ltd v Lifeplan Australia Friendly Society Ltd* [2018] HCA 43, Gageler J stated in obiter that a fiduciary obligation imposes upon the fiduciary an obligation to not be 'swayed by considerations of personal interest'; nor is the fiduciary allowed to misuse their position for personal advantage (at [68]-[69]). His Honour described contraventions of fiduciary obligations as 'unconscionable', reflecting that such obligations imposed by the fiduciary duty are not prescriptive but proscriptive, which follows obiter by Gaudron and McHugh JJ in *Breen v Williams* (1996) 186 CLR 71 (at [40]).

Financial adviser disclosure obligations

The proscriptive obligations imposed on strata managers are, when compared to the obligations imposed on financial advisers, observably more stringent. Indeed, it is the *standard* of obligations, which had been recommended to apply to financial advisers, that remains unadopted. At the time of publication of the Hayne final report, the disclosure obligations financial advisers had, with respect to retail clients, fell into two categories:

1. to provide various disclosure documents; and
2. to disclose conduct with respect to clients.

The former was introduced following the Financial System Inquiry in 1996 which recommended the creation of standardised disclosure to remove the inconsistencies between the various disclosure requirements existing at the time (p 236). It culminated in the *Financial Services Reform Act 2001* ('***FSR Act***') which required advisers to disclose conflicts of interest and to facilitate easy to understand comparison between financial products by providing retail clients various disclosure documents. These disclosure documents include financial services guides, statements of advice and product disclosure statements.

Following the Storm Financial and Opes Prime collapses, the Inquiry into Financial Products and Services in Australia ('**Inquiry**') in 2009 found *FSR Act* documents incapable of protecting consumers. Australian Securities and Investment Commission reported to the Inquiry that those disclosure documents were too complicated for most consumers to properly understand (p 99, [5.125]) and were ineffective where the financial adviser was not required to act in the best interests of the client (p 27, [3.33]).

In its final report, the Inquiry recommended that financial advisers be required to act in the best interests of their client and went on to recommend this be a fiduciary duty (p 110, [6.28]). Consequently, the Future of Financial Advice reforms ('**FOFA**') were introduced which imposed a duty on financial advisers to act in the best interests of their clients and a duty of appropriate advice. However this fell short of being a fiduciary obligation because those duties 'do not prohibit, and were not intended to prohibit, an adviser acting in their own interests', according to a Treasury review in 2022 (at [2.2]). Additionally, FOFA introduced what is notoriously referred to as the 'safe harbour' into the *Corporations Act 2001* (Cth) at s 961B(2). These are the formal steps that a financial adviser can point to in demonstrating satisfaction of the duty of best interest.

Subsequently, in Hayne, the effectiveness of the *FSR Act* documents were further challenged. They were referred to in its final report as a 'teetering edifice', finding these documents are often not read as they are too lengthy and complex (p 172, 174-5). While Hayne recognised FOFA 'represented an important step towards making financial advice a profession', he also criticised it (p 131). He identified the 'safe harbour' as problematic because in 'allowing advisers to adopt a "tick-a-box" approach to compliance, the safe harbour provision has the potential to undermine the broader obligation for advisers to act in the best interests of their clients' (p 177). Hayne recommended a further review to consider whether the 'safe harbour' should be removed entirely.

This further review was the Levy review. Its recommendations are still being implemented by Government with the Delivering Better Financial Outcomes Bill currently being considered by the Senate. Levy again observed the ineffectiveness of *FSR Act* disclosure and recommended that disclosure by financial advisers should be in a way that consumers 'would like advice to be provided to them' (p 3, 42). Levy also echoed the Ripoll Inquiry calling for implementation of a fiduciary duty and recommended removing the 'safe harbour', observing that disclosure should be proscriptive, instead of prescriptive, where '[t]he adviser must ask themselves – if I had complied with my best interests duty, would my advice be appropriate?' (p 28).

Towards restoring consumer confidence

Consumer confidence in financial advisers has greatly improved notwithstanding the disclosure obligation reforms having not yet been implemented, which points to these as not being immediately causal. That Hayne had recommended these be investigated in a further review reflects their relative urgency. Additionally, as outlined previously, the obligations imposed on strata managers are already much higher than was the case for financial advisers and this also suggests that increasing obligations is not necessarily the pathway forward.

The Hayne interim report raised questions as to the effectiveness of more obligations when considering reforms for financial advisers. In light of the above, that question is perhaps more applicable now, with respect to strata managers. Indeed, the executive summary of the Hayne interim report states:

> 'The law already requires entities to "do all things necessary to ensure" that the services they are licensed to provide are provided "efficiently, honestly and fairly". Much more often than not, the conduct now condemned was contrary to law. Passing some new law to say, again, "Do not do that", would add an extra layer of legal complexity to an already complex regulatory regime. What would that gain?' (p 2)

It is thus worth considering the Hayne recommendations that were immediately implemented and addressed the lack of compliance with already existing protections. In the Hayne interim report, the regulators ASIC and APRA were criticised for their lack of enforcement against offending financial advisers, which often 'either went unpunished or the consequences did not meet the seriousness of what had been done' (p 1).

With respect to industry participation, the Hayne interim report identified that misconduct arose from the culture of the industry and observed that the relevant industry bodies did not perform the disciplinary role as they claim (p 150-151, 155). They had no teeth because financial advisers do not need to be members.

There was also no information sharing of past misconduct from financial advisers to their prospective employers; amongst financial service licensees who employ or employed financial advisers; nor by financial service licensees to ASIC (p 149-155).

The Hayne interim report found, with respect to enforcement and industry participation, that whilst consumer protection is important, the regime also needs to denounce bad actors in order to address the culture of misconduct (p 154). It is a fallacy to only focus on 'consumer protection' which often leaves bad actors unpunished where they had already left the industry (p 155).

The Hayne final report concluded that one of the priorities is to reform enforcement and to that end recommended:

1. ASIC must serve the role of an enforcement body; and
2. the creation of an industry misconduct reporting mechanism.

Since then, the Government has implemented the necessary legislative and policy reform – with the *Financial Sector Reform (Hayne Royal Commission Response) Act 2020* (Cth) – which included a requirement that financial services licensees are to report any reportable event. As outlined in the reform bill's second reading:

> 'Strengthened breach reporting requirements will ensure more misconduct is reported, reports are provided in a timely manner, and strengthen ASIC's ability to take any necessary enforcement action.'

Failure to report a reportable event is itself a breach, carrying civil and even criminal penalties. ASIC has since taken an increased role in enforcement, and reported that in July to December 2023 there were 26 outcomes against financial advice misconduct, including two criminal and 15 currently ongoing enforcement litigations, including seven criminal. Since the introduction of these reforms, consumer confidence in financial advisers has improved.

Path forward for strata managers

In the upcoming review of reform in strata management, consideration should be given to the rhetorical question posed by Hayne: what would further regulations gain? Whilst the inquiry into strata managers is recently called, it would perhaps serve little to focus on reforming the obligations of strata managers. Rather, questions should be asked about the enforcement regime because of the similarity of the strata management industry to the pre-Hayne landscape in financial advising.

There is no equivalent of an ASIC in the strata management industry. The office of Strata Commissioner was very recently created, in September 2023, with that office previously being, since December 2021, the Property Service Commissioner. NSW Fair Trading has served an enforcement role and, according to their complaints guidelines, there is a detailed complaints handling process, involving various information gathering and negotiation stages and which may culminate in possible legal action in the NSW Civil and Administrative Tribunal. There is no industry reporting mechanism to the regulator for obligation breaches. Membership of the industry body for strata managers, the SCA, is not mandatory.

There are thus many signs that, if the allegations against strata managers are true and sufficiently widespread to justify reform, reforms should start with improving the reporting and enforcement of misconduct.

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