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AUSTRALIA

Financial Services Disputes – What's New?

June 2017

This publication aims to help you keep abreast of current trends and developments in disputes in the Australian financial markets and financial services sector, including contentious regulatory matters.

CURRENT ENFORCEMENT THEMES AND REVIEWS

As we noted in our February edition of *What's New*, 2017 promised to be a year of potentially significant legislative reform in the financial services sector. As we approach the midpoint of the year, the debate surrounding various reforms continues, through inquiries, committee hearings and consultations.

As Matt Thistlethwaite MP noted during the March hearings held by the House of Representatives Standing Committee on Economics: "on my calculation, there are 20 inquiries going on into banks and financial services in Australia at the moment. There are eight government inquiries, there are five parliamentary committee inquiries, and there are seven industry-led reviews".

It is far from easy to keep track of all this. In this edition we try and make sense of the talk of reform and focus on the Government's proposals in the recent Federal Budget to introduce a "one-stop shop" for all financial disputes called the Australian Financial Complaints Authority by 1 July 2018 and plans for introducing a regime designed to increase the accountability of senior executives of banks (Federal Budget). We also consider some recent developments with ASIC who have a number of important consultations ongoing (ASIC developments).

We also take a look at ASIC's joint review with the Australian Small Business and Family Enterprise Ombudsman (ASBFEO) into the compliance of small business standard form contracts with the unfair contract terms legislation. The review sends a strong message to Australian lenders to ensure their loan agreements are fully compliant with this legislation (Updating small business loans to comply with the new unfair terms provisions).

Contents

IN THE COURTS

In this edition we take a look at two recent decisions in the courts.

The first decision is the Full Federal Court decision in *Commonwealth Bank of Australia v Kojic* [2016] FCAFC 186. The decision is important as it clarifies that the collective knowledge of officers and employees generally cannot be aggregated and attributed to a corporation for the purpose of finding statutory unconscionability where no individual has acted unconscionably (No need to overshare: knowledge of individual bank employees could not be aggregated and attributed to the bank to establish statutory unconscionability).

The second decision is the first judgment from a court dealing with allegations of breach of the best interest obligations introduced by the FOFA reforms. While ASIC and the defendant in that case agreed liability, it remained necessary for the court to be satisfied that a proper basis existed for this agreement and the judgment contains some useful observations about what is required to satisfy the best interest obligations in Division 2 of Part 7.7A of the *Corporations Act* (Judgment in first Future of Financial Advice case).

We hope you find this publication useful, and welcome any feedback you might have.

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Federal Budget

Creating a one-stop shop for all financial disputes

In the Federal Budget handed down on 9 May 2017, the Government announced that it will create a "one-stop shop" for all financial disputes – the Australian Financial Complaints Authority (AFCA) – by 1 July 2018 to replace the Financial Services Ombudsman, Credit and Investments Ombudsman and the Superannuation Complaints Tribunal.

Since May 2016, the independent expert panel chaired by Professor Ian Ramsay has been reviewing the existing external dispute resolution and complaints framework (Ramsay Review). The "integrated package of reforms" recommended in its Final Report, all of which have been accepted by the Government, are expected to radically overhaul how financial disputes are dealt with in Australia. The key elements of the proposed new framework would appear to be:

1) *Independent and industry-funded*: AFCA will be funded by industry and governed by an independent board comprising an independent chair and equal numbers of directors with industry and consumer backgrounds.

2) *Broad remit with necessary powers*: new legislation will require financial firms that deal with retail clients, including superannuation funds, to be members of AFCA and comply with its determinations. Under the new framework, AFCA will be provided with the powers necessary to handle all financial disputes and bind AFCA members.

3) *Increased access to redress*: for most disputes, significantly higher monetary limits and compensation caps will increase access to external dispute resolution for consumers and small businesses. AFCA will commence operations with a limit of $1m and a cap of $500,000 for financial disputes (other than superannuation disputes), subject to regular indexation and review. Government will consult about whether a higher cap of $1m should apply to disputes involving mortgages and general insurance products, and whether current sub-limits for different insurance products are warranted. Special treatment is to be afforded to consumer disputes about superannuation and setting aside a guarantee (where a mortgage/security supports the guarantee) and small business disputes about credit facilities.

4) *Enhanced accountability and oversight*: AFCA's accountability will be enhanced by several mechanisms, including frequent independent reviews and reporting and an independent assessor to review complaints about AFCA's handling of disputes. ASIC will also receive $4.3 million over four years (from 2017-18), be provided with stronger powers to oversee AFCA and require financial firms to report on internal dispute resolution (IDR) activity.

5) *Strengthened IDR*: In addition to increased reporting on IDR, AFCA will refer all complaints that it receives back to the AFCA member to provide a final opportunity to resolve disputes within a defined timeframe. This mechanism will ensure that IDR is the primary avenue for aggrieved consumers and a gateway to external dispute resolution. Referred complaints will be registered and tracked, and AFCA will retain a discretion to exempt certain cases from the referral process.

A further report from the Ramsay Review is expected by the end of June 2017, which will make recommendations on the establishment, merits and design of a last resort compensation scheme and consider whether the scheme should apply to past disputes.

Banking Executive Accountability Regime

The Government has also announced its plans to introduce proposed reforms to increase the accountability of senior management in the banking industry.

Our Financial Services Update from 21 March 2017, identified the key elements of the Banking Executive Accountability Regime (BEAR) including a requirement for all senior executives and directors to register with APRA; APRA disqualification powers, new misconduct rules and civil penalty regime, deferred senior executive remuneration and increased APRA funding to implement these proposals. Our update also sets out our initial thoughts on the package and other implications the BEAR may have on banks' business operations and processes.

We expect to see further details of the BEAR fleshed out later this year and proposed changes implemented through legislative amendments, APRA's prudential standards and other APRA guidance.

ASIC developments

The capability review of ASIC last year noted that ASIC had a tendency to be reactive as opposed to forward looking in the way that it uses its resources. ASIC's current consultations and recent reports – and the ongoing reviews of ASIC itself – demonstrate an attempt to move towards a more balanced approach that emphasises the full scope and use of its regulatory toolkit.

ASIC consults on its proposal to develop and implement a Financial Services Panel

On 11 April 2017, ASIC released a Consultation Paper on its proposal to establish a Financial Services Panel. Initially, the Panel would be responsible for determining (in some circumstances), whether ASIC will make banning orders against individuals for misconduct in the financial services and credit industries. Over time, ASIC may expand the range of matters that the Panel may make decisions on, including ASIC's power to issue infringement notices or cancel an AFS licence or Australian credit licence.

Matters would be referred to the Panel where the significance, complexity or novelty of the circumstances lends itself to peer review. It is envisaged that the range of matters referred to the Panel may expand over time.

ASIC believe that by adding "a strong element of peer review" the proposed Panel – comprising industry participants or non-industry participants with relevant experience and expertise (eg lawyers and academics) – is intended to enhance regulatory outcomes by ensuring that ASIC's administrative decisions take into account current industry practices.

ASIC Enforcement Taskforce consults on significant breach reporting

The ASIC Enforcement Review Taskforce, formed in October last year, recently released a Position and Consultation Paper on the self-reporting regime for Australian financial licensees under section 912D of the *Corporations Act*.

In the Position Paper, the Taskforce discusses a number of the challenges which licensees face in applying the self-reporting test when considering whether a breach has occurred, or is likely to occur, and whether the breach or likely breach is significant. The Taskforce also identified a number of ways that the self-reporting regime could be improved; developing twelve preliminary positions, which encompass a range of reforms designed to enhance the current regime and make it more effective. Our Financial Services Update from 13 April summarised each of these preliminary positions.

Submissions on ASIC's product intervention powers

The first round of public consultation on the Commonwealth Treasury's Proposals Paper in December 2016 concerning ASIC's product intervention powers (see our Financial Services Update from December 2016) has now concluded, with submissions and feedback provided now to be considered by the federal government before the development of draft legislation, prior to a further round of consultation.

The submissions of ANZ, Westpac and NAB are publicly available. CBA has meanwhile signposted its involvement in the consultation process and expressed public support for the objectives of these reforms, yet previously had identified "considerable challenges" associated with the product intervention power in particular.

In their submissions, the major banks provide in principle support for the introduction of design and distribution obligations for product issuers and distributors as well as for enhancing ASIC's regulatory toolkit to intervene where there is a risk of significant consumer detriment. ANZ, Westpac and NAB's submissions qualify their support, however, in a number of important respects. Some of the highlights from the submissions in relation to the product intervention power are set out in the table below.

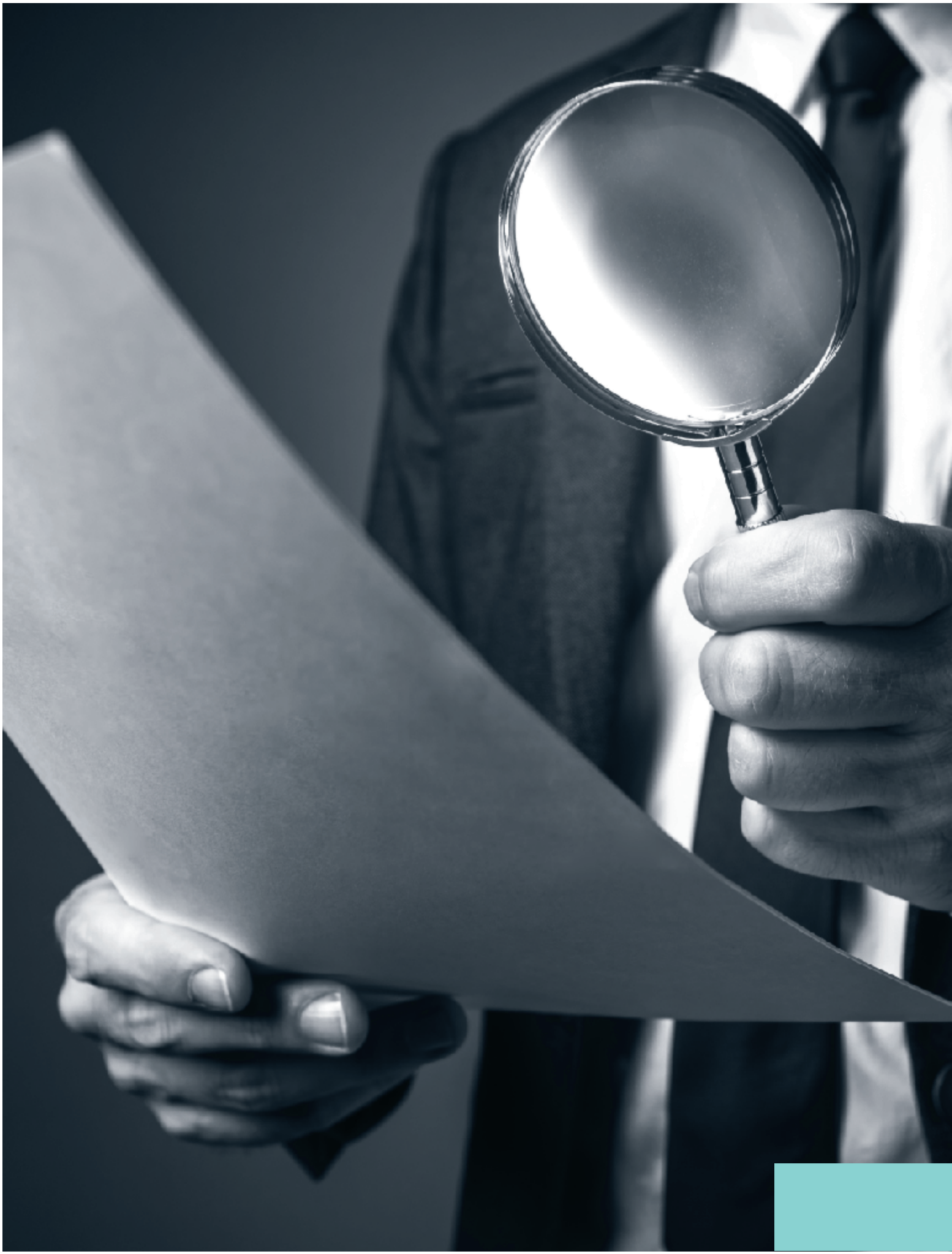
How large institutions oversee their advisers: ASIC report

In March, ASIC released a report on its observations and findings from its 18 month review of how large financial institutions oversee their financial advisers.

Our Financial Services Update from 21 March 2017, identified eight key messages from ASIC to financial advice businesses, including its expectations for compliance in areas such as breach reporting, adviser file audits, supervision and monitoring through data analytics, background checks, remediation and culture in advice businesses.

ASIC's report forms part of ASIC's broader Wealth Management Project – its findings should assist the financial advice industry to raise its standards and reduce the risk of providing non-compliant advice and poor customer outcomes.

Types of intervention	The potential interventions outlined in the Proposals Paper are appropriate, but an extension of the power to allow ASIC to make other types of interventions (eg intervening on matters relating to price) is not supported.
Applicable products	The power should apply to financial products made available to retail clients but, in addition to ordinary shares, several other financial products should be excluded. The lists of recommended exclusions differ between the banks, but include a number of OTC products.
Steps required prior to intervention	Prior to using the power, ASIC should be required to undertake consultation and consider alternative powers/other avenues, or otherwise carefully establish the need to intervene. This is consistent with the exceptional nature of the power and expectations that it would be used as a "last resort" and with a high level of accountability. For example, consultation with APRA may be appropriate where intervention raises issues that are relevant to other regulatory objectives (eg capital raising).
Regulatory guidance from ASIC	Further clarity is sought in relation to a number of matters, including when the power may be used (eg not to be used for pre-approval of financial products), prior consultation with affected industry participants and other regulators, transparency in its use and public reporting on intervention and assessing consumer detriment.
Duration of temporary intervention	NAB and ANZ consider that an intervention of up to 18 months is reasonable, whereas Westpac submitted that an 18 month intervention will adversely impact product innovation and create market uncertainty and that a 12 month maximum (with no ability for extension) would strike an appropriate balance.



Updating small business loans to comply with the new unfair terms provisions

Since 12 November 2016 the unfair contract terms legislation has been extended to standard form contracts with small businesses.

However in December 2016 the Australian Small Business and Family Enterprise Ombudsman (ASBFEO) queried whether the changes banks were making to their small business terms went far enough. The report on ASBFEO's inquiry raised the example of whether inserting the word "reasonable" into certain clauses which give banks discretionary powers would be sufficient for compliance with the new legislation.

In March 2017, ASIC and ASBFEO announced that they had reviewed small business loan contracts from eight lenders and found there had been a failure to take sufficient steps to comply with their new obligations.

The review identified concerns about unilateral variation rights, non-monetary default provisions, entire agreement clauses and broad indemnities. ASIC and ASBFEO reiterated that simply including the word "reasonable" in contracts does not go far enough. ASIC said that it would use its range of regulatory powers including taking a matter to court if ASIC identified a potentially unfair term and a lender refused to amend or remove it.

In March, the ABA's response to the independent review of the Code of Banking Practice said that it supported the removal of catch all material adverse change clauses but that individual banks needed time to consider the potential consequences of removing those clauses.

Following a round table hosted by ASIC and ASBFEO in May 2017, the regulators announced that the big four banks had committed to a series of comprehensive changes to apply to small business loans entered into or renewed from 12 November 2016. In some cases the changes will apply to all small business loans.

The changes include:

- removing entire agreement clauses from small business contracts;
- limiting financial indicator covenants (such as loan-to-valuation ratio covenants) to products where those clauses are essential to the operation of the product;
- removing material adverse effect clauses (that give banks the power to trigger a default) when unspecified negative changes occur;
- limiting the operation of indemnities against losses, costs, liabilities and expenses beyond the control of the borrower; and
- significantly limiting the operation of unilateral variation clauses.

These developments send a strong message to lenders to ensure that contacts with small businesses fully comply with the requirements in the legislation. ASIC has already identified particular types of provisions of concern and may test the operation of the new unfair contact term legislation in the courts.

No need to overshare: knowledge of individual bank employees could not be aggregated and attributed to the bank to establish statutory unconscionability

COMMONWEALTH BANK OF AUSTRALIA v KOJIC [2016] FCAFC 186

IN BRIEF

A complex issue facing large banks every day is when to share information about customers internally. There are many factors involved, such as confidentiality, credit risk and the need to identify and disclose any regulatory breaches. One aspect often misunderstood is the implications that sharing information may have if the bank is sued.

Large banks sometimes provide banking services to more than one party to a transaction, with different bank employees dealing separately with the different customers. In this situation, the bank employees may receive information from their respective customers which is not known to the other parties to the transaction, or to the other bank employees servicing those parties.

Even though the individual bank employees have not themselves acted unlawfully, a question can arise as to whether the knowledge of the employees can be aggregated and attributed to the bank in circumstances where this aggregated knowledge would establish that the bank has acted unlawfully, for example, in breach of statutory unconscionability provisions.

In *Commonwealth Bank of Australia v Kojic* [2016] FCAFC 186, the Full Federal Court found that the collective knowledge of officers and employees could not be aggregated and attributed to the bank for the purpose of finding statutory unconscionability where no individual had acted unconscionably and where the employees had no duty to inform each other about what they knew.

The bank provides services to two parties involved in a property development

In *Commonwealth Bank of Australia v Kojic,* two separate bank managers provided services to two parties involved in a property development project: the property developer and another investor who contributed funds towards the development.

The property developer borrowed $480,000 from the bank to buy a property costing $850,000. This loan was secured by a first registered mortgage over the property. The investor provided additional funds towards the purchase price, with a view to obtaining a 50% interest in the property. The investor knew that the property was encumbered by the mortgage, but did not know that the mortgage secured not only the $480,000 loan, but also other debts of the property developer to the bank. In particular, the investor did not know that the other borrowings of the property developer secured by the mortgage left no residual equity in the property.

What did the bank employees know?

The investor's bank manager understood that the investor's payment would result in a 50% equity in the property and that the bank was to finance half the purchase price, but not that this loan was secured by a mortgage which also secured other borrowings of the property developer.

The property developer's bank manager also knew that the investors were proposing to take a half share in the property and he knew that mortgage secured additional borrowings, but the two bank managers never spoke to one another.

The employees' knowledge should not be aggregated and attributed to the bank

The primary judge held that bank had engaged in unconscionable conduct contrary to sections 51AB and 51AC of the *Trade Practices Act*. This decision was based on a finding that the knowledge of the two bank officers could be aggregated and attributed to the bank. The primary judge concluded that it was contrary to good conscience for the bank to accept the funds from the investor when it knew that that payment was intended to secure a half interest in the property but would not do so because of the terms of the mortgage. The Full Federal Court overturned this decision, finding that the knowledge of the two bank officers could not be aggregated and attributed to the bank but that even if it could, the bank did not act unconscionably in the circumstances.

When considering whether knowledge of an officer or employee should be attributed to a corporation, the Court noted that the starting point should always be the statute rather than general principles of company law or agency, although those principles will be relevant. Here, the terms and context of the unconscionability provisions in sections 51AB or 51AC of the *Trade Practices Act* presented several obstacles to a novel approach of aggregation of knowledge. In particular, an aggregation principle could undermine the fundamental question of whether the conduct was unconscionable: "[i]t is not easy to see how a corporation which can only act through natural persons can engage in unconscionable conduct when none of those natural persons acts unconscionably".

On a practical level, the Court noted that if employee knowledge could be aggregated, in order to avoid liability, corporations would be required to speak with each and every employee and former employee to ensure that no one possesses any knowledge that, when coupled with an unknowing misstatement, could give rise to collective knowledge of wrongdoing. It may be impossible for corporations to put in place effective processes for this kind of knowledge sharing, with the effect that the aggregation of knowledge could impose a near-strict liability on companies. Importantly, the bank officers here had no duty to communicate their knowledge to each other, so there was no way the Bank could have acted differently to avoid liability for unconscionable conduct.

The Court also observed that it may well be that there are instances where proper and conscionable conduct by a corporation would *confine* information rather than disseminate it, for example where the information is confidential or where there is market sensitivity.

The Court commented that although this is not such a case, it is possible that there could be examples where a corporation acts unconscionably even though no individual has acted unconscionably. This might arise, for example, where a corporation has put in place procedures intended to ensure that no particular individual could have the requisite knowledge. It may also be, depending on the statutory context or substantive rule, that aggregation of knowledge might be appropriate if the officers or agent have a duty communicate with each other, but that was not the case here.

Judgment in first Future of Financial Advice case

AUSTRALIAN SECURITIES AND INVESTMENTS COMMISSION v NSG SERVICES PTY LTD [2017] FCA 345

In our October 2016 edition of *What's New?*, we provided a brief overview of *ASIC v NSG Services Pty Ltd*, the first case brought by ASIC alleging breaches of the best interests obligations in Division 2 of Part 7.7A of the *Corporations Act*. On 30 March 2017, the Federal Court delivered its judgment in the case. The court's judgment includes useful observations about what is required to satisfy the best interests obligations under the Act.

NSG Services Pty Ltd (NSG) holds an Australia Financial Services Licence permitting it to advise retail clients about life insurance and superannuation products through its representatives.

In June 2016, ASIC brought proceedings against NSG alleging that NSG's representatives had failed to:

- act in the best interests of their clients pursuant to s 961B (best interests duty); and
- provide advice appropriate to their clients pursuant to s 961G (appropriate advice duty).

ASIC and NSG agreed that NSG was liable for the alleged breaches, but it remained necessary for the court to be satisfied that a proper basis existed for this agreement.

Moshinsky J considered the legislative provisions and made the following observations:

- The best interests duty imposed by s 961B(1) will be satisfied if an advisor proves that, in giving financial advice, the advisor took each of seven steps in s 961B(2). Section 961B(2) was therefore a "safe harbour" for persons alleged of breaching s 961B(1). However, it was accepted by both parties including ASIC that a person may be able to satisfy the best interest duty in s 961B(1) even if they did not have the benefit of the "safe harbour" in s 961B(2). ASIC however argued that generally in the real world coming within the safe harbour will at least be the main way of showing the duty was discharged.
- His Honour noted a possible contrast between the best interests duty under s 961B and the appropriate advice duty under s 961G. He observed that it was common ground that "while s 961B is concerned with the process or procedure involved in providing advice that is in the best interests of the client, s 961G is concerned with the content or substance of that advice."
- His Honour observed that at first blush the text of s 961B did not appear to support the proposition that s 961B is concerned with the process or procedure involved in providing advice that is in the best interests of the client. However, he then went on to say that support for this way of viewing the focus of s 961B is provided by the context in which it appears including the language of 961G, the legislative history and the legislative materials.

Although his Honour did not reach a concluded view on this issue (as it was not necessary to do so), it seems to us his comments lend support to the proposition that s 961B is focused primarily on the process by which an adviser goes about ensuring he or she gives advice, rather than the content of the advice itself (which is the focus of s 961G).

Although ASIC and NSG reached agreement concerning NSG's liability, they did not reach agreement concerning the level of pecuniary penalties that were appropriate for the court to impose, which is likely to be determined by contested hearing at a later stage.

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