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Financial Services Disputes – What's New?

October 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.

IN THE COURTS

There is a lot happening in the Courts besides the more high profile actions which have dominated the headlines in the past couple of months. In this edition we take a look at three recent decisions.

Doing the maths on penalties: *Australian Building and Construction Commissioner v Construction, Forestry, Mining and Energy Union* [2017] FCAFC 113

The Full Court held that a single penalty cannot be imposed for multiple contraventions of a civil penalty provision on the basis of the "totality principle" or the "course of conduct" principle, unless specifically authorised by statute (although those principles still apply). The Full Court held that, generally, a separate penalty must be imposed for each offence. This is a departure from the approach that has sometimes been taken, and highlights some of the uncertainties in this relatively new, but increasingly important, feature of the regulatory landscape.

When does a lead manager and underwriter in a capital raising owe a shareholder a duty of care?

Following a capital raising, share price movements may cause investors loss. Underwriters, advisers and others involved in the transaction have always been a potential target of claims from investors who seek to make good such losses. One basis on which recovery is sometimes sought is negligence, but a signficant hurdle investors face is establishing they were owed a duty of care. We look at how the the New South Wales Court of Appeal dealt with this issue in *RinRim Pty Ltd v Deutsche Bank AG* [2017] NSWCA 169, a negligence action by a shareholder against a company and three joint lead managers and underwriters to a capital raising by means of an Accelerated Renouncable Entitlement Offer.

Full Federal Court clarifies criminal fault position for civil penalty proceedings

In a decision which will have come as a welcome relief to ASIC, the Full Federal Court has clarified that where a contravention of a provision of the *Corporations Act* may have separate civil and criminal consequences, the provisions of the *Criminal Code* that would apply to a criminal prosecution do not apply to a civil action.

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CURRENT ENFORCEMENT THEMES AND REVIEWS

Against the backdrop of some headline dominating regulatory activity in recent months – which has in some quarters renewed calls for a Royal Commission – it is easy to overlook other developments which could see significant changes.

These developments include:

- **The ASIC Enforcement Review Taskforce recent consultation paper which proposes extending ASIC's banning order powers to senior managers.** If accepted by Government, this would mean that directors, officers or senior managers of a financial services business could be the subject of an ASIC banning order as a result of their role. Along with the proposed BEAR (which affects a narrower range of licensees), the proposal represents another attempt by Government to increase accountability in the financial sector.
- **The Taskforce's preliminary recommendation that the financial sector (or parts of it) move from a self-regulatory model (ie industry codes) to a "co-regulatory model".** According to the Taskforce's recommendation, a "co-regulatory model" would involve a combination of self-regulation, with a degree of oversight by ASIC. The Taskforce has expressly declined to call for the content of codes to be incorporated into statute or regulation, but its proposals would result in customers having increased rights of redress where a code of conduct applies.

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

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Full Federal Court clarifies criminal fault position

FOR CIVIL PENALTY PROCEEDINGS FOLLOWING ITS DECISION IN *GORE V ASIC* [2017] FCAFC 13

In a decision which will have come as a welcome relief to ASIC, the Full Federal Court has clarified that where a contravention of a provision of the *Corporations Act* may have separate civil and criminal consequences, the provisions of the *Criminal Code* that would apply to a criminal prosecution do not apply to a civil action.

In *ASIC, in the matter of Whitebox Trading Pty Ltd v Whitebox Trading Pty Ltd* [2017] FCAFC 100, ASIC asked the Full Federal Court to clarify the law on whether there is a requirement to prove any fault elements of Chapter 2 of the *Commonwealth Criminal Code* in civil penalty proceedings relating to certain breaches of the *Corporations Act*.

ASIC sought clarification from the Full Federal Court following a decision, in February 2017, by a differently constituted Full Federal Court in *Gore v ASIC* [2017] FCAFC 13. In that case, the Full Court reasoned, in *obiter dicta*, that where a contravention of a provision of the *Corporations Act* could lead to both civil and criminal liability, the elements of the contravention must be the same irrespective of whether the question arises in civil or criminal proceedings.

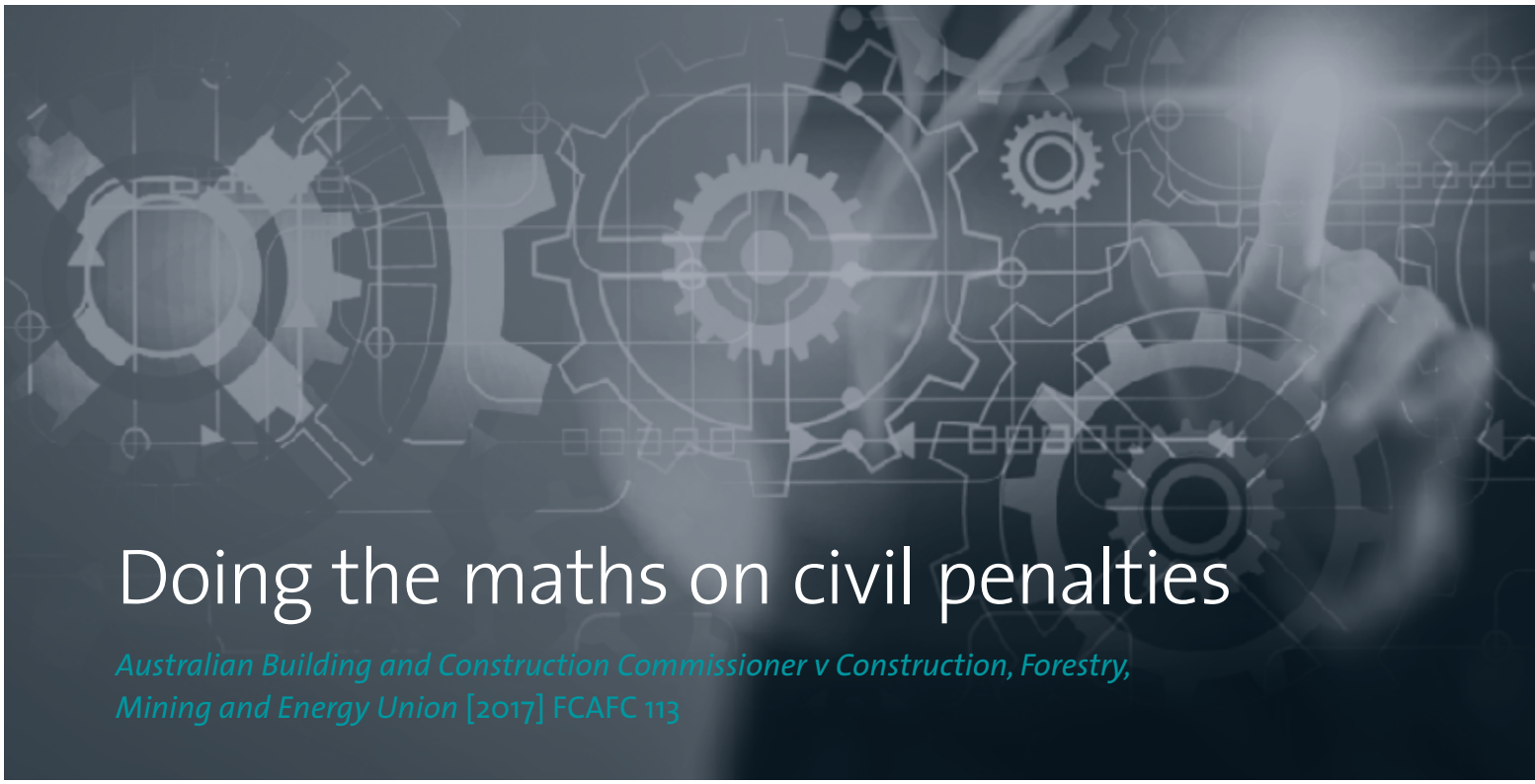
The observations in *Gore* were clearly of concern to ASIC as, if correct, ASIC would have been required to prove a fault element of intention or recklessness in order to obtain civil remedies (prior to this ASIC acted on the basis that it only had to prove fault in criminal proceedings). This would have constituted a significant obstacle to ASIC's ability to successfully pursue civil actions for alleged breaches of the *Corporations Act* where breach of the relevant provision has potential criminal and civil consequences.

Accordingly, ASIC applied to have the issue determined as a separate question by the Full Federal Court in its ongoing civil proceedings against Whitebox Trading Pty Ltd, in which it is seeking civil penalties against Whitebox Trading for allegedly engaging in market manipulation practices in breach of sections 1041A and 1041B of the *Corporations Act*.

Contraventions of these provisions may lead to civil penalties (pursuant to section 1317E) and criminal liability (pursuant to section 1311(1)). No allegations have been made by ASIC that Whitebox Trading committed a criminal offence and there are no criminal proceedings on foot. If the reasoning in *Gore* were to apply, ASIC would be required to prove criminal fault elements derived from the Chapter 2 of the *Criminal Code* for each of the proscribed physical elements in order for the Court to impose a civil penalty.

In June 2017, the Full Federal Court in *Whitebox Trading* (comprising Allsop CJ and Middleton and Bromwich JJ) unanimously accepted ASIC's submissions that the reasoning in *Gore* was incorrect. The Court found that a textual analysis of the relevant provisions of the *Corporations Act* leads to the conclusion that Chapter 2 of the *Criminal Code* does not apply to civil penalty proceedings relating to market manipulation. The structure adopted by the *Corporations Act* whereby Part 9.4 relates only to criminal proceedings and Part 9.4B relates only to civil consequences of contravening civil penalty provisions is a telling indicator that a crossing of the criminal and civil streams is not contemplated by the *Corporations Act*.

The Court concluded that proof to the civil standard of failure to comply on the balance of probabilities suffices to establish a contravention of the civil penalty provisions listed in section 1317E of the *Corporations Act*. The Court also confirmed that Chapter 2 of the *Criminal Code* does not apply to proceedings for contravention of a civil provision, including civil penalty proceedings. ASIC will therefore not need to prove criminal fault to obtain civil remedies against Whitebox Trading for market manipulation at the recommencement of the proceedings in September.



Doing the maths on civil penalties

Australian Building and Construction Commissioner v Construction, Forestry, Mining and Energy Union [2017] FCAFC 113

In an apparent departure from some past cases, the Full Court decided that a single penalty cannot be imposed for multiple contraventions of a civil penalty provision on the basis of the "totality principle" or the "course of conduct" principle, unless specifically authorised by statute. Instead, a separate penalty must be imposed for each offence. Whether this ultimately leads to higher penalties and whether this is the last view on the matter, remains to be seen.

The case is also interesting because the Court imposed larger penalties than those sought by the regulator and criticised the parties for jointly seeking a single penalty and failing to identify the number of contraventions that had occurred.

In a previous episode in this litigation, it briefly became harder to settle civil penalty proceedings in Australia when the Full Federal Court said it would ignore the figures agreed with a regulator, because submissions on agreed penalties were not allowed. Six months later, the High Court overturned this, saying this restriction on agreed settlements only applies in criminal cases, and unanimously holding that in determining a civil penalty in regulatory proceedings, courts are entitled to have regard to the parties' submissions on an agreed penalty.

Unlike criminal and other forms of civil litigation, civil penalties are a relatively new feature of the Australian legal landscape. This litigation illustrates the extent to which key principles applicable to civil penalties are still being worked out by the Courts.

THE GROWING ROLE OF PENALTIES

Three other recent penalties imposed by the Federal Court illustrate the increasing size and uncertainty surrounding the calculation of penalties. The approach to identifying and treating multiple contraventions based on related conduct is one of the key factors affecting this.

In August 2017 the Court imposed a $25 million fine on a Japanese shipping company for a criminal cartel with other shipping lines affecting cars transported to Australia. In that case a rolled up criminal charge and plea of guilty enabled the court to impose a single penalty for more than one criminal offence, calculated as a percentage of the company's annual turnover. This was Australia's first criminal cartel sentence and the second highest cartel penalty that has been imposed in Australia.

In March 2017 the Court imposed a record civil penalty of $45 million on Tabcorp for 108 contraventions of the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* over a 5 year period.

In 2015 ASIC obtained record penalties totalling $18.975 million for breaches of the *National Consumer Credit Protections Act 2009* and unconscionable conduct. In a sample of 281 credit contracts, 277 contravened the legislation, and it was likely that over 300,000 further contracts similarly contravened the legislation. The Court imposed penalties by reference to 5 classes of responsible lending contraventions.

These cases underscore a trend towards increasingly large civil penalties. Legislative change will also have an impact, as illustrated by the $200 million per contravention civil penalties proposed as part of the proposed Bank Executive Accountability Regime (BEAR).

FIXING PENALTIES FOR MULTIPLE CONTRAVENTIONS

One of the areas where uncertainty about the applicable principles has given rise to particular problems is where there are multiple related contraventions. In some previous civil penalty cases, the "totality principle" and the "course of conduct principle" have been relied on to impose a single pecuniary penalty for multiple contraventions.

The course of conduct, or one-transaction, principle is derived from criminal law sentencing principles. According to this principle, care must be taken so that the offender is not punished twice for the same criminal conduct. In these cases, sentences of imprisonment may be served concurrently, but fines are also calculated with regard to this principle. In the civil penalty context, the courts have on occasion used the course of conduct principle to group together separate contraventions as part of a course of conduct and impose a single penalty for those contraventions.

The totality principle requires a Judge imposing a sentence to review the aggregate and consider whether it is a just and appropriate outcome for all the offences. The principle has likewise been applied in the context of civil pecuniary penalty proceedings to impose a single penalty for multiple contraventions.

The Full Court accepted that the course of conduct and totality principles should be applied in civil penalty proceedings. After reviewing relevant authorities, it determined that, absent a statutory provision to the contrary, neither the course of conduct principle nor the totality principle permits the court to impose a single penalty in respect of multiple contraventions. The Court pointed out that in the criminal context, these principles do not result in a single sentence, rather in concurrent sentences (in the case of imprisonment) and reduction of the fine imposed for each offence (rather than a single fine).

The Court here applied the course of conduct principles and totality principles to conclude the appropriate penalty for each of the CFMEU's 605 contraventions to be $1,000 (there being a course or courses of conduct involving encouraging industrial action at three sites). Having regard to the Commissioner's submissions (as a specialist regulator), the Full Court then applied the totality principle, reducing the penalty by 50% to $302,500 and rounding it down to $300,000. For the CEPU's contraventions, the appropriate penalty was $800 per contravention, which was reduced by 50% to $138,000 and rounded down to $130,000.

IS A SINGLE PENALTY EVER APPROPRIATE?

The Court allowed for the possibility that in some limited cases a single penalty may be imposed for multiple contraventions where that course is agreed or accepted by the parties.

The Court said this may be possible where the pleadings and facts reveal that contraventions arose from a course of conduct and the precise number of contraventions cannot be ascertained, or is so large that the fixing of separate penalties is not feasible, or there is a large number of relatively minor related contraventions most sensibly considered compendiously.

An example of a case where a pecuniary penalty for multiple contraventions was imposed having regard to these principles is *Australian Competition and Consumer Commission v Coles Supermarkets Australia Pty Ltd* [2015] FCA 330. In that case, par-baked products were sold as "fresh" on an estimated 85 million occasions. The maximum penalty for each contravention was $1.1 million. The Court imposed a penalty of $2.5 million for four separate "courses of conduct".

In addition, particular legislation may allow for a single penalty. For example, s 557 of the *Fair Work Act 2009* provides that two or more contraventions that arose out of a course of conduct by a person are to be taken to constitute a single contravention. The *Corporations Act* civil penalty provisions do not include any provision of this kind.

SIGNIFICANCE OF THE CASE

The practical significance of the case may be limited and given the case represents an apparent departure from certain previous cases, it is possible that a differently constituted Full Court, or indeed the High Court, may take a different approach. It is clear, however, that where there are multiple contraventions, the Court should consider applying the course of conduct principle to reach penalties for each contravention, and then apply the totality principle to consider if the outcome in the aggregate is appropriate (and if, for example, it is disproportionate, reduce each penalty). It also highlights that the Court will bring its own assessment to bear, and that there are complications associated with working out penalties for multiple contraventions.

When does a lead manager and underwriter in a capital raising owe a shareholder a duty of care?

In transactions such as capital raisings, there is the potential for shareholders to suffer economic loss when share prices fluctuate. Shareholders who suffer loss might seek compensation from those who coordinated the capital raising, such as the investment banks who acted as lead managers and underwriters, and the company itself. But the courts will only find that a defendant owes a duty of care to a plaintiff who has suffered pure economic loss in limited circumstances – and without a duty of care a negligence action cannot succeed. So when will those involved in a capital raising be exposed to liability in negligence to a shareholder who has sustained a loss?

In *RinRim Pty Ltd v Deutsche Bank AG* [2017] NSWCA 169 a shareholder brought a claim in negligence against a company and three joint lead managers and underwriters which carried out a capital raising by means of an Accelerated Renouncable Entitlement Offer (AREO). The New South Wales Court of Appeal held that neither the company, nor the joint lead managers and underwriters, owed the shareholder a duty of care in the circumstances.

The question of whether a duty of care arises in a novel situation will always be fact dependant, but one of the key elements in establishing such a duty of care is showing that the plaintiff is vulnerable (in the sense of being unable to take steps to protect itself from any economic loss which might be caused by the defendants' conduct). This was the focus in this case. Here the shareholder "was not vulnerable in the relevant sense" and this presented an "insurmountable barrier to its contention that the defendants owed a duty of care". Among other things, the shareholder was a sophisticated investor and it could have protected itself by examining the available information and obtaining advice from its own financial advisers.

SHAREHOLDER EXCLUDED FROM AN INSTITUTIONAL OFFER OF SHARES UNDER A CAPITAL RAISING

The AREO here involved two tranches: an Institutional Offer and a Retail Offer, both of which were followed by an automatic sale in a bookbuild of any entitlements not taken up. The Retail Offer closed one month after the Institutional Offer, during which time the share price fell sharply, with the result that those who participated in the Institutional Offer and renounced their entitlements made substantially more than those who participated in the Retail Offer.

The shareholder was only offered shares under the Retail Offer but alleged that it was eligible to be offered shares under the Institutional Offer, and the underwriters and joint lead managers had a duty to make reasonable attempts to identify this and contact it. It asserted that, had it been contacted, it would have taken steps to participate in the Institutional Offer, and by being excluded it sustained a loss of more than $4 million.

NO DUTY OF CARE

The shareholder was unsuccessful primarily because, even if the company and the lead managers and underwriters owed a duty of care, the shareholder failed to establish that any breach of duty caused it to suffer a loss (as on the facts the shareholder would not have entered into the Institutional Offer if invited). Nevertheless, the Court of Appeal went on to address whether the defendants owed the shareholder a duty of care, although not comprehensively.

The Court considered the High Court decisions in *Woolcock Street Investments Pty Ltd v CDG Pty Ltd* (2004) 216 CLR 515 and *Brookfield Multiplex Ltd v Owners Corporation Strata Plan 61288* (2014) 254 CLR 185. These cases establish that where in pure economic loss cases a plaintiff seeks to demonstrate the existence of a duty of care in novel circumstances, the plaintiff's vulnerability to loss caused by the defendant's negligence is an extremely important if not determinative consideration. "Vulnerability" in this context refers to the plaintiff's inability or limited ability to take steps to protect itself from economic loss by reason of the defendant's conduct. This may be by contractual arrangements or otherwise.

In this case, the shareholder "was not vulnerable in the relevant sense". Among other things, the shareholder knew some months before the capital raising, following an announcement to the ASX, that the company intended to raise capital by means of an AREO and that the AREO would involve an Institutional Offer and a Retail Offer. The shareholder also had ways of obtaining information about what the AREO involved, including internet searches, and could have sought advice from its financial advisers. It was able to protect itself by seeking out participation in the Institutional Offer.

Investment banks will no doubt take comfort from the decision, as well as the decision of the primary judge, both of which demonstrate a reluctance to impose a duty of care in this situation. The primary judge acknowledged that the outcome of the AREO process was "dependent on the vagaries of the market" and observed that to impose a duty of the kind alleged might make underwriting more expensive, or otherwise make AREOs unattractive as a form of capital raising and therefore less obtainable.

At the time of going to print, a special leave application has been filed but not yet listed.

ASIC's power to ban senior officials in the financial sector

The ASIC Enforcement Review Taskforce has released a consultation paper proposing amendments to ASIC's administrative powers which, if accepted by Government, would mean that directors, officers or senior managers of a financial services business could be the subject of an ASIC banning order as a result of their role.

In its consultation paper, the Taskforce notes the shortcomings of ASIC's existing banning power under s920A of the *Corporations Act*. These shortcomings of the banning power have, in recent years, been the subject of scrutiny in the Financial System Inquiry (FSI) and a Senate report on ASIC's performance. Both the Senate report and the FSI noted two key problems:

- **The existing scope of banning orders:** while ASIC has the power to cancel an AFS licence or credit licence, or ban a person from *providing* financial or credit services, it lacks power to prevent a person having *a role in managing* a financial services or credit business.
- **The threshold for making a banning order:** while the circumstances in which ASIC is empowered to make a banning order cover many circumstances involving poor conduct, these are not very effective in dealing with individuals who are responsible for managing a financial services firm that has compliance issues, but who do not themselves provide financial services.

The proposal to address these two key issues is to broaden the scope of the existing power and to reduce the threshold for ASIC to make a banning order.

BROADER SCOPE TO MAKE A BANNING ORDER

The Taskforce proposes that the scope of ASIC's banning power should be widened to allow ASIC to ban a person from:

- performing a specific function in a financial services business, including being a senior manager or controller of a financial services business; and/or
- performing any function in a financial services business.

REDUCED THRESHOLD FOR A BANNING ORDER

The Taskforce proposes that the grounds for ASIC's power to ban individuals be extended where ASIC has reason to believe:

- is not a fit and proper person to provide a financial service or financial services, or to perform the role of officer or senior manager in a financial services business; or
- is not adequately trained, or is not competent, to perform the role of officer or senior manager in a financial services business.

Current grounds for banning orders include ASIC having reason to believe the person is not of good fame and character, or that that the person is not adequately trained or competent to provide financial services. These expanded grounds would provide greater scope for banning those involved in a financial services business, particularly on the management side.

The Taskforce also considers that the grounds for ASIC to ban a director, officer or senior manager, should include where a person has breached their obligations in sections 180-183 of the *Corporations Act* (directors' and officers' duty to exercise care and diligence and duties of good faith, proper purpose and proper use of position and information). In respect of the potential inclusion of breach of s 180, the Taskforce has said it recognises that this equates to enabling banning on a "negligence" standard, and therefore specifically welcomes comments on this.

OVERLAP WITH THE BEAR?

As covered in our Financial Services Update, the Banking Executive Accountability Regime (BEAR) proposes a number of new powers for APRA which relevantly include a power to ban executives of Authorised Deposit-taking Institutions (ADIs) and their subsidiaries. The Taskforce's proposed amendments are intended to operate independently of the BEAR, and will apply well beyond ADIs, although there will be overlap as they will apply to financial services businesses and holders of an AFS licence.

POTENTIAL IMPLICATIONS

The proposed amendments to the banning power have implications particularly for those involved in the management of a financial services business. Along with the BEAR, the proposal represents another attempt by Government to increase individual accountability in the financial sector.

Submissions in repose to the Consultation paper are due by 4 October 2017.

ASIC Enforcement Review - Industry Codes in the Financial Sector

The ASIC Enforcement Review Taskforce has made a preliminary recommendation that the financial sector – or parts of it – move from a self-regulatory model (ie industry codes) to a "co-regulatory model". According to the Taskforce's recommendation, which it says hopes "may have the potential to enhance consumer trust and confidence in the sector", a co-regulatory model would involve a combination of self-regulation with a degree of oversight by ASIC.

The Taskforce has expressly declined to call for the content of codes to be incorporated into statute or regulation. Nonetheless, as it is proposed non-compliance with a code would result in customers being entitled to redress, these could significantly impact on those parts of the financial sector subject to them.

On 28 June 2017, the Taskforce released a Position and Consultation Paper on industry codes in the financial sector. The paper seeks to address two issues which the Taskforce says are key:

- the benefits of industry codes not being available to many consumers because not all players in relevant industry subsectors subscribe to existing industry codes; and
- industry codes not being required to contain a minimum set of consumer protections and standards of enforceability because there is currently no requirement for ASIC to approve industry codes and they may only be approved upon application. As a result, only one of 11 codes in the financial services industry has received ASIC approval under section 1101A of the Corporations Act.

Having considered international practices in the UK, Canada and Hong Kong, the Taskforce's paper rejects calls for financial sector codes to be incorporated into statute or regulation and, instead, proposes that the existing code regime be strengthened by mandatory participation and compulsory ASIC approval.

In effect, for financial sector activities that are specified by ASIC as requiring coverage by an industry code, the proposed regime would introduce a "co-regulatory model" whereby:

- the content of, and governance arrangements for, relevant codes would be subject to approval by ASIC. Approved codes would set out base level (rather than "best practice") service standards for industry participants;
- the content of the code would remain a matter for industry to determine (ie self-regulatory), consistent with the broad criteria set by ASIC;
- industry participants that engage in specified activities would be required to subscribe to relevant approved codes;
- approved codes would be binding on, and enforceable against, industry participants by contractual arrangements with an incorporated code body (and, possibly, through contracts with customers);
- in the event of non-compliance with the code, customers would be entitled to seek appropriate redress through the industry participants' internal and external dispute resolution arrangements;
- the code body would monitor the adequacy of, and industry compliance with, the approved code and report to ASIC periodically on these matters. In addition, industry participants would be required to monitor their ongoing compliance with the code and report periodically to the code body;
- the code body would keep the code under review on an ongoing basis and, if required, adapt it to changing market conditions.

As noted in the paper, codes can give rise to enforceable rights in court actions—see for example our article on the Code of Banking Practice as a new source of liability in our *October 2016 edition* of *What's New*?. As noted in that article, the status of the Code of Banking Practice in terms of enforceability in the courts has not always been entirely clear, and the current proposals would give such codes more teeth. It therefore remains to be seen just how far, under a co-regulatory model, various codes will introduce further sources of liability for industry participants, but it is an important development to watch.

Submissions on the paper closed on Wednesday, 26 July 2017. The Taskforce is expected to provide its recommendations to the Government later this year.

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