FINANCIAL SERVICES DISPUTES

What's New?

May 2018

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 midst of the activity surrounding the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, it is easy to overlook other developments. Recent significant developments include:

- changes to regulators' powers to disqualify or ban individuals;
- changes which the Australian Government intends to implement in relation to ASIC enforcement;
- the new Australian Financial Complaints Authority; and
- a proposed law to introduce deferred prosecution agreements in Australia.

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

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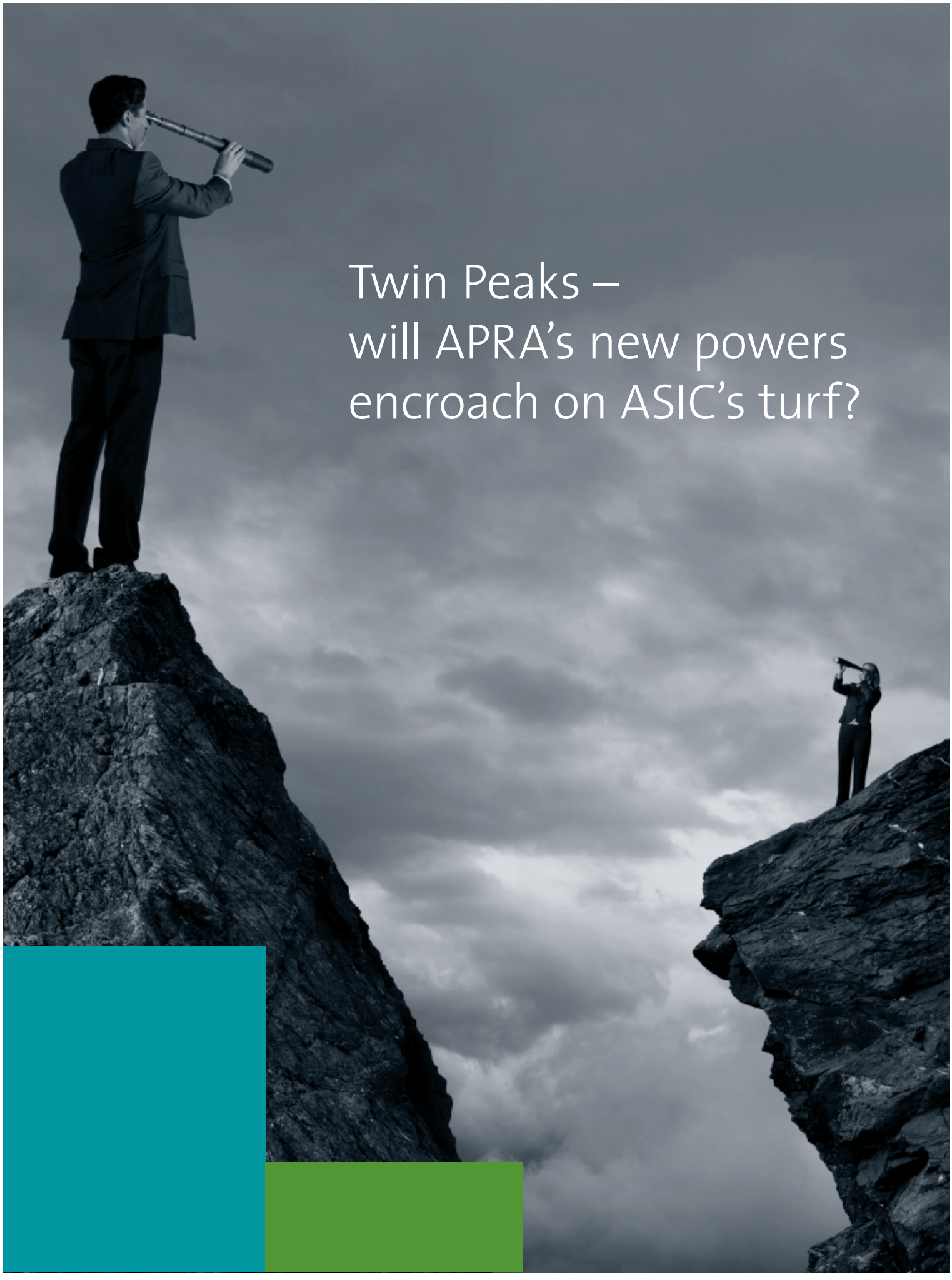

Twin Peaks – will APRA's new powers encroach on ASIC's turf?

On 7 February, Commonwealth Parliament passed legislation to implement the Banking Executive Accountability Regime (**BEAR**), to take effect in July for large Authorised Deposit-Taking Institutions (**ADIs**) and July 2019 for small and medium ADIs. The Australian Prudential Regulation Authority (**APRA**) will receive new powers to hold senior individuals within ADIs accountable. In parallel, the Australian Government has recently agreed with a recommendation by the ASIC Enforcement Review Taskforce that Australian Securities and Investment Commission (**ASIC**) be given complementary new powers to ban individuals who are not fit and proper persons from managing financial services businesses.

The expansion of APRA's powers in relation to individual conduct arguably blurs and confuses the "twin peaks" approach to financial regulation in Australia. The twin peaks approach is the establishment of separate regulators for financial system stability (APRA) and market conduct and consumer protection (ASIC).

WHAT ARE THE IMPLICATIONS FOR REGULATED ENTITIES OF THE GROWING DUPLICATION OF POWERS AND RESPONSIBILITIES BETWEEN ASIC AND APRA?

The expansion of APRA's power into individual misconduct may create an additional burden on individuals subject to concurrent investigations by ASIC and APRA, and raise doubts about which regulator is responsible for holding individuals to account for misconduct. Ironically, the regime intended to hold individuals more personally accountable may risk making the regulators themselves less accountable. It could also potentially create new challenges for regulated institutions, which may have to deal with multiple regulators.

WHAT ARE APRA'S POWERS OVER INDIVIDUAL CONDUCT AND HOW IS THAT CHANGING?

APRA already has the power to apply to the Federal Court for a disqualification order on the basis that a person is not a fit and proper person to be a director or senior manager. This power applies in the banking, superannuation and insurance sectors. APRA may also remove a director or senior manager by direction in writing if satisfied that the person is disqualified because of a relevant conviction, insolvency or overseas disqualification or does not meet the requirements for fitness or propriety set out in the prudential standards.

APRA's Prudential Standard CPS 520 Fit and Proper requires regulated institutions to maintain a Fit and Proper Policy, ensure that fitness and propriety of responsible persons (including senior managers) are assessed and provide each responsible person's personal details, main responsibilities and whether they have been assessed. The criteria for fitness and propriety are, in essence, that it would be prudent to conclude that the person possesses the competence, character, diligence, honesty, integrity and judgment to perform his or her duties properly, the person is not disqualified, and there is no conflict of interest that will create a material risk.

If APRA removes a director or senior manager under existing provisions, that decision is subject to internal and external administrative review, and ultimately judicial review.

Under the new legislative provisions introduced to implement the Banking Executive Accountability Regime, individuals will be required to act honestly, with due care, to cooperate with APRA and to take reasonable steps to prevent matters arising which could affect the prudential reputation of the ADI. APRA will gain the power to disqualify a person from being or acting as an accountable person if it is satisfied that the person has not complied with these new obligations. Although the exposure draft of the legislation did not provide for merits review of APRA's disqualification decisions, merits review will be available under the legislation as passed.

HOW DOES THAT OVERLAP WITH ASIC'S POWERS?

ASIC has the power to make a banning order against a person, which prohibits the person from providing any financial services or specified financial services in specified circumstances or capacities. ASIC may make a banning order if it has reason to believe that the person is not of good fame or character, that the person is not adequately trained, or is not competent to provide financial services.

ASIC may also make a banning order against a person, which prohibits the person from engaging in any credit activities or specified credit activities in specified circumstances or capacities. The order may prohibit the person from engaging in a credit activity permanently or for a specified period.

In addition, the Australian Government is planning to implement changes which will give ASIC the power to ban individuals from performing a certain function in a financial services business, such as acting as a manager or controller, on the grounds that they are not a fit and proper person, not adequately trained or incompetent.

This proposed ASIC banning power would apply to financial services businesses and would not be limited to APRA regulated institutions. Further, unlike APRA's powers under the BEAR, the power would not be limited to the most senior executives. Once the Government implements changes to ASIC's banning power, there is the potential for regulatory overlap with APRA's powers under the BEAR, given both would involve the concept of 'fit and proper' and both apply to management of financial services businesses.

DEALING WITH TWO REGULATORS

The current twin peaks model has been regarded as successful in part because the different goals of APRA and ASIC have been well understood. The twin peaks model was replicated after the global financial crisis in other countries including the United Kingdom, which created a Prudential Regulation Authority separate from the Financial Conduct Authority. In the UK, the PRA and the FCA are both involved in the implementation of a Senior Managers Regime (analogous to BEAR).

However, the fact that an individual's conduct could simultaneously trigger APRA's disqualification power and ASIC's banning power gives rise to two risks for individuals who may be the subject of an investigation.

First, an individual could be subject to separate investigations by APRA and ASIC with respect to the same conduct, and those investigations could progress in different manner and at a different pace. Secondly, APRA and ASIC could take inconsistent approaches in the exercise of their powers to disqualify or ban an individual. Whilst APRA and ASIC have a history of cooperation under joint Memoranda of Understanding entered into in 1998, 2004 and 2010, it remains to be seen how they will coordinate their action in this regard.

ASIC Enforcement Review Taskforce – what's new?

In December 2017, the ASIC Enforcement Review Taskforce delivered a report to government on the enforcement regime of the Australian Securities and Investments Commission (**ASIC**), including the suitability of the existing regulatory tools available to ASIC. The Australian Government responded to the report in April 2018 by agreeing, or agreeing in principle, with all 50 recommendations made by the Taskforce. Key changes on the horizon include:

Increased criminal and civil penalties

Maximum civil penalties to be increased for individuals to 5,000 penalty units or three times the value of benefits obtained or losses avoided, and increased for corporations to the higher of 50,000 penalty units ($10.5 million), three times the benefit obtained/loss avoided, or 10% of annual turnover to a maximum of 1 million penalty units ($210 million), and the introduction of disgorgement remedies in civil penalty proceedings brought by ASIC.

ASIC's power to ban individuals in the financial sector

ASIC will be given the power to ban individuals from performing a specific function (eg being a senior manager or controller) once an administrative banning power is triggered, and the grounds for exercising that power will be expanded to include circumstances where ASIC has reason to believe that a person is not fit and proper.

ASIC's direction powers

ASIC will have the power to direct financial services licensees in the conduct of their business where ASIC has reason to suspect a contravention of licensing requirements, and failure to comply with directions may result in civil penalties.

Self-reporting of significant breaches by financial services licensees

The introduction of an objective test to determine whether a breach is 'significant', a requirement to report suspected breaches still under investigation, and increased criminal penalties and a new civil penalty for failure to report breaches.

The Australian Government plans to implement some of the recommendations promptly, whilst others will be deferred pending the findings of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry. For more details, read our update on the ASIC Enforcement Review – Government Response.

The New Australian Financial Complaints Authority

In February 2018, the Australian Parliament passed reforms[1] to establish the Australian Financial Complaints Authority (**AFCA**) as a new one-stop-shop for resolving financial disputes from 1 November 2018. AFCA will replace the Credit and Investments Ombudsman (**CIO**), Financial Ombudsman Service (**FOS**) and Superannuation Complaints Tribunal (**SCT**).

WHAT YOU NEED TO KNOW

- The reforms affect all Australian financial services licensees, Australian credit licensees, regulated superannuation funds, and other financial firms.
- Consumers and small businesses with fewer than 100 employees can make complaints to AFCA.
- AFCA complaints will have implications for the way in which financial firms handle disputes, legal proceedings and settlements.
- Complaints lodged with AFCA may potentially be reported to regulators and become the subject of investigations if AFCA considers that there has been a serious contravention of law or there is a broader systemic issue.
- In most cases, AFCA may hear complaints up to a monetary limit of $1 million and a compensation cap of $500,000 (except for superannuation and small business credit disputes).

BACKGROUND

These reforms implement the Australian Government's response to the Ramsay Review, an independent comprehensive review of the financial services dispute resolution framework.

Amongst the recommendations made in the Ramsay Review were:

- the creation of a single external dispute resolution scheme for all financial complaints based on an industry ombudsman model;
- improved access to dispute resolution schemes for individual and small business consumers through higher monetary limits and compensation caps; and
- enhanced oversight and monitoring by ASIC and reporting arrangements.

WHEN THE AFCA COMMENCES AND WHO WILL NEED TO BE A MEMBER OF AFCA

AFCA will commence accepting complaints from 1 November 2018. Complaints may be lodged with the CIO, FOS and SCT until AFCA commences. Financial firms required to become members of AFCA by law will need to do so by no later than 21 September 2018.[2]

Categories of financial firms required to become members of AFCA include all Australian financial services licensees, Australian credit licensees, regulated superannuation funds (except for self-managed superannuation funds), approved deposit funds, retirement savings account providers, annuity providers, life policy funds and insurers[3].

THE NEW FRAMEWORK

The way the AFCA scheme operates will be set out in terms of reference, rather than in legislation. This will allow the scheme to be flexible and for changes to be implemented more quickly than if legislative change were required.

AFCA's terms of reference will set out its jurisdiction, including what complaints it can and cannot deal with. In this regard, ASIC released a Consultation Paper 298 and draft Regulatory Guide 139 in March 2018 for public comment (discussed further below).

AFCA'S JURISDICTION AND IMPACT ON LEGAL PROCEEDINGS

Consumers and small businesses, defined as any business with fewer than 100 staff, can access AFCA[4]. This is in contrast with the existing FOS scheme which defines small businesses as business that have fewer than 20 employees, or where the business which includes the manufacture of goods has fewer than 100 employees.

AFCA will have higher monetary limits and compensation caps than the existing schemes. The Australian Government has indicated that AFCA will commence operations with the following monetary limits[5]:

- a monetary limit of $1 million and a compensation cap of $500,000 for most nonsuperannuation disputes;
- unlimited monetary jurisdiction for superannuation disputes;
- no monetary limits or compensation caps for disputes about whether a guarantee should be set aside where it has been supported by a mortgage or other security over the guarantor's primary place of residence; and
- a monetary limit of $5 million and a compensation cap of $1 million for small business credit facility disputes.

AFCA will undergo an independent review within 18 months of operation to examine the appropriateness of these monetary limits.

As to what impact an AFCA complaint will have on legal proceedings, ASIC's draft regulatory guide proposes that AFCA's terms of reference:

- prohibit financial firms from commencing legal proceedings when a complaint has been lodged with AFCA, unless the legal limitation period is about to expire, or there is a test case situation; and
- allow AFCA to accept a complaint even if a financial firm has already commenced debt recovery proceedings against the complainant, and in such circumstances, the firm will be required not to pursue legal proceedings beyond the minimum necessary to preserve its rights[6].

FINALITY OF AFCA DECISIONS?

The new legislation provides that determinations by AFCA of a superannuation complaint are binding[7].

For non-superannuation complaints, ASIC's draft regulatory guide proposes that AFCA's decisions are not binding unless the consumer accepts the decision at the end of the process and (where a compensation cap applies) waives the excess of their claim[8]. Complainants would retain their legal right to reject an AFCA decision and pursue their complaint in court.

OVERSIGHT OVER AFCA

Whilst the AFCA scheme is independent and ASIC has no role in individual complaints handling, ASIC will have powers of oversight over AFCA. These include the power to:

- issue general directions to AFCA and directions to increase the limits on value of claims or remedies that can be made under the AFCA scheme[9];
- issue regulatory requirements that AFCA must comply with[10]; and
- approve material changes to the AFCA scheme[11]. ASIC's draft regulatory guide indicates that this could include changes to AFCA's jurisdiction and time limits for accessing the scheme.

AFCA'S REPORTING OBLIGATIONS

The AFCA is required to refer or report certain matters to ASIC, APRA and the Commissioner of Taxation (as appropriate)[12]. This includes complaints involving a serious contravention of law by financial firms, or systemic issues (such as multiple complaints of a similar nature, for example, where a financial product has been mis-sold).

ASIC's draft regulatory guide envisages that, where AFCA refers a settled complaint to a regulator for investigation, AFCA should ensure (so far as practicable) that settlements do not preclude a complainant from referring the complaint to a regulator, or preclude a complainant from taking further action in relation to matters that are not the subject of the complaint.

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1 *Treasury Laws Amendment (Putting Consumers First—Establishment of the Australian Financial Complaints Authority) Act 2018*

2 http://kmo.ministers.treasury.gov.au/media-release/044-2018/

3 *Explanatory Memorandum, Treasury Laws Amendment (Putting Consumers First – Establishment of the Australian Financial Complaints Authority) Bill 2017*, page 7

4 http://kmo.ministers.treasury.gov.au/media-release/015-2018/?utm_source=wysija&utm_medium=email&utm_campaign=Media+Release+%E2%80%93+Consumers+win+as+a+one-stop-shop+for+financial+complaints+passes+through+parliament

5 *AFCA Fact Sheet* issued by the Treasury of the Australian Government (https://treasury.gov.au/consultation/c2017-232832/)

6 *ASIC Draft Regulatory Guide 139* published 5 March 2018, at p25 (http://download.asic.gov.au/media/4661720/attachment-to-cp298-published-5-march-2018.pdf)

7 s1055D of the *Corporations Act 2001* (Cth)

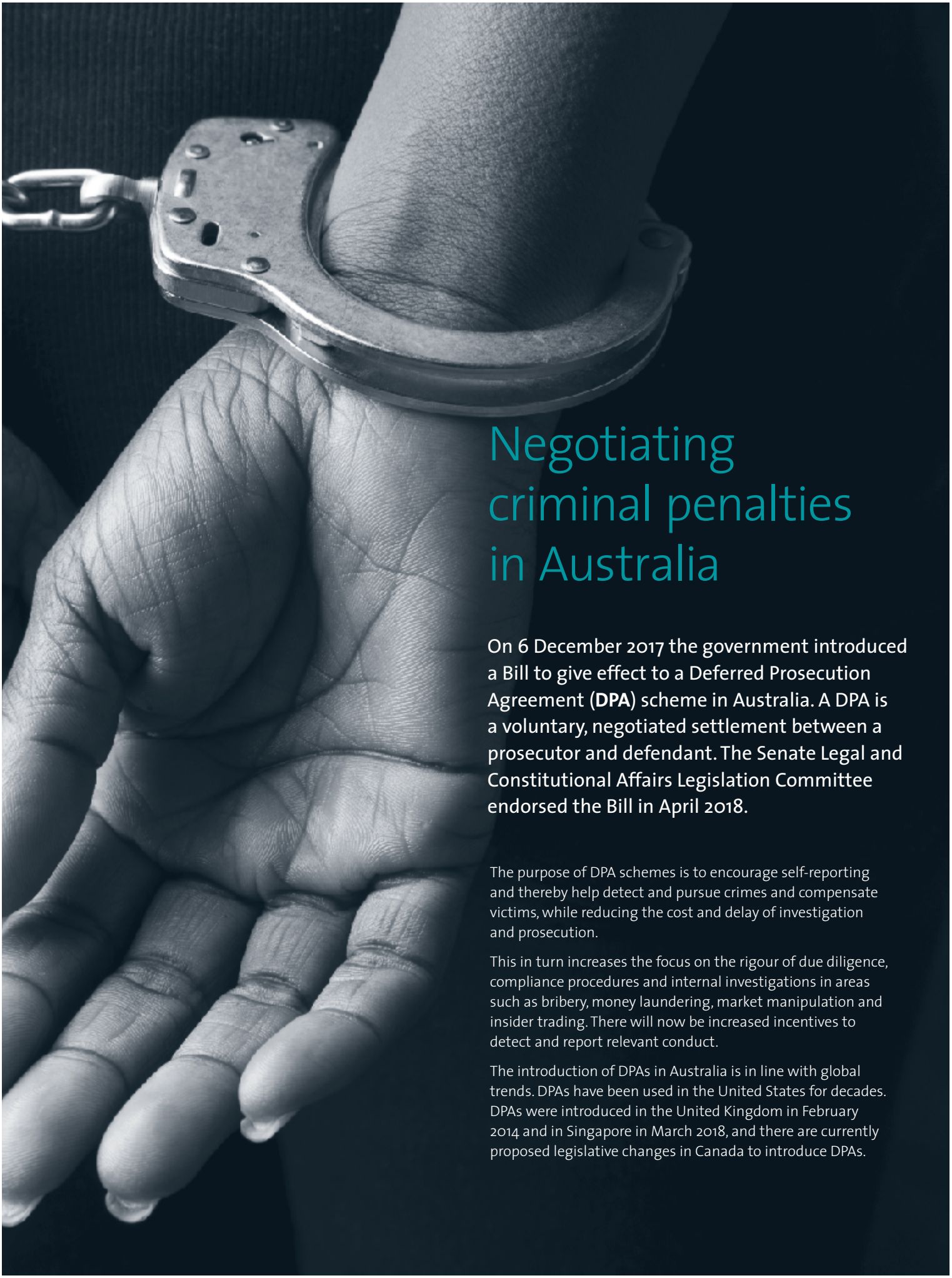
8 *ASIC Draft Regulatory Guide 139* published 5 March 2018, at p35

9 ss1052C and 1052B of the Corporations Act

10 s1052A of the Corporations Act

11 s1052D of the Corporations Act

12 s1052E of Corporations Act



Negotiating criminal penalties in Australia

On 6 December 2017 the government introduced a Bill to give effect to a Deferred Prosecution Agreement (DPA) scheme in Australia. A DPA is a voluntary, negotiated settlement between a prosecutor and defendant. The Senate Legal and Constitutional Affairs Legislation Committee endorsed the Bill in April 2018.

The purpose of DPA schemes is to encourage self-reporting and thereby help detect and pursue crimes and compensate victims, while reducing the cost and delay of investigation and prosecution.

This in turn increases the focus on the rigour of due diligence, compliance procedures and internal investigations in areas such as bribery, money laundering, market manipulation and insider trading. There will now be increased incentives to detect and report relevant conduct.

The introduction of DPAs in Australia is in line with global trends. DPAs have been used in the United States for decades. DPAs were introduced in the United Kingdom in February 2014 and in Singapore in March 2018, and there are currently proposed legislative changes in Canada to introduce DPAs.

WHO CAN USE A DPA?

The Director of Public Prosecutions (**DPP**) will have the power to enter into a DPA with a company for various offences relevant to banking and financial services. The Bill does not allow agreements with individuals and limits DPAs to specified offences, thereby following the UK legislation and departing from the US practice.

The DPA Scheme only provides for agreements with the Commonwealth DPP in relation to prosecution for specified offences under Commonwealth legislation, and therefore does not apply to State prosecutors or State offences.

WHAT CRIMES DO DPAs APPLY TO?

DPAs will be available for offences under five Acts covering corporations, the criminal code, anti-money laundering and international sanctions.

The Corporations Act offences covered by the DPA scheme are, in essence, market manipulation and related conduct, false trading, market rigging, false or misleading statements in relation to financial products, dishonest conduct in relation to a financial product or service, insider trading and falsification of books.

The Criminal Code offences covered are, in broad terms, bribery, theft, obtaining property or financial advantage by deception, forgery, fraud, money laundering, financial information offences, false accounting and related offences.

WHAT ABOUT INDIVIDUALS WHO WANT TO COME FORWARD?

Individuals are not covered by the proposed Australian DPA scheme. In Australia, individuals can engage in plea negotiation, but the High Court held in 2014 that prosecutors could not make submissions on the appropriate sentencing range in a criminal matter.

On 7 December 2017 the Australian government also introduced a separate Bill to strengthen Commonwealth whistleblower protections.[1] Whistleblower policies with defined features will be mandatory for public and large proprietary companies. Unlike DPAs, the whistleblower scheme is designed to provide specific protections to individuals. In addition to internal reports by whistle-blowers, the scheme covers reports to ASIC, APRA and prescribed authorities by officers and employees in relation to offences or contraventions under legislation covering corporations, banking, insurance, consumer credit and superannuation.

WHAT WILL A DPA SAY?

The main features of a DPA provided for in the Bill are:

- a statement of agreed facts
- when it will be in force
- requirements to be fulfilled
- the financial penalty
- when it will be ineffective if contravened or based on satisfactory information
- terms providing for compensation, donation to charity, forfeiting of benefits
- mandatory compliance programs
- cooperation in investigation or prosecution
- costs.

WHAT OVERSIGHT IS THERE?

In the US, DPAs are filed with the court and required to be approved by a judge. In the UK, by contrast, DPAs are subject to ongoing judicial scrutiny through two judicial hearings to determine whether the DPA is in the interests of justice and its terms are fair, reasonable and proportionate.

In Australia, the DPP will be required to give a proposed DPA to a retired judge for approval. The DPP will need to be satisfied that there are reasonable grounds to believe that an offence specified in the DPA has been committed and that entering into the DPA is in the public interest. The approving officer must review the DPA and either approve or disapprove it on the assumption that the information set out in it is true and correct.

On approval, a DPA must be published online, but parts of it may be redacted to avoid prejudice to public safety, an ongoing investigation or a fair trial, or where there is a court order.

HOW ARE NEGOTIATIONS PROTECTED?

The Bill provides that in civil or criminal proceedings against a person who is or was party to a DPA or to negotiations for a DPA, any record of the negotiations is not admissible unless the person has given evidence inconsistent with the documents.

However, information obtained during the negotiation of a DPA may be used by Commonwealth entities to assist with performing their functions. In addition, both Commonwealth and State or Territory authorities will be able to use information obtained during the negotiation of a DPA for law enforcement.

WHAT IS THE LIKELY IMPACT OF DPAs?

While DPAs will only apply to certain Commonwealth criminal offences, the potential to negotiate a DPA will be a significant incentive to self-report relevant misconduct when discovered by Australian companies. When combined with other developments such the enhancement of the whistle-blower protection regime and international cooperation in the investigation of corporate misconduct, the introduction of DPAs may well increase the number and size of penalties and compensation payments.

More immediately, the likely introduction and commencement of a DPA regime in Australia provides an incentive for companies to review and strengthen their compliance procedures and the quality of internal investigations, as these are likely to be scrutinised and taken into account in determining the consequences imposed under future DPAs.

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1 *Treasury Laws Amendment (Enhancing Whistleblower Protections) Bill 2017*

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