Financial Services Disputes – What's New?

October 2016

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

Against the background of very public calls for a Royal Commission into the Banks and bank chiefs being called before the House of Representatives Standing Committee on Economics (with a view to the Committee reporting on Australia's banking and financial system), it is easy to overlook other developments and inquiries into the regulatory and dispute resolution systems which could see some significant changes.

ASIC developments

The recent Government commitment to boost ASIC's funding will lead to ASIC being able to take stronger action and more effectively deliver on its goals, as outlined in ASIC's *Corporate Plan 2016-17 to 2019-20*. We also discuss recent trends in ASIC's enforcement activity.

Global trends in individual accountability

ASIC has increasingly been approaching regulatory enforcement by looking at corporate culture as a key to the prevention of corporate wrongdoing. In this article, we discuss how ASIC's approach to culture contrasts with that of the regulators in the US and the UK, which increasingly focus, to a much greater degree than ASIC, on individual accountability.

Concurrent reviews of dispute resolution bodies

A Government appointed expert panel has released an issues paper for its independent review of the financial system's external dispute resolution and complaints schemes. ASIC and FOS are separately reviewing the Financial Ombudsman Service's small business jurisdiction. The Prime Minister has now effectively said Australia will end up with a very different non-Court based dispute resolution system for smaller matters (and not just the smallest matters, with suggestions FOS's jurisdiction be increased to $2 million).

Capability review of ASIC – "reactive" rather than "forward looking"

The Federal Government has released a review of ASIC: *Fit for the Future: A Capability Review of ASIC*.

Contents

ASIC ENFORCEMENT IN THE COURTS

There is a lot happening in the Courts besides the high profile ASIC BBSW actions and ANZ's win in the exception fees class action.

ASIC has for the first time brought proceedings alleging contraventions of the best interests obligations that were introduced as part of the Future of Financial Advice reforms, in proceedings also raising breach of licensee obligations in rather new ways.

Win some, lose some

ASIC has had mixed success in obtaining enforcement outcomes in contested matters in recent months. Its successes include winning civil proceedings against the directors of Storm Financial for breach of their statutory directors' duties (an interesting example of "stepping stones" liability) (ASIC win against Storm Financial directors) and obtaining injunctions preventing Macro Realty from promoting and marketing a Pilbara property investment scheme (ASIC Targets property investment spruikers). On the other hand, it lost civil penalty proceedings against directors of the Prime Retirement and Aged Care Property Trust in *Lewski v ASIC* and took the unusual step of discontinuing proceedings against two of the directors of LM Investment Management Ltd (On the other hand...).

THE CODE OF BANKING PRACTICE AS A NEW SOURCE OF LIABILITY

Two recent Victorian Court of Appeal cases have highlighted how the Code of Banking Practice can be used to establish new obligations. The High Court of Australia has now refused special leave in one of them, so attention is on a review of the Code – but whatever the outcome, the Code is set to feature more prominently in future claims.

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

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ASIC developments

ASIC is now more cashed up and its stated enforcement priorities mean financial institutions can expect even more attention from ASIC

ASIC'S POWER AND FUNDING

As has been widely reported, in April this year the Turnbull Government announced a $127.2 million reform package to equip ASIC with stronger powers and additional funding (although one may query if this does more than partially unwind past cuts). The funding is earmarked for investment in specific initiatives including enhancing ASIC's data analytics and surveillance capabilities, modernising its data management systems with a focus on the areas of financial advice, responsible lending, life insurance and breach reporting.

Funds have also been allocated to fast-track the implementation of a number of key recommendations by the Financial System Inquiry, including a review of ASIC's enforcement regime and penalties, to ensure that it can effectively deter misconduct. An expanded "toolkit" of criminal, civil and administrative sanctions is being foreshadowed. Although the specific impacts on enforcement are yet to become clear, it seems likely there will be an increase in civil penalties, which are low by international standards ($200,000 in most cases, although corporations may get a $1 million penalty in financial services civil penalty matters, but not in corporations/scheme civil penalty matters).

ASIC'S MEDIUM TERM FOCUS

In its recently published *Corporate Plan 2016-17 to 2019-20*, ASIC observed that the additional funding support announced by the government will enable it to detect misconduct through more proactive surveillance that targets poor practices within the financial advice, superannuation and managed funds, credit and insurance sectors.

The plan identifies ASIC's strategic focuses: gatekeeper culture and conduct, the misalignment of retail products and consumer understanding, digital disruption and cyber resilience, and cross-border businesses, services and transactions.

ASIC has flagged several new surveillance projects to promote better gatekeeper culture and conduct in financial services and consumer credit. These include assessing the quality of financial advice, monitoring for unlicensed financial advice by accountants, marketing by credit card issuers, and breach reporting practices within large banks.

In the area of governance practices and risk management systems, ASIC has new surveillance projects focussing on processes for IPOs and improving the quality of financial information in prospectuses.

ASIC has said it is also targeting:

- advice compliance and conflicted advice at the big five financial advice firms, including how firms identify and deal with misconduct by advisers and the impact of conflicts of interest on the quality of advice;
- situations where clients are paying fees every year for financial advice services they are not receiving;
- responsible lending practices in relation to interest only loans and high-risk lending products such as payday loans and consumer leases; and
- undesirable, collective industry practices in relation to the design, disclosure and marketing of financial products that jeopardise financial outcomes for customers.

ASIC'S RECENT ENFORCEMENT ACTIVITY

ASIC's enforcement objectives align with the long-term challenges identified in ASIC's Corporate Plan. In particular, ASIC's current priorities for enforcement activity are corporate governance, financial services (eg obligations on financial advice firms and advisers introduced following the FOFA reforms) and market integrity (eg disclosure obligations and market abuse).

Enforcement results published for the July 2015 to June 2016 period indicate the increasing use of infringement notices in ASIC's regulatory toolkit and an ongoing focus on banning individuals from practising in the Australian financial services or credit industry (51 individuals have been removed from financial services during the period).

Global trends in individual accountability

Given ASIC's propensity to take its lead from overseas regulators and the global trends in individual accountability, one has to ask how long it will be before ASIC refocuses its emphasis on gatekeeper responsibility to include greater individual accountability.

"Culture" has, for some time now, been a favourite ASIC term. The question of how culture is regulated, what good corporate culture looks like, and how poor culture should be addressed, all remain key ASIC priorities, even if exactly what "good culture" means is not always clear. The international trend among regulators by contrast has been increasingly to emphasise *individual* accountability and the importance of enforcement actions targeting those individuals responsible for wrongdoing.

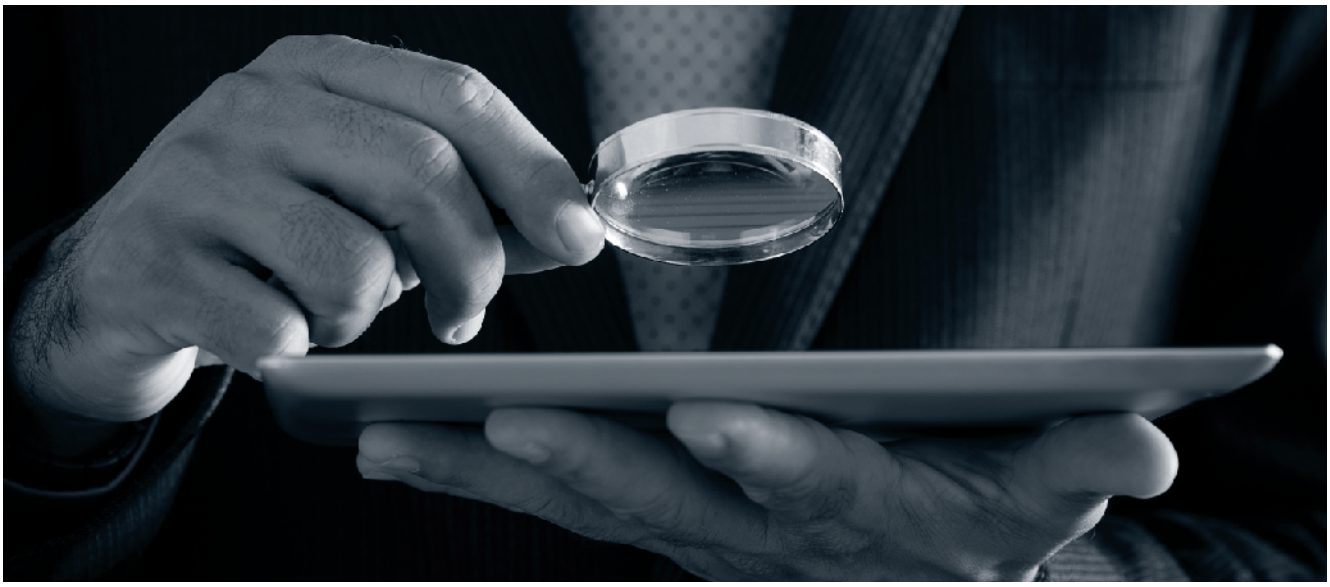
For instance, late last year, the US Department of Justice (DOJ) issued a new policy memorandum signed by Deputy Attorney General Sally Yates, which concerned the prosecution of individuals in corporate fraud cases. The so-called "Yates Memorandum" highlights the importance of individual accountability for corporate wrongdoing and was heralded as a harbinger of a fresh DOJ resolve to target "flesh-and-blood people" over corporates. Perhaps most significantly, the Yates Memorandum makes it clear that in order to qualify for any cooperation credit whatsoever, corporations under investigation (in both criminal and civil cases) must provide the DOJ with all relevant facts about the individuals involved in corporate misconduct.

Similarly, the UK Financial Conduct Authority's Senior Managers Regime (SMR), which came into force in March this year, requires all regulated firms operating in the UK to clearly allocate responsibilities under the SMR and to ensure that there is an individual senior manager accountable for every aspect of regulated activities within the relevant firm.

In noting the UK developments, Chairman Medcraft said in a speech late last year that, while he did believe holding senior managers and key staff accountable was important to culture, he considered the SMR to amount to "micromanagement".

To date, ASIC's position has been that in order to drive cultural change, individuals need to be responsible for a company's culture and actions, and that senior management are responsible in setting the "tone from the top".

Notwithstanding the global trend, it remains to be seen whether legislation will be introduced in Australia based on the approaches taken in the US or the UK. It currently seems more likely that ASIC will continue to hold individuals to account by emphasising gatekeeper responsibility and by making use of the soon-to-be-introduced power to ban individuals from managing financial firms.



Concurrent reviews of financial ombudsman look to extend scope

Reviews of specialist dispute resolution mechanisms for the financial services sector that are currently underway suggest that non-Court based resolution of claims in the sector may be set to be remoulded and greatly expanded. In addition ASIC and Financial Ombudsman Service (FOS) are separately reviewing FOS's small business jurisdiction.

The Federal Government has established an independent review into the financial system's external dispute resolution and complaints schemes (the Financial Ombudsman Service, the Superannuation Complaints Tribunal, and the Credit and Investments Ombudsman), chaired by Professor Ian Ramsay. The review panel will consider whether changes to the existing dispute resolution bodies in the financial sector are necessary to deliver effective outcomes for users.

An issues paper recently released shows the panel is considering:

- the roles, powers and funding arrangements of these dispute resolution bodies;
- the gaps and overlaps between the functions of each of the bodies;
- their roles in working with government and regulators;
- the merits of any possible alternative dispute resolution models, including the possibility of a banking tribunal to be established as an alternative to private legal action; and
- whether a statutory compensation scheme of last resort is needed, though it will not make formal recommendations on this point.

The review will also take into account ASIC's concurrent review of FOS and the proposal to extend its small business jurisdiction to include claims to the value of $2 million (up from $500,000). The proposal would also permit FOS to award up to $2 million in compensation on claims (up from $309,000). FOS has recently sought stakeholder feedback on the proposals, which will be considered before any changes are determined. Should this proposal be taken up, FOS would have jurisdiction extending beyond claims by retail clients or small claims, and see it dealing for the first time with a range of claims which would normally be dealt with at Supreme Court level.

An interim report and draft recommendations will be prepared in November, with a final report to be provided to Government by 31 March 2017.

As we were going to press, the Prime Minister made it clear in a radio interview that we are heading towards having some form of banking tribunal – so then the question now is not if we will have one, but its form.

Capability review of ASIC – "reactive" rather than "forward-looking"

Earlier this year, the report of the capability review of ASIC was released. Some of the review's findings were critical of ASIC's approach to enforcement:

- ASIC has a tendency to be reactive in the way it uses its resources and is often issue driven (that is, responding to high profile events such as financial advice and planning scandals) instead of focussing on ASIC's longer term strategic goals.
- ASIC places too much emphasis on enforcement, which is often a reactive tool. This is demonstrated by the fact that ASIC's resource allocation to enforcement significantly exceeds that of any of its peer regulators. Although enforcement is critical to the effectiveness of a regulator, the report considers a more balanced approach "emphasising the full scope and use of ASIC's regulatory toolkit would be more appropriate" for a modern regulator.
- ASIC's approach to litigation lags behind some of its peers when it comes to certain features of litigation practices (such as focused pleadings, narrowing of matters of issues, targeted evidence, etc). Amongst other things, the report recommends that ASIC develop a targeted approach to litigation and use litigation as a way of communicating messages to the regulated population to have "the desired deterrence effect".

Interestingly, the report also noted a number of areas where there is significant divergence between how ASIC thinks it has performed and the perceptions of external stakeholders. For example, 95% of ASIC's leadership consider that ASIC is proactive in identifying risks in the financial system, compared with only 23% of external stakeholders. The report considers that this disparity can be addressed through more meaningful reporting of performance and ensuring ASIC's mandate and expectations are well understood.

While ASIC's response (at Appendix E of the report) agrees with a number of the panel's observations, it does not agree that it is "defensive, inward looking, risk averse and reactive". ASIC also disagrees that enforcement is a reactive tool and considers that it already has the right balance between enforcement and non-enforcement tools.

Given this response, it is unclear whether the capability review will have any immediate impact on ASIC's approach to enforcement. If recent activity is any indication, it would seem that ASIC's emphasis on enforcement has only increased and there is a renewed focus on promoting deterrence in the market by publicising enforcement actions and outcomes.

The First Future of Financial Advice case

ASIC has for the first time brought proceedings alleging contraventions of the "best interests obligations" in Division 2 of Part 7.7A of the Corporations Act. The best interests obligations were introduced as part of the Future of Financial Advice reforms.

The defendant, NSG Services Pty Ltd (NSG), holds an Australian Financial Services Licence and provides advice to retail clients about life risk insurance and superannuation products. ASIC is seeking declaratory relief and civil penalties against NSG, alleging that its representatives have contravened the best interests obligation in section 961B and its appropriate advice obligation in section 961G of the *Corporations Act*.

In particular, ASIC alleges that NSG's representatives gave financial product advice which was not in the clients' best interests because the advice was given without:

- proper and sufficient information about the client's objectives, financial situation and needs;
- necessary inquiries into the client's relevant circumstances;
- any, or sufficient, investigation into existing and suitable alternative financial products;
- comparing the client's existing position with the recommended products; and
- comparing or discussing an alternative product.

ASIC alleges that NSG had insufficient training and inadequate policies (including because they were descriptive rather than prescriptive, with little information about the consequences of breach), with key policies not having been updated in the light of the FOFA reforms. It also alleges that there was inadequate supervision of representatives, with failures to take adequate steps to sanction representatives for compliance breaches. Relying on these and other matters, ASIC alleges NSG contravened section 961L of the *Corporations Act* because it did not take reasonable steps to ensure that its representatives (including authorised representatives) comply with sections 961B and 961G of the Act. ASIC also alleges NSG is directly liable for the acts and omissions allegedly committed by NSG's representatives who were not authorised representatives by reason of s 961K.

NSG is defending the proceedings and has filed a defence contesting ASIC's allegations.

The case has the potential to provide guidance as to the steps a licensee is obliged by s 961L to take to ensure that its representatives, including its authorised representatives, comply with the best interests obligation.

Further information about the requirements for meeting the best interests duty for financial product advisers can be found at Regulatory Guide 175 Licensing.

ASIC win against Storm Financial directors

The collapse of Storm Financial Ltd in 2008 has received much publicity. ASIC has now obtained a Federal Court judgment against Mr and Mrs Cassimatis, directors of Storm Financial (*ASIC v Cassimatis (No 8)* [2016] FCA 1023). The win for ASIC is an interesting example of so called "stepping stones" liability, in which the directors breached their statutory duty of care because they did not take appropriate steps to ensure that the company complied with *its* legal obligations (the breach by the company being the stepping stone to the director's liability). Although the Court held the contraventions alleged by ASIC were made out, it did not accept ASIC's argument that the directors had breached their duties simply by failing to ensure compliance with the law – the Court held that went too far and one has to look at what steps were taken and whether they were reasonable in all the circumstances.

The Court took an illuminating approach to directors' liability for breach of their duty of care under s 180, holding that directors could not avoid liability under that section merely because the shareholders had consented. This highlights that directors' statutory duty of care is quite different to their general law duty of care. Edelman J, in what is likely to be a widely cited as a careful analysis of the nature of a director's duty of care, disagreed that the duty in section 180 of the *Corporations Act* is merely a replication of the private duty owed purely to the company with public sanctions. The Court's reasoning also indicates that directors have a particular responsibility to ensure that the company complies with the law, regardless of the financial consequences.

This is probably the first time a Court has found a breach of civil penalty provisions by directors (Mr and Mrs Cassimatis) who were also the sole shareholders in the company, based on conduct at a time when the company was solvent. As such, it is a very significant decision on directors' duties. It has implications for directors (and others managing a financial services business or part of one, given the extended definition of "officer" in the Corporations Act) as it signposts a potential route by which they may be individually liable if they do not take reasonable steps to ensure the company complies with the law (particularly the financial services law in the case of an AFSL holder).

The company's breach of law

Edelman J noted that ASIC had set itself a high bar by running its case on the basis that Storm Financial Limited had breached the Act. His Honour pointed out a breach by the company of the law is neither necessary nor sufficient to establish a breach of a duty of care.

The company's directors ran their financial investment business with an aggressive strategy known as the "Storm model", which involved borrowing funds secured against the family home to invest in index funds. The company applied the Storm model to financially vulnerable clients who were retired or approaching retirement age, had little income and few assets, and had little prospect of rebuilding their financial position in the event of significant loss, without adequately considering the appropriateness of the advice for the client's individual circumstances. By doing so, the company was found to have contravened s 945A *Corporations Act* (as in force at that time) because of inadequate investigation of the subject matter of the advice, and because the advice was not appropriate for those investors having regard to the consideration and investigation of its contents that ought to have been undertaken. The case contains a useful discussion of the matters relevant to determining whether advice is appropriate, which will be relevant also to the post-FOFA provisions.

The directors' breach of duty

Edelman J found that the Cassimatises had an extraordinary degree of control over the company's operations, and a reasonable director in their position would have realised that the Storm model was inappropriate for some investors. As such, they should have been aware that delivering that advice indiscriminately would be likely to contravene the *Corporations Act*. This was not based on knowledge of specific advice being given, but because as directors they allowed advice generally to be given in accordance with the Storm model.

In applying the test of whether the directors' actions involved a reasonably foreseeable risk of harm, Edelman J found that harm is not limited to financial harm, but rather includes all the legitimate interests of the corporation (including its reputation). (His Honour left open the possibility that interests other than those of the corporation might be relevant as he did not need to decide that point.) Potentially illegal activity is of itself a relevant risk of harm, regardless of whether the activity is profitable.

Shareholders could not consent to the directors' breach of duty

The Court rejected the directors' arguments that directors do not breach their statutory duty of care and diligence if they have the consent of shareholders of a solvent company - which, as the sole shareholders of Storm Financial, they did. His Honour reasoned that as there is both a private and a public interest in the enforcement of directors' duties, the interests of a corporation may not be identical to, and may go beyond, the interests of shareholders. Shareholders therefore not only cannot ratify a breach of duty for the purposes of s 180, they cannot consent to it in advance (although shareholder acquiescence may affect the practical content of the duty).

At this stage the Court has given reasons but is yet to make any declaration of contravention or determine the penalty.

ON THE OTHER HAND...

ASIC has not had it all its way. The hearing of its civil penalty proceedings against the directors of LM Investment Management Ltd were such that it took the unusual step of discontinuing the proceedings against two of the directors at the conclusion of the hearing. The matter continues against three other directors.

Meanwhile, the Full Federal Court in *Lewski v ASIC* [2016] FCAFC 96 overturned a judgment in ASIC's favour at first instance, holding that directors of a responsible entity did not breach their duty in s 601FD of the *Corporations Act* to act in the best interests of members by making payments to related entities. The directors had acted in accordance with the constitution as purportedly, but ineffectively, amended by them. The original amendment to the constitution could not be challenged because proceedings were started after the limitations period in respect of the amendment resolution had expired. See our Dispute Resolution Update of 19 July 2016.

ASIC targets property investment spruikers

ASIC has obtained injunctions against a company preventing it from promoting and marketing a Pilbara property investment scheme. The marketing material for the scheme was found to contain misleading representations as to the investors' duties as a company director and that the investment proposal was essentially risk free. Two companies involved in the promotion of the scheme were held to have engaged in the unlicensed provision of financial services in contravention of the *Corporations Act*.

Macro and 21st Century (two companies, Property Tuition Pty Ltd and Education Holdings Pty Ltd) distributed documents which promoted a property investment opportunity using the catchphrase "Do you know how to buy Australian property, no money down?".

The proposal involved investors establishing and being appointed the sole shareholder and director of a company which was required to acquire properties from Macro in the Pilbara region. The investors would receive a weekly fee, but had to give effective control of the companies to Macro.

The Federal Court in *ASIC v Macro Realty Developments Pty Ltd* [2016] FCA 292 granted the injunctions and declarations sought by ASIC. The Court held that by giving Macro effective control of the investor's company, the investment documents fettered the investors' discretion such that the investor could not, in their capacity as a director, exercise their discretion in the interests of the company. The Court also found that certain representations in the investment documents, including that an investor's obligations as director could be fulfilled by signing one annual return a year, and that the investment proposal was essentially risk free, were misleading or deceptive.

The Code of Banking Practice as a new source of liability

Two recent Victorian Court of Appeal decisions, *Doggett v Commonwealth Bank of Australia* [2015] VSCA 351 and *National Australia Bank Ltd v Rose* [2016] VSCA 169, have confirmed that the provisions of the Code of Banking Practice can and do have contractual effect between a bank and, not only its customers, but also guarantors. Special leave was refused by the High Court of Australia in *Doggett* in June 2016.

Especially now the High Court has refused special leave, banks will need to consider carefully strict compliance with the provisions of the Code, including for guarantees. The impact of these decisions will also likely prominently feature in the report on the independent review of the Code of Banking Practice, due later this year.

DOGGETT V COMMONWEALTH BANK OF AUSTRALIA [2015] VSCA 351

In *Doggett*, the Court of Appeal unanimously concluded that, by reason of the Code, the bank had an obligation under certain guarantees to exercise the care and skill of a diligent and prudent banker in assessing and forming an opinion about the borrower's ability to repay the loan and that the bank had breached its duty to the guarantors to exercise such care and skill. The majority held that the bank's failure to exercise such care and skill caused the guarantors loss and damage such that the bank's claims under the guarantee were, in effect, expunged.

There is still some controversy about the extent to which the Code is contractually binding where there is no express provision incorporating the Code into an agreement. In this case however the guarantees stated that "relevant provisions of the Code of Banking Practice apply to this guarantee."

The Court was unanimous in concluding that, on a proper construction of the incorporating provision of the guarantee, Clause 25.1 of the Code[1] (providing that a bank must exercise care and skill in assessing and forming an opinion about a lender's ability to repay) was a relevant provision of the Code for the purposes of incorporation into the contract.

The Court agreed that Clause 25.1 did not oblige a bank to form an opinion that a borrower will be able to repay the loan. It requires a bank to exercise care and skill in forming an opinion, irrespective of whether the opinion is that the borrower will be able to repay the loan.

It may be that a bank offers accommodation notwithstanding that it forms the opinion that a borrower will not be able to repay the loan. The Court observed that other factors such as additional security, or guarantees provided, may inform a bank's ultimate decision to provide accommodation.

NATIONAL AUSTRALIA BANK LTD V ROSE [2016] VSCA 169

In *Rose*, a personal guarantee was rendered unenforceable by operation of the Code because the individual signed the guarantees on the spot without reading them, and therefore was not given "prominent notice" of specified matters set out in the Code (eg the right to obtain independent legal advice). The majority considered that it would have been different if the guarantees had been posted for signature the next day, or if the notices had been given in person separately from the guarantee documents.

Citing these decisions, the ABA's submission to the independent review of the Code of Banking Practice sought greater clarification of what a "diligent and prudent banker" means, criticised the provisions concerning guarantees as too complex and too long and submitted that they should be redrafted to make them clearer, while maintaining the existing protections for guarantors.

1 Clause 25.1 of the Code of Banking Practice 2004, now Clause 27 of the Code of Banking Practice 2013.

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