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Financial Services Disputes – What's New?

February 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 ENFORCEMENTS, THEMES AND REVIEWS

2016 ended with a flurry of inquiries, reviews and reports into the regulatory and dispute resolution systems. It is easy to lose track as to who is recommending what and often less easy to predict how this will impact on legislative reform.

2017: a year of financial services legislative reform?

2017 promises to be a year of potentially significant legislative reform in the financial services sector. As 2016 came to a close, the House of Representatives Standing Committee on Economics released its report *Review of the Four Major Banks* following the bank chiefs being called before the Committee. Further hearings in March 2017 have recently been announced.

We look at two of the legislative reforms recommended by the Committee, which we think are potentially of particular significance, and look ahead as to what other reform may be on the horizon in 2017.

ASIC Enforcement Review Taskforce

ASIC's enforcement powers are again being put under the microscope. In October 2016, the Turnbull Government announced the terms of reference for and members of the ASIC Enforcement Review Taskforce.

In this article, we examine the terms of reference and consider the possible recommendations and their impact on ASIC's regulatory toolkit.

Financial system external dispute resolution and complaints framework—Interim Report

In our 18 October 2016 edition of *What's New*, we reported that the Federal Government had established an independent review into the financial system's external dispute resolution and complaints schemes: the Financial Ombudsman Service (FOS), the Credit and Investments Ombudsman (CIO) and the Superannuation Complaints Tribunal (SCT). An Interim Report was released in December, requesting feedback on a number of draft recommendations, which included a recommendation of two separate industry ombudsman schemes at odds with the recommendation of the House of Representatives Standing Committee's report.

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With the more high profile inquiries taking up column inches and drawing comment at the end of 2016, it is easy to overlook the impact on the financial services industry of a number of recent court decisions.

Disclosing privileged documents to regulators: the implications of *Cantor v Audi Australia Pty Ltd* [2016] FCA 1391 on ASIC's limited waiver regime

In *Cantor v Audi Australia Pty Ltd* [2016] FCA 1391, the Federal Court held that the disclosure of privileged documents on a confidential basis to a German regulator did not amount to a waiver of privilege for the purpose of Australian class actions where the privileged documents had not been inconsistently deployed.

The decision provides some support to the proposition that a disclosure to ASIC of privileged communication under ASIC's limited waiver regime should not amount to a wider waiver of privilege.

Penalty cases following *Paciocco*

In two recent cases, the New South Wales Court of Appeal held that a default interest rate provision in a loan agreement was not a penalty. The Court of Appeal in both *Wu v Ling* [2016] NSWCA 322 and *Arab Bank Australia Ltd v Sayde Developments Pty Ltd* [2016] NSWCA 328 held that a default interest rate of 2% above the ordinary rate was not a penalty having regard to the risks and costs associated with defaults.

Court finds that a bank's standard terms and conditions were not incorporated into the bank's contract with its customer

In *NAB v Dionys as Trustee for the Angel Family Trust* [2016] NSWCA 242, the NSW Court of Appeal found the bank's standard terms and conditions booklet did not form part of the contract with the customer. The case suggests banks must do all that is reasonably necessary to bring onerous incorporated terms to a customer's attention, contrary to many common practices.

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2017: a year of financial services legislative reform?

2017 promises to be a year of potentially significant legislative reform in the financial services sector. As 2016 came to a close, the House of Representatives Standing Committee on Economics released its report *Review of the Four Major Banks* following the bank chiefs being called before the Committee. There will be further hearings in March.

Of the various recommendations, two of the legislative reforms recommended by the Committee are potentially of particular significance.

The first recommendation – found within a chapter of the report titled "Make Executives Accountable" – recommended that, by 1 July 2017, ASIC require Australian Financial Services Licence (AFSL) holders to publically report on any significant breaches of their licence obligations within five business days of reporting the incident to ASIC. Most notably, this public reporting would detail the consequences for any senior executives involved, including where termination was not pursued details of why not.

In the Committee's view, the risk of being publicly named will create further incentives for executives to prioritise good consumer outcomes and, the need for AFSL holders to publicly justify the consequences imposed on senior executives, will force institutions to more comprehensively engage with questions of executive accountability on a more regular basis.

In our last edition, dated 18 October 2016, we examined global trends in individual accountability and questioned how long it would be before ASIC refocused its emphasis on gatekeeper responsibility to include greater individual accountability. The cross-party Committee's approach certainly seems to favour a significant increase in focus on accountability of individuals. The majority report would do this largely by the naming mechanism mentioned above. Another alternative discussed — favoured by the Committee's Labor members and expressed in a dissenting report — was replicating the UK's recently introduced Senior Managers Regime. However, as noted in the dissenting Labor report, differences in the financial systems of the two countries and their regulatory structures mean the regime itself could not simply be copied.

The second recommendation of note was that the Government establish a Banking and Financial Sector Tribunal by 1 July 2017. This Tribunal would replace the Financial Ombudsman Service, the Credit and Investments Ombudsman and the Superannuation Complaints Tribunal.

This "one-stop" banking tribunal was recommended at a time that Government reviews of specialist dispute resolution mechanisms for the financial services sector were already underway. As we report below, one such review, an independent review into the financial system's external dispute resolution and complaints schemes chaired by Professor Ian Ramsay, released an interim report which is at odds with this recommendation.

Legislative reform in 2017 will also focus on the implementation of the proposed product intervention power for ASIC. In December 2016, the Commonwealth Treasury released a proposals paper for public consultation, which included the details of the proposed product intervention power, something that has been debated since it was first recommended by the Final Report of the Financial System Inquiry in 2014. You can see our December 2016 *Financial Services Update* briefing on the proposal paper here.

Continuing the theme of regulatory legislative reform, this may also be on the horizon in the shape of recommendations coming out of the Senate Inquiry into foreign bribery, which is due to report in mid-2017. The Terms of Reference for that inquiry include "an increased focus on the offence of failure to create a corporate culture of compliance". Given ASIC's continued focus on culture, we would expect ASIC to be paying close attention to what the Senate's report recommends and then pushing for a similar mechanism with which to promote good culture in the financial services sector.

Finally, a separate Parliamentary Committee is to report by 30 June 2017 on the whistle-blower provisions of the Registered Organisation Commission legislation, with the objective of implementing the substance and detail of those provisions – effectively as a model – to achieve an equal or better whistle-blower protection and compensation regime in the corporate sector. Any legislative reform, which would include amendment of the relevant *Corporations Act* 2001 provisions, introduced in response to recommendations is to be brought before Parliament by December 2017.

ASIC Enforcement Review Taskforce

ASIC's enforcement powers are again being put under the microscope. In October 2016, the Turnbull Government announced the terms of reference for and members of the ASIC Enforcement Review Taskforce. The Taskforce is part of the Government's broader agenda of ensuring the financial system is regulated efficiently and builds on the Financial System Inquiry Report released in 2014, also known as the Murray Report, and the ASIC Capability Review conducted in 2015.

The Taskforce is charged with reviewing and reporting on the adequacy of ASIC's enforcement toolkit and, more significantly, proposing new powers to remedy any "gaps or deficiencies" in the current regime.

It is comprised of a core Panel chaired by Treasury and includes representatives from various government entities, including ASIC, the Attorney-General's Department and the Commonwealth Director of Public Prosecutions. The inclusion of the Commonwealth DPP is noteworthy and suggests that criminal penalties are squarely in the Taskforce's sights. A six-member Expert Group, comprised primarily of academics and lawyers, will provide advice and feedback to the Panel.

The terms of reference themselves are wide and include assessing the adequacy of:

- ASIC's powers: (i) in respect of licensing of financial services and credit providers, including powers to grant and cancel those licences; and (ii) to ban offenders from occupying company offices following serious contraventions;
- civil and criminal penalties for serious contraventions; and
- frameworks for notifying ASIC of breaches of law, including the triggers giving rise to the obligation to notify.

The Taskforce is additionally empowered to examine "any other matters, which arise during the Taskforce's review... which appear necessary to address any deficiencies in ASIC's regulatory toolset".

Observations

Although an assessment of the adequacy of ASIC's powers will provide market participants with a useful commentary on ASIC's current enforcement role, the findings of most significance to industry will likely be any additional regulatory tools and policy options recommended by the Taskforce.

As ASIC has been given a seat on the core Panel, it would be of little surprise if many of the powers for which the regulator has made repeated requests make their way into the Taskforce's final report as recommendations. In December 2016, ASIC chairman Greg Medcraft said that ASIC was "very supportive of this review" and commented that "there is a gap in the civil penalties regime and also in the proportionality of the infringement regime". Furthermore, a Reference Group, which includes international regulators, has been established to advise the Taskforce and any recommendations are therefore likely to closely mirror international developments.

In this context, the Taskforce may call for stronger civil and criminal penalties for *Corporations Act* breaches, as well as increased powers for ASIC to cancel financial services and credit licences. It is also probable that the Taskforce will recommend expanding the classes of persons obliged to report breaches of the law to ASIC, with a view to enhancing the regulator's ability to identify and prosecute breaches.

The terms of reference expressly provide that the Taskforce is to ensure that its recommendations do not impose an undue regulatory burden on business, and promote engagement between ASIC and its regulated population. Despite this there is a lack of industry representation on the core Panel, although whether this will ultimately have any impact on the Taskforce's recommendations remains to be seen.

The Taskforce is due to report to Government later this year, following which the public will be invited to comment on any policy recommendations made.

Financial system external dispute resolution and complaints framework – Interim Report

In our October 2016 edition of *What's New,* we reported that the Federal Government had established an independent review into the financial system's external dispute resolution and complaints schemes: the Financial Ombudsman Service (FOS), the Credit and Investments Ombudsman (CIO) and the Superannuation Complaints Tribunal (SCT). An Interim Report was released in December, requesting feedback on a number of draft recommendations. The Panel is expected to release its final report by the end of March 2017.

Draft recommendations

The Interim Report includes draft recommendations that:

- A single industry ombudsman scheme for financial, credit and investment disputes (other than superannuation disputes) should replace the FOS and the CIO;
- The SCT should transition into an industry ombudsman scheme for superannuation disputes.

The Panel acknowledges that a fully integrated ombudsman service for all financial system disputes should be considered in the future once the separate schemes are established and have garnered consumer and industry support.

Banking tribunal not recommended

As acknowledged in the Interim Report, the recommendation of two separate industry ombudsman schemes is at odds with the recommendation of the House of Representatives Standing Committee's report. We also note the Prime Minister's media comments (reported in our last edition of *What's New*) that we are heading towards having some form of banking tribunal.

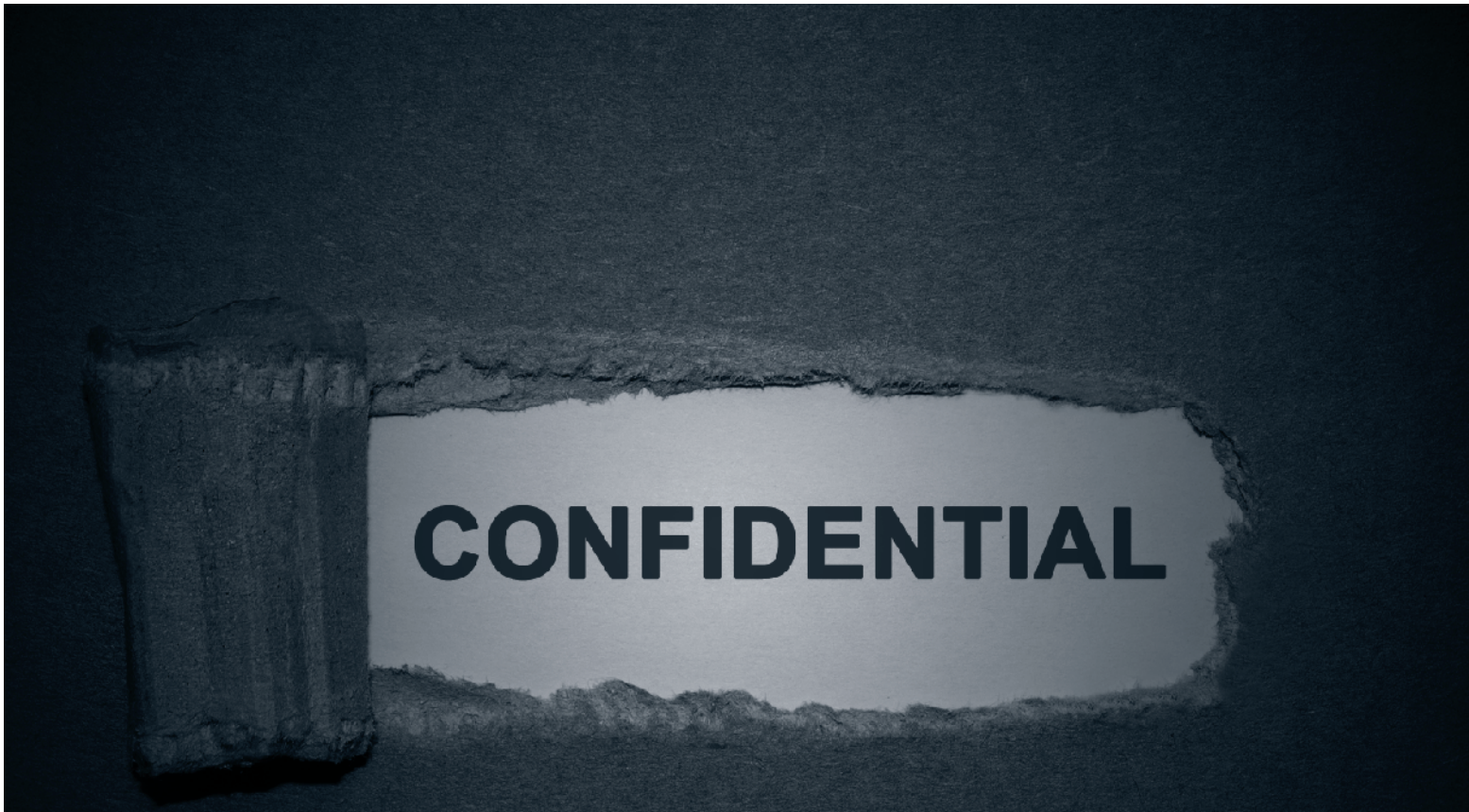
The Panel will consider this issue further in its Final Report, but describes a number of shortcomings of tribunals in relation to flexibility, cost and access to justice. The Interim Report observes that tribunals can apply a "black letter law" approach to decision making, in contrast to ombudsman schemes where the approach is based on achieving "fairness in all the circumstances", which factors in good industry practice and Codes of Practice. The interim report states that there is a general consensus among stakeholders that ombudsman services are an effective dispute resolution mechanism which promotes access to justice and decreases the burden on the judicial system.

Addressing gaps in the framework

A number of draft recommendations were also made to address gaps in the framework, including increasing monetary limits and compensation caps for financial, credit and investment disputes (with regular indexation), enhancing and strengthening ASIC's powers, the development of a superannuation code of practice, the use of panels for resolving complex disputes and requiring debt management firms to be a member of an industry ombudsman scheme.

The Panel also considered improvements to internal dispute resolution processes, recommending enhanced public reporting by financial businesses of internal dispute resolution activity and outcomes. The industry ombudsman schemes should also be required to track the progress and outcomes of disputes referred back to a financial business's internal dispute resolution process.

Although the Panel did not make formal recommendations as to whether the framework requires a scheme of last resort, it acknowledged that many Australians currently lack confidence in the financial system at least in part because of uncompensated consumer losses. The Panel observed that there is considerable merit in introducing an industry-funded compensation scheme of last resort, and will consider this issue further in its Final Report.



Disclosing privileged documents to regulators: the implications of *Cantor v Audi Australia Pty Ltd* on ASIC's limited waiver regime

In *Cantor v Audi Australia Pty Ltd* [2016] FCA 1391, the Federal Court held that the disclosure of privileged documents on a confidential basis to a German regulator did not amount to a waiver of privilege for the purpose of Australian class actions where the privileged documents had not been inconsistently deployed. The decision provides some support to the proposition that a disclosure to ASIC of privileged communication under ASIC's limited waiver regime should not amount to a wider waiver of privilege.

Background

The German regulatory authority for vehicle testing, Kraftfahrt Bundesamt (KBA), investigated the use of software by Volkswagen AG (VW) to reduce omissions produced during laboratory tests. The KBA wrote to VW requesting that it provide a formal binding statement on whether the operation of the software was legally characterised as a "defeat device". VW sought and obtained written advice from its German lawyers, Freshfields Bruckhaus Deringer LLP, which it enclosed on a confidential basis with its response to the KBA.

In proceedings in Australia, the class action plaintiffs disputed that the Freshfields' advice and related communications were privileged and argued that, even if they were, that privilege had been waived in the Freshfields' advice and related documents by disclosing the advice to the KBA.

Bromwich J upheld the claims for privilege and further held that there had been no waiver. The most interesting aspect of the judgment was his Honour's consideration of whether there had been an implied waiver as against the rest of the world by the disclosure of the advice to the KBA and the other communications referring to the advice.

In reaching his conclusion, Bromwich J applied the inconsistency test in *Mann v Carnell* (1999) 201 CLR 1 at [29] and distinguished *Goldberg v Ng* (1995) 185 CLR 83.

In *Goldberg v Ng*, the disclosure of documents to the Law Society of NSW by a solicitor in the course of the investigation of a complaint had amounted to waiver of privilege during court proceedings. The High Court concluded that the disclosure amounted to waiver on the basis that it was voluntary and made for the express purpose of rebutting the complaint, and that the court proceedings and the complaint dealt with the same subject.

In the present case, Bromwich J held that the commonality of issues between the KBA investigation and the substantive proceedings did not of itself make it inconsistent for Volkswagen to confidentially disclose the Freshfields' advice to the KBA and assert privilege in the Australia proceedings. His Honour held that there was no relevant nexus between the disclosure to the KBA and the conduct of the litigation which would give rise to the inconsistency required for waiver.

An important part of his Honour's reasoning was that the disclosure to the German regulator was in all the circumstances confidential.

Implications on ASIC's limited waiver regime?

Regulators in Australia, including ASIC, cannot compel the production of privileged communications. Nevertheless, it is often the case that the targets of ASIC's investigations are requested to, and come under pressure to, waive legal professional privilege. Information Sheet 165 explains ASIC's approach to claims of legal professional privilege, and significantly, sets out how ASIC may elect to receive voluntarily produced privileged information on written terms of confidentiality. As correctly noted by ASIC however, any such agreement does not prevent a third party from contesting that privilege has been waived generally.

In this regard, the decision in *Cantor v Audi Australia Pty Ltd* provides some support to the proposition that a disclosure to ASIC should not amount to a wider waiver of privilege. It is noteworthy that on the facts of this case, the apparent absence of an express agreement to keep the documents confidential was not fatal. Having regard to German law, his Honour found that since the advice was provided to the KBA in circumstances of confidentiality, VW's conduct in handing over the advice resulted in a limited waiver in favour of the KBA only, and only for the purposes of the KBA performing its regulatory functions.

As noted by Bromwich J however, there are limitations on using prior cases other than for points of principle and a fact-based inquiry is required in order to determine whether the requisite inconsistency is manifest for a waiver to be established.

Before any privileged documents are provided to ASIC, it is important to obtain legal advice on the framework within which those materials are disclosed. While this decision lends support to the view that the provision of privileged communications under the sort of regime contemplated by Information Sheet 165 should not amount to a wider waiver, the fact remains that even when such agreements are in place, the risk of waiver being argued remains.

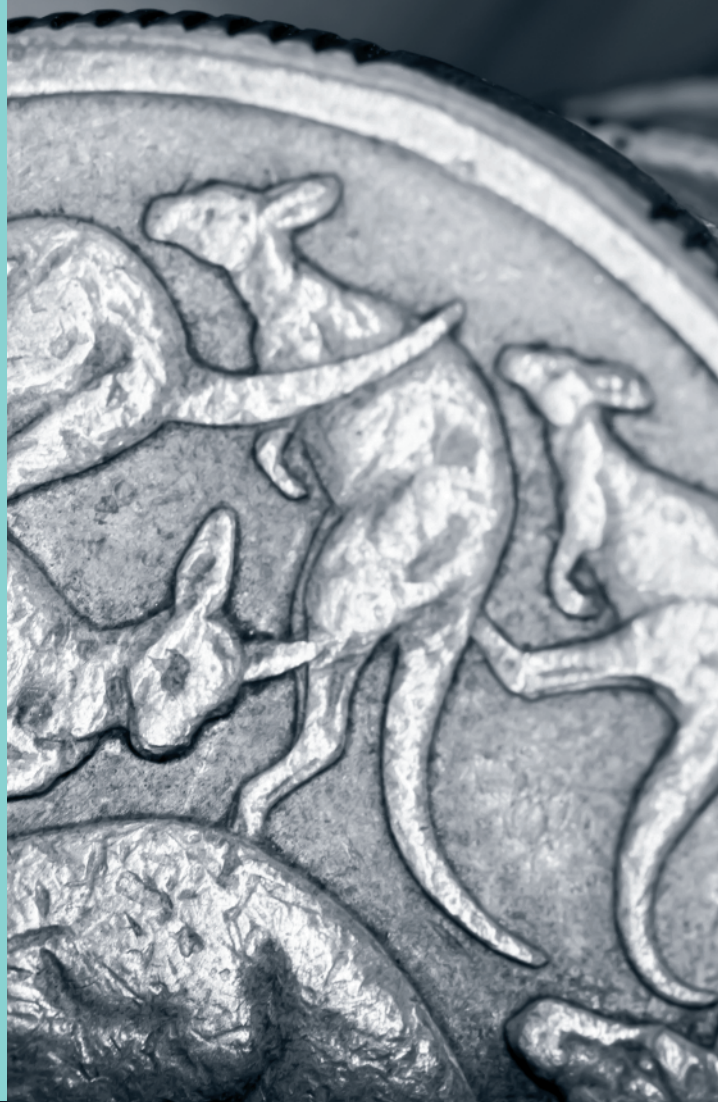
Penalty cases following Paciocco

In two recent cases, the New South Wales Court of Appeal held that a default interest rate provision in a loan agreement was not a penalty. The Court of Appeal in both *Wu v Ling* [2016] NSWCA 322 and *Arab Bank Australia Ltd v Sayde Developments Pty Ltd* [2016] NSWCA 328 held that a default interest rate of 2% above the ordinary rate was not a penalty having regard to the risks and costs associated with defaults.

In both *Wu* and *Arab Bank*, despite different factual circumstances, the Court concluded that a default interest rate provision increasing the interest rate payable on a loan by 2% upon default was not a penalty. The cases demonstrate that charging a margin to account for the increased costs and risk associated with default will not be found to be a penalty if that margin is reasonable.

Both cases considered the High Court's judgment in *Paciocco v Australian & New Zealand Bank* (2016) 90 ALJR 835. The decisions confirm that when determining whether a default interest rate provision (or indeed any other provision) constitutes a penalty, the following principles apply:

- is the default interest rate extravagant or out of all proportion to, or unconscionable in comparison with the greatest amount of loss that could possibly be foreseen to flow from a breach? This was considered implicitly in *Wu*, with Bergin J finding that 2% was a reasonable reflection of the costs that could flow from default. In *Arab Bank*, the Court found that the default rate of 2% could not be regarded as extravagant or unconscionable;
- the analysis is to be made at the time and taking into account the circumstances applicable when the contract was made. The actual consequences of default, however, can be probative of the earlier probability of those consequences occurring. By way of example, in Arab Bank the Court found that the actual cost of provisions against impaired loans gave some indication that the stipulated default rate could not be regarded as extravagant or unconscionable; and
- is the sole or predominate purpose of the default interest rate to punish the borrower for breach? In both *Arab Bank* and *Wu*, the Court found that there was no basis upon which it could be found that the predominate purpose of the default interest rate was to punish the borrower.



ARAB BANK V SAYDE [2016] NSWCA 328

The commercial loan facility

The borrower (Sayde) borrowed about $7 million under a commercial loan facility between 2008 and 2013, when the facility was repaid in full from the lender (Arab Bank).

The facility was an interest only facility, and pursuant to its terms, required the borrower to pay interest monthly. Interest was charged on the principal of the loan at a rate specified in various letters of offer and was also charged at a default rate that was 2% above the ordinary rate if, among other things, the monthly payments were not made on time. Over the course of the loan the borrower paid almost $249,000 in default interest. After repaying the loan, the borrower sued the bank to recover the default interest, claiming it was a penalty.

In a judgment pre-dating *Paccioco* in the High Court, the primary judge found the 2% default interest provisions to be penalties on the basis that they were not a genuine pre-estimate of the cost to the bank of a default by the borrower.

Default interest rate provision held not to be a penalty

The Court of Appeal overturned the primary judge's finding and found that the default interest rate was not a penalty. In making this finding, McDougall J, with Sackville AJA and Gleeson JA agreeing, applied the principles outlined in *Paciocco*.

His Honour held that the default interest provisions were not extravagant or out of all proportion to, or unconscionable in comparison with, the maximum amount of damage that might be anticipated to follow from the breach to the Bank. His Honour found that if the borrower was late in making repayments, the Bank would be required under certain banking regulations to monitor the loan with a view to deciding whether it should be classed as "impaired" and, accordingly make provision in its financial statements for the possible loss. Therefore the need to make provision against bad or doubtful loans was real and readily foreseeable even though the precise quantum could not be foreseen.

Although the likely consequences of default was to be assessed at the time the contract was made, McDougall J referred to Gageler J's statement in *Paciocco* that evidence of the later occurrence of an event can be probative of the earlier probability of that event occurring. Therefore having regard to the actual cost of provisions against impaired loans which averaged 5.45% of the total amount in default, McDougall J found that the default rate of 2% could not be regarded as extravagant or unconscionable.

A more detailed consideration of this case can be found in our December 2016 Dispute Resolution Update.

WU V LING [2016] NSWCA 322

The loan agreements

The borrower (Ms Wu) borrowed from the lender (Mr Ling) a total of $670,000 in accordance with five loan agreements during the period February 2009 to October 2010.

Under the first loan agreement, the lender lent $350,000 to the borrower for a period of 12 months, with an interest rate of 9% per annum rising to 11% in the event of default. The evidence at trial was that entirety of the monies borrowed was lost through a Nigerian scam and, consequently, the borrower did not repay the loans.

The borrower claimed that the default interest provision in the first loan agreement was a penalty and, therefore, should be set aside. The primary judge held that the default interest provision was not a penalty.

Default interest rate provision held not to be a penalty

Bergin CJ in Eq, with whom Leeming JA and Payne JA agreed, upheld the primary judge's decision that the default interest rate provision was not a penalty. Her Honour accepted the primary judge's findings that: (1) the lender was entitled to charge a somewhat higher rate of interest in the circumstances of default on the first loan; and (2) the increase in the rate of interest of 2% was a reasonable reflection of the lender's enforcement and other costs in the event of default, and a reasonable pre-estimate of the cost of him being kept out of his money, which may have included having to obtain finance from elsewhere, missed profitable opportunities and the portion of his legal fees which might not have been recovered from taxation.

Bergin CJ in Eq also considered the proposition in *Paciocco* per Gageler J at [165] that the essence of a penalty is that its sole purpose is to punish the borrower. Her Honour held that, having regard to the facts, there was no basis upon which the primary judge could have concluded that the only purpose of the default interest rate provision was to punish the borrower.

Court finds that a bank's standard terms and conditions were not incorporated into the bank's contract with its customer

In *NAB v Dionys as trustee for the Angel Family Trust* [2016] NSWCA 242, the NSW Court of Appeal upheld a decision of the District Court of New South Wales requiring a bank to reimburse its customer almost $500,000 (plus interest) in funds which were withdrawn from the customer's account without her authority, even though the customer did not notify the bank of the unauthorised withdrawals for some months after she discovered them.

The bank was unable to rely on a clause (clause 5.18) in its standard terms and conditions requiring customers to promptly check their bank statements and notify the bank of any transactions which the customer suspected were unauthorised. Failure to do so meant that the customer would "not have any right to make a claim against [the bank] in respect of such a matter...".

These terms and conditions were contained in a 71 page booklet provided to customers when they opened an account. The Court concluded they were not part of the contract. When opening her account, the customer had signed an Authority Card which contained a number of other terms and conditions, but not clause 5.18 in the booklet. Nor did the Authority Card expressly refer to the terms and conditions. The Court accepted, for the purposes of deciding the case, that she had received it when she opened the account. However, on the evidence the contract was not shown to have been concluded after the customer got the booklet.

Sackville AJA (with MacFarlan JA and White J agreeing with White J giving further reasons) held that the terms and conditions in the booklet were not incorporated into the contract between the bank and the customer. This was because the agreement between the bank and the customer was concluded when the customer signed the Authority Card. The bank had not established that the booklet had been given to the customer, or even that it was referred to, *before* she signed the Authority Card. Once the agreement had been concluded, it was not open to the bank unilaterally to introduce new terms and conditions into the agreement, whether by handing the customer the booklet or otherwise.

That reasoning is unsurprising, but highlights the importance of ensuring terms in ancillary documents are clearly referred to in the primary document.The Court also considered, even if it were wrong on that point and the customer had the terms and conditions booklet at the point in time the contract was formed, the bank had not taken sufficient steps to incorporate clause 5.18 into the agreement. As the customer was never asked to sign the booklet or to acknowledge its terms in writing, clause 5.18 could only form part of the agreement if the customer accepted or at least had the opportunity of accepting clause 5.18. The bank was required to show that it had done all that was reasonably necessary to bring any "unusual conditions" to the customer's attention. Clause 5.18 was an "unusual condition" because it significantly limited the bank's liability to the customer under common law principles.

The Court said the bank had not taken the steps reasonably necessary to bring clause 5.18 to the customer's attention so as to incorporate the provision into the agreement. On the bank's evidence, the bank officer did no more than hand the booklet to the customer and inform her she could also access the terms and conditions on the website. This was not enough given the length of the booklet and the effort required of a lay person to read and comprehend its contents. The terms imposing duties on customers or limiting the bank's liability were not highlighted.

As Sackville AJA observed at [89]:

> *"If a bank wishes a customer to be bound by unusual or onerous terms in a document, there is no obvious reason why it should not ensure that the document is signed. The customer's signature ordinarily gives contractual effect to the document that it otherwise may not have. In the absence of such a signature, the bank runs the risk that the terms contained in the document will not form part of the contractual arrangements between it and the customer."*

The second part of the Court's reasoning raises an important point for bankers. It will not be enough to incorporate by reference unusual conditions, such as those limiting common law principles. Reasonable steps must be taken to bring unusual conditions to the attention of the customer. The safest course will be to obtain the customer's signature on the separate terms and conditions booklet.

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