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Access by beneficiaries to trust documents

Michael Vrisakis FREEHILLS

The recent decision of the Supreme Court of New South Wales in *Silkman v Shakespeare Haney Securities Ltd*¹ sheds some light on the vexed question of whether and when beneficiaries can obtain access to documents held by the trustee of the relevant trust.

The case involved a registered managed investment scheme which had become illiquid.

A beneficiary of the trust made a request to the trustee for trust documents based on the beneficiary's expressed rights in equity, expressing a concern that many of the mortgage investments of the fund may not have been suitable and proper investments.

Part of the motivation for the request was to determine whether breaches of law had occurred and whether causes of action existed against the trustee and its directors.

The plaintiff sought an order that various documents be produced for inspection and copying.

The plaintiff's case relied on the authority of *Re Londonderry's Settlement*; *Peat v Walsh*² and the more recent *McDonald v Ellis*.³

As observed in the judgment, this line of case law authority attributes the right of a beneficiary to inspect "trust documents" as residing in the beneficiaries' equitable proprietary interest.

His Honour described this approach as the "*Londonderry* approach", observing:

The underlying idea is that such documents are themselves either trust property or are so closely related to trust property that they may be characterised as documents in which the beneficiary has such an interest. In *Re Simersall*; *Blackwell v Bray* (1992) 35 FCR 584 at 589 Gummow J described this right as proprietary in nature although falling short of a full beneficial interest. It is not necessary to contribute to the prolixity of this judgment by citing the authorities which have followed this approach. Bryson AJ referred to a number of them in *McDonald v Ellis*. I will call this approach the *Londonderry* approach.⁴

His Honour then referred to the Privy Council case of *Schmidt v Rosewood Trust*,⁵ where the court declined to follow the *Londonderry* approach, negating the proposition that a beneficiary has an equitable proprietary interest in trust documents giving rise to a right to production and inspection. His Honour noted that the basis of this decision was expressed rather as the

inherent jurisdiction of the court to intervene in the administration of trusts, referring to this line of authority as the "*Schmidt* approach".⁶

His Honour then referred to the NSW decision in *Ayanes v Marshall*,⁷ wherein Justice Gzell adopted the *Schmidt* approach.

Various other decisions are referred to by his Honour, with ultimately his Honour following the *Schmidt* approach.

His Honour observed in this context:

Absent clear appellate guidance, I propose to follow the *Schmidt* approach. A consideration of the authorities reveals that the *Londonderry* approach has jurisprudential difficulties which the *Schmidt* approach does not have, including:

- a ascribing a workable and principled definition of the term "trust documents";
- b divining the nature of the beneficiary's so-called proprietary interest in such documents. In *Hartigan Nominees v Rydge* [(1992) NSWLR 405; BC9203940] at [444] Sheller JA articulated this difficulty by describing this "trail" as unhelpful if not false;
- c that on the *Londonderry* approach a discretionary beneficiary who has no lesser interest in the due administration of the trust (but who has no proprietary interest in the assets) should, illogically, be denied disclosure;
- d that authorities which have taken the *Londonderry* approach have limited the beneficiary's right to disclosure by reference to the interests of third parties in maintaining confidentiality. It is difficult to reconcile this limitation with the principle for which *Londonderry* stands; and
- e reconciling a beneficiary's entitlement to documents such as a settlor's statement of intention or a constituent trust deed (which undoubtedly a beneficiary should properly have) with the fact that these instruments are themselves not assets or appurtenances to assets of the trust.⁸

The plaintiff, however, raised an alternative argument on the assumption that the court followed the *Schmidt* approach based on specific concerns of the plaintiff about the management of the trust.

In response to this submission, his Honour observed:

Whilst the defendant undoubtedly has a fiduciary obligation to the plaintiff to provide information as to the amount of the trust property and its investments, the extent of that obligation is affected by the circumstances of the relationship including the terms of the contract between them, in

this case the Constitution; *Hospital Products Ltd v United States Surgical Corp* (1984) 156 CLR 41 at 97; *Kelly v C A & L Bell Commodities Corp* (1989) 18 NSWLR 248.⁹

He also commented:

Taking the *Schmidt* approach, the court would intervene were it shown that the defendant has fallen short of its duty to make disclosure to the plaintiff, by requiring such disclosure as is needed to remedy the default. It would mould any orders to take into account competing interests for and against disclosure.¹⁰

His Honour declined to make the order sought on three separate grounds, as follows.

1. The plaintiff had not established that the defendant had fallen short of its disclosure obligations under the Corporations Act 2001 (Cth) or the Constitution, or that inspection of the wide scope sought was necessary to cure any disclosure deficiency.
2. The plaintiff's concerns generally related to the sufficiency of the information provided to assess whether there had been actionable breaches of trust rather than whether the trustee had been deficient in its disclosure obligations. His Honour noted that in this context the defendant had offered to provide explanations and respond to specific questions, which offers had not been availed of.
3. The wide ambit of the documents sought.¹¹

His Honour noted in passing that he would not uphold:

- the defendant's submission that information could be withheld because of an unfettered discretion of the defendant to make investments — the trust deed restricted that discretion to investment in Authorised Investments;¹² and
- the defendant's submission that relief should be withheld because the plaintiff was acting for an improper purpose, noting: "Were the plaintiff to have established an entitlement to disclosure, her intentions to use the documents to seek an appropriate remedy would not erode that entitlement."¹³

This decision follows very shortly after the decision of the Supreme Court of Victoria in *Krok v Szaintop Homes Pty Ltd (No 1)*.¹⁴

This case involved a claim for access by a beneficiary to certain material previously held by trustee entities and then seized pursuant to an "Anton Pillar" order. The beneficiary sought inspection of certain documents in respect of which the trustees claimed legal professional privilege.

Justice Judd observed in this regard.¹⁵

10. The trustee responded to Ms Krok's contentions by seeking to align the circumstance in which a trustee may be required to disclose a privileged document to

those in which a trustee is required to disclose trust documents. They sought to focus attention on the beneficiary's proprietary interest in the document. The trustee argued, in effect, that if a beneficiary was not entitled as of right to the document, because of the nature of the document or the status of the beneficiary, there could be no basis for joint privilege. The trustee argued that Ms Krok and her late father were mere objects of a discretionary power and were only entitled as of right to a limited range of documents which did not include documents that were antecedent to the trustee's decision to exercise a power. They argued that the legal advice embedded in the disputed documents was of that character.

11. The trustee placed great reliance on *Avanes v Marshall*,¹⁶ a decision of Gzell J in the Supreme Court of NSW. In that case, a beneficiary had brought a proceeding against a trustee in relation to the administration of a testamentary trust. In the course of discovery, the trustee challenged the right of the beneficiary to inspect the documents on the ground of client legal privilege. The beneficiary, in turn, challenged the trustee's claim on the footing that the documents were trust documents in which she had a proprietary interest.
12. The trustee in the present proceeding relied on the decision in *Avanes* to contend that an analysis of a trustee's entitlement to withhold disclosure on the ground of client legal privilege was to be determined by reference to the beneficiary's proprietary interest in the document. In *Avanes*, Gzell J adopted the approach of the Privy Council in *Schmidt v Rosewood Trust Ltd*,¹⁷ concluding that there was no longer a general rule that a beneficiary had a right to inspect trust documents, subject to some exceptions. His Honour concluded that in relation to documents other than trust accounts, it should be for the court to determine to what extent information should be disclosed. It was for the court to exercise its discretion by balancing competing interests.
13. One difficulty with such an approach is that a trustee's right to withhold a document on the ground of client legal privilege becomes susceptible to the exercise of discretion, as part of a balancing process between the protection of the trustees from fishing expeditions by beneficiaries, and the entitlement of beneficiaries to documents and information. Such an approach seems inconsistent with the nature of the privilege. Client legal privilege is part of the substantive law, and its maintenance is not discretionary.
14. In my opinion, a trustee's right to withhold, in the course of litigation, disclosure of a document from a beneficiary, on the ground of client legal privilege, is not to be determined by an analysis of the beneficiary's proprietary right to trust documents. The question is to be resolved by reference to the ordinary principles applicable to the protection of privileged information and documents, and obligations of disclosure in litigation. I respectfully agree with the remarks of Pullin JA in *Schreuder v Murray (No 2)*,¹⁸ where his Honour drew a distinction

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between the issue on appeal — whether legal professional privilege may be maintained — and the question of whether a beneficiary may inspect trust documents because of a proprietary interest in them.

It was not necessary for the purpose of this decision for the court to decide between the Londonderry approach and the Schmidt approach. The *Silkman* decision does, however, clearly continue the approach taken in *Avanes* and referred to in *Krok*.



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Footnotes

1. *Silkman v Shakespeare Haney Securities Ltd* [2011] NSWSC 148.
2. *Re Londonderry's Settlement; Peat v Walsh* [1965] Ch 918; [1964] 3 All ER 855; [1965] 2 WLR 229.
3. *McDonald v Ellis* (2007) 72 NSWLR 605; [2007] NSWSC 1068; BC200708266.
4. At [18].
5. *Schmidt v Rosewood Trust* [2003] 2 AC 709; [2003] 3 All ER 76; [2003] 2 WLR 1442.
6. At [20].
7. *Avanes v Marshall* (2007) 68 NSWLR 595; [2007] NSWSC 191; BC200701448.
8. At [27].
9. At [46].
10. At [53].
11. At [54]–[59].
12. At [60].
13. At [61].
14. *Krok v Szaintop Homes Pty Ltd (No 1)* [2011] VSC 16; BC201100297.
15. At [10]–[14].
16. *Avanes v Marshall* (2007) 68 NSWLR 595; [2007] NSWSC 191; BC200701448.
17. Above note 5.
18. *Schreuder v Murray (No 2)* (2009) 3 ASTLR 105; 260 ALR 139; [2009] WASCA 145; BC200907350, [10]–[12]. See also Buss JA at [98]–[99].

Consequential loss ... and its consequences

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It is common in the financial services industry for service providers to seek to limit their liability under the outsourcing agreement for consequential loss.

Until *Allianz v Waterbrook*¹ (the *Allianz* case), there was no binding authority in New South Wales for the meaning of the term “consequential loss” in exclusion clauses. However, the NSW Court of Appeal in the *Allianz* case followed the Victorian decision of *Environmental Systems Pty Ltd v Peerless Holdings Pty Ltd*² (*Peerless*) to find that consequential loss is loss other than “normal loss”, being loss that every person in a like situation would suffer.

Until a High Court decides upon the issue, the meaning of consequential loss in exclusion clauses is now settled in both Victoria and New South Wales. However, there are still many questions regarding its application. This article considers the meaning of consequential loss as it could apply in outsourcing agreements in the financial services industry and recommends that trustees and responsible entities must now take even greater care when considering an exclusion for consequential loss.

Consequential loss was commonly believed to equate to the second limb of *Hadley v Baxendale*

Before *Peerless*, perhaps the commonly held view was that consequential loss referred to loss falling within the second limb of the rule in *Hadley v Baxendale*.³

The rule in *Hadley v Baxendale* states that where two parties have made a contract which one of them has broken, the damages the other ought to receive in respect of the breach of contract consists of:

- **first limb:** damages that ought fairly and reasonably be considered as arising naturally — ie, from the usual course of things — from the breach of contract itself; or
- **second limb:** damages that ought reasonably be supposed to have been in contemplation of both parties, at the time they made the contract, as the probable result of a breach of it.

Where consequential loss takes on the meaning in the second limb in *Hadley v Baxendale*, an exclusion for consequential loss may not have been sufficient to exclude loss of profits, loss of production and other

categories of loss — unless those losses fell within the second limb of *Hadley v Baxendale*.

Consequential loss under *Peerless* and the *Allianz* case

The view that the general meaning of consequential loss equates with the second limb in *Hadley v Baxendale* was rejected in Victoria in *Peerless* and in New South Wales in the *Allianz* case.

Both courts adopted the view set out in the English textbook *McGregor on Damages*,⁴ which states that the true distinction is between “normal loss”, being loss every person in a like situation would suffer, and “consequential loss”, which is anything beyond the normal measure, such as profits lost or expenses incurred through the breach.

However, such a simple formulation is deceptive. It can be difficult to apply — particularly in the financial services industry, which involves trust structures where one of the most common types of loss is investment loss.

Neither case gives much practical guidance for the financial services industry. In light of the uncertainty surrounding the nature of the approach adopted by the courts, it is worthwhile undertaking a more detailed examination of the views in *McGregor on Damages*.

The McGregor view

A more complete explanation of the McGregor view is found in *McGregor on Damages*, which states:⁵

... the useful and important division between normal and consequential losses. The normal loss is that loss which every claimant in a like situation will suffer; the consequential loss is that loss which is special to the circumstances of the particular claimant. In contract the normal loss can generally be stated as the market value of the property, money or services that the claimant should have received under the contract, less either the market value of what he does receive or the market value of what he would have transferred but for the breach. Consequential losses are anything beyond this normal measure, such as profits lost or expenses incurred through the breach ...

Accordingly, if one party defaults in performing his or her side of the contract, the normal measure of damages in contract under the McGregor view is the market value of the benefit of which he or she has been deprived through the breach — in effect, the claimant is entitled to compensation for the loss of his or her bargain.

In this sense, it appears that the distinction between normal loss and consequential loss is primarily concerned with the measure of loss of bargain damages.

Accordingly, under the McGregor view, consequential loss is anything other than loss of bargain damages. This can be compared to consequential loss under the second limb of *Hadley v Baxendale*, which is loss within the contemplation of the parties. This means that the meaning of consequential loss under the McGregor view is wider than a definition which equates the term to the second limb in *Hadley v Baxendale*. For example, loss of profits and loss of use may well constitute consequential loss under the McGregor view, but may not constitute consequential loss under the second limb of *Hadley v Baxendale*.

Measure of normal loss

McGregor on Damages considers that there are different measures of normal loss, depending on the type of breach and the type of benefit being provided under the contract. In this regard, it outlines the following classifications:⁶

- breaches of contract can be classified into non-performance, delayed performance and defective performance; and
- benefits can be divided into three principal types, being property, money and services.

Where a breach consists of a failure (or non-performance):

- to transfer property, the measure of normal loss is the market value of the property, always deducting the contract price if it has not already been paid;
- to lend money, the measure of normal loss is the difference between the terms upon which the borrower had made the loan and the terms upon which he or she can go into the market and effect a substitute loan; and
- to render services, the measure of normal loss is the price the claimant would have to pay in the market in order to obtain such services, always deducting the contract price if that has not yet been paid.

Where a breach consists of:

- a delayed transfer of property, the normal loss is the market value at the date of due delivery less the market value at the date of actual delivery;
- a delay in lending money, the same type of normal loss as a delay in transferring property can be worked out (but there are no authorities); and

- a late rendering of services, the normal loss is the value to the claimant of the services it rendered at the due date less their value at the time actually rendered.

Where the breach is a transfer of property which is either defective or is not of the quality promised, the normal loss is the value of the property as represented less its actual market value.

However, where the breach of contract is the provision of defective services, McGregor states that the position is more diverse. If property is adversely affected (eg, defective performance of a building contract), the normal loss is the diminution in value of the property.

In the case of an ordinary service contract where no property is affected, there is no clear normal loss — McGregor suggests that most loss involved in such a contract could be consequential.

Based on the reasoning in *McGregor on Damages*, normal loss in a superannuation fund or managed fund context could include the difference in price of property, such as shares or units. Arguably, normal loss can include investment loss and could be recovered notwithstanding an exclusion clause for consequential loss.

Type of consequential loss

There are three main types of loss that are considered in *McGregor on Damages* to be consequential loss, being:⁷

- gains prevented by the breach, such as:
 - loss of use, loss of profits, or interest; and
 - loss of future reputation, loss of publicity, or loss of credit;
- expenses caused by the breach; and
- expenses rendered futile by the breach.

Accordingly, in the financial services industry, consequential loss could include:

- gains prevented by the breach, such as lost dividends and distributions and lost bonus issues;
- lost profits, such as loss of trustee or management fees;
- loss of reputation and brand power;
- expenses caused by the breach, such as legal costs involved in relation to the breach; and
- regulatory and compliance costs.

Some consequences for the financial services industry

One way to explain the impact of the McGregor view is to consider a simple example in which a custody agreement contains an exclusion of liability for consequential loss.

Consider the situation of negligence or a breach by the custodian which results in a delay in the implementation of a proper instruction to sell one set of shares (A Shares), and to purchase a second set of shares (B Shares). As a result of the delay, A Shares were sold at a lesser value and B Shares were purchased at a higher value. Also, the trustee did not receive dividends which were distributed by Company B during the delay period.

In this example, there is a delay in the provision of services by the custodian. However, the delay results in the delayed purchase of property and a delayed sale of property. Accordingly, property has been adversely affected. Arguably, the measure of normal loss to apply under the McGregor view is the measure for a delay in the transfer of property.

Under the McGregor view, the measure of the normal loss:

- in relation to the A Shares, is the difference between the market value of the A Shares at the date of due sale and the market value of the A Shares at the time of the actual sale; and
- in relation to the B Shares, is the difference between the market value of the B Shares at the date of due purchase and the market value of the B Shares at the time of the actual purchase.

Both amounts would appear to be recoverable under the custody agreement, notwithstanding the exclusion clause.

However, all other losses, damages and expenses would appear to be consequential loss. This would include the loss of dividends, the loss of trustee fees, any additional tax payable by the trustee, and legal costs incurred by the trustee in claiming the losses. The exclusion of liability for consequential loss would mean that the trustee could not recover these amounts from the custodian.

Accordingly, in adopting the McGregor view of consequential loss, the Victorian and New South Wales courts provide greater impetus for service providers such as custodians, investment managers and adminis-

trators to include exclusions of liability for consequential loss in their outsourcing agreements. Further, it serves investment managers, custodians and administrators well not to define the term in the outsourcing agreement.

On the other hand, trustees and responsible entities must now take even greater care when considering an exclusion for consequential loss. It is incumbent upon them to have a proper understanding of the nature of consequential loss under the McGregor view, and of the types of losses which could be incurred by the fund but are not claimable from the custodian, investment manager or administrator.

Perhaps the most important consequence is that, because the McGregor view is the wider of the two interpretations, there is greater exposure for trustees and responsible entities in leaving the term “consequential loss” undefined in an outsourcing agreement. Those who agree to an exclusion for consequential loss should define the term if they wished to move away from the McGregor view.



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Footnotes

1. *Allianz v Waterbrook* [2009] NSWCA 224; BC200907207.
2. *Environmental Systems Pty Ltd v Peerless Holdings Pty Ltd* (2008) 19 VR 358; 227 FLR 1; [2008] VSCA 26; BC200800882.
3. *Hadley v Baxendale* (1854) 9 Exch 341; 2 WR 302; 156 ER 145.
4. McGregor H, *McGregor on Damages* (17th ed), Sweet & Maxwell, London, 2003.
5. Above note 4 at p [23].
6. Above note 4; see ch 2.
7. Above note 4 at pp [37]–[48].

The government's proposed exit fees ban

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Government reform

The Commonwealth Government released an Exposure Draft Amendment Regulation¹ to the National Consumer Credit Regulations on 15 February 2011, allowing interested parties only two weeks to make submissions, which were due by 1 March 2011. The Exposure Regulation proposes to prohibit exit fees for home loans entered into on or after 1 July 2011.

The Exposure Regulation does not propose to prohibit all fees payable on termination of a credit contract, but would essentially limit the fees and charges payable on or in relation to the termination of a home loan contract to a:

- “break fee”, relating to the early termination of a fixed rate loan only and payable as a result of any loss caused to the credit provider due to movement in their cost of funds since the start of the relevant fixed rate period; or
- “discharge fee”, to reimburse the credit provider for reasonable administrative costs relating to the termination of the credit contract — the amount of the discharge fee must not exceed “a reasonable estimate of the average reasonable administrative cost to the credit provider of terminating that class of credit contract”.

The prohibition is not limited to fees payable on early termination or pre-payment, but extends to a fee payable on termination at any point in time, including on maturity. This may not have a significant impact, but we query whether it was intended in the context of a reform with a stated objective to address impediments to refinancing.

Effects of the reform

The proposed Exposure Regulation banning exit fees is being criticised by many commentators as severely restricting lenders' ability to charge any fees on termination of the loan, regardless of the loss suffered by lenders as a result of early termination of a home loan. A consequence of this will be the outright prohibition of deferred establishment fees, which will have a flow-on effect of prohibiting the products that are enabled by those fee structures, such as products that feature hon-

eymoon rates or rely on the amortisation of upfront costs (such as commission payments). Commentators are questioning whether there is a legitimate need for further regulation in this area, particularly given the recent commencement of the National Consumer Credit Protection Act 2009 (Cth) (NCCPA) and the Australian Securities and Investments Commission's (ASIC's) recent attention to the issue of exit fees. Commentators are also questioning whether the reforms proposed by the Commonwealth Government will increase competition or in any way benefit consumers.

Background

On 12 December 2010, Treasurer Wayne Swan announced a number of reforms to the banking system, with the stated aim of promoting a “competitive and sustainable banking system”.² The first part of those reforms was a promise to “ban exit fees outright on new home loans after 1 July 2011”.

Exit fees are perceived to reduce competition in the banking sector by penalising customers who refinance their loans and discouraging those seeking to do so. Ironically, products with deferred establishment fees, now considered a type of exit fee, were very successful when they were introduced. The deferment of establishment fees made home loans more affordable (as there was no upfront expense) and rewarded those customers who did not change lenders in the early years of the loan (see ASIC Report 125: *Review of mortgage early entry and exit fees*).³ Lenders' ability to charge exit fees to those who terminate early can therefore operate to subsidise those customers who remain with one lender (by replacing entry fees).

ASIC Report 125 found Australia to have the lowest entry and discharge fees when compared with the United Kingdom and the United States. Further, and despite seemingly widespread public opinion, there is little evidence, other than anecdotal evidence provided by consumer interest groups (see ASIC Regulation Impact Statement: *Early termination fees for residential loans*),⁴ that the existence of exit fees dissuades customers from refinancing. The Australian Bureau of Statistics data for housing finance in December 2010⁵ shows that home loan refinances constituted 32% by number and 28% by value of all financings for established dwellings (and

this figure is conservative, as the data does not include refinances with the same lender). This shows that almost one in three new home loans relating to an established dwelling was a refinancing. That is not to say, however, that those figures would not be higher in the absence of exit fees.

Paradoxically, however, a ban on exit fees may lead to the introduction of other measures to recover loan establishment costs (such as upfront establishment fees or higher interest rates). Upfront fees may well discourage refinancing and affect portability and therefore reduce competition, as well as burden first home owners. Higher interest rates for all customers may result in those who stay with one lender for an extended period effectively subsidising the “churn” costs incurred in relation to those who switch more often.

That these consequences are known to Treasury and the Minister is demonstrated by certain internal Treasury emails⁶ made publicly available pursuant to an FOI request, in which Treasury officials advising the Minister state that “Banks are likely to move to recover the legitimate costs associated with establishing a mortgage through other means (eg, higher interest rates, higher other fees — eg establishment fees)”. Treasury also states that a ban on exit fees “penalises consumers who don’t want to, and never would, switch, as they are likely to end up paying higher prices (and cross subsidising the switchers)”.

Current position — a lender’s loss

The Exposure Regulation is a substantial change from the current regulation of exit fees, which is primarily under the National Credit Code (NCC). Under s 78 of the NCC, fees payable on early termination or prepayment are open to review by the court if they are found to be “unconscionable”, and this can only occur if they “exceed a reasonable estimate of the credit provider’s loss arising from the early termination or prepayment, including the credit provider’s average reasonable administrative costs in respect of the termination or prepayment”. In summary, under current regulation an early exit fee is only acceptable if it is limited to the credit provider’s loss caused by the early termination.

ASIC’s Regulatory Guide on exit fees, RG 220: *Early termination fees for residential loans: Unconscionable fees and unfair contract terms*, released in November 2010 (RG 220), suggested that a credit provider’s loss caused by early termination could include (RG 220.30):

- (a) break fees when a fixed rate loan is terminated;
- (b) administrative costs for calculating the payout figure and the amount of the fees payable on early termination;
- (c) administrative costs for processing the early termination;

- (d) third party costs that arise because of the early termination (eg, if a function associated with processing an early termination is outsourced);
- (e) costs that have not been recovered because a loan with a honeymoon or introductory interest rate is terminated early. Loans with a honeymoon or introductory interest rate are those which offer a discounted interest rate at the start of a loan, typically for the first one to two years; and
- (f) unrecovered establishment costs arising from a lender’s inability to recover establishment costs during the shortened period the loan was on foot.

Consumers may also be able to challenge early exit fees through a credit provider’s external dispute resolution (EDR) scheme.

From “loss” to “administrative cost”

Except in the case of the early termination of a fixed rate loan and any resulting break fee, the Exposure Regulation proposes to only allow credit providers to charge a fee for reimbursement of “administrative costs”. This contrasts with the current NCC regime which allows lenders to recoup any “loss”. This potentially means that credit providers will not be able to recover on an early termination:

- third-party costs associated with the early termination (eg, if functions are outsourced) — unless they fall within “administrative costs”;
- costs that have not been recovered because a loan with a honeymoon or introductory interest rate is terminated early; or
- unrecovered establishment costs, the cost of which was to be amortised over the life of the loan — including commissions paid to loan originators (eg, brokers, mortgage managers and aggregators).

If the Exposure Regulation is made in its current form, credit providers will need to review and amend their fee and commission structures. Honeymoon rates, in particular, are likely to become unviable, as consumers could switch credit providers without adverse consequence as soon as the honeymoon rate expires.

Overall effects

The Exposure Regulation changes the regulation of exit fees in that it prohibits those fees outright, as opposed to them being reviewable by the court as potentially “unconscionable”.

The Exposure Regulation limits the amount chargeable as a fee in relation to a credit provider’s administrative costs to a reasonable estimate of the “average reasonable administrative cost of terminating that class of credit contract”. This may mean that a credit provider must charge an average administrative cost even if, in relation to a particular credit contract, it can be demonstrated that the actual cost exceeds that average.

Why the change?

The Government's focus on exit fees is perhaps surprising, given the statement by ASIC chairman Tony D'Aloisio in November 2010⁷ that the current law is clear and "importantly ... still allows lenders to be flexible in their pricing". The Government taking action to ban exit fees appears to greatly undermine ASIC's extensive consultation process on the subject, during which ASIC received 19 responses from industry bodies, consumer groups and lenders, including authorised deposit taking institutions (ADIs) and non-ADI lenders (see ASIC Report 216: *Response to submissions on CP 135 Mortgage exit fees: Unconscionable fees and unfair contract terms*)⁸ and which resulted in ASIC producing RG 220.

The proposed Exposure Regulation, if enacted, may limit how flexible lenders can be in their pricing. Banning exit fees, according to the Australian Bankers' Association's submission to ASIC on CP 135: *Mortgage exit fees*, will mean that consumers will "face much higher upfront costs with their new lender when switching ... regardless of how long they held the loan". Some commentators say that it is doubtful that an outright ban on exit fees in the form of the Exposure Regulation will actually increase competition. For example, many commentators have noted that non-bank lenders (which at one stage were credited with greatly increasing home loan competition) are likely to be particularly adversely affected by the ban. However, the Government seems to be committed to legislating in relation to bank fees in the current political climate following the global financial crisis. It remains to be seen whether the reforms do indeed end up reducing competition and adversely impacting consumers. It may well be simpler for consumers to compare products when seeking a loan (as customers would primarily be comparing only entry fees

and interest rates). However, the risk is that this may come at a cost — namely, that a reduction of options for lenders may reduce their flexibility and ability to innovate, and this may ultimately reduce competition.



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Credit reporting under the privacy reforms

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Introduction

The Commonwealth has issued its much-awaited Exposure Draft of proposed legislation to implement reform to the current credit reporting provisions of the Privacy Act 1988 (Cth).¹ The Exposure Draft contains some 195 sections which will form a part of a proposed new privacy Act. This part of the new privacy Act will contain provisions relating to the collection, use and disclosure of information for credit reporting purposes. The Exposure Draft is accompanied by a Companion Guide issued in January (the Guide), which highlights the major features of the new provisions.²

Historical context

A report published by the Australian Law Reform Commission (ALRC) in August 2008 has been the impetus for driving reform of the privacy laws in Australia. Following this report, the Australian Government committed to responding to the ALRC's recommendations in two stages. The most recent Exposure Draft released by the Senate Finance and Public Administration Committee is the second stage of this response. The earlier response included the publication of a proposed new set of uniform privacy principles, called the Australian Privacy Principles (APPs), to apply to both the public and private sectors.

The National Consumer Credit Protection Act 2009 (Cth) is a significant driver in the reform process relating to credit reporting. A fundamental feature of the Commonwealth's consumer credit regime is a requirement for credit providers to collect and verify information about a loan applicant's financial position. This is a necessary part of the loan assessment that all credit providers must carry out before entering into a credit contract or increasing a credit limit under a credit contract. Similar obligations also fall on credit assistance providers under this regime. The credit industry has been eagerly awaiting privacy reform which allows more comprehensive information to be maintained by credit reporting agencies and accessed by credit providers. The current regime in Pt IIIA of the Privacy Act restricts the information that can be included in the credit reports to information that is of a negative nature (eg, defaults and dishonoured cheques). The expansion

of the credit reporting regime to include comprehensive credit information has been anticipated as a powerful tool to assist credit providers in meeting their responsible lending obligations.

The current reform package

The Exposure Draft contains provisions relating to the collection, use and disclosure of information for credit reporting purposes. Under these provisions, the Privacy Act will continue to regulate credit reporting in conjunction with the proposed APPs.

The APPs provide a baseline for compliance, but the proposed new credit reporting provisions contain more modified and specific rules than the general obligations in the APPs. It is acknowledged in the Guide that the specific credit reporting rules will impose more onerous provisions under the APPs. This is justified in the Guide because there is a need to ensure a higher standard of privacy protection where personal information is collected, used and disclosed for credit reporting purposes.

The existence of a separate set of specific rules for credit reporting is, of course, not new. The existing rules in Pt IIIA of the Privacy Act, which specifically relate to credit reporting, set out provisions that are more onerous than the more generally drafted National Privacy Principles. The Exposure Draft contains provisions which are proposed to replace Pt IIIA.

The key measures of the Exposure Draft are stated by the Commonwealth to be:

- (a) the introduction of more comprehensive credit reporting provisions;
- (b) the credit reporting provisions having an increased coverage over "credit reporting agencies" and "credit providers"; and
- (c) clear and simplified structure and drafting of the provisions.

The obligations of credit reporting agencies and credit providers in relation to the collection and use of personal information are contained within Divs 2 and 3 of the Exposure Draft. The definition of "credit provider" is expanded in the Exposure Draft to include organisations or small business operators that provide credit as a substantial part of its business or undertaking. It is also important to note that the definition of "credit

provider” now also extends to organisations or small business operators acting as *agents* of credit providers.

Division 4 of the Exposure Draft contains rules in relation to the use of information by other recipients, including mortgage insurers, trade insurers, body corporates, credit managers, and legal and financial advisers. These rules ensure that information used and disclosed for the purposes of credit reporting continues to attract the same privacy protections as contained within Pt IIIA of the existing Privacy Act. Division 4 somewhat simplifies Pt IIIA, and also sets out the rules by reference to the recipient of the information. The expansion of the definition of “credit provider” will also impact on the operation of the rules contained within this division

Division 5 of the Exposure Draft provides an avenue for individuals to lodge a complaint against a credit reporting agency or credit provider for failure to grant access to, or correct, personal information in credit reporting information and for a “credit reporting infringement”, defined as a contravention of the credit reporting part of the Privacy Act or of the Credit Reporting Code of Conduct (see discussion below regarding the Code).

Division 5 also contains provisions in relation to how and when a credit reporting agency or credit provider is to respond to a complaint. Generally, the respondent (whether a credit provider or a credit reporting agency) will have seven days to acknowledge the complaint and is then under an obligation to investigate that complaint. Unless the complainant agrees to a longer period, the respondent will have 30 days to give a written notice containing the substantive determination of the complaint and explaining that the complainant may seek further review by taking the matter for external dispute resolution (to the scheme of which the respondent is a member) or to the Information Commissioner. Access to the external dispute resolution scheme or the Information Commissioner is also available if a substantive determination is not made within the relevant 30-day period.

The existing retention period provided for under the Privacy Act has been largely followed by the Exposure Draft. However, there are new provisions in relation to personal insolvency agreements, debt agreement proposals and property retention orders. The practical effect of a retention period is that a credit reporting agency must keep credit information about an individual for the maximum permissible period in the event that there is a dispute or request for correction in relation to the information, or some other event occurs which requires the agency to retain the information.

Comprehensive credit reporting

Perhaps the most significant reform proposed by the Exposure Draft is the introduction of a comprehensive

credit reporting system based on five additional positive data sets. These data sets will be:

- (a) the type of each active credit account (eg, mortgage, credit card);
- (b) the date of opening each account;
- (c) the date of closing each account;
- (d) account credit limits; and
- (e) credit repayment history.

The five new data sets are intended to increase the scope of positive consumer credit information that is captured. It may of course take some time before this additional information starts to appear in credit reports.

These provisions will have a significant impact on lenders, as they will have access to a more comprehensive reporting regime that provides an objective and reliable source of assessment data. Lenders will be better able to assess the creditworthiness of an individual and ascertain those who match their risk profile. This will also assist providers in meeting their responsible lending obligations.

The Guide suggests an underlying policy objective that individuals will also benefit from positive reporting. The regime will improve access to affordable and sustainable credit and may reduce the likelihood of an individual having to seek credit from lenders with a greater appetite for risk. It may also lead to lower credit default rates.

Credit Reporting Code of Conduct

Under the current provisions of the Privacy Act, the Australian Information Commissioner is empowered to issue a binding Code of Conduct. A Credit Reporting Code of Conduct has been in effect since 24 September 1991.

The Exposure Draft provisions contain only minor references to the proposed new Credit Reporting Code of Conduct. It is intended that the Code of Conduct be developed in conjunction with industry and key stakeholders and be subject to approval by the Australian Information Commissioner.

Notwithstanding, the Exposure Draft provisions expressly refer to some matters proposed to be dealt with in the Code of Conduct. These include:

- (a) compliance practices and procedures for credit reporting agencies;
- (b) notification requirements when an individual’s application for consumer credit is refused;
- (c) notification requirements when information of a personal nature is likely to be disclosed to a credit reporting agency;
- (d) disclosure requirements in relation to direct marketing; and

(e) requirements for access to credit reporting information.

Submissions

Submissions have been received from a number of government departments and companies. A list is available on the Parliament of Australia website. Submissions closed on 24 March 2011.

Concluding remarks

The Exposure Draft, like its predecessor — Pt IIIA of the Privacy Act — is relatively complex. At over 100 pages, it is quite substantial. In addition, it forms only part of the picture so far as future credit reporting practices are concerned. That picture will only be complete once the Credit Reporting Code of Conduct is developed. However the Exposure Draft reconfirms that comprehensive credit reporting is a clear reform objective, and it provides an idea of the additional information that will eventually be available to credit providers for the purposes of credit assessment.



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Footnotes

1. Available at www.aph.gov.au (follow the links to /Senate/committee/fapa_cte/priv_exp_drafts/guide/credit_draft.pdf).
2. Available at www.aph.gov.au (follow the links to /Senate/committee/fapa_cte/priv_exp_drafts/guide/credit_guide.pdf).

New disclosure rules for hedge funds

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Introduction

The Australian Securities and Investments Commission (ASIC) has released Consultation Paper 147: *Hedge funds: Improving disclosure for retail investors* (CP 147), which describes ASIC's proposal to introduce disclosure principles and benchmarks for hedge funds. CP 147 prescribes various key features and risks that ASIC considers will need to be addressed in the product disclosure statement (PDS), and other communications, for a hedge fund.

A separate disclosure regime does not currently apply to hedge funds and the application of the law and general ASIC policy to a particular hedge fund is left to the individual issuer and its advisers to determine.

The paper follows a recent approach by ASIC to prescribe specific disclosure principles and benchmarks for particular asset classes, such as mortgage schemes, unlisted property schemes and infrastructure funds.

Scope of CP 147

It is proposed that the disclosure principles and benchmarks will apply to any registered managed investment scheme that is, or has been, promoted as, or is generally regarded as, a hedge fund or a fund of hedge funds. ASIC is formulating its definition of hedge fund for these purposes and it seems it will apply a broad definition that looks at whether a fund has some or all of the following features:

- **strategy** — the fund pursues complex strategies that aim to generate absolute returns, returns with low correlation to equity and bond indices, or a positive return in both rising and falling markets;

- **leverage** — the fund often uses leverage to increase investment returns;
- **derivatives** — the fund often uses derivatives to create complex investment strategies or for gearing purposes;
- **short selling** — the fund often engages in short selling; and/or
- **complexity** — the fund often has exposure to diverse risks and complex underlying products.

This approach could potentially sweep up a broad range of funds with one or more of these features, even those which may not traditionally be regarded as hedge funds.

The disclosure requirements outlined in CP 147 consist of a combination of disclosure principles and “if not, why not” benchmarks. An issuer is required to state in the PDS and in certain “other disclosures” whether it meets a benchmark (and if not, why not). Failure to comply with the disclosure principles and benchmarks may result in ASIC issuing a stop order on an offer.

Interestingly, ASIC also notes that “as a matter of best practice”, disclosure of information similar to that set out in CP 147 would be useful for investors in other types of funds, not just hedge funds. ASIC is also considering excluding any fund that would fall within the scope of the CP 147 disclosure guidance from being able to use the new “shorter PDS” regime.

Proposed disclosure principles and benchmarks

A brief summary of the proposed disclosure principles and benchmarks applicable to a PDS for a hedge fund is set out in Table 1.

Table 1: Proposed disclosure principles and benchmarks for PDSs

<p><i>Disclosure principle:</i> Investment strategy</p>	<p>The PDS discloses the following information:</p> <ul style="list-style-type: none"> • a description of the fund’s investment strategy, including the asset classes typically invested in; the typical location and currency denomination of the assets; the role of leverage, derivatives and short selling; and the resources available to execute the investment strategy; • an explanation of how the strategy will produce investment returns with reference to the general market circumstances in which the fund trades; • what the diversification guidelines are; • any specific risks associated with the relevant investment strategy; • disclosure of the key aspects of the fund’s risk management strategy; and • how the investment strategy can change and what notification would be provided to investors.
<p><i>Disclosure principle:</i> Investment manager</p>	<p>The PDS should disclose a description of:</p> <ul style="list-style-type: none"> • the identities and relevant commercial experience of the senior officers playing a key role in investment decisions; • if the fund manager is not the responsible entity, any unusual or materially onerous (from the investor’s perspective) terms in the agreement under which the fund manager is appointed and the scope of this appointment; and • the circumstances in which the responsible entity is entitled to terminate the manager’s appointment and on what terms (including any payments).
<p><i>Disclosure principle:</i> Fund structure</p>	<p>The PDS should explain:</p> <ul style="list-style-type: none"> • the fund’s investment structure, including the key entities involved, their relationship to each other and their roles; • the identities of the key service providers and intermediaries (eg, prime broker, custodian, administrator, compliance service provider, independent auditor and sub-advisers), where applicable; • the jurisdictions involved; • the rationale for the structure and the jurisdictions used; • the risks of the structure, including any risks associated with holding assets overseas; • the due diligence process performed on underlying funds and the key service providers; • for all collective investment schemes invested in by the fund that make up, or are likely to make up, more than 10% of the fund’s net asset value, the identities of the key service providers for any underlying collective investment schemes; • how the responsible entity ensures that key service providers will comply with service agreement obligations; • any related-party relationships within the structure; and • the existence and nature of material arrangements in connection with the fund that are not on arm’s length terms.
<p><i>Disclosure principle:</i> Assets</p>	<p>The PDS should disclose the following information:</p> <ul style="list-style-type: none"> • the key aspects of the valuation policy; • the types of assets and the allocation range to each asset type, using a specified list of asset types provided by ASIC (including the assets of collective investment vehicles invested in by the fund); • any policy about asset location; and • the custodial arrangements, including details of the roles provided by custody service providers.

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<p><i>Benchmark:</i> Custody</p>	<p>The PDS should disclose that all custodians (including custodians of any funds invested in by the fund) involved in the fund structure are independent third-party custodians. If the fund does not meet this benchmark, it should disclose why not.</p>
<p><i>Disclosure principle:</i> Liquidity</p>	<p>If more than 20% of a hedge fund's assets cannot be sold at market value in less than 10 days, the PDS should disclose the following information:</p> <ul style="list-style-type: none"> • a description of any illiquid asset class that has a value greater than 10% of the fund's net asset value; and • the key aspects of the liquidity management policy.
<p><i>Disclosure principle:</i> Leverage</p>	<p>The PDS should disclose the following information:</p> <ul style="list-style-type: none"> • the sources of leverage, including type, amount and providers of the leverage; • whether any assets are used as collateral and the extent to which they are otherwise encumbered; • the anticipated level of leverage (including leverage embedded in the assets of the fund), as a multiple of the amount invested by an investor (eg, for every \$1 the investor invests, the fund is leveraged \$x); and • a worked example showing the impact of leverage on investment returns and losses, assuming the anticipated level of leverage (including leverage embedded in the assets of the fund).
<p><i>Disclosure principle:</i> Derivatives</p>	<p>The PDS should disclose the following information:</p> <ul style="list-style-type: none"> • the purpose and rationale for the use of derivatives or structured products (eg, investment, hedging, leverage and liquidity), including how they form part of the fund's investment strategy; • the types of derivative or structured product used or planned to be used; • the criteria for engaging derivative and structured product counterparties (including principal protection providers); • the key risks to the fund associated with the collateral requirements of the derivative counterparties; and • whether the derivatives and structured products are over-the-counter (OTC) or exchange traded.
<p><i>Disclosure principle:</i> Short selling</p>	<p>If a hedge fund intends, or is likely, to engage in short selling, the PDS should disclose the following information:</p> <ul style="list-style-type: none"> • the purpose and rationale of short selling, including how short selling forms part of the fund's investment strategy; • the risks associated with short selling; • how these risks will be managed; and • an example showing the potential gains and losses from short selling.

<p><i>Benchmark:</i> Periodic reporting</p>	<p>The PDS should disclose that the fund will report on the following as soon as practical following the relevant period end:</p> <ul style="list-style-type: none"> • the current funds under management (FUM) of the fund; • the actual allocation to each asset type; • the liquidity profile of the assets as at the end of the period — the representation of asset liquidity (the time required to sell an asset at its market value) in a graphical form that allows easy comparison with the maturity profile of the leverage; • the maturity profile of the leverage as at the end of the period — the representation of maturities in a graphical form that allows easy comparison with the liquidity profile of the assets; • the leverage ratio (including leverage embedded in the assets of the fund) as at the end of the period; • the undrawn amount of loan facilities as at the end of the period; • the derivative and structured product counterparties engaged (including capital protection providers); • the investment returns; and • the key service providers, if they have changed since the last report given to investors. <p>The PDS should disclose that the latest periodic report is available on the fund's website. If the PDS does not meet this benchmark, it should disclose why not.</p>
<p><i>Disclosure principle:</i> Withdrawals</p>	<p>The PDS should disclose the following information:</p> <ul style="list-style-type: none"> • any significant risk factors or limitations that may affect the ability of investors to withdraw from the fund, including any gating restrictions that may be imposed or the requirement for a statutory withdrawal offer if the scheme is non-liquid; • how investors can exercise their withdrawal rights, including any conditions on exercise; • if withdrawal is to be funded from an external liquid facility, the material terms of this facility, including any rights the provider has to suspend or cancel the facility; and • how investors will be notified of any material changes to their withdrawal rights (eg, if withdrawal rights are to be suspended).

Key issues

The paper requires careful consideration and fund managers will need to adopt additional measures to be in a position to comply. Some of the key issues for consideration by issuers of “hedge funds” and “funds of hedge funds” arising out of the proposals in CP 147 include the following.

- As mentioned above, the proposed approach for determining whether a scheme is a hedge fund, involving consideration of a number of “indicia”, may potentially sweep up a broad range of funds, even those which may not traditionally be regarded as hedge funds.
- ASIC has indicated that where a scheme could be characterised as a hedge fund but also falls “more specifically” within another category of schemes covered by other ASIC disclosure guidance, the more specific disclosure guidance will apply. This may lead to some confusion as to the applicable

disclosure guidance — eg, if a scheme can be characterised as a hedge fund and an unlisted property fund, both the CP 147 requirements and the requirements under ASIC Regulatory Guide 46: *Unlisted Property Schemes — Improving disclosure for retail investors* may apply.

- ASIC is considering whether to “encourage” issuers to apply the disclosure benchmarks and principles when providing similar offers to wholesale investors and offers by listed investment companies that have some of the features of hedge funds.
- ASIC indicates that it is separately considering alternative or supplementary measures to deal with the perceived risks of investing in hedge funds — eg, investor education, enhanced licensing requirements, enhanced compliance plan requirements, statutory suitability tests and banning retail investor access to hedge funds. No detail is

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provided in the paper. These possible measures may have major implications for hedge fund issuers if implemented.

- If an underlying investee scheme of a hedge fund makes up more than 10% of the fund's net asset value, the identities of key service providers for the underlying scheme will need to be disclosed in a PDS and updated in periodic disclosures. This may require a hedge fund issuer to ensure that suitable reporting or notice requirements are in place with operators of underlying schemes (eg, in side letter arrangements) so that it can comply with such disclosure requirements.
- ASIC suggests that, although the Corporations Act 2001 (Cth) requires a fund to give investors at least an annual periodic statement regarding FUM and investment returns, it is "current market practice" to provide more frequent reports. Going forward, issuers of hedge funds may need to provide more frequent periodic statements regarding the fund, and ad hoc reports (in addition to the periodic reports) where there are changes to key features of a hedge fund that might not currently be required under the Corporations Act.

Way forward

ASIC proposes 1 July 2012 as the commencement date for:

- new and current issuers of hedge funds to apply each of the disclosure principles and address each of the benchmarks in PDSs given after that date; and

- existing issuers of hedge fund to provide updated disclosure to existing investors that applies each of the disclosure principles and addresses each of the benchmarks.

The deadline for comments on the paper is 21 April 2011. ASIC has flagged that it may undertake a second round of consultation in mid 2011, once it develops more detailed proposals following on from the first round of consultation. It is expected that following the close of the consultation and subject to comments from stakeholders, ASIC will release a regulatory guide in late 2011.

In addition, ASIC has indicated that it is considering what "other measures" may be desirable to adopt in light of recommendations flowing from the *Hedge Funds Oversight* report issued by the International Organization of Securities Commissions (IOSCO) in June 2009 and the *Review of the Differentiated Nature and Scope of Financial Regulation* report issued by the Joint Forum in January 2010.



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Update on possible extension of unfair contract terms to insurance contracts

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Overview of the unfair contract terms (UCT) laws

The UCT laws arose from the Productivity Commission's 2008 Review of Australia's Consumer Policy Framework,¹ which recommended that new generic national consumer law should apply to all sectors of the economy.

The laws were implemented as laws of the Commonwealth and of Victoria and New South Wales on 1 July 2010 and extended to apply to all other states and territories on 1 January 2011.

They apply to all sectors of the economy, and to all businesses operating in those sectors in Australia which use standard form contracts in their dealings with consumers, subject to the following.

Insurance carve out

The UCT laws apply to financial products and financial services through the Australian Securities and Investments Commission Act 2001 (Cth) (ASIC Act). However, their application to the insurance sector is affected by an exclusion under s 15 of the Insurance Contracts Act 1984 (Cth) (ICA).

That section provides that:

- (1) A contract of insurance is not capable of being made the subject of relief under:
 - (a) any other Act; or
 - (b) a State Act; or
 - (c) an Act or Ordinance of a Territory.
- (2) Relief to which subsection (1) applies means relief in the form of:
 - (a) the judicial review of a contract on the ground that it is harsh, oppressive, unconscionable, unjust, unfair or inequitable; or
 - (b) relief for insured from the consequences in law of making a misrepresentation;but does not include relief in the form of compensatory damages.

The exclusion was recommended by the Australian Law Reform Commission (ALRC) in its 1982 report on insurance contracts. The reasons in support were cited as:

- to avoid difficulties of distinguishing between business and non-business contracts in the insurance context;

- to avoid insurance contracts being subject to judicial review in some jurisdictions and not others; and
- the doctrine of utmost good faith, especially when elevated to a contractual term, should provide sufficient inducement to insurers and their advisers to be careful in drafting their policies and to act fairly in relying on their strict terms.

The version included in the 1984 ICA went beyond the ALRC's recommendation, as it excluded relief under Commonwealth law (as well as state and territory law) regarding harsh, oppressive, unconscionable, unjust, unfair or inequitable contracts. The relief that was excluded encompassed, but was not limited to, "relief by way of variation, avoidance or termination of a contract".

In a 1992 Government Working Party report on consumer credit insurance, it was noted that there was much confusion about the scope of the 1984 version of s 15. As a result, the section was amended in 1994 to clarify that s 15 did not stop consumers from making a claim under other legislation for compensatory damages, so that consumers should be more willing to exercise such rights.

Senate Economics Legislation Committee 2009 inquiry

The Senate Economics Legislation Committee (the Committee), in its 2009 inquiry into the Trade Practices Amendment (Australian Consumer Law) Bill 2009 (Cth), considered the impact of s 15 of the ICA and whether the inclusion of insurance contracts under the UCT provisions of the ASIC Act was appropriate.

There was a clear divergence of views in the submissions.

Consumer representatives argued that the UCT provisions should operate in respect of terms in insurance contracts, while insurance industry representatives argued that there was no justification to have the UCT provisions apply to terms in insurance contracts.

The Committee stated in its September 2009 report that:

- the Committee is of the view that consumers are not provided with adequate protection in insurance contracts under existing law;
- the Committee recommends that the Government address insurance contract legislation to ensure that the ICA provides an equivalent level of protection for consumers to that provided by the Australian Consumer Law (ACL); and
- consideration by the Government of the 2004 review of the ICA should determine whether this will be achieved by amending the ICA to achieve a harmonisation with the amendments proposed in the ACL, or by amending the ACL to apply to insurance contracts.

Government options paper on unfair terms in insurance contracts 2010

In March 2010, the then Minister for Financial Services, Superannuation and Corporate Law, the Hon Chris Bowen MP, introduced the Insurance Contracts Amendment Bill 2010 (Cth) (ICA Bill) into Parliament. The ICA Bill did not deal with unfair contract terms.

The Minister also released a paper seeking comments on options to address unfair terms included in insurance contracts. The paper described five possible options, as follows:

- *Status quo*: The issue would continue to be addressed primarily through the operation of the ICA, in particular through s 14 (utmost good faith), s 35 (standard cover for certain household/domestic contracts) and s 37 (unusual terms for other contracts).
- *Option A*: Permit the UCT provisions of the ASIC Act to apply to insurance contracts. Changes to the operation of s 15 would be made to permit the unfair terms provisions in the ASIC Act to operate in addition to, and alongside, the ICA remedies.
- *Option B*: Extend ICA remedies to include UCT provisions. The ICA would be amended to include remedies relating to unfair contract terms along the lines of those included in the ASIC Act, but the provisions would be specifically tailored to the case of insurance contracts and the regulatory framework in the ICA. Section 15 would continue in operation so that the unfair contract terms provisions of the ASIC Act would not apply.
- *Option C*: Enhance existing ICA remedies. Existing remedies in the ICA, particularly s 14, would be modified (beyond the changes proposed in the ICA Bill) to improve their effectiveness to prevent the use of unfair contract terms in standard form insurance contracts with consumers. Section 15

would continue in operation so that the UCT provisions of the ASIC Act would not apply.

- *Option D*: Encourage industry self-regulation to better prevent use of unfair terms by insurers. Use of unfair terms by insurers would be addressed through self-regulatory means, such as a specific section dealing with the issue in, for example, the General Insurance Code of Practice.

Submissions were made, with the industry favouring the status quo and consumers favouring Option A.

Options B, C and D were generally not supported, though some considered one or more of those could be second-best solutions.

The ICA Bill did not pass the Senate before the calling of the election in July 2010, and the Bill has lapsed.

Consideration of the issue by the Parliamentary Secretary to the Treasurer

Following the election, the ICA Bill and the issue of UCT in insurance became the responsibility of the Parliamentary Secretary to the Treasurer, the Hon David Bradbury MP.

He has since engaged in discussions with stakeholders and held a roundtable discussion in March 2011 to have an open debate on the relevant issues and consider an appropriate course of action.

Key arguments

The key arguments being made as part of the above process by the insurance industry, and the consumer response, are essentially as follows.

- *Insurers* argue that the majority of insurance claims are processed by insurers without dispute, and most are paid in full. Consumers also have access to low-cost dispute resolution mechanisms such as the Financial Ombudsman Service (FOS). There is no evidence of systemic reliance on unfair terms to deny claims.
Consumers disagree and believe that:
 - there are numerous examples of unfair terms in insurance contracts, which have been documented in various reports;
 - overall statistics about claims and dispute rates are misleading, as many disaffected consumers do not have the resources to challenge an insurer's decision; and
 - access to dispute resolution is not limited to insurance, and other financial services subject to UCT provisions have access as well.
- *Insurers* believe that the consumer examples of alleged unfair terms relate to complaints about how a term has been applied/interpreted, rather

than any innate unfairness of the term.

Consumers argue that this distinction is illusory and if a policy term is unclear/ambiguous, the term itself is unfair.

- *Insurers* believe that the ICA (eg, doctrine of utmost good faith) already provides adequate remedies — FOS has used s 14 to prevent reliance in the records of dispute resolution bodies.

Consumers note that while in theory this may be true, the duty has proven in practice to be of very little assistance to insureds, and it is typically used by insurers against insureds.

- *Insurers* note that s 35 (standard cover) provides insureds with protection, as it requires insurers to clearly inform potential insureds of prescribed contracts (eg, domestic/household policies) in writing about non-standard cover and limits.

Consumers do not believe the section has been effective, as provision of the policy wording is generally sufficient to comply and this will not assist consumers to properly understand the extent of cover and exclusions.

- *Insurers* believe that the ICA should continue to be the main source of regulation of insurance contracts and, if caught by the UCT provisions, this would add to complexity and the number of disputes.

Consumers note that the ICA is already supplemented by other legal requirements covering similar ground, such as disclosure obligations in the Corporations Act 2001 (Cth) and consumer protection provisions (other than those excluded by s 15) in the ASIC Act. They oppose the anomalous exclusion of insurance, which they believe creates complexity from an economy-wide consumer protection perspective.

- *Insurers* believe that the status quo option avoids the difficult distinction between the regulation of consumer and non-consumer insurance contracts. *Consumers* note that such distinctions already exist — eg, the prescribed contracts distinction under the ICA and the retail/wholesale distinction in the Corporations Act, and parts of consumer protection laws not excluded by s 15 (such as those providing remedies in the nature of compensatory damages).
- *Insurers* are concerned that the broad remedies offered under UCT provisions (such as declaring an offending term to be void) go beyond the parties to the dispute and, given the unique nature of insurance policies, what is unfair in an insurance context can depend on the circumstances, and

that the global remedy may not benefit all consumers. *Consumers* note that a similar argument could be made in respect of non-insurance contracts.

- *Insurers* are particularly concerned that the legal uncertainty that would arise from insurance contracts being subject to unfair contract terms remedies will increase risk for insurers, which will need to be priced in to premiums and allowed for in reserves. There would also be a flow-on effect for reinsurance coverage that may impact on the pricing and availability of insurance.

Consumers note that the United Kingdom has had UCT laws applying to insurance since 1995 and it does not appear to have resulted in any significant negative impact.

- *Insurers* note that there will be significant costs for the industry if they need to vet all contracts for unfair terms.

Consumers note that this argument could be made for non-insurance contracts.

- *Insurers* are concerned that there are likely to be large numbers of actions by consumers based on the UCT provisions that may be without merit, unnecessarily increasing defence costs.

Consumers note that this argument could also be made for non-insurance contracts, and frivolous actions have not proved to be a significant issue for existing UCT regimes.

- *Insurers* believe that the main subject matter exclusion to UCT laws is uncertain in scope but would be likely to effectively rule out of review, for UCTs, many key clauses, thereby suggesting that the benefits to consumers are limited.

Consumers believe that the main subject matter exemption (together with the legitimate interest test for unfairness) can restrict avenues for review and thus decrease uncertainty for insurers.

- *Insurers* note that prior inquiries into this issue recommending a generic law (eg, by the Productivity Commission) did not focus on the special characteristics of the insurance industry.

Consumers note that the prior recommendations favoured an economy-wide approach and the Senate Economics and Legislation Committee did consider the insurance industry.

Where is it all headed?

The industry and consumer views are clearly at opposite poles.

Based on the author's involvement in the roundtable discussions, there is no doubt that the Hon David Bradbury appreciates the industry-specific concerns and is giving the issues thorough and careful consideration.

financial services newsletter

There is a clear push towards including insurance to some degree, subject to the cost–benefit analysis adding up. It is unlikely that the status quo or industry self-regulation options will be favoured.

The insurer concern likely to be given most weight by Government is the potential impact of having an exclusion declared void, which then affects all contracts of the same type.

Application of the UCT law in an insurance context clearly has a greater impact than in other industries, where the risk of adjustment of non-core contractual terms will not significantly affect business finances and operations.

This is because insurers use exclusions to define the risk they are willing to bear, and they price policies and seek reinsurance protection on the basis that the exclusions will operate.

Were an exclusion to be declared void in the context of a natural disaster, insurers would be exposed to losses for a risk for which they have not collected premium. This could have major ramifications for an insurer’s balance sheet. How the Australian Prudential Regulation Authority would need to take such an issue into account is also complex and needs to be carefully considered.

As a flow-on effect, reinsurers would also need to take steps to manage the flow-on risk to them. This, combined with the above, would affect the price and possibly the availability of insurance.

The above may also ultimately affect insurers that are not directly affected by the UCT laws.

If insurance is caught, one area of focus will be around the main subject matter exclusion. Section 12BI of the ASIC Act states that s 12BF (the provision that voids unfair terms) does not apply to a term to the extent (but only to the extent) that it defines the main subject matter of a contract.

It is likely that arguments will arise as to what provisions form part of the main subject matter. Consideration is being given to whether this can be avoided or

reduced by additional regulations or ASIC guidance — for example, by providing that policy terms which circumscribe the scope of the cover, including exclusions/limitations, are not part of the main subject matter.

Another area of focus has been on the effectiveness of pre-contractual disclosure and consumer protection under the current laws, with particular consideration being given to the effectiveness of s 35 (standard cover), s 37 (notification of unusual terms) and s 14 (reliance in the absence of utmost good faith) of the ICA, as well as the product disclosure statement requirements of the Corporations Act.

Consideration is being given to changing the “clearly inform” rule under the ICA to a “clear, concise and effective” test consistent with the Corporations Act; the possibility of a different method of presentation in policies, such as bolding departures from standard cover or unusual terms; or the provision of a supplementary disclosure document setting out important points. Methods of better community education are also being considered.

Given the complexity of the above, further discussions will be required to ensure that the end result is practically workable and that the detriments and costs do not outweigh the benefits.



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Footnotes

1. Available at www.pc.gov.au/projects/inquiry/consumer.

Keeping the regulators in line with the rule of law

Richard Gilbert RULE OF LAW INSTITUTE OF AUSTRALIA

RoLIA'S role in overseeing the rule of law

The Rule of Law Institute of Australia (RoLIA) ¹ has been vocal on a number of issues that it believes have seen the undermining of the rule of law in Australia.

These include:

- the need for better parliamentary scrutiny of legislation and in particular the need for the Senate Scrutiny of Bills Committee to have expanded terms of reference with particular reference to fundamental rights and liberties;
- a lack of transparency and accountability by government agencies in their use of coercive powers despite the Administrative Review Council's (ARC's) 2008 report into the use of coercive powers and their 20 best practice recommendations;
- the reversal of onus of proof regarding charges levelled by government agencies in the area of OH&S, and the removal of the right of silence in certain legislation; and
- encroachment by government agencies on judicial decisions and the resulting challenge to civil liberties.

RoLIA'S link to the financial services industry through our reporting of Senate Estimates Committee questions to the regulators

We have a watching brief to monitor all legislation going to Federal Parliament to see whether it conforms to sound rule of law principles. This includes all economic regulation and the estimates process, where we have made suggestions on how procedures can be streamlined and improved. An important area that we have highlighted is the posting of regulators' responses to Senate questions — as well as the questions themselves — on the regulators' websites and in their annual reports, and the timeliness of those responses. For example, a regulatory agency can send a letter to a financial planner and demand a response within two weeks, otherwise penalties may apply. But for the regulators, it seems there is a lot more latitude. They should comply with the orders of the Senate, as ultimately they are accountable to the Parliament. While there have been improvements in timeliness for some

regulators, others need to improve. Answers to numerous questions taken in the June 2010 Estimates had not been returned to the Senate before the Federal Election, in spite of a generous time to provide this material. Consequently, RoLIA has written to the Secretary of the Department of Prime Minister and Cabinet suggesting that the "caretaker provisions" be amended so as to ensure that answers become available, notwithstanding the calling of an election.

Our third report on the Senate Estimates Committee was published in January 2011. Table 1 shows the questions from October 2010 still outstanding at 18 January 2011.²

Table 1

Agency	Question number	Question content
APRA	SBT 15	Business lending
ASIC	SBT 9	ASIC guidelines
	SBT 11	ASIC guidelines
	SBT 21	LKM capital
	SBT 22	Section 420A of the Corporations Act 2001 (Cth)
	SBT 24	Phoenix
	SBT 31	Managed investment schemes
	SBT 64	Late answers to questions on notice
	SBT 67	Consultation paper related to mortgage exit fee
	SBT 69	Cooper Review
	SBT 141	Election commitments
	SBT 190	Short selling ban
	SBT 196	Claims lodged with ASIC re unfair contracts
SBT 197	Supervision of market lending	

Regulators' use of coercive powers

The ARC's 2008 report into the coercive powers of six agencies, including the financial regulators,³ advocated that the use of these special powers — which are usually vested in the courts — must be accompanied by a high degree of transparency and accountability. The ARC recommended 20 best practice procedures for the agencies to follow. While the Government has not yet responded to the report, the Senate has taken a keen interest in it.

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Some of the agencies have not yet provided answers on the use of their coercive powers.

The Senate Committees can make the heads of agencies accountable in terms of knowing what their powers are. We've seen evidence of some agencies not even knowing their powers, as well as some extraordinary use and seemingly excessive use of the powers.

RoLIA's work with ASIC

RoLIA has made submissions to Parliament on the Australian Securities and Investments Commission's (ASIC's) use of its powers over the past five years. ASIC has agreed to publish more information on its use of coercive powers. That ASIC is taking seriously its responsibility for these powers is in part evidenced in its 2011 Summer School program which included a session on ASIC's powers. RoLIA participated in this session and, in turn, its success was canvassed in the February 2011 Senate Estimates hearings.

RoLIA believes that some of the agencies would benefit from an external opinion/review on the use of their powers. These agencies should begin by revisiting the 20 best practice procedures put forward in the ARC report.

RoLIA's advocacy in the area of privacy

In the area of privacy, RoLIA has played a pivotal role in winning amendments to the Tax Laws Amendment (Confidentiality of Taxpayer Information) Bill 2010 (Cth). Initially, the Bill would have allowed the Australian Taxation Office (ATO) to disseminate taxpayers' private information to 50 government agencies, both state and federal, with only limited checks and balances. RoLIA felt that this was Orwellian in its implications for the right of privacy. Following submissions from RoLIA and the NSW Council for Civil Liberties, key amendments were made. As a result, the ATO will now be required to publish how it disseminates information across the 50 state and federal agencies, and to provide details of how its policy will work. Decision making on disclosure is to be made by a senior staff member, and the ATO must produce a statement of the procedures it will use to disseminate taxpayer information.

RoLIA's concern re funding and governance of the ARLRC

Recently, RoLIA appeared as a witness at the Senate inquiry into the funding and governance of the Australian Law Reform Commission. Readers will recall that

the ARLC played a vital role in law reform on the regulation of Australia's \$1 trillion plus managed investment sector and also on the use of genetic tests by public and private sector agencies, including life insurance companies. RoLIA has advocated a much needed boost in funding for the ALRC and also a restoration of its multi full-time commissioner structure which has been progressively downsized. The Committee is due to report its findings in late March 2011.



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Footnotes

1. RoLIA was founded in 2009 by a group of commercial lawyers who believed that some of the laws being passed in Federal Parliament were antithetical to the rule of law, and that there needed to be a greater level of accountability of the regulators and the government agencies responsible for administering the laws. RoLIA's current Governing Council includes newly appointed members Richard McHugh SC, Dr Melissa Perry QC and Emeritus Professor Geoffrey Walker. As well, RoLIA's Advisory Council comprises Professors David Weisbrot, Macquarie University, and Martin Krygier (UNSW), NSW DPP, Nicholas Cowdery QC, Russell Stewart, formerly a Minter's partner, and Melbourne's Michael Wyles SC.
2. RoLIA Senate Estimates Survey No 3 is available on the RoLIA website at www.ruleoflaw.org.au.
3. ARC, *The Coercive Information-gathering Powers of Government Agencies*, Report No 48, June 2008, available at www.ag.gov.au/arc. ARC's analysis focused on the Australian Competition and Consumer Commission (ACCC), the Australian Prudential Regulation Authority (APRA), the Australian Securities and Investments Commission (ASIC), the Australian Taxation Office (ATO), Centrelink, and Medicare Australia. These agencies are representative of Commonwealth agencies involved in revenue collecting (the ATO), revenue spending (Centrelink and Medicare), and corporate regulation (the ACCC, APRA and ASIC).



Financial Services Council Insurance Conference

The key event for the life insurance industry this year will be the 2011 Financial Services Council Life Insurance Conference at the Hilton Sydney on 6 April 2011

Attendance at this conference is a must for those wanting to hear the latest from politicians, regulators, industry leaders and other experts on where the life insurance industry is heading and the risks and opportunities likely to be confronted.

Following nearly two years of reviews, inquiries and government responses, the financial services industry faces unprecedented reform which will have an impact on life insurance.

The conference will not only inform and help broaden your network, it will also support continuous professional development with up to 6.5 CPD hours available to delegates.

Conference details

Date: Wednesday 6 April 2011

Time: 8.30am–7.00pm, closing drinks from 5.30pm

Venue: The Hilton Hotel, 488 George Street, Sydney

Speakers secured include:

- Senator Mathias Cormann, Shadow Assistant Treasurer and Shadow Minister for Superannuation and Financial Services
- Ian Laughlin, Executive Member, Australian Prudential Regulation Authority
- Margaret Craig, Acting Director General, Association of British Insurers,
- Geoff Summerhayes, CEO, Suncorp Life
- Helen Molloy, Chief Underwriter, Retail Life, Tower Australia
- Neil Sprackling, Director & Head of Client Markets Life & Health, Swiss Re
- Jamie Pride, Deloitte Online
- For the full program and to register online please visit the 2011 Financial Services Council Life Insurance Website at www.fsc.org.au.

Banking and Finance Conference

BANKING & FINANCE 2011

- 6 April 2011, Parkroyal Darling Harbour, Sydney
- 7 April 2011, Stamford Plaza, Brisbane
- 8 April 2011, Stamford Plaza, Melbourne

CHAIRPERSON

SYDNEY: Jon Denovan, Senior Partner, Gadens Lawyers

BRISBANE: David Jacobson, Partner, Langes + Lawyers

MELBOURNE: Bruce Taylor, Partner, Baker & McKenzie

TOPICS

How do we “responsibly lend” under the consumer credit protection laws?

New developments regarding how to tackle the responsible lending requirements will be discussed in this session:

- Reviewing the required disclosure documents, including credit guides and quotes
- Altering standard documentation to comply
- Explaining ASIC’s priorities for responsible lending enforcement

SYDNEY: Jon Denovan, Senior Partner, Gadens Lawyers

BRISBANE: Speaker to be advised

MELBOURNE: Bruce Taylor, Partner, Baker & McKenzie

Enforcing the unfair contract terms reforms

The new Australian Consumer Law regarding unfair contract terms began on 1 July 2010. This session will focus on how unfair contract terms may be dealt with, by both government agencies and the judiciary:

- A review of the laws behind the unfair contract terms
- Explaining recent government guidelines for compliance and enforcement
- Foreseeing how the judiciary may deal with matters

SYDNEY: Elise Ivory, Senior Associate, Gadens Lawyers

BRISBANE: Anthony Haly, Senior Associate, Mallesons Stephen Jaques

MELBOURNE: Mark Sneddon, Partner, Clayton Utz & David Kreltzhim, *Special Counsel*, Clayton Utz

Reviewing recent case law

This session provides a practical review of the most recent case law developments in both State and Federal jurisdictions.

SYDNEY: Patrick Dwyer, Partner, Langes + Lawyers

BRISBANE: David Jacobson, Partner, Langes + Lawyers

MELBOURNE: Speaker to be advised

Examining topical issues in banking & finance

An update on key financial services developments and current issues in banking and finance including:

- Australia and economic recovery from the GFC
- Recent changes and proposed amendments to the Corporations Act 2001 (Cth)
- Class action litigation involving financial institutions
- The pending bank reforms proposed by Federal Treasurer Wayne Swan (VIC topic only with no other topic covered in this session)

SYDNEY: Patrick Dwyer, Partner, Langes + Lawyers

BRISBANE: David Jacobson, Partner, Langes + Lawyers

MELBOURNE: Andrew Galvin, Partner, Corrs Chambers Westgarth

Practice workshop

Q&A session — Preparing for the Personal Property Securities Act (PPSA). Key topics will include:

- Getting a firm grip on the concepts and definitions under PPSA
- Traps & pitfalls to watch out for during the transitional phase
- Examining the impact on different areas of your practice, including drafting documentation and enforcement

SYDNEY: Patrick Dwyer, Partner, Langes + Lawyers

BRISBANE: David Jacobson, Partner, Langes + Lawyers

MELBOURNE: Andrew Galvin, Partner, Corrs Chambers Westgarth & Brad Husband, *Partner*, Corrs Chambers Westgarth

FSN NEWS

ASIC NEWS

ASICs forward focus for the financial advice industry

In 2011, ASIC will be focusing on the following financial advice themes:

- aggregator licensees;
- quality of advice;
- advice relating to complex products such as capital guaranteed products; and
- the use of managed discretionary accounts (MDAs).

The update details the types of issues ASIC will be looking at, and why we consider them important.

ASIC Commissioner Greg Medcraft said, “We want to flag to the financial advice industry the types of issues we will be looking at in 2011. By drawing attention to these issues we hope to help licensees avoid pitfalls and ensure quality financial advice is being provided to consumers.

“Where consumers have received, or are at risk of receiving, inappropriate advice we will step in and take tough regulatory action. Poor quality advice cannot be tolerated. It is not just the individual client that suffers loss, but the reputation of the industry as a whole is damaged as consumers lose confidence in the advice process.”

Source: 11-44MR 11 March 2011.

Views from the Australian Securities and Investments Commission

A speech by Dr Peter Boxall, Commissioner, Australian Securities and Investments Commission, delivered to the Insurance Council’s annual Regulatory Update can be downloaded.

Source: 9 March 2011

Revised internal dispute resolution procedures for financial institutions

On 16 February 2011 ASIC announced new regulatory guidance for financial institutions:

- To settle simple disputes internally with customers.
- For the coverage of internal dispute resolution (IDR) and external dispute resolution (EDR) procedures for customers who have loans from bodies which make or buy loans or leases, and repackage and sell them to investors (securitisation).

Greater flexibility in settling simpler complaints

A final written response setting out the right to complain to an EDR scheme will not be required where a complaint is resolved to the customer’s complete satisfaction by the end of the fifth business day after the complaint is received, and where the customer hasn’t requested a response in writing. The exceptions to this are complaints relating to hardship, a declined insurance claim, or the value of an insurance claim — all of which will still require a final response.

Insurance customers often phone the insurer to discuss a potential claim before lodging a claim. The Insurance Council of Australia (ICA) will consult with ASIC and consumer stakeholders on a proposal to amend the General Insurance Code of Practice in relation to those situations. The amendment would require insurers to ask customers verbally if they’d like to lodge a formal claim in situations where customers make enquiries about whether they have the necessary cover. The aim is to make the proposed change without waiting for the next formal review of the Code in 2013.

In the meantime, ASIC anticipates insurers will follow this approach as soon as possible.

IDR requirements for customers of securitisation bodies

Securitisation bodies (ie entities which make or buy loans or leases, and repackage them as investment products to sell to investors) may be exempt from holding an Australian Credit Licence where they have a service agreement with a credit licensee who acts on their behalf as “representative”, and, separately, they join one of the two ASIC-approved EDR schemes by 1 April 2011. This means that customers who have loans or leases involving a securitisation body will not be disadvantaged — when making a complaint, or seeking to vary or set aside the consumer loan or lease (eg for a hardship variation) — compared with customers of other lenders. They will effectively have access to the same dispute resolution procedures as other consumers. Key changes regarding securitisation bodies include:

- “clarifying that the representative’s IDR procedures must cover disputes relating to the credit activities they engage in on behalf of the securitisation body, and to disputes about the conduct of the securitisation body;

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- introducing a priority system for complaints handling at EDR, where the securitisation body and representative are members of different EDR schemes; and
- clarifying that both the representative credit licensee and securitisation body should refrain from commencing or continuing any legal action or other enforcement action (ie debt collection) while a complaint is handled at IDR or EDR.

Source: ASIC 11/23 AD 16.02.2011. www.asic.gov.au

REGULATIONS

Corporations Amendment Regulations 2010 (No 2) (SLI 55 of 2010)

These regulations amend the Corporations Regulations 2001. They provide that Authorised Deposit-taking Institutions (ADIs) and general insurers must make certain disclosures to customers in relation to the Financial Claims Scheme (FCS) by informing investors and clients about the relationship between relevant banking and insurance products and the FCS.

These Regulations were registered on 25 March 2010. Regulations 1–3 and Sch 1 commenced on 18 April 2010 and Sch 2 will commence on 12 October 2011.

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