



Michael Vrisakis Hi everyone. I'm Michael Vrisakis, a Partner in the Herbert Smith Freehills Financial Services Team. Welcome to our podcast series called the FSR GPS. This series focuses on topical and emerging issues in financial services regulation which we think are the most strategic and important issues for our clients. Feel free to suggest topics you would like us to cover in the future but for now, we hope you enjoy today's episode.

Hugh Paynter Hello, I'm Hugh Paynter, a Partner in the Disputes Practice at Herbert Smith Freehills in Sydney. I focus on litigation, investigations and contentious matters, including in the financial services sector.

Alice Molan Hi, I'm Alice Molan, a Partner in the FSR Practice at HSF with expertise in banking, non-bank lending, payments and fintech sectors.

Michael Vrisakis I'm Michael Vrisakis and welcome you to our podcast. I'm a Partner in the FSR Practice at HSF specialising in superannuation, insurance, financial advice and regulatory strategy.

This episode is called efficiently, honestly and fairly and we're going to abbreviate that in the rest of the presentation to EHF. But it is titled the quest for certainty and we'll be discussing one of the most vexed obligations under financial services law and that is the obligation to do all things necessary to ensure the relevant financial services and credit activities are provided efficiently, honestly and fairly.

As listeners will be aware, the EHF obligation is one of the conduct obligations applying to all financial services and credit licensees. In our experience, there is no obligation that gives rise to more questions, more uncertainty and indeed more inconsistency in application across the industry. We see our clients grapple with this issue and looking for the need for certainty. On this last point, one of the greatest areas of inconsistency across the industry is in breach reporting practices. We see what we consider to be considerable over-reporting of breaches of the EHF obligation to ASIC. So with that in mind, a good place to start our discussions today is the scope of the EHF obligation in financial services on the one hand and on the other, credit activities.



Alice, would you be able to take us through the scope of the obligation under the Credit Code and what sort of activities will be caught?

Alice Molan Sure, Michael. Holders of Australian credit licences under the National Consumer Credit Protection Act or NCCP Act must, and I quote, do all things necessary to ensure that the credit activities authorised by the licence are engaged in efficiently, honestly and fairly. As a brief overview of who's subject to that obligation, the NCCP Act regulates consumer credit, so it regulates those who provide credit or those that provide credit assistance in respect of it. It will cover lenders under home loans, personal loans and credit cards, as well as providers of consumer leases, mortgages and guarantees. So think banks, credit card issuers, mortgage brokers, non-bank lenders to give you a flavour. Anyone that is required to hold a licence under the NCCP Act must ensure that the regulated activity is engaged in to the standard of efficiently, honestly and fairly.

Michael Vrisakis Thanks very much Alice. On the financial services side of things, just looking at this aspect, that's going to cover insurers, superannuation trustees, financial advice licensees, fund managers as well as banks, the formulation under the Corporations Act in relation to EHF is very similar to the NCCP Act, but it's not exactly the same. For financial services licensees, the licensee must do all things necessary to ensure that the financial services covered by the licence are provided efficiently, honestly and fairly. The key commonality between the financial services and credit regimes is, in fact, the EHF obligation is one that requires the licensee to do all things necessary to act efficiently, honestly and fairly. In other words, it's not formulated as a reasonable steps obligation, but an all-necessary obligation.

Hugh Paynter Thanks Michael. It's important to note that do all things necessary would generally be seen as a very onerous threshold from a legal perspective. That's coupled in the case of EHF that both the Corporations Act and the NCCP Act require the licensee to ensure that the services are provided efficiently, honestly and fairly. If someone is telling me that I have to ensure something is done and to do all things necessary to see it done, to my mind, that means I have to make it happen. But the courts have not treated it in those black and white terms.



Alice Molan That's right Hugh. Because it is a general conduct obligation, the EHF obligation can and does operate at all levels of a licensee's business. But I think really when you distil it down to the relevant principals, the EHF obligation is designed to regulate the licensee's overall behaviour and conduct in providing financial or credit services. So in other words, you need to think about, is the licensee acting with appropriate care, skill and diligence, are they acting in a way that's consistent with commercial fairness, honesty and decency, and really is a licensee acting ethically.

Michael Vrisakis Yeah, no that's absolutely right, Alice. The EHF obligation should inform all aspects of the licensee's financial services or credit services business. It's an umbrella obligation with incredible breadth, but importantly as we discuss later, the EHF obligation is not a catch-all obligation that should be used or can be used as a proxy for all other breaches of financial services law.

So just now shifting slightly our focus to recent developments in the EHF obligation. It's true that the EHF obligations existed in financial services law for a long time, but in reality it's really coming to sharp focus for licensees in 2019 after it became a civil penalty provision. At this juncture, the EHF obligation also became a key enforcement tool for ASIC which has inevitably delivered us new case law on EHF obligation.

Hugh, what would you say are some of the key principles that can be instilled from the recent case law?

Hugh Paynter Thanks, Michael. Well, the recent case law of principles can probably best be categorised into two key buckets. One, principles on whether the EHF obligation is a compendious or non-compendious obligation. And two, what a breach of the EHF obligation actually requires, taking those in turn.

On the first point of course, one of the biggest issues over the last few years has been whether the EHF obligation is a compendious obligation or three concurrent obligations. This debate was reopened following the full federal court decision in the ASIC and Westpac personal advice case. However, the case law coming out of the Federal Court continues to be open on this front. For example, in ASIC and Westpac, Chief Justice Alsop and Justice O'Bryan made comments, albeit on obiter, that perhaps the EHF obligation was not compendious and that the breach of the fairly limb was enough to constitute a breach of the EHF obligation.



Subsequent case law such as the ASIC and AGM markets decision, refuse to follow this approach and continued to adopt the historical compendious formulation. And then beyond that, there had been a range of decisions such as the MobiSuper case and the RI Advice decisions where the Court seems to take a hybrid approach between compendious and non-compendious.

So it's perhaps safe to say that when confronted by a scenario raising EHF issues, we would approach it by analysing the EHF obligation both compendiously as well as involving three discreet obligations or ideas.

Michael Vrisakis Yeah, no, thanks Hugh. Well said. It's worthwhile noting in that context that the Australian Law Reform Commission has recommended that the EHF obligation be redrafted to clarify that it, in fact, comprises three separate and concurrent obligations rather than a single amorphous, compendious one. And just while we're on the topic of the Law Reform Commission's recommendations, the Commission also suggested that the word 'efficiently' be changed to read 'professionally'. We at HSF in the financial services team made a submission on that point, and we noted in our view that the word 'efficiently' should better be replaced by the word 'competently' rather than 'professionally'. On the basis that competently is more reflective of the case law on EHF to date, and consistent with Alice's comments earlier, EHF is fundamentally targeting licensee standards of conduct and behaviour which fundamentally relate to care and diligence.

Hugh Paynter Yeah, I agree with that, Michael. 'Competently' certainly captures what appears to have been contemplated by 'efficiently'.

Anyway coming back to the second issue in the bucket that I mentioned on the relevant case law henceforth applying to that, what does the obligation require, the case law has focused on what actually constitutes a breach of the EHF obligation and including in a number of recent cases including ASIC and NAB and ASIC and CBA – and they are particularly instructive.

From these cases, two very important and useful principles can be identified. First, the EHF obligation does not require a standard of perfection. It's accepted by the Federal Court that errors can occur in the context of operating financial services or credit business, and that's best illustrated by the CBA case from late last year, and that is relevant to the "do all things necessary to ensure" point that we discussed before.



Second, related to this point, the existence of an effective and timely remediation or rectification program can impact on whether or not there is a breach of the EHF obligation. We get that from the NAB case from late last year.

In other words, where errors occur, it may be possible for the licensee to remediate or rectify conduct before there is a breach. That is, the provision of financial services covered by the licence can be dealt with by that remedial conduct before it can be said to be a breach. Both of these principles are useful for licensees particularly in the context of breach reporting.

Alice Molan

Yeah, I agree. These are really useful principles. And as you mentioned Hugh, the cases clarified that perfection isn't required. So context is really important. Not every instance of failing to act efficiently means that the EHF obligation has been breached and must be reported. And reporting's a really key question that gets raised when we're thinking about whether this has been breached.

The CBA judgment was particularly helpful in articulating that while there are high standards expected of licensees, the EHF standard does not require perfection. So when you are looking at a particular failing in assessing the EHF limb, we would consider that the context is really important. What has the impact on customers been? How many times has this occurred? Was it truly an ad hoc human error or really was this a failing of systems and controls?

Michael Vrisakis

Yeah, that's a really important point. And I think it indicates that perhaps the courts seem to build in the concept of materiality into the EHF standard, and I think that's absolutely appropriate in the context of very broad conduct obligations designed to govern standards of behaviour. The key in determining what materiality is in built into the EHF obligation itself when considering where there's been conduct or an event that means that the relevant activity or service has not been engaged and/or provided efficiently, honestly and fairly.

It's also worthwhile noting that in our interactions with ASIC senior leadership, they all recognise that mistakes can happen. The important question is how quickly the mistake was identified and rectified. But there needs to be a focus on materiality and we think the courts are right in looking at that. For us here at HSF, a major unexplored, but extremely relevant question that has bearing on this matter is whether the EHF obligation houses itself an in-built concept of materiality as it refers in its wording, in its phraseology to the financial



services covered by the licence. So that first threshold point is that this means the breach has to occur in respect of the financial service, which is a relatively tightly defined concept under the Corporations Act including issuing, arranging, but it is very tightly defined.

And secondly, looking at the relevant financial service, say for example, the issue of financial product. From a materiality perspective, is it legitimate to measure the relevant subset of deficient conduct against the total activity whether it be in financial services or credit services space that's undertaken by the licensee under the licence. For example, out of 60,000 issues of a product to clients, only 1,000 were deficient.

So we are starting to see some grappling by the courts with this issue in materiality, because I think it's really relevant to the question. Because if you get a very small number of incidents, does that automatically mean that it's not, for example, being conducted efficiently?

Another common question that we get from clients is when to report a breach of the EHF obligation, and agree to which a separate assessment is required when there are other technical breaches under the financial services law.

From our observations across the industry, there are a lot of licensees who identify some kind of technical breach of financial services law and assume that automatically there is an EHF breach. And whilst this commonly might be seen in terms of enforcement by the regulator, we consider that this needs to be looked at quite closely, and we are actually seeing considerable over-reporting of EHF breaches in some pockets of the industry.

Alice, can I ask, what are your observations on this?

Alice Molan

So thanks, Michael. The EHF obligation can certainly be breached in addition to other breaches of the relevant financial services law. But the really important thing is that that's not a forgone conclusion. It's really important to do a separate assessment because in our view, and it's supported by the recent case law that Hugh mentioned, there is a discreet standard of assessment for the EHF obligation.

So when you identify a breach of a particular requirement in connection with the provision of financial services, we would suggest that consideration is given to whether the circumstances mean that there has also been a breach of the EHF standard. This will not necessarily be the case but should be considered having regard to things that we've mentioned already, like the



customer impact, whether it was the result of an ad hoc human error or really it was a failing of systems and controls for example.

Hugh Paynter I probably agree with that, Alice. And the flip side of this coin is also an interesting issue. That is, can you have an EHF breach when you otherwise do not have any other technical breach of financial services law or credit laws. This is of course possible given the EHF obligation stands independent of other obligations under financial services law. As a general proposition, it would seem to be unusual to have an EHF breach with no other breaches of financial services law. There have been some cases which have focused on the efficiently limb, in particular in the sense of competently. However, the fairly limb is where this sort of issue is mostly likely to arise given the broad operation of the concept of fairness, which is evolving at law in line with community expectations and principles of commercial ethics. It is possible that a failure to comply with the fairly limb of the EHF obligation could give rise to a freestanding breach of the EHF obligation with no other breaches of financial services law.

Alice Molan I think one possible example here, Hugh, is the case of financial hardship. Financial hardship obligations I do think have a real direct link with the fairly limb of the EHF obligation.

There was a recent case in the federal court called ASIC versus Member Finance where the court found that there was an EHF breach on the basis that among other things, the licensee failed to comply with the financial hardship provisions in the NCCP Act. Similar financial hardship provisions do not exist under the Corporations Act, but it is conceivable that a failure to adequately address consumer vulnerability through appropriate financial hardship mechanisms may give rise to an EHF breach. So principally through the fairly limb.

Michael Vrisakis And that's a relatively unexplored area which I think in its substance is probably the topic for another episode. But the other issue in this space touches on one of the case law principles that you actually mentioned early, Hugh, and that's the interaction of the EHF obligation with remediation. It seems to us that the issue is really multifaceted. Can remediation be used to alleviate or eliminate a potential EHF breach? And secondly, can EHF obligation give rise to an obligation to remediate historical misconduct which



may have only been discovered fairly recently. Hugh, what are your thoughts on this?

Hugh Paynter

Yeah, thanks Michael. I see that there is an inextricable link between the EHF obligation and remediation. As I mentioned earlier, from the recent case law particularly the NAB judgment, the court is starting to recognise the existence of the remediation program can impact whether or not there has been an EHF breach on the basis that remediation can itself be a component of providing a financial service. But equally given the breadth of EHF obligation and its relevance to all aspects of the financial services or credit services business, it can give rise to certain expectations to remediate conduct current or historical, and that's a complex topic probably for discussion on a forthcoming episode in this series.

Alice Molan

I think that's right. Thanks Hugh.

With that, I think that we can best distil the takeaways for today's episode on the EHF obligation. They would firstly be that the EHF obligation is a standalone obligation under the financial services regulatory regime. So a breach of a technical provision of financial services law does not automatically mean that you have an EHF breach. Licensees need to undertake a separate assessment of EHF, having regard to the concepts of materiality we've discussed today. And secondly, just because you have made an error doesn't mean you have an EHF breach. It's not a standard of perfection and remediation is relevant to this equation.

For those that are interested, we publish regularly on this topic of EHF on our blog called "FSR Australia Notes". Head there on hsfnotes.com/fsraustralia/. You can subscribe for regular updates. That's all we have time for today. Thanks for joining.

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