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# Banking and Financial Services Law Association
# 30th Annual Conference, Plenary Session 3
# "Developments in Financial Services Laws over the last 30 years"

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**The Hon Paul de Jersey AC***
**Chief Justice**

I am very pleased to join you today for the Association's 30th annual conference. I have been privileged to address the conference on a number of occasions over the years. From memory, the first was in about 1989, here at the Marriott Hotel, when I was still reasonably fresh from the commercial bar. Then, as now, I was nonetheless daunted by the prospect of addressing your vast collective expertise and experience. I recall I then spoke about the concept of constructive notice and the decision of the High Court of Australia in Northside Developments and the Registrar General.[1] If that address was analytical, today's will be more in the narrative style; but I trust not the less useful on that account.

I should add that I have most frequently been "paired" at the event with a New Zealand Judge, often Peter Blanchard, which I have greatly enjoyed, as now in prospect with Justice Mark O'Regan.

I will today briefly explore Australia's regulation of financial services since the 1980's with a focus on prudential supervision, mentioning underlying philosophical approaches and trying to draw some contrasts with other jurisdictions.

I will also discuss two cases where Australian courts have been among the first in the world to impose liability on certain actors in the global financial crisis – an investment bank and a ratings agency. Particularly in the ratings agency case, there are significant global ramifications.

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* I am indebted to my Associate, Mr Andrew Wydmanski, for his substantial assistance in the preparation of this paper.

[1] *Northside Developments Pty. Ltd v Registrar-General* (1990) 170 CLR 146.

Most changes in our financial regulations have involved a response to one of two events: a report or a crisis. We begin our foray into the past with the 1981 Campbell Report, which followed the inquiry launched in 1971 by Treasurer John Howard.

The Campbell Report's underlying philosophy was neoclassical economics which, in simplified terms, emphasises that markets are largely self-correcting, subject to certain exceptions such as (using terms I am obliged to adopt) information asymmetry and public externalities like pollution. This approach advises against government intervention in the economy, unless the benefits outweigh the costs.[2] In this vein, the Campbell Report recommended that various regulations be rolled back, reduced or repealed.

Following a change of government and another report from the Martin Commission, which recommended further deregulation, changes were then implemented by the Hawke Government with bipartisan support.

These changes included: relaxing direct interest rate controls, floating the Australian dollar and allowing the entry of foreign banks into the Australian market. The traditional distinction between savings banks and trading banks was eliminated.

The next Report, Wallis, was commissioned by Treasurer Peter Costello in 1996. At the time, Australia's regulatory framework was reminiscent of the situation in the United States. There were multiple federal and state authorities, many with overlapping jurisdiction and applying widely divergent standards.

Two major problems arise with that sort of regulatory fragmentation. First, inconsistencies between regulators can result in regulatory arbitrage, in which financial institutions "shop around" and seek the jurisdiction of the least demanding regulator. In the US, it has been argued that this drove a "race to the bottom", as competing regulators tried to drum up "business" from financial institutions.

[2] McCracken et al, 2013, *Everett and McCracken's Banking and Financial Institutions Law (8th ed)*, Lawbook Co, p.1; p.8.

Another difficulty is that the use of narrow specialised agencies can create gaps and inconsistencies as financial institutions evolve and blur traditional distinctions which previously existed between them.

To combat these problems, Wallis emphasised the need for competitive neutrality; that is, functionally equivalent products should be treated alike, regardless of their provenance. As we might say in equity, the law should focus on the substance rather than the form.

This meant, for example, that all deposit-taking institutions should be subject to the same licensing regime, be they bank, credit union or building society. This was implemented with amendments in 1999 to the *Banking Act* 1959 (Cth).[3]

To advance consistency and avoid regulatory gaps, Wallis also urged that one broad-based regulator take responsibility for the supervision of all financial institutions. This was achieved with the creation of the Australian Prudential Regulation Authority or APRA. It absorbed and consolidated the prudential roles of various entities, including: the Reserve Bank, the Financial Institutions Commission and the Insurance and Superannuation Commission.[4]

APRA’s supervisory jurisdiction extends throughout the financial industry and includes banks, credit unions, building societies, insurers, Lloyd’s underwriters and superannuation funds, among others.[5]

Along similar lines, the *Financial Services Reform Act* 2001 (Cth) achieved largely uniform licensing, conduct and disclosure rules under the *Corporations Act* 2001 (Cth) for providers of financial products.

Following these reforms, Australia has achieved a so-called “twin peaks” model of financial regulation. Under this system, APRA is one “peak”, with responsibility for supervising

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[3] *Financial Sector Reform (Amendments and Transitional Provisions)* *Act* (*No. 1*) 1999 (Cth).
[4] J Hill, 2012, ‘Why Did Australia Fare So Well In The Global Financial Crisis?’ *Sydney Law School Legal Studies Research Paper No. 12/35* (Online), <http://ssrn.com/abstract=2063267>, p 21.
[5] *Australian Prudential Regulation Authority Act* 1998 (Cth), s 3(2).

financial institutions. The other "peak" is the Australian Securities and Investments Commission, ASIC, which focusses on consumer protection and corporate conduct. ASIC grants Australian Financial Services and Australian Credit Services licences and monitors licensees' compliance with their legal obligations. Consistent with the Wallis Report, the focus of financial sector regulation in the *Corporations Act* is largely on conduct and disclosure obligations, and is designed to combat information asymmetry.

Other entities also play an obviously important role in Australia's financial system, including the Reserve Bank, the Australian Consumer and Competition Commission, ACCC, and the Commonwealth Treasury. There is also the council of Financial Regulators, which facilitates coordination between the Treasury, Reserve Bank, APRA and ASIC.

As I previously noted, Australia's twin peaks model differs from that of the United States, where there is a patchwork of overlapping regulators. At the other extreme, it also differed from that of the United Kingdom, which for many years combined the functions of APRA and ASIC into one super-regulator, the Financial Services Authority.

Following difficulties with its financial sector, including the collapse and nationalisation of the bank Northern Rock, the UK Government decided to split the functions of its Financial Services Authority among smaller agencies, advancing closer to our twin peaks model.

I mentioned earlier that regulation often changes in response to a report or a crisis. APRA encountered its first major challenge soon after its creation in 1998 – the failure of HIH, then Australia's second largest insurer. The collapse led to a quite dramatic and controversial re-setting of Australian tort law which substantially reduced citizens' rights.

Also, and more relevantly today, the resulting Royal Commission recommended various changes to APRA's procedures. This included structural changes to the agency, strengthening its early warning systems and shifting from a largely non-interventionist

strategy of consulting with troubled firms to a "more sceptical, questioning and where necessary, aggressive approach".[6]

As Professor Jennifer Hill notes in a recent paper, the HIH collapse influenced APRA's subsequent approach not only to insurers, but also to other institutions such as banks.[7] In 2004, the National Australia Bank suffered $360 million in losses following unauthorised trading in forex – Queenslanders will appreciate I refer here to currencies.

APRA exercised rigorous supervision of NAB to ensure that its proposed remedies were implemented, which included a team of APRA staff effectively living in NAB's offices for the next two years.

APRA's minimum capital requirements for banks have been described as conservative and in some ways stricter than the recently concluded Third Basel Accord on capital adequacy standards.[8]

It would be remiss not to mention some of the developments following the GFC, which admittedly sounds more like a fast food brand than an economic disaster. Happily, our country has suffered less than many in the northern hemisphere. Very much at home, the Queen Elizabeth II Courts of Law in Brisbane, at $600 million, is a vibrant example of a survivor of the GFC – although I note that construction was already very well advanced when the financial disaster struck.

Various circumstances have been offered to explain to Australia's good fortune. One is the local banks' more cautious lending practices compared with that of their Atlantic counterparts. Others involve matters of regulation, such as the four pillars policy preventing a single Australian mega-bank emerging, and our strong regulatory framework. Still others credit the Federal Government's guarantee of bank deposits during the height of the crisis as having had a positive effect, although this entailed rejecting the Wallis

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[6] *Report of the HIH Royal Commission*, Recommendation 26 (Online), 4 April 2003, <http://www.hihroyalcom.gov.au/finalreport/Chapter%208.HTML>.
[7] Hill, above n2, pp 42-43.
[8] Ibid, p. 44.

Report's warning that a guarantee of bank deposits could increase incentives for unsafe risk-taking since losses would be covered by taxpayers. I note that the Government has recently proposed a bank deposit insurance levy from 1 January 2016, which is said to amount to a guarantee of savings. This approach continues the shift away from the Wallis Report's recommendation in this area.

Other suggested reasons for Australia's performance in the GFC include the Federal Government's stimulus program which was designed to boost consumer demand, our superannuation system providing liquidity to local banks and our proximity to China. The weight you attach to each explanation depends to some extent on your political outlook, so I leave this assessment to others.

That is not to say that our financial industry emerged entirely unscathed, given the collapse of Storm Financial, Opes Prime and Westpoint. Those events instigated a new Report, the joint parliamentary Ripoll Report. Following its recommendations, the Government introduced the "Future of Financial Advice" or FOFA reforms in 2012. These changes represent a move away from the neoclassical approach as I will discuss later.

FOFA includes measures intended to reduce conflicts of interest in the finance industry. Among other changes, it introduces a "best interest duty" owed to the client, introduces a requirement for the periodic renewal (or cancellation) of instructions, and bans various commissions and other payments to financial advisers where a potential conflict of interest arises. The fate of this initiative may be affected by the result of the forthcoming federal election.

These, and other recent changes in our financial laws, appear to be influenced by behavioural economics, a philosophy different from the neoclassical approach of Wallis and Campbell.[9] Behavioural economics emphasises that, contrary to the assumptions of neoclassical economists, individuals are not inherently rational in their actions and decision making. As its proponents Thaler and Sunstein note, the contrary would require

[9] McCracken et al, above n1, p. 14.

people to "think like Einstein, store memory like Big Blue, and exercise willpower like Mahatma Gandhi".[10]

By contrast, behavioural economics seeks to apply the insights of neuroscience and psychology to economic issues, rather than rely on stylised models and standardised assumptions of human behaviour. This is used to justify a greater scope for government regulation and involvement.

Behavioural economics underpinned the Cooper Review's 2010 report on the superannuation system. Whereas the Wallis Report inherently assumed, consistent with neoclassical economics, that consumers would look after their own interests if provided with enough information, the Cooper Review was clearly influenced by the work of Thaler and Sunstein, who noted humans' tendency to choose the option requiring the least effort, even if not in their best interests.[11]

There is also the paradox of choice – if people are confronted with too many options, they may encounter "analysis paralysis" and stick with the status quo, regardless of whether better alternatives are available.

Such concepts informed the MySuper proposal. Wallis assumed that, when provided with enough information, people would switch superannuation providers if they could secure lower fees and a product better suited to their needs in return. By contrast, Cooper suggested there was a significant level of disengagement, with few people making an active investment choice and many simply relying on the default option.

The Cooper Review therefore suggested that for these people, the default option should focus on keeping fees low and eliminating unnecessary add-ons. Engaged investors are still able to optimise their own choice. The Cooper Report described this philosophy as

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[10] R Thaler & C Sunstein, *Nudge: Improving Decisions About Health, Wealth and Happiness*, Yale University Press, 2008, p. 7.
[11] D Gruen and T Wong, *MySuper: thinking seriously about the default option* (Online), 28 September 2010 <http://www.treasury.gov.au/PublicationsAndMedia/Speeches/2010/MySuper-Thinking-seriously-about-the-default-option>.

"libertarian paternalism", in which outcomes are maximised for passive super fund members while still allowing the actively engaged to select their own direction.[12]

Before I turn to the two Federal Court cases, among the first in the world to impose liability in the wake of the Global Financial Crisis, I note two important factors which permeate them both: conflict of interest and complexity.

As to complexity, I recall the professor, expert in highly complex securities, who was regularly called upon to lecture on the same topic all over the world. One day, asked to speak at a new location where he was not previously known, and deciding he had had enough, he asked his chauffeur to change places. The chauffeur would simply read the speech from the Professor's speaking notes. All went well, until the chauffeur was asked a difficult derivatives question. To the consternation of the professor, who was sitting in the audience, the driver replied, "What a simple question; in fact, I'll ask my driver sitting up the back to provide the answer!" To any wondering, I reassure you that my driver and I did not come to a similar arrangement today! But that is not an invitation for difficult questions.

The first of these cases was a class action taken by several local authority councils against Grange Securities, the Australian branch of the now-defunct Lehman Brothers.[13] Mindful of the need to protect ratepayers' money, the councils had pursued conservative investment strategies, which offered positive returns while minimising the risk of loss. The councils were unsophisticated investors. They had no prior experience in Synthetic Collateralised Debt Obligations or SCDOs, which were the fiendishly complex financial products they were advised to buy.

Among the SCDOs Grange advised them to buy were the charmingly named Dante Notes. These had nothing to do with the latest Dante-inspired novel by Dan Brown. Grange made representations that the rate of loss for these products was equivalent to that of the relatively safe Floating Rate Notes, so that acquiring them was consistent with a

[12] *Review of the Governance, Efficiency, Structure and Operation of Australia's Superannuation System* (Online), 30 June 2010, <http://www.supersystemreview.gov.au/content/downloads/final_report/part_one/Final_Report_Part_1_Consolidated.pdf>, p. 9 (p.17 of PDF).

conservative investment strategy. Grange also directly invested in these Notes on behalf of several councils as part of Individual Managed Portfolio agreements reached with them.

Following legal and financial turmoil in mid-2007, the investments were rendered largely worthless. The councils successfully pursued four causes of action against Grange: breach of contract, misleading or deceptive conduct under s.12DA(1) of the ASIC Act, negligence and breach of fiduciary duties.[14]

Justice Rares found that the peculiar complexities and risks of SCDOs made them an inappropriate investment choice for a risk averse council, contrary to Grange's representations. There was no established secondary market for the products; nor could they be easily liquidated at short notice.

The Judge held that Grange failed in its contractual and tortious duty to exercise reasonable skill and care in advising councils to make the investment. He rejected a contributory negligence defence, since the councils were reliant on Grange and unable to make their own assessments.

In trading in the Notes with the councils, Grange was also held to have breached its fiduciary obligations. The first was the duty not to obtain an unauthorised benefit from its trading in SCDOs with the councils. The second was the duty to avoid being in a position where its interests or duties conflicted with the interests of the councils. This was because Grange had not made sufficient disclosure of its own gains from such trades, so the councils could not provide their fully informed consent.

The Judge held that such fiduciary duties could be contractually modified or extinguished; however, this was not achieved by the disclaimers Grange had added in its product presentations, notwithstanding that the duties *were* somewhat reduced by clauses in the individual managed portfolio agreements. Those clauses disclosed that Grange might earn fees from the issuer of a SCDO and that Grange could act in a transaction either on the council's behalf or as a counterparty.

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[13] *Wingecarribee Shire Council v Lehman Brothers Australia Ltd (In Liq)* [2012] FCA 1028.

Ultimately, Justice Rares found that the councils – financially unsophisticated in relation to this "product" – had not provided their fully informed consent to Grange. Grange knew that the councils had reposed their trust and confidence in it to act in their interests while making investment decisions or recommendations. His Honour noted that this knowledge allowed Grange to "exploit their significant access to large amounts of public money to finance Grange's business of promoting and selling SCDOs for its own profit".[15]

In this judgment, the financial sophistication of Grange contrasted with the relative ignorance of the councils was crucial to the finding of liability. The case confirms that investment banks can owe their clients fiduciary obligations, and although these can be contractually excluded, full disclosure to the client is critical.

Another class action brought by twelve councils in the Federal Court could have wide-reaching implications for ratings agencies. In *Bathurst Regional Council v Local Government Financial Services Pty Ltd (No 5),*[16] the Federal Court held that Standard & Poors (S&P) was negligent in awarding highly complex derivative products a "AAA" rating.

These products were called "Constant Proportion Debt Obligations" or CPDOs. Again, they were marketed under an artistic moniker, this time as Rembrandt Notes. Sadly, these Notes were worth far less than their namesake. Perhaps it would have been more apt to name them after the painter of *The Scream,* Edvard Munch; after the Notes' value plummeted in late 2008, the councils which had bought them lost $16 million.

The CPDOs were created by ABN Amro, which hired S&P to give them a rating. Importantly, Justice Jagot of the Federal Court found that S&P had used "unreasonably optimistic" projections in deciding to award a AAA rating to the CPDOs.[17]

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[14] *Australian Securities and Investments Commission Act* 2001 (Cth).
[15] *Wingecarribee Shire Council v Lehman Brothers Australia Ltd (In Liq)* [2012] FCA 1028, [474] (Rares J).
[16] [2012] FCA 1200.
[17] [2012] FCA 1200, [2684] (Jagot J).

The Court found that had various assumptions been properly tested by S&P, the appropriate rating would have been below BBB or investment grade.[18] As such, this constituted misleading or deceptive conduct under both the *Corporations Act*[19] and the *ASIC Act.*[20]

The case notably establishes a duty of care on the part of ratings agencies towards third parties. Previously, they could hide behind the assertion that their ratings were mere opinions that were subject to broad disclaimers. This decision requires ratings agencies to take care in choosing the assumptions, input data and modelling that justify their ratings.

It has significant global implications, since the Rembrandt notes were distributed in the US, UK, Netherlands and New Zealand using the same rating.[21] S&P and the other defendants have lodged an appeal against the judgment.

The power of ratings agencies is immense. Their views instrumentally affect the development of economies; even, who governs. They are understandably subject to increasing analysis and scrutiny. Part of the problem is that they occupy a niche which is abstruse for most of us to the point of incomprehensibility. Or is that an impression those companies have cleverly created?

What else can we expect in financial services laws in the future? No doubt one area of interest will be the rise of mobile payment systems, as people swap their credit cards for smartphone applications. Another issue of interest is the rise of BitCoin, a digitally created currency that is independent of any central bank and can be used anonymously, potentially for nefarious purposes. Another Report is also possible, with the Federal Opposition flagging a "Son-of-Wallis Inquiry" into the financial system should it win office.[22]

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[18] Ibid, [2853] (Jagot J).
[19] *Corporations Act* 2001 (Cth), ss 1041E (false or misleading statements), 1041H (misleading or deceptive conduct).
[20] *Australian Securities and Investments Commission Act* 2001 (Cth), s 12DA (misleading or deceptive conduct).
[21] H Low and J Shapiro, 'S&P ratings ruling could cost billions', *The Australian Financial Review* (Online), 5 November 2012, <http://www.afr.com/p/national/ratings_ruling_could_cost_billions_DkUcF9kn0EAf4gtKSR0nVN>.
[22] J Hockey, 'Son of Wallis is long overdue', *The Australian Financial Review* (Online), 22 November 2010, <http://www.afr.com/p/opinion/son_of_wallis_is_long_overdue_oH05gEDCE7wasTz8VgrZSO>.

Today has seen a necessarily brief overview of recent developments in the laws relating to financial services. Other areas which time prevents me from discussing include the National Consumer Credit Code, recent attempts at increasing banking competition such as the ban on mortgage exit fees, and post-September 11 amendments to money laundering laws.

The law of financial services is a field where opposing political, social and economic interests compete intensely. The only constant in this dynamic field is change.