

HUGGINS LEGAL

LITIGATION AND REGULATORY RISK UPDATE

EDITION 3 – 8 JANUARY 2023

Welcome to the third edition of Litigation and Regulatory Risk Update – a newsletter for AFSL holders about developments in litigation risk (both in a Court and at AFCA) and regulatory risk.

1. **What has happened?**

AFCA's Rules about its jurisdiction currently operate in a way that creates significant risk for firms that appoint Authorised Representatives.

Under the Corporations Act (s917A and s917B), an AFSL Holder is responsible for the conduct of its representatives whether or not the AR's conduct is within authority. It used to be the case that AFCA relied upon these provisions as the source of its jurisdiction to accept complaints about the conduct of ARs. Importantly, this meant that AFCA would only accept a complaint that was about the provision of a *financial service* as this concept is defined by the Corporations Act (in particular, providing advice about and dealing in a *financial product*).

In January 2021 (as a result a Supreme Court of NSW decision to the effect that AFCA could only accept complaints about an AR's conduct that was within the authority given to it by the AFSL holder) AFCA amended its Rules so as to make it clear that it could accept complaints whether or not the conduct was within authority. Importantly, under the old system, liability was limited to issues about a *financial service* (as that concept is defined in the Corporations Act) whereas under the new system liability extends to issues about the provision of a *financial service* as that concept is defined in AFCA's Rules (this being a far wider concept) – whether or not the AR's conduct is within or without the authority given to it by the AFSL holder.

2. What do I need to know about this?

The danger for AFSL holders that flow from the new system can be illustrated by 2 simple examples:

- (1) An AFSL holder authorises an AR to provide advice about a particular managed investment scheme. Without the AFSL's holder's knowledge, the AR begins providing advice about guarantees with respect to residential or commercial property investment and a person suffers a loss as result of entering into a guarantee. Under the old system, AFCA would not have jurisdiction because a guarantee is not a financial product for the purposes of the Corporations Act and, in any event, the advice concerned a direct investment in property (which is also not a financial product for the purposes of the Corporations Act). Under the new system, AFCA would have jurisdiction because providing advice about a guarantee is a *financial service* for the purposes of AFCA's Rules. It could also be argued that the advice about direct property investment falls within AFCA's jurisdiction (even though direct property investment is a not a financial product for the purposes of the Corporations Act).
- (2) An AR advises a client to invest in bitcoin and the client suffers a loss as a result. Bitcoin is not a financial product for the purposes of the Corporations Act. Under the old system, a complaint could not be accepted by AFCA (because for a financial service to be provided advice needs to be given about a financial product). However, under the new system a complaint could be accepted by AFCA even though bitcoin is not a financial product (because AFCA's Rules includes advice given about *things* that are not financial products for the purposes of the Corporations Act).

What these examples illustrate is that AFCA's jurisdiction has been de-coupled from the Corporations Act. An AFSL holder is a *Financial Firm* for the purposes of AFCA's Rules. For there to be jurisdiction, the *Financial Firm* has to have provided a *Financial Service* as this concept is defined by AFCA's Rules. This being a far wider concept than how this concept is defined for the purposes of the Corporations Act.

3. **What should I do?**

AR arrangements have a substantial level of risk associated with them even when the ARs are acting within authority (because it can be difficult to properly supervise activities that are being undertaken by ARs). Essentially, the new system makes risks that have always existed more severe. In my experience, issues about ARs providing advice or dealing in unauthorised products tend to arise where an AR has been authorised to provide advice about and/or deal in a particular financial product (for example managed investment schemes that are to be marketed to wholesale clients) as part of a business that is not a financial services business (for example a property developer is authorised to provide advice about and deal in interests in a particular managed investment scheme that is associated with the property developer). Without the AFSL holder's knowledge, the AR *branches out* into providing advice about and/or dealing in other financial products (for example, a property developer starts providing advice about shares issued by a company that is associated with it). My impression is that this issue arises in this type of context because the persons involved are not financial services industry participants in the usual sense and may not necessarily be aware of the regulatory system that underlies the provision of financial services (and/or perceive that this system applies to them).

Under the old system, the AFSL holder was responsible for this type of conduct but the risk was more manageable (but still substantial particularly, in the context referred to above) because it was limited to conduct in relation to financial products as that concept is defined by the Corporations Act. The new system creates a new level of risk because it applies to a far wider range of activities.

In this context, I suggest that the following needs to be done:

- (1) Avoid arrangements whereby people outside of the standard financial services industry are authorised to provide advice about or deal in particular financial product that they are directly associated with – in my view, there is a substantial risk in these types arrangements that the ARs will branch out into undertaking other activities that are not authorised– for example providing personal advice to retail clients when they are only authorised to provide general advice to wholesale clients or providing advice about a loan or a guarantee that could be entered into to enable a person to purchase a financial product.
- (2) If these arrangements are entered into, be sceptical about what is actually happening – for example, if someone is only authorised to provide general advice to wholesale clients be sceptical as to whether this is all that is actually happening.
- (3) Actively look for evidence about what the AR is actually doing rather than relying on passive approaches such as requiring the AR to provide a quarterly attestation to the effect that it is complying with its obligations – passive approaches create a cause of action against on the AFSL holder’s part against the AR (that may be worthless if the AR is insolvent) but they do not protect the AFSL holder from AFCA claims being made against it (which it will have to respond to irrespective of whether it can recover anything from the AR).
- (4) Ensure that the precise nature of what the AR is authorised to do is disclosed in the FSG (where relevant) and on the AR’s website. Vague disclosures are not sufficient. The disclosure needs to be specific – for example *ABC* has authorised *XYZ* to provide advice about and deal in *XYZ* product and it is not authorised to act on behalf of *ABC* with respect to any other product or service.

If you would like to discuss any of the issues raised in this Update please, of course, don’t hesitate to contact me.

Regards

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CAPABILITY STATEMENT

Huggins Legal has expertise in the following areas:

1. AFCA complaints concerning financial planning, stockbroking, finance broking, irresponsible lending, insurance and superannuation.
2. Financial services related litigation including disputes with advisers and disputes concerning financial services related commercial transactions.
3. Management of issues concerning adviser misconduct including breach reporting.
4. Management of issues concerning client complaints including providing advice about internal dispute resolution, breach reporting and remediation.
5. ASIC investigations.
6. AFS licensing.
7. Financial services related compliance including issues concerning the ASIC Market Integrity Rules and drafting/reviewing SOAs, FSGs and PDS'.
8. Financial services related commercial work.
9. AML/TF advice and reviews.

Huggins Legal acts for clients across Australia.