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Financial Services Law Bulletin

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Are you covered by your D&O policy?

In an environment of increased scrutiny and heightened expectations of corporate behaviour, D&O coverage is a topic of acute interest to directors and company officers. In 2003, ASIC actively pursued both civil and criminal actions against directors and officers of companies. The following cases highlight examples of situations where coverage may not be available and which you may wish to discuss with your broker.

Whitlam v Australian Securities & Investments Commission

■ NSW Court of Appeal, 10 July 2003

In this case, voting proxies were given to Whitlam as the chairman of the 1998 AGM of NRMA Limited. The Court of Appeal found that, when voting the proxies, Whitlam was not subject to a director's duty of honesty because he was acting in his capacity as the holder of a proxy, not as a director. The proceedings are now subject to an appeal application to the High Court.

The determination of whether a person was acting in the capacity of a director or officer is relevant to deciding whether a D&O policy will respond to a claim.

Robert Porter v GIO Insurance Limited & OAMPS Ltd

■ NSW Supreme Court, 21 August 2003

A company and its directors have a duty to make full disclosure to a potential insurer, before entering into a policy, of any matters which might affect the decision of the insurer to accept the risk and, if so, on what terms.

In this case, a potential purchaser of OAMPS shares threatened to remove Porter as director of OAMPS. To prevent that from happening, Porter arranged for OAMPS to purchase shares in a third party company so that the third party could use the proceeds from the share sale to finance the purchase of OAMPS shares. Porter was subsequently sued by OAMPS and prosecuted by the DPP. Porter sought indemnity for the costs and expenses he incurred in defending these proceedings.

The Court held that the D&O policy did not indemnify Porter because the directors and officers' insuring clause only applied in circumstances where the company "is not required or permitted to indemnify the Insured for such Loss". The Court found that Porter's claim did not satisfy this proviso.

The Court also held that because there had been a deliberate concealment by Porter, the insurer was also entitled to reduce its liability under the policy to nil under the Insurance Contracts Act. The Court held that coverage was also excluded by the dishonesty exclusion on the basis that Porter participated in the circular share transaction because of his desire to secure a personal benefit.

Silbermann v CGU Insurance Limited

■ NSW Court of Appeal, 25 July 2003

This case concerns a D&O insurer's decision to refuse to advance defence costs to three former directors of One.Tel in connection with proceedings commenced against them by ASIC, despite there being no final adjudication of the ASIC proceedings. The dishonesty exclusion clause in the D&O policy in question provides that the insurer has the discretion to refuse D&O coverage, even in the absence of an existing judgment, order or final adjudication adverse to the directors. The Court of Appeal held by majority that the language of the exclusion clause should be given its effect, as the terms were clear and unambiguous. This case has been appealed.

Baycorp Advantage Limited v Royal Sun Alliance Insurance Australia Ltd

■ NSW Supreme Court, 23 October 2003

D&O policies are intended to cover the liabilities of individual directors and officers, not the liabilities of the company (except to the extent that the company has indemnified the liabilities of the directors/officers). Where the individuals and the company are jointly and severally liable to a claimant, how does the D&O policy respond? The D&O policy in this case contains an allocation clause which provides, essentially, that when the individuals and the non-insured company were defendants in the same proceedings, the two parties will agree on a fair and proper allocation of damages, interest, claimant's costs and expenses and defence costs between loss covered by the policy and loss not covered by the policy.

The Court held that the clause was unenforceable and void for uncertainty because it did not specify any "machinery" for determining a fair and proper allocation of covered loss and non-covered loss, and there was no definition of what a fair and proper allocation was. The decision seems to be at odds with the intention of the D&O policy (see above). The case is being appealed.

If you have any queries, please contact us to discuss.

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This article was adapted from a presentation by Ebsworth & Ebsworth Partner Matthew Harding to Chartered Secretaries Australia (CSA) and was published in the CSA's journal *Keeping Good Companies* – please visit www.ebsworth.com.au for a full version of the presentation paper.

The ones to watch in 2004

Following is a shortlist of the developments likely to impact the financial services sector in 2004.

- 1. Insurance Contracts Act:** The operation of the Act is under parliamentary review. The initial report into the operation of section 54 made several broad recommendations in relation to reporting and notice provisions. The final report is due for release on 31 May 2004.
- 2. CLERP 9:** The Bill will be debated during the first session of Parliament this year, with a proposed commencement date of 1 July 2004. If successful in its current form, the Bill will impact significantly on listed companies and their auditing and disclosure arrangements.
- 3. Superannuation licensing:** *The Superannuation Safety Amendment Bill 2003* introduces a range of reforms to amend the *Superannuation Industry (Supervision) Act 1993* (SIS Act). Subject to the passage of the Bill through Parliament, the legislation introducing the new regime will commence in July 2004. The Bill requires that all trustees of APRA regulated superannuation entities must be licensed by APRA.
- 4. Government response to mutuals and unauthorised insurers:** Recommendation 42 of the HIH Report recommends that the government amend the *Insurance Act 1973* to extend prudential regulation to all discretionary insurance-like products. The government's response, in the form of the Review of Discretionary Mutual Funds and Direct Offshore Foreign Insurers, was due for release on 30 January 2004.
- 5. Financial Services Reform:** The FSR transition period will expire on 10 March 2004. For those who

have transitioned (either as a licensee, authorised representative or beneficiary of a licensing exemption), the focus is now shifting to ongoing compliance (in particular, the disclosure obligations).

6. **IASB Standards:** The Financial Reporting Council announced on 3 July 2002 that Australia will adopt the IASB accounting and auditing standards. As a result, the AASB has begun issuing IASB EDs with a “wrap around” providing Australian context. Comments are invited on several IASB EDs, in contemplation of implementation.
7. **Prosecutions coming out of the HIH Royal Commission:** ASIC has been provided additional funding of \$17.5 million in 2003–2004 and \$10.7 million in 2004–2005 to undertake investigations and prepare briefs for civil prosecutions following the findings of the HIH Royal Commissioner, confirmed in the report “The failure of HIH Insurance”. To ensure the investigations are carried out expeditiously, a specialised taskforce has been established within ASIC to undertake the investigations and civil prosecutions. The government is considering whether a Special Prosecutor will be appointed to prosecute criminal charges and has provided funds in the contingency reserve for criminal prosecutions.
8. **Review of the ASX Business Rules:** The ASX released three new sets of operating rules, the ASX Market Rules, the ACH Clearing Rules and the ASTC Settlement Rules. The three sets of rules will replace the ASX Business Rules, the ASX Futures Business Rules, OCH Derivatives Clearing Rules and SCH Business Rules. The ASX process is not intended to be a complete re-write of all the Rules but has resulted in significant structural and formatting changes that market participants will need to be familiar with.
9. **APRA discussion paper:** On 20 November 2003, APRA released its Stage 2 discussion paper on reforms to the framework for supervision of general insurers. The paper identifies issues or deficiencies in the prudential regime and APRA’s proposals to resolve these by revising existing prudential standards and guidance notes.

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FSR update

FSR Amendment Act

The *Financial Services Reform Amendment Act 2003 No. 141* (Cth) received assent on 17 December 2003. The FSR Amendment Act contains amendments to the *Corporations Act 2001* to clarify interpretation and operation of the FSR regime. It includes provisions with respect to:

- the regulation of unsolicited offers to purchase financial products off-market (*Corporations Act 2001* Part 7.9, Division 5A);
- the documents on which an AFS licensee must disclose its AFS licence number (section 912F); and
- combining a financial services guide (FSG) and a product disclosure statement (PDS) in a single document (section 942DA).

New Regulations gazetted

These sets of amending Regulations have been gazetted:

- Corporations Amendment Regulations (No. 9) 2003 No. 367 (Cth) – provide partial exemptions to foreign-based market licensees for reporting requirements to ASIC.
- Corporations Amendment Regulations (No. 10) 2003 No. 368 (Cth) – revise existing disclosure provisions, list further items which are not “financial products” and provide further licensing exemptions
- Corporations Amendment Regulations (No. 11) 2003 No. 369 (Cth) – include the documents on which an AFS licensee must disclose its AFS licence (Regulation 7.6.01C) and provides additional reporting requirements to ASIC for breach by an AFS licensee.

Note: the FSR Amendment Act and new Regulations (and their respective commencement dates) are extensive. Please contact us for further information.

Joint PDS

In addition to previous relief, ASIC has issued Class Order CO 03/1092, Further relief for joint product disclosure statement, allowing two or more product issuers to prepare and issue a joint PDS in certain circumstances. This reflects ASIC’s recognition of the sale of complementary financial products by separate, and often unrelated, issuers. ASIC confirms that the issuers of a joint PDS will be held jointly responsible for the whole PDS. We note the need for issuers to carefully consider concerns in relation to joint and several liability for the disclosure in a joint PDS.

Managed Discretionary Accounts (MDA)

ASIC has released its policy approach to the regulation of MDA services. Under the MDA policy, operators of MDA services (MDA operators) are exempted from the managed investments provisions in Chapter 5C of the *Corporations Act 2001* (the Act) and the product disclosure provisions in Part 7.9 of the Act. To have the benefit of this relief, MDA operators must comply with the licensing and conduct provisions in Parts 7.6 and 7.7 of the Act and some additional conduct requirements designed to promote consumer protection.

New draft Regulations

The government has released batches 7 and 8 of the draft Corporations Amendment Regulations. The batch 7 draft

Regulations contain further amendments to the Regulations to clarify interpretation and operation of the FSR regime. The batch 8 draft Regulations follow Parliamentary debate on the FSR Amendment Act and provide for certain exemptions from dollar disclosure requirements.

News in brief

Advancement of defence costs refused

Two recent NSW cases have established that insurers can refuse to advance defence costs where they had discretion to do so, provided they are "acting reasonably". Insurers should ensure that the insured's right to defence costs in advance is at the insurer's discretion. In addition, the cases also established that insurers could deny indemnity on the basis of dishonesty exclusions, provided there was a basis for doing so, even before a court determination. In these instances, however, insurers will still ultimately be required to support their denial of indemnity with a finding of dishonesty. For more information, visit the Publications section of our website at www.ebsworth.com.au:

- *Daniel Wilkie v Gordian RunOff Limited & anor – Insurance Law Alert*: 'No cash upfront for insured's legal fees, 11 Dec 2003.
- *Silbermann v CGU Insurance Limited; Rich v CGU Insurance Limited; Greaves v CGU Insurance Limited [2003] NSWCA 203 – E&E Insurance Review*, vol. 15, no. 2, pp. 13-15.

Code proposes to ban gifts

The IFSA/FPA Draft Code of Conduct on Alternative Remuneration proposes to ban gifts and conferences linked to product sales; establish a public register of payments (for conferences etc.) greater than \$300, as well as other disclosure reforms. Agents and brokers have until the end of February to comment on the draft code, which will become a part of the FPA's professional code of conduct and become an IFSA standard.

ASIC crackdown

ASIC plans to run a significant surveillance operation to check for unlicensed advisers following the 10 March 2004 deadline by which financial services providers must be licensed. The hardline approach being adopted by ASIC is welcomed by industry groups, who see the new laws as providing an opportunity for an age of improved performance.

Risk management under review following NAB incident

APRA has announced that it will review the risk management practices of Authorised Deposit-Taking Institutions (ADIs) with treasury functions following revelations that NAB may have lost around \$180 million in unauthorised trading in foreign trading options (see our recent *Corporate Governance Alert*, 'Forex trading losses and directors' duties revisited', for further comment at www.ebsworth.com.au).

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