

□ INSURERS

Bringing them home

For completely opposite reasons, captive insurers and lenders mortgage insurers are being given encouragement to repatriate back to Australia.

Captives

The Australian Prudential Regulation Authority (APRA) has released a discussion paper proposing to exempt captives from prudential regulation in recognition of the fact that captive insurance is essentially a form of self insurance for corporate groups. Exempting captives from prudential regulation results in consistent treatment of risk retention arrangements, whether by way of self insurance or by setting up a captive insurer. It also eliminates the present problem of inconsistency in the prudential regulation of onshore and offshore captive insurers.

Under the proposal, captives will have to meet certain criteria to be exempt. Among these criteria, captives will not be able to insure third parties under the insurance provided (e.g. contractors, joint venture partners or customers) or write statutory classes of insurance or insurance to enable the corporate group to meet statutory obligations (e.g. workers compensation). If the captive provides insurance to an APRA regulated institution, the exemption must not prejudice the interests of the policyholders, depositors or members.

Exempt captives will no longer be subject to APRA levies or reporting requirements such as under the *Financial Sector (Collection of Data) Act 2001*. The result is that offshore captives can reassess the drivers for remaining overseas – tax considerations will remain critical. APRA will accept comments on the paper until 15 April 2005.

Lenders mortgage insurers (LMIs)

APRA has released amendments to the proposed reforms to the prudential supervision of LMIs published in August 2004 following consultation with stakeholders and the industry. The paper sets out changes to the proposed LMI maximum event retention (MER) model, provides an overview of changes to the proposed MER reporting requirements and clarifies the proposed definition of an acceptable LMI for the purposes of granting capital concessions to authorised deposit-taking institutions (ADIs).

The mono-line requirement for LMIs will be retained. APRA expects LMIs to meet new capital requirements by restructuring reinsurance arrangements and/or through “modest increases” in capital. The LMI must have a formal rating of “A” or higher.

Importantly, APRA has proposed criteria in relation to the overseas regulator and the LMI regulatory regime aimed at ensuring that the quality of both the regulator and the prudential regime is comparable to Australia and meet international standards. (As an aside, this may be an indication of APRA’s position on comparable regulation foreshadowed in the Potts Report.) ADIs with offshore LMIs will need to assess the prudential regulation of their LMI’s domicile to determine whether capital concessions will continue to be granted. If concessions will not be granted, offshore LMIs will also need to reassess the drivers for remaining overseas.

APRA is seeking comments on the amended proposals by 1 April 2005 and intends to implement the new proposals on 1 October 2005.

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in this issue

FSG relief for secondary service providers	2
Refinement of relief allowing SOAA	2
'til mortgage do us part	3
Gaol terms for cartel conduct	3
Restraining ex-employees	4
Unit pricing errors, death & taxes	5
News in brief	5

introduction



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In the March issue of our *Financial Services Law Bulletin* our lead article discusses how APRA seems to be easing and proposing exemptions in cases where prudential regulation is not required, such as for captive general insurers.

Also in this issue:

- we provide an update on FSR;
- we look at the recent changes to family law legislation, which may affect creditors, including financiers;
- we discuss a recent decision which affects post employment restraints in consultancy or employment contracts; and
- we discuss unit pricing errors in light of APRA and ASIC’s joint consultation paper.

□ FSR UPDATE

FSG relief for secondary service providers

ASIC has granted FSG relief to secondary service providers, that is, those who provide financial services to retail clients via an intermediary.

Provided some conditions are met, class order relief has been granted in the following areas:

- when there is an arrangement for an intermediary to give a retail client the secondary service provider's FSG;
- where secondary service providers provide an FSG to retail clients by posting it on their website, making it available on request (available until 30 June 2005);
- where an expert's report is to be included in a third party's disclosure document, the expert's FSG may be included as a separate and clearly identifiable part of the report; and
- where a person is arranging for the issue of a financial product by a product provider under an

intermediary authorisation, the arranger's FSG can be included as a separate and clearly identifiable part of the product provider's PDS.

The relief has been granted in recognition of the difficulty faced by secondary service providers in complying with the retail client requirements of the *Corporations Act 2001* and in an effort to assist them in providing information to retail clients in a practical and cost-effective manner.

Further information is available in ASIC Information Release 04-78, *ASIC grants relief for secondary financial service providers*, which is available with the class orders (CO 04/1571, CO 04/1572, CO 04/1573) at www.asic.gov.au

Refinement of relief allowing SOAA

The relief issued by ASIC in July 2004 allowing Statements of Additional Advice (SOAA) to be provided to retain clients instead of a Statement of Advice (SOA) in certain circumstances has been refined. The changes are intended to allow greater flexibility in providing the information required in an SOA, where an adviser has an ongoing relationship with a retail client.

The main changes are:

- an adviser may now incorporate by reference information from more than one clearly identified "eligible advice document" previously given to the client;
- the definition of "eligible advice document" has been expanded to include SOAs, SOAAs and certain documents provided to the client before the application of the FSR regime; and
- an adviser may incorporate by reference from an eligible advice document provided to the client by another adviser representing the same licensee.

Information and statements contained in the SOAA, including information and

statements being incorporated by reference, must be worded and presented in a clear, concise and effective manner.

Information that cannot be incorporated by reference into an SOAA includes:

- the warning where advice is based on incomplete or inaccurate information about the client's relevant personal circumstances; and
- information about the costs and benefits of replacing one product with another.

A copy of the class order (CO 04/1556) is available at www.asic.gov.au/co

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in brief: Relief from disclosure in dollars

ASIC has granted limited class order relief from disclosure in dollars in a number of circumstances. As outlined in *PS 182 Dollar Disclosure* relief has been granted for:

- disclosure items which depend on unknown facts and circumstances;
- costs of derivatives, foreign exchange contracts, general insurance products and life risk insurance products;
- interest payable on deposit products;
- non-monetary benefits and interests; and
- amounts denominated in a foreign currency.

Transitional relief was also granted until 1 July 2005. Items in SOAs, PDSs and periodic statements prepared on or after 1 July 2005 must disclose items as amounts in dollars.

in brief

Consent to quote: Draft updated practice note

ASIC has released a draft update of Practice Note 55 *Disclosure documents and PDS: consent to quote* (PN55). Under the *Corporations Act 2001* consent must be obtained from persons to quote them in a PDS or prospectus. However, ASIC considers that where the information is important and obtaining consent is difficult, relief may be appropriate.

□ FAMILY LAW

'til mortgage do us part

Changes to family law legislation mean you may have a few more people involved in your divorce proceedings than you expected – such as your bank manager and creditors. The *Family Law Amendment Act 2003* commenced on 17 December 2004 and may change the way creditors are dealt with during family law proceedings.

The new Part VIII A of the *Family Law Amendment Act 2003* (“the Amending Act”) allows the Family Court to make orders effecting third parties. Prior to the Act it was settled law that the Family Court had no power to make orders binding third parties (with some exceptions). With the introduction of the Amending Act the Court has the power to make orders that are directed to, or alter, the rights, liabilities or property interests of third parties.

Third parties bound by the Family Court may include any creditor, including financiers.

The Amending Act allows the court to:

- substitute one party to a marriage for another or for both parties in relation to a debt owed to the creditor;
- alter the proportion of liability as between the parties to the marriage for the debt;
- allow the director of a company to register a transfer of shares from one party of a marriage to another;
- make an order restraining the person from repossessing the property of a party to a marriage; and
- grant an injunction restraining the person from commencing legal proceedings against a party to a marriage.

The legislation applies to creditors. This includes all forms of personal debt and

secured debts, including registered mortgagees.

On their face, the new powers of the court may have a far-reaching impact upon creditors to parties to a marriage. However, the court is constrained in that it may only make orders if the making of the order is “reasonably necessary” or “reasonably appropriate” to effect a division of property between the parties to the marriage, and:

- it is not foreseeable that the order or injunction will result in the debt not being paid in full;
- the third party has been accorded procedural fairness; and
- the court is satisfied that in all the circumstances it is just and equitable to make the order.

The impact on credit providers is not known, however, it is likely that credit providers will be required as parties to family law proceedings more often than has been the case to date, to ensure that they are heard and accorded procedural fairness.

As the court must have regard of the effect of its orders on third parties and repayment of debt, it is hoped that the position of financiers will not be weakened by the introduction of the Amending Act.

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□ COMPETITION

Gaol terms for cartel conduct

The federal government has announced it will amend the *Trade Practices Act 1974* so there will be criminal penalties for cartel conduct. The proposed amendment allows a criminal conviction if a person has engaged in a cartel with the intention of dishonestly obtaining a gain from customers.

The maximum gaol term for individuals will be 5 years, with a fine of up to \$220,000. Corporations will be able to be fined either a maximum of \$10 million or three times the value of the benefit derived from the cartel, whichever is the greater amount. If the value cannot be determined, the court will be able to fine a corporation 10% of its annual turnover. There will be a published enforcement protocol of the procedures involved in a criminal investigation and when the ACCC will refer a matter for criminal prosecution. There will also be monetary

thresholds. Additional amendments will be made to the ACCC’s leniency policy for whistleblowers who do in criminal activity.

This is an ideal time for companies to consider updating or implementing trade practices compliance programs. The ACCC is likely to be on high alert in looking for just the right contravention to run its first test case of the new provisions once enacted.

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Read our *Competition Law Alert: Gaol terms for cartel conduct* (February 2005) for a more information on this topic – visit www.ebsworth.com.au

□ EMPLOYMENT LAW

Restraining ex-employees: can your employment contracts help you keep your competitive advantage?

Post employment restraints in consultancy contracts or in employment contracts are unenforceable unless they are reasonable as to time, area and content. In states such as Queensland and Victoria, the common law determines the enforceability of restraints. In New South Wales, the *Restraints of Trade Act 1976* allows the Supreme Court to reduce unreasonable post employment restraints to enforceable terms.

Woolworths Limited v Olson
Supreme Court of New South Wales –
Court of Appeal, 18 November 2004

In each state it is common to have combination or cascade restraints which start with a maximum restriction on the area and the length of time for which a former consultant or employee cannot compete against the former employer. The restraints are structured so they can be removed if they are unenforceable, without affecting the enforceability of the lower level restraints. An example of a cascade restraint is:

- for a period of 12 months in Australia;
- 9 months in New South Wales, Victoria and Queensland;
- 6 months in New South Wales; and
- 3 months in the Sydney CBD.

In common law jurisdictions such as Victoria and Queensland the removal of restraints in a cascade clause is only permitted where it can be done by running a line through the unenforceable restraint. What is left must be grammatical and have a clear meaning and must not alter the effect of the original contract by imposing a new obligation.

In New South Wales the *Restraints of Trade Act 1976* permits a more involved type of cascade restraint provided the Supreme Court has clear choices, both as to the breadth of the area and the restraint duration. This principle has been extended by the Court of Appeal in the decision of *Woolworths Limited v Olson*. The Act permitted the Court to amend the restraint provisions which were not cascade restraints so that they were reasonable.

In *Woolworths Limited v Olson*, Olson, a senior executive, was part of a team developing a software system designed to transform Woolworths' product supply procedures. Before he resigned from Woolworths, he had sent to his wife's email address, documents relating to the software project that were "extremely confidential and valuable". After his resignation he signed a contract of employment with Franklins. When Woolworths discovered the breach of the email policy, Olson was summarily dismissed for misconduct and was given a letter consistent with his employment agreement preventing him from being

involved in a "competitive business in Australia and New Zealand for a period not exceeding 6 months". Olson was paid by Woolworths for this period. At first, this restraint was held to be unenforceable because it was unreasonable in its scope and it was incapable of being read down to give it a reasonable operation.

The Court of Appeal found that the trial judge had only applied the common law principles, which allow unreasonable restraints to be crossed out so that what remains is a reasonable restriction. The Court found that the *Restraints of Trade Act 1976* permitted it to define "competitive business" as being involved with Franklins or any other supermarket with which Woolworths competes in Australia, rather than any business of Woolworths such as "Big W", Liquor, Petrol or Dick Smith Electronics and to define the "geographic area" as Australia.

If a post employment restraint is to be enforceable it must be reasonable as to:

- **content:** it cannot prevent an employee or consultant from engaging in any employment but only in employment which is competitive with the former employer's business;
- **area:** the geographical area must be no greater than is reasonably necessary to protect the existing or contemplated business operations of the employer at the time the restraint becomes effective;
- **time:** restraints of 12 months or more duration are likely to be unenforceable. The restraint's duration should be equal to the time within which the former employee's knowledge and contact with the business and its customers becomes "stale". A 12 months restraint may be suitable for financial planners, taxation accountants and insurance brokers who may review clients' affairs annually. A period of not more than 6 months may be permitted where the work is project-based and technological change is rapid, such as in development of computer software or where a new product is put on the market during the period of restraint.

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in brief: fsr hot spot

The long & short of confirming transactions on life & super products

When FSR was first implemented in March 2002, a new regime of confirming transactions was also introduced which formalised those requirements for the full spectrum of financial products. While these requirements are in most cases straightforward, there are some pitfalls.

Visit www.ebsworth.com.au to read more in our recent *Financial Services Law Update* (March 2005).

□ REGULATION

Unit pricing errors, death & taxes

The old adage that there are two certainties in life – death and taxes – might well be extended to a third category, unit pricing errors. In May 2003, the Australian Prudential Regulation Authority (APRA) indicated that unit pricing had become an area of increasing interest, particularly in the context of superannuation since the growth of member investment choice.

As a starting point, it was recommended that all institutions affected by unit pricing adopt IFSA Standards No. 8 and No. 9 and Guidance Note No. 4, if they had not already done so.

Over the past year or two, unit pricing has been moving up on APRA's agenda and late last year APRA and ASIC jointly released a consultation paper setting out their proposed guidance for good practice in unit pricing, following their review on industry unit pricing practice. Among other things, the consultation paper indicates that attention is required in these areas:

- establishing an effective risk management culture;
- consistently applying appropriate unit pricing policies that are up-to-date;
- maintaining robust systems, processes and interfaces to cope with the applicable volume and frequency of unit pricing activity, and the diversity and complexity of product designs and fund structures;
- aligning unit pricing practices with statements in related documents (such as product disclosure statements);
- taking responsibility for all unit pricing functions, including those which are outsourced;
- ensuring reasonable allowance is made for the value of all assets and liabilities attributable to unit holders, including non-market assets and future tax assets and liabilities;
- reconciling values used in unit pricing with those reported in published accounts; and

- accepting the obligation to compensate all unit holders in an equitable fashion when material errors are identified.

The paper goes on to offer suggestions for good practice. For example, to ensure that there is consistency between unit pricing practices and statements in related documents, it is suggested that, among other things, organisations establish periodic independent reviews of documents and practices. Product providers should check statements made about unit pricing in, as applicable, the life insurance policy, managed investment scheme constitution, superannuation trust deed, scheme compliance plan, and PDS.

Importantly, APRA and ASIC acknowledge that errors may nevertheless occur with even the most robust systems and controls in place. One of the main emphases, therefore, is the need for **diligent focus on risk management** and control of systems and processes in order to minimise the size and frequency of unit pricing errors, and compensation in a manner that is equitable to all unit holders if or when a unit pricing error occurs.

Final guidance on the matter is to be released some time later this year. As generally acknowledged, death is hard to avoid, and taxes less so; it will be interesting to see to what extent the regulators' guidance helps industry to better avoid unit pricing errors.

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□ NEWS IN BRIEF

Amendments to SIS & RSA regulations

Amendments have been made to the SIS regulations including the following:

- SIS regulations 1.05 and 1.06 have been amended to allow complying lifetime or life expectancy annuities or pensions to be commuted within 6 months of commencement, subject to the requirement that the annuity or pension was not funded from the commutation of another "complying" income stream.
- An amendment was also made to the SIS regulations to clarify the operation of the rule allowing a complying lifetime income stream to be commuted on the death of the primary beneficiary within a certain period. The amended rule refers to the primary beneficiary's life expectancy rounded up to the next whole number.

Review of the provision of pensions in small superannuation funds

As part of its review of the topic, the Treasury has released a discussion paper regarding the provision of pensions in small superannuation funds. The review is being carried out following concerns regarding the ability of small funds to gain unintended access to tax and social security benefits and about small funds providing defined benefit pensions.

□ NEWS IN BRIEF

Managed investment schemes: extended transitional relief for certain managed investment schemes

ASIC recently announced the extension of transitional relief for certain managed investment schemes from 31 December 2004 to 30 September 2005. The extension applies to the following class orders:

- (CO 98/51) Relief from the duty to separate assets of a managed investments scheme;
- (CO 98/55) Investments in unregistered schemes;
- (CO 02/239) Participating property syndicates.

The extension only applies to relief with a time limit under these three class orders. The announcement is available at IR 04-76 *ASIC extends transitional relief for certain managed investment schemes*, issued 22 December 2004.

IFRS discussion paper released by APRA

On 24 February 2005 APRA released a discussion paper setting out its proposed prudential response to the adoption of International Financial Reporting Standards (IFRS) by APRA regulated institutions. APRA intends to align its prudential and reporting standards with the Australian Accounting standards and principles. The proposals will have implications for a number of accounting standards, including:

- fair value measurement;
- non-accrual loans and deferred acquisition costs;
- treatment of hedges;
- available for sale financial assets;
- property;
- excess of market value over net assets (EMVONA);
- loan loss provisioning; and
- employer sponsored defined benefit superannuation plans.

APRA intends to bring the proposals into effect from 1 January 2006. A copy of the paper is available at www.apra.gov.au. Comments on the proposals in the discussion paper should be submitted to APRA by email no later than 29 April 2005.

Public liability and professional indemnity insurance findings issued

On 17 February 2005, the government released the ACCC's fourth report monitoring public liability indemnity insurance costs and premiums. The report stemmed from a request from the government in July 2002 to monitor costs and premiums in these classes of insurance and assess the impact that the reforms implemented by federal and state governments have made on premiums. The report shows that in the first half of 2004 for public liability insurance:

- the average premium fell by 15 per cent;
- the average claim cost decreased by 11 per cent; and
- the underwriting financial performance for issuers declined.

And for professional indemnity insurance:

- the average premium fell by 17 per cent;
- the average claim cost increased by 21 per cent; and
- the underwriting financial performance for issuers declined.

A copy of the report is available at www.accc.gov.au

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