Small Business Commissioner

Small Business Commissioner

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OUT19/4082

James Mason
Manager, Financial Services Reform Implementation Taskforce
The Treasury
By email: enforceablecodes@treasury.gov.au

Enforceability of Financial Services Industry Codes – consultation paper

Dear Mr Mason,

The Office of the NSW Small Business Commissioner (OSBC) is focussed on supporting and improving the operating environment for small businesses throughout NSW. The OSBC advocates on behalf of small businesses, provides mediation and dispute resolution services, speaks up for small business in government, and makes it easier to do business through policy harmonisation and regulatory reform.

The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry ('the Royal Commission') has highlighted a very wide range of practices that reflect the industry's prioritisation of profit, above and at the expense of customer welfare. As the fallout from the findings of the Royal Commission continues, it is vital that the government take a more proactive stance in monitoring and regulating the financial services industry.

Improving the enforceability of financial services industry codes is a long-overdue step towards ensuring better outcomes for customers – a great many of whom are small businesses. The heart of the issue was succinctly characterised by the Honourable K. Hayne AC QC, Commissioner:

> *"... **the promise [in a code] is either worth something or it's not. If it's worth something, what's the downside in making it enforceable**?"* [1]

The OSBC therefore welcomes publication of Treasury's '*Enforceability of Financial Services Industry Codes*' consultation paper ('the consultation paper'). The paper should represent the first step towards implementation of much more robust system of industry codes. For the hundreds of thousands of small businesses that depend on their relationships with banks, insurers, and other financial service providers, these codes must be genuinely binding on industry and genuinely reliable for customers. Anything less than reform at this scale would be inconsistent with the Commissioner's findings - most particularly recommendations 1.15 and 1.16 around which Treasury's consultation paper is based.

Executive Summary

The standards of financial service providers when dealing with small businesses must improve.

Effective regulation of the financial services industry is crucial to ensuring economic growth and financial stability. The agreements that underpin finance are often struck between two parties that possess vastly different bargaining power. This is obviously the case when small businesses are dealing with financial service providers.

The consequences of this can be significant for small businesses. Poor practices could lead to the closure of businesses, losses of jobs, and the livelihoods that go with them. This has an impact on local communities and economies, and the people within them.

The poor practices of financial service providers in their dealings with small businesses have been highlighted by the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry. Some of Australia's largest corporations were shown to be flagrantly disregarding the law, in the pursuit of profit, and at the expense of small business customers. This is to say nothing of the multitude of breaches of the various codes that exist today in the financial services industry.

An enforceable codes regime, industry or government-led, may prove an effective mechanism through which to lift standards in the industry.

The Royal Commission has highlighted that codes play a particularly important role in determining standards in the dealings of financial service providers with small businesses.

The Banking Code of Practice, for example, is the primary protection for small businesses when entering into arrangements with banks. The General Insurance Code of Practice, too, sets out key protections for small businesses.

We agree with the government and the Royal Commissions' recommendations that the current codes regime must be strengthened. Breaches are commonplace and systemic. There must be consequences introduced to ensure effective deterrence.

If industry moves quickly, and with the right spirit, to improve their standards and work with regulators, then an industry-led approach may prove successful. However, in the absence of timely action from industry, government must move to ensure customer outcomes.

This submission sets out our recommended approach to achieving better outcomes, and ensuring that codes of conduct in the financial services industry start to deliver on their promises to small business customers.

This submission provides **24** recommendations to government on how best to implement recommendation 1.15 of the Royal Commission (with regard for other relevant recommendations). We have also taken account of the ASIC Enforcement Taskforce Review and its key recommendations.

The recommendations and analysis in this submission are divided into three parts, outlining our positions on:

- Improving outcomes for small businesses in their dealings with financial service providers.
- Protecting those small businesses that look to alternatives.
- Particulars of the reformed industry codes regime.

We also provide brief context on the nature of small business interactions with financial service providers.

Our submission proposes two approaches to enhancing the enforceability of industry codes to adequately protect small business:

- Introduce enhanced enforceability to the current co-regulatory approach, by making most code provisions enforceable and providing the regulator with enforcement powers; or, in the alternative;
- Introduce mandatory codes.

Our commentary relates primarily to the Banking Code of Practice and the General Insurance Code of Practice. We also discuss the Online Small Business Lenders Code of Lending Practice.

Should you have any questions concerning our submission, please contact James Davis, Advisor Advocacy & Strategic Projects on 8222 4883 or james.davis@smallbusiness.nsw.gov.au.

Summary of recommendations

Recommendation 1: ASIC should prioritise the need for effective compliance monitoring and enforcement when considering the approval of codes.

Recommendation 2: ASIC should ensure that, in the event that significant and repeated breaches of code provisions occur, sanctions will be levied by the relevant code compliance committee. This should be a condition of the approval of codes.

Recommendation 3: ASIC should be provided with the legislative powers to prescribe 'enforceable code provisions' within codes of conduct.

Recommendation 4: In relation to both the Banking Code of Practice and the General Insurance Code of Practice, all provisions that govern the terms of the contract between service providers, and small businesses or individuals, should be designated 'enforceable code provisions'.

Recommendation 5: Both the Australian Banking Association (ABA), in relation to the Banking Code of Practice, and the Insurance Council of Australia (ICA), in relation to the General Insurance Code of Practice, should provide ASIC with a proposed subset of enforceable code provisions. The selected subset should reflect Recommendation 4.

Recommendation 6: Enforceable code provisions should be identified by the ABA and ICA, and submitted to ASIC, within six months of the passage of legislation establishing ASIC's new powers. ASIC should then ensure enforceable code provisions are given force by 30 June 2021.

Recommendation 7: ASIC should be provided with the powers to prescribe and impose voluntary and mandatory codes for all parts of the financial services industry.

Recommendation 8: In the event that an industry sector resists partaking in an enforceable codes regime, ASIC should exercise its new powers to prescribe mandatory codes to improve industry standards.

Recommendation 9: The *Treasury Industry Codes of Conduct Policy Framework* should form the basis upon which ASIC assesses the need to prescribe a financial services industry code.

Recommendation 10: AFIA should immediately work to expand the Online Small Business Lenders Code of Practice to new product types and business models.

Recommendation 11: Signatories to the Online Small Business Lenders Code of Practice Code should be required to be members of the Australian Financial Complaints Authority.

Recommendation 12: ASIC's new powers should have a broad remit, to ensure that codes of conduct in the alternative lending market can be captured. This should include the Australian Finance Industry Association's (AFIA) Online Small Business Lenders Code of Practice.

Recommendation 13: AFIA should make adjustments to the Online Small Business Lenders Code of Practice so as to be compliant with Regulatory Guide 183.

Recommendation 14: AFIA should submit the Online Small Business Lenders Code of Practice to ASIC for approval by 30 June 2021. When submitting to ASIC, AFIA should identify the provisions within the code that they wish to be prescribed as

'enforceable code provisions'.

Recommendation 15: ASIC should consider the need for a prescribed code in the event that industry-led regulation fails in the online small business lending sector.

Recommendation 15: Ongoing supervision and compliance monitoring of industry codes should be undertaken as a matter of course.

Recommendation 16: ASIC should be made responsible for ongoing and active supervision and compliance monitoring. It should assume full responsibility in the case of mandatory codes, and principal responsibility in relation to codes with enforceable provisions.

Recommendation 17: ASIC should review financial services industry codes under its remit no less than once every three years.

Recommendation 18: ASIC should be provided with powers to enforce compliance with financial services industry codes equivalent to those provided to the ACCC in Part IVB of the *Competition and Consumer Act 2010* (Cth).

Recommendation 19: The pecuniary penalties available to ASIC to enforce compliance with financial services industry codes should be equivalent to those provided by the *Treasury Laws Amendment (Strengthening Corporate and Financial Sector Penalties) Act 2019* (Cth).

Recommendation 20: ASIC should be provided with a disgorgement power to enforce compliance with financial services industry codes.

Recommendation 21: The provision of statutory remedies for breach of an industry code should not impact upon customers' rights in respect of the same misconduct (including contractual rights).

Recommendation 22: ASIC should pursue the imposition of penalties as its preferred and default approach to enforcing industry codes.

Recommendation 23: An individual litigant that has undertaken dispute resolution through AFCA should not be preventing from litigating - but should have to establish good cause for doing so before the court. Regulation should prescribe a non-exhaustive list of what constitutes 'good cause'.

Recommendation 24: A party that has undertaken dispute resolution through AFCA should not, for that reason, be restricted from participating in class action litigation.

Context

The relationship between a small business and their financial service provider is characterised by an imbalance of power.

The power imbalance between a small business and its financial service providers is similar to that faced by a consumer. As the Financial Services Royal Commission noted:

> *"Small businesses can be seen to resemble consumers in several ways. Like consumers, small businesses lack the bargaining power and resources of larger entities."* [2]

Likewise, the Ramsay review of the financial system's dispute resolution framework highlighted the many shared characteristics of small businesses and consumers in their dealings with financial services.

> *"Small businesses can possess characteristics which means they face many of the same issues as consumers in dealing with disputes and when seeking redress. This can include the owner's personal characteristics (language and cultural barriers), the nature of small business (lack of time and money) and the power imbalances they face against larger businesses."* [3]

In addition to these general considerations, there are discrete factors that contribute to small business vulnerability when dealing with financial service providers. In their 2016 report on the Impairment of Customer Loans, the Parliamentary Joint Committee on Corporations and Financial Services identified four factors that establish this dynamic:

1. Banks enjoy very broad discretion as to what constitutes acceptable conduct in their engagements with borrowers, both in initial lending and the management of loans in financial difficulty;
2. Complex, non-negotiable loan contracts, coupled with regulatory gaps, give banks the power to behave in ways that are unethical, unreasonable and lacking in transparency;
3. In many cases, borrowers in financial difficulty are unable to pursue their rights though the courts - because the process is either unaffordable, or they have lost control of their financial assets due to the appointment of receivers; and
4. There are significant gaps in the coverage of mediation and external dispute resolution schemes - leaving borrowers without the means to test their disputes.[4]

We contend that these factors can and should be addressed through enhanced regulation of financial services provided to small businesses.

It is crucial for small businesses that codes are suitably enforceable, and that standards are lifted in the financial services industry

Industry codes have been afforded a central position in regulating the relationships between small businesses and their financial services providers. This is particularly true of two of the most important small business relationships.

The Banking Code is the 'chief protection' available to small businesses when dealing with financial institutions.[5] The responsible lending provisions of the *National Consumer Credit Protection Act 2009* (Cth) do not apply to business lending.[6] Similarly, in relation to insurance, the General Insurance Code of Practice outlines the industry's major commitments to small business customers.

The cost to small businesses of breaches of industry codes by financial service providers is high. Banks and insurers are, in effect, the major financial backers of many of the more than 2.3 million small businesses trading in Australia.[7] They exert significant power over small businesses - often determining success or survival.

The Organisation for Economic Cooperation and Development (OECD) has found that for industry self-regulation to be successful where the risk to customers is high, it is particularly important that industry coverage and compliance is high.[8] In this context, the success of financial services industry codes is reliant upon high rates of compliance, and near-total coverage of the relevant sectors. This has not been the case in Australia to date.

Ensuring that codes can be relied upon, and will effectively hold their subscribers to account, is therefore crucial. The findings of the Royal Commission, and recommendations 1.15 and 1.16, certainly reflect the gravity of this issue. They also speak clearly to a need for reform, to address fundamental deficiencies in the current regime.[9]

Our submission

This submission makes recommendations to help reshape the regulatory framework governing industry codes. We have developed our positions with both an eye to the shortcomings of the current regime, and a desire to reflect the letter and the spirit of recommendations arising from the Royal Commission's exhaustive inquiries.

Our own recommendations would deliver a new and robust codes framework. It would greatly enhance the enforceability of codes, and compel ASIC to play a considerably stronger hand – while preserving that which has served both small business and the industry well.

The body of our submission, commencing below, is divided into three overarching sections:

1. **'*Improving outcomes for small businesses in their dealings with financial service providers*'**;
2. **'*Protecting those small businesses that look to alternatives*'**; and
3. **'*Particulars of the reformed industry codes regime*'**.

While these themes guide the content therein, each section also addresses questions posed by Treasury's consultation paper.

Part One: Improving outcomes for small businesses in their dealings with financial service providers.

Questions addressed in this section:

- *What are the benefits of subscribing to an approved industry code?*
- *What issues need to be considered for financial services industry codes to contain 'enforceable code provisions'?*
- *What criteria should ASIC consider when approving voluntary codes?*
- *Should the Government be able to prescribe a voluntary financial services industry code?*
- *When should the Government prescribe a mandatory financial services industry code?*

Approved industry codes confer upon their subscribers a perceived level of trustworthiness and reliability. Subscribers may derive competitive advantages from this perception.

In the view of the Australian Securities and Investment Commission (ASIC), where an industry seeks and receives approval of a code of conduct, a signal is sent to consumers that they can have confidence in that code.[10]

As noted by Treasury, only two financial services codes have received such approval: the Banking Code of Practice ('the Banking Code') and the Financial Planning Association's Professional Ongoing Fees Code ('the Ongoing Fees Code'). In addition, the Insurance Council of Australia intends to seek approval for the updated General Insurance Code of Practice ('the Insurance Code').[11]

Indeed, ASIC approval of codes is used by businesses and their industry associations to build and secure trust from their customers. Both the Financial Planning Association of Australia and the Australian Banking Association celebrated the 'first-ever' approval of a financial services industry code - in 2016[12] and 2018[13], respectively. Upon approval of the Banking Code, the Australian Banking Association (ABA) distributed a media release with the headline "*A new standard in Australian banking*".[14] Similarly, the Financial Planning Association highlighted that "*the approval is acknowledgment from the regulator on the rigour and robust nature of FPA's application*".[15]

Industry bodies attempt to maximise the public relations benefits of ASIC approval. They utilise approval to suggest not only that industry codes are reliable, but that the industry binds itself to high behavioural standards in general.

For customers, this may contribute to enhanced faith in their financial service providers. For ASIC, granting approval for a code leaves their reputation as a regulator intertwined with the success or failure of that instrument. Indeed, Insurance Council of Australia CEO Robert Whelan has referred to ASIC approval as a "*seal of approval*".[16]

There should be a cost to significant, repeated breaches of codes. To date, this has not been the case.

The Treasury has previously expressed concern that signatories to industry codes face no consequence for breaching the provisions they have agreed to abide by:

> *"...Another key failure of the current framework for codes is the absence of real consequences for systemic breaches...The result is that compliance with the code may be seen as optional or aspirational rather than the norm."* [17]

In our view, and plainly the Royal Commission's, codes represent promises to customers. For this reason, failure to uphold these promises should lead to consequences. This has not been the case to date.

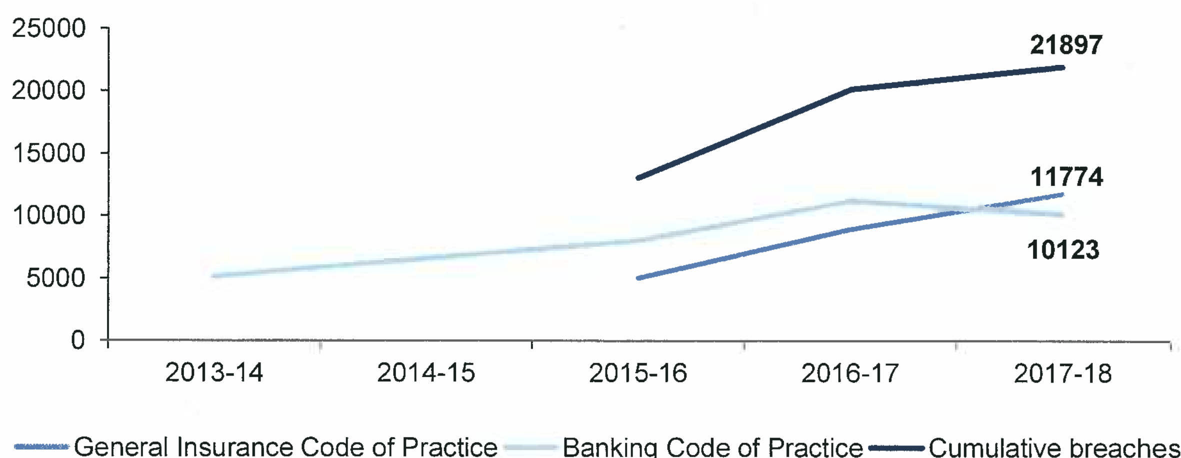
The evidence presented to the Royal Commission provided evidence of widespread breach of code provisions. In summarising the round of hearings into lending to small and medium sized enterprises, Senior Counsel Assisting the Commission, Mr Michael Hodge QC, outlined to the Commissioner it was open to him to find that ANZ, Westpac, Bank of Queensland, Suncorp, Bank of Melbourne and NAB had all breached the Banking Code, by either:

- Failing to exercise the care and skill of a diligent and prudent banker,
- Failing to act fairly and reasonably towards their customers; or
- Failing to promote an informed decision in relation to their banking services.

In addition, Mr Hodge suggested that the Commissioner was open to finding the Commonwealth Bank had contravened the *ASIC Act 2001* (Cth) and the *Corporations Act 2001* (Cth) ('the Corporations Act') in the course of their business lending operations.[18]

Collectively, from 2015-16 to 2017-18, there were over 55,000 breaches of these codes, with no sanctions applied against any subscribers. In 2017-18 alone, there were more than 21,000 breaches of the codes - more than 10,000 for the Banking Code and more than 11,000 for the Insurance Code. Since its creation, the Banking Code's Code Monitoring Compliance Committee has only ever named one bank as breaching the code in its annual report (the naming function being the only sanction available to them).[19] The General Insurance Code Compliance Committee has never used its powers to impose sanctions, despite 31,000 self-reported breaches of the code.[20]

Figure 1: Breaches of the Banking and General Insurance Codes[21]



The impact of breaches is high; **3.4 million people** were affected by confirmed breaches of the Banking Code in 2017-18, at a financial cost of more than **$95 million**.[22]

Whilst these breaches cover all manner of bank and insurance customer - not just small businesses - it is alarming that industry codes, as the chief protection for small businesses, are so readily contravened and disregarded by signatories.

During the hearings of the Royal Commission, and in other forums, it has been contended that sanctions have not been used as they have not been required. Rather, a 'remediation' approach has been adopted - whereby the code compliance committee notifies the subscriber of a breach, and the subscriber takes steps to remedy the issue. However, it is the OSBC's view that preventative steps need to be taken to ensure breaches do not occur in the first instance. Remediation, in and of itself, is not sufficient, if it not accompanied by improved practices in the future. Under the current codes regime, breaches have continued and practices have not improved.

In this context, while it is our view that the current criteria for ASIC approval of codes are broadly appropriate, we would implore the regulator to ensure that compliance monitoring and enforcement mechanisms are sufficient to ensure confidence that significant and repeated breaches will face sanction by the relevant code compliance committee. Deterrence plays a key role in ensuring against breaches of regulations. This needs to be considered by ASIC when choosing whether or not to approve codes.

To further strengthen this deterrence, we also support the Royal Commission's recommendation that any **provisions in codes that govern the terms of the contract** should be designated as enforceable.[23] For small businesses, it is particularly important that this occurs in relation to both the Banking Code of Practice and the General Insurance Code of Practice.

Once legislation is passed to give this effect, it is crucial that industry provides ASIC with a proposed subset of enforceable code provisions in a timely fashion. Given the urgent need for charge, ASIC should then act swiftly to negotiate, finalise and give these provisions force. In the event of a delay, other options should be considered by ASIC.

Recommendation 1: ASIC should prioritise the need for effective compliance monitoring and enforcement when considering the approval of codes.

Recommendation 2: ASIC should ensure that, in the event that significant and repeated breaches of code provisions occur, sanctions will be levied by the relevant code compliance committee. This should be a condition of the approval of codes.

Recommendation 3: ASIC should be provided with the legislative powers to prescribe 'enforceable code provisions' within codes of conduct.

Recommendation 4: In relation to both the Banking Code of Practice and the General Insurance Code of Practice, all provisions that govern the terms of the contract between service providers, and small businesses or individuals, should be designated 'enforceable code provisions'.

Recommendation 5: Both the Australian Banking Association (ABA), in relation to the Banking Code of Practice, and the Insurance Council of Australia (ICA), in relation to the General Insurance Code of Practice, should provide ASIC with a proposed subset of enforceable code provisions. The selected subset should reflect Recommendation 4.

Recommendation 6: Enforceable code provisions should be identified by the ABA and ICA, and submitted to ASIC, within six months of the passage of legislation establishing ASIC's new powers. ASIC should then ensure enforceable code provisions are given force by 30 June 2021.

The Government should have the power to prescribe voluntary and mandatory financial services industry codes.

In the OSBC's view, the Corporations Act should be amended to provide ASIC with powers to prescribe voluntary and mandatory financial services industry codes, equivalent to those currently held by ACCC in relation to industry codes under its jurisdiction. That is, primarily, ASIC should be provided with powers to:

- Prescribe an industry code, or specified provisions within an industry code;
- Declare an industry code mandatory or voluntary; and
- Set out the method by which a party agrees to be bound by the code, and how it would cease to be bound.

These powers reflect those set out in section 51AE of the *Competition and Consumer Act 2010* (Cth) ('the Competition and Consumer Act'). Amending the Corporations Act to grant ASIC these powers would reflect the findings and recommendations of the Royal Commission:

> *"... the law should be amended to provide for the establishment and imposition of mandatory financial services industry codes... Those provisions should be in a similar form to the provisions that exist in the Competition and Consumer Act, including section 51AE of that Act."* [24]

Whilst a higher degree of care is clearly required in deciding to prescribe a mandatory code, the OSBC does not see value in attempting to classify this requirement by statutory means.

It is also clear that industry's response to the Royal Commission's recommendations would contribute to the decision to proceed to prescribing a code. We note that the Australian Banking Association has refused to accept recommendation 1.8 of the Royal Commission, relating to expanding the definition of small business in the Banking Code.[25] The Insurance Council of Australia has also indicated that they do not support making the General Insurance Code contractually enforceable[26] - suggesting they may resist reforms to the same effect.

Recommendation 7: ASIC should be provided with the powers to prescribe and impose voluntary and mandatory codes for all parts of the financial services industry.

Recommendation 8: In the event that an industry sector resists partaking in an enforceable codes regime, ASIC should exercise its new powers to prescribe mandatory codes to improve industry standards.

In prescribing a financial services industry code, ASIC should have regard for the *Treasury Industry Codes of Conduct Policy Framework*.

It is the OSBC's view that the *Treasury Industry Codes of Conduct Policy Framework* (the framework) should provide the basis upon which ASIC assesses the need to prescribe a financial services code, whether voluntary or mandatory.

While the framework applies to all industry codes, the rationale for industry codes that it sets out strongly resonates with the experience of small businesses in dealing with the financial services industry. The framework sets out five decision-making criteria for prescribing industry codes:

1. Is there an identified problem in the industry?
2. Can the problem be addressed using existing laws or regulations?
3. Has industry self-regulation been attempted?
4. Is an industry code the most suitable mechanism for resolving the problem?
5. Is there likely to be a net public benefit?

For this reason, we do not see the need for a radical overhaul of the framework, or for an altogether separate document that addresses the financial services industry specifically. The OSBC broadly supports the use of the abovementioned criteria as fundamental regulatory questions that must be considered when deciding whether to prescribe a code. These criteria rely on similar principles to those set out by both the Australian[27] and NSW governments.[28]

Recommendation 9: The *Treasury Industry Codes of Conduct Policy Framework* should form the basis upon which ASIC assesses the need to prescribe a financial services industry code.

Part Two: Protecting those small businesses that look to alternatives

Question addressed in this section:

- *When should the Government prescribe a mandatory financial services industry code?*

Hundreds of small business lenders are outside the Banking Code of Practice's remit, and are unlicensed by either ASIC or APRA.

At present, the Banking Code provides incomplete coverage of the industry it intends to regulate. Nearly one hundred authorised deposit-taking institutions are not covered by Banking Code, because they are not members of the ABA. In addition, nearly 700 fintech businesses are not covered by any code. Of these, a majority are unregulated, as they only lend to businesses.[29] Whilst the major banks, as signatories to the Banking Code, provide over 80 per cent of small business lending[30], an increasing proportion of lending is being provided by the alternative lending market, with over $1.14 billion of funding in 2017 and rising.[31]

Prospa's prospectus, released in 2018 during their now-delayed initial public offering attempt, highlights the regulatory gap with many alternative lenders occupy:

- *"Despite not providing services that require an ACL, we have held an ACL since 13 January 2015 and regularly submit reports to ASIC. However, in the future we may choose to allow our current ACL to lapse.*
- *Based on current activities, we are not required to hold an AFSL.*
- *Based on current activities, we are not required to prepare any formal prospectus, product disclosure statement or financial services guide in connection with our ordinary business."* [32]

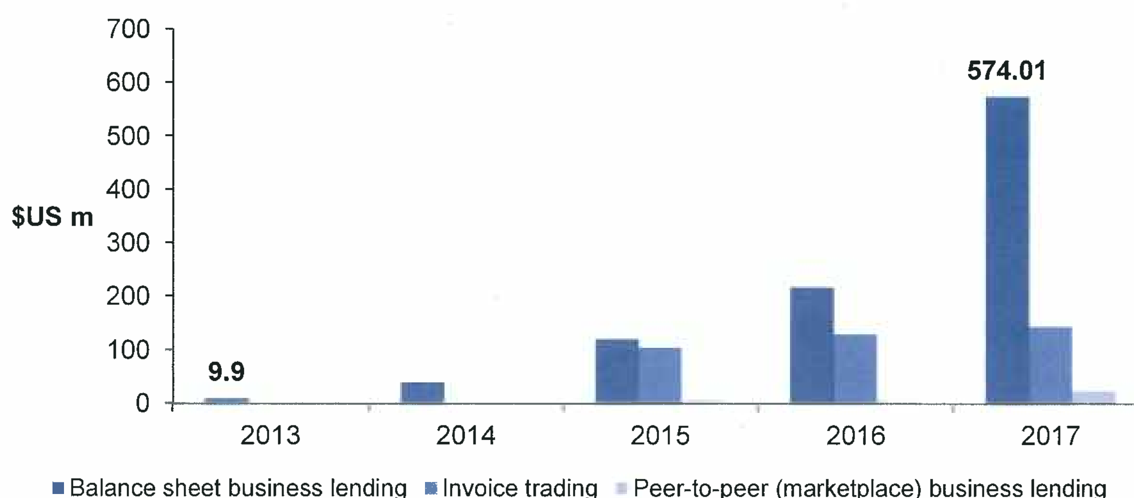
Moreover, unregulated lenders are not required to be members of the Australian Financial Complaints Authority (AFCA). This means that in the event of misconduct, small businesses seeking redress must rely on the courts – a costly and lengthy process which many cannot pursue.[33]

Small businesses are turning to alternative lenders, meaning an increasing proportion of small business lending comes without legislative or code protections.

As the fallout from the Royal Commission continues, small businesses are increasingly looking to alternative sources of credit. In the presence of this demand, supply has materialised in the form of a larger alternative lending sector. The sector had already experienced remarkable growth over recent years. In 2017, the market was valued at nearly AUD$1.6 billion[34]. This makes Australia the second largest alternative finance market in the Asia Pacific, behind only China.[35]

Balance sheet business lending in particular grew spectacularly from 2013 to 2017, climbing, from US$10 million to US$574 million. This represents a near 60 fold increase over just 5 years.

Figure 2: Business alternative financing in Australia – total market volume[36]



A key driver of this growth is the fact that traditional lenders require collateral when issuing debt. The Reserve Bank of Australia has found at least three-quarters of small business lending offered by traditional lenders is collateralised. They outline several reasons that small business operators may find requirement difficult, including:

- An entrepreneur may not own a home, or hold much equity in their home;
- If they have already borrowed to purchase their home, the entrepreneur may not have enough equity to borrow against; and
- Even if they do have sufficient equity, using their home as collateral concentrates the risk faced by the entrepreneur.[37]

The Council of Financial Regulators considers this inability to provide collateral a growing concern. In March 2019, it highlighted that as house prices fall, borrowing by small businesses is likely to fall with it, as business capacity to provide collateral is even further diminished.[38]

By contrast, alternative lenders offer many unsecured products, meaning businesses do not face the same constraints when trying to access credit. In September 2018, Scottish Pacific's *SME Growth Index* found the key reasons a small business would seek finance from an alternative lender are:

- The short time from application to approval (24 per cent of survey respondents)
- The regulatory and compliance requirements (19 per cent)
- To avoid using property as security (19 per cent)
- To avoid using non-property assets as security, such as personal guarantees (17 per cent).[39]

In addition, alternative lenders, relying on innovative business models and technologies, are able to provide financing quickly, with limited documentation and often without security. These features are attractive to many small businesses.

In this context, the alternative finance sector is expected to continue to flourish. The CEO of OnDeck Global, a major online small business lender, has claimed that recent growth trends indicate the Australia small business lending market could

reach over $2 billion in annual originations by 2020.[40] Craig Blair, board member of Prospa (Australia's largest balance sheet business lender) has stated that the online lending market could grow to be worth at least $20 billion by 2021.[41] Perhaps most strikingly, East & Partners have predicted that, by late 2020, alternative lenders could fund the majority of new SME growth.[42]

As alternative financing continues to grow, the importance of ensuring the industry meets community expectations and is acting in the interests of its customers –most prominently, small businesses – grows with it. Already a billion dollar industry and growing, the OSBC sees a pressing need for a regulatory scheme that covers all small business lenders.

This gap in the regulatory framework means that an increasing number of small business borrowers are entering into contracts with financial service providers that are not committed to any minimum standards of service such as fair and reasonable behaviour.

In the absence of regulation, the standards of alternative lenders vary greatly.

The Australian online small business lending market's expansion has not been free of controversy.

In one case it was reported that Barclay Finance[43] provided a tradesman with a loan of $6000 for the purchase of a new business - despite the borrower having already defaulted on a $9000 loan and experiencing substance abuse problems.[44] In another case, Barclay Finance reportedly provided a $60,000 business loan to an intellectually disabled man with $28 in his bank account that was living on welfare payments.[45]

Financial Counselling Australia has recently reported increased incidences of predatory lending to small businesses.[46] In consultations with Financial Rights Legal Centre and Consumer Action Law Centre, the OSBC has been told of small businesses seeking assistance for financial hardship arising out of credit contracts with alternative lenders.

Lenders themselves have also reported poor practices. The CEO of marketplace lender Marketlend has reported that his firm had observed that SMEs customers have their cash flow drained by frequent direct debits which they cannot afford, after having an unsuitable product recommended to them by accountants or other financial advisors. He has also highlighted the practice of 'stacking', whereby lenders issue loans to businesses that have already taken out multiple loans with other lenders.[47] This practice is often associated with the payday lending sector. It is only possible because no legislative requirement exists for the lender to assess the capacity of the borrower to repay the loan.

Even larger players have recently been questioned by ASIC. After Prospa was forced to remove several unfair terms from their small business contracts, delaying its IPO,[48] the alternative lending industry was asked to review its loan terms.[49]

Predatory practices are particularly problematic for sole traders that retain unlimited liability in their business. In this situation, personal and professional finances are often inextricably linked. The absence of any separation leaves sole traders open to a concentrated level of risk. Sole traders account for a significant proportion of the business community, representing more than a quarter of all private organisations in

Australia.[50] To deal with cash flow problems, many business owners turn to personal finances, often in the form of expensive credit card debt. Scottish Pacific has found that credit cards are the preferred method of managing cash flow issues for two thirds of SMEs.[51] In the event credit card funds are exhausted, some desperate small businesses may turn to online SME lenders at inappropriate times.

Alternative lenders in the market offer markedly different products, with varying levels of transparency. In our review of online business lenders, we identified one lender, ALC Commerical, which advertises twelve lending products and a "*97 per cent approval rate*". No pricing information is available on the lender's landing page. Its products include:

- "*No Credit Check Loans*"
- "*Low Doc Business Loans*"
- "*Bad Credit Business Loans*"
- "*Tax Debt Relief*" [52]

By comparison, larger operators often offer a single product and provide a loan calculator on their landing page. National Australia Bank's Quickbiz landing page identifies the fixed annual interest rate, specifies that no other fees will be levied, and outlines the credit amounts on offer.[53]

This variation impacts small businesses in their attempts to select a lending product. Different firms provide guidance on price using different formulas. This has an impact in a market where annual percentage rates of interest vary from 14 to 80 per cent.[54] The most widely accepted, transparent pricing method is the annual percentage rate (APRs) that accounts for all interest, fees and charges. This provides an annual rate that can be used to compare across products. However, not all market participants employ this method. Some use a factor rate, which equates to the total cost of the loan divided by the initial loan amount, and others provide an interest rate per week, month or quarter (i.e. 5 per cent interest per month). These various methods reduce transparency and the ability of small businesses to effectively select the best value product.

Increasing the transparency of this market will facilitate better decisions by small business customers. Setting basic standards for transparency in pricing will drive further competition among lenders.

The industry has tried to introduce minimum standards to ensure their reputation as a lender.

The online SME lending market has repeatedly asked for more regulation, in the hope that this may mitigate the significant business risk that poor lending practices associated with a minority of lenders represents.

- *"The solution is regulation. Regulation, if done right, can ensure emerging industries continue to flourish while protecting the interests of consumers and small business owners. We're in the business to help an underserved, yet deserving group of Australian small businesses that need a helping hand to achieve their goals. We aren't and will never be a last resort lender."* Keeley Reynolds, Head of Communications, Spotcap Australia.[55]

- *"On our side of the fence we have a flood of new entrants – where's the regulation, where's the tried and tested credit model?"* John de Bree, Managing Director, Capify.[56]

- *"Small businesses, which employ half of the nation's workforce and make one fifth of its domestic product, remain vulnerable to the loan shark practices of fintech bad guys."* Leo Tyndall, CEO, Marketlend.[57]

- *"ASIC are not being armed with the legislation ... the struggle they have is they don't have the tools."* Leo Tyndall, CEO, Marketlend.[58]

Many lenders have built their businesses in a way that anticipates future regulation. Moula and Kikka Capital have both publicly stated that they see regulation as inevitable, and that their current practices will ensure it does not come at a major cost to their businesses.[59]

In lieu of government-led regulation, the industry has developed the Code of Lending Practice for Online Small Business Lenders. This instrument sets out a series of best practice principles to standardise unsecured small business lending. The Code was developed by the Australian Finance Industry Association, in collaboration with the Australian Small Business and Family Enterprise Ombudsman, SME advocate theBankDoctor.org, industry association FinTech Australia, and six online business lenders (Capify, GetCapital, Moula, OnDeck, Prospa and Spotcap). Since its release, Lumi has also signed on to the Code.

In releasing the Code, the six CEOs of the founding signatories to the Code commented:

> *"We're proud to be working together to take proactive steps to bring transparency to the market, and ensure we're doing what's best for Australian small business owners."* [60]

The Code mandates that all signatories adhere to several new measures, over and above the requirements imposed on them by legislation. Signatories to the Code are expected to report on their compliance with the Code on an annual basis. The Australian Finance Industry Association (AFIA) is appointing a Code Compliance Committee to govern, monitor and enforce the Code.

Moody's Investors Service has praised the Code, stating:

> *"Greater transparency around the cost of loans and the improved governance resulting from an industry code of conduct will enhance the sustainability of the sector."*[61]

The OSBC sees the Code as a good first step – but no more than a first step - towards setting a minimum standard for online SME lenders. Allowing borrowers to easily compare products on the market will ensure the market operates efficiently, and competition drives further innovation and reductions in price. These outcomes are beginning to be observed; Prospa's annual percentage rate of interest has fallen from 59 per cent in June 2016 to 37 per cent in June 2017.[62]

The Code's release has prompted criticism from some stakeholders, and it does not cover all types of loan products or lenders.

Many lenders remain outside the remit of Code of Lending Practice for Online Small Business Lenders – including notable lenders Kikka Capital, Merchant Cash and 365 Capital. Leo Tyndall has openly questioned the code's efficacy, stating:

> *"It's not clear whether the code can be enforced or is merely a set of guidelines. In other words, we're not signing up because it is not a legitimate attempt to enable responsible lending."* [63]

The Code was only developed with balance sheet lenders; marketplace lenders were not consulted. In addition, it currently only covers unsecured loans to small businesses.[64] This limits the scope of the Code, and reduces its capacity to act as a 'one-stop' guide for SMEs to refer to when dealing with online SME lenders.

The OSBC also has concerns with the make-up of the Code Compliance Committee. The Banking Code of Practice provides that the three members of its compliance committee are jointly selected by the Australian Banking Association (ABA) and the Australian Financial Complaints Authority (AFCA);

- An independent chair is appointed jointly by the ABA and AFCA
- A consumer representative member is appointed by consumer representatives on the Board of AFCA
- A banking representative member is appointed by the ABA.[65]

This model ensures that the independence of the committee is unquestionable.

In our view, the Online Small Business Lenders Code should provide a similar selection process for members – one that provides for a small business advocate. AFCA or the Australian Small Business and Family Enterprise Ombudsman could serve as the party involved in this selection process. Adopting this approach would will ensure that investigations of breaches, and their outcomes, can be seen as truly independent.

ASIC should monitor the development of this industry closely, and understand the particularities of the market that may make industry-led regulation challenging.

While the AFIA Online Small Business Lenders Code of Lending Practice is a positive step toward an acceptable minimum standard, self-regulation may prove difficult in the alternative lending sector.

The OECD has identified several factors that contribute to the success of industry self-regulation:

1. Industry self-interest: Businesses are more likely to support self-regulation where there are clear benefits;
2. Alignment of industry, government and consumer interests: Shared goals can boost industry "buy-in";
3. Number of market players: A relatively small number of players can facilitate management of self-regulation agreements;
4. Market coverage: The higher the level of participation in an self-regulatory instrument, the greater the likely impact;

5. Homogeneity of products: Product similarity can simplify the application of self-regulation;
6. Nature and magnitude of consumer detriment: The more serious the potential detriment, the more critical the need for high industry coverage and compliance; and
7. Competition. Self-regulation should not result in barriers to entry or facilitate market-distorting collusion.[66]

These factors suggest that self-regulation will be difficult for the online small business lending sector in Australia. Opaque pricing practices have benefited a number of lenders. In a market where financially inexperienced borrowers are unable to identify the best product in the market, lenders charging higher interest rates are able to grow their businesses faster - as they are able to spend more on advertising, pay higher brokerage and commissions, offer wholesale investors and lenders better returns and take on riskier loans.[67] This suggests that for some industry participants, their self-interest does not lay with any form of regulation that improves transparency. For these reasons, it is also difficult to say that customer and industry interests are aligned.

Moreover, the alternative lending market is a nascent industry. It is also very diffuse, with many market participants. As previously stated, there are nearly 700 fintech businesses not covered by any code with a majority unregulated as they only lend to businesses. Similarly, the online lending market offers vastly different products. This diversity reflects the state of the market. With such a large number of market players and products, developing an industry-led, unified, minimum service standard will be difficult. Indeed, an industry participant has previously described efforts to bring market players together to discuss self-regulation efforts as "*like herding cats*".[68]

AFIA should work to expand the Code as soon as practicable.

It is in the interests of responsible lenders in the alternative lending sector and small businesses that a minimum service standard is set and required as soon as possible. If this is not achieved, the cost will not only be borne by small business customers, but by the industry itself.

If the industry was considered 'the payday lenders of business lending', this would threaten its longevity. As the Royal Commission has highlighted, reputational damage can have major consequences for financial service providers' bottom lines. The Commission has shown that the transaction cost of a delayed response to poor industry practices will be significant.

Therefore, a 'wait and see' approach from the industry would not constitute an effective response. AFIA must work to expand the Code as soon as practicable. The Code should cover unsecured and secured product lines. Marketplace lenders should also be covered, as well as invoice traders. As the OECD has highlighted, the success of Code is affected by coverage of market participants, and their compliance with it.[69]

Once expanded, it is important that the Code provides for, at a minimum, the following:

- Minimum standards of conduct when lending;
- Standards in pricing practices;

- Minimum standards of disclosure to borrowers; and
- Access to internal and AFCA dispute resolution processes.

In our view, signatories to the Code should also be required to be members of AFCA.

Recommendation 10: AFIA should immediately work to expand the Online Small Business Lenders Code of Practice to new product types and business models.

Recommendation 11: Signatories to the Online Small Business Lenders Code of Practice Code should be required to be members of the Australian Financial Complaints Authority.

The Code must be enforceable, as it is in the only legal protection available to small businesses dealing with alternative lenders.

To ensure the promises of the Code are honoured, online small business lenders must engage with the enforceable codes regime. ASIC's remit to approve codes, and enforceable code provisions within them, must be broad, so as to cover alternative business lenders. We note that Regulatory Guide 183 already provides that ASIC may consider approving codes outside their regulatory responsibility.[70]

Once this legislative change is made, AFIA should make the necessary adjustments to the Code, so as to be compliant with Regulatory Guide 183. AFIA should then seek approval from ASIC, and identify provisions within the Code that they see as representing 'enforceable code provisions'. This should be completed to the same timeline as the Australian Banking Association and the Insurance Council of Australia – by 30 July 2021.

In the event that the online small business lending market is unable to effectively lead regulation of the industry, ASIC should utilise its other, new powers to ensure a minimum standard of service.

Proactive regulation will ensure the continued growth and longevity of the industry, and that trust will be maintained — a critical feature of successful financial service businesses. Delay may lead to further scandals and the need for future Royal Commissions into financial services. Alternative lending to business is already a billion dollar industry in Australia.

For small businesses, this would allow them to access credit from all small business lenders with confidence - armed with the knowledge that they are dealing with a reputable sector that accounts for the interests of customers when making lending decisions.

For responsible market participants, and those that have designed a business with a customer focus, new compliance costs associated with compliance with additional regulation should be limited. In addition, regulators will be well positioned to take action against unscrupulous operators - levelling the playing field and increasing standards. This will ensure the longevity of the industry, and guard against scandals and the reputational damage such incidents would cause to the broader sector.

Recommendation 12: ASIC's new powers should have a broad remit, to ensure that codes of conduct in the alternative lending market can be captured. This should include the Australian Finance Industry Association's (AFIA) Online Small Business Lenders Code of Practice.

Recommendation 13: AFIA should make adjustments to the Online Small Business Lenders Code of Practice so as to be compliant with Regulatory Guide 183.

Recommendation 14: AFIA should submit the Online Small Business Lenders Code of Practice to ASIC for approval by 30 June 2021. When submitting to ASIC, AFIA should identify the provisions within the code that they wish to be prescribed as 'enforceable code provisions'.

Recommendation 15: ASIC should consider the need for a prescribed code in the event that industry-led regulation fails in the online small business lending sector.

Part Three: Particulars of the reformed industry codes regime

Questions that are addressed in this section:

- *What level of supervision and compliance monitoring for codes should there be?*
- *Should code provisions be monitored to ensure they remain relevant, adequate and appropriate – and what entity should be responsible?*
- *Should there be regular reviews of codes? How often should these reviews be conducted?*
- *Should ASIC have similar enforcement powers to the ACCC in Part IVB of the Competition and Consumer Act in relation to financial services industry codes?*
- *Are there other remedies that should be available in relation to breaches of enforceable code provisions in financial service codes?*
- *How should the available statutory remedies for an enforceable code provision interact with consumers' contractual rights?*
- *Should only egregious, ongoing or systemic breaches of the enforceable provisions of an industry code attract a civil penalty?*
- *What issues may arise if consumers are not able to pursue matters through a court following a determination from the Australian Financial Complaints Authority?*

'What level of supervision and compliance monitoring for codes should there be? Should code provisions be monitored to ensure they remain relevant, adequate and appropriate – and what entity should be responsible?'

In our submission, it is important that any authority tasked with administration of a regulatory instrument engages in active monitoring and evaluation of its impact on those whose behaviour it is intended to guide. Such efforts are nothing short of necessary to ensure regulation remains fit to serve its policy objectives. This work should therefore represent an ordinary part of the policy process, wherever regulation is imposed.

The recent review of the NSW Government regulatory policy framework, led by former Premier Nick Greiner AC, reflected precisely this view:

> *"Effective monitoring and evaluation of regulation helps to ensure that the desired policy outcomes are being achieved and enables agencies to identify and manage any unintended outcomes…*[they] *also provide an opportunity to consider the continued relevance of the objectives of regulation and whether regulation is needed."* [71]

Accordingly, the review recommended that all agencies actively monitor regulation for which they are responsible, including by publishing reports on these efforts every year.[72] Equally, the Commonwealth Government's own guide to regulation assumes that regulators will engage in ongoing and active monitoring as a matter of course.[73]

In relation to the issue of which body should carry out this work, we note that our submission proposes two approaches to enhancing the enforceability of industry codes to adequately protect small business:

- Introduce enhanced enforceability to the current co-regulatory approach, by making most code provisions enforceable and providing the regulator with enforcement powers; or, in the alternative;
- Introduce mandatory codes.

Both models would require principal responsibility for monitoring and overseeing industry codes to fall to ASIC as regulator, rather than to any industry body.

It follows that ASIC should be charged with principal responsibility for monitoring code provisions.

As mandatory codes, by definition, require a government regulator to assume full responsibility, it is difficult to envisage any continued relevance for code compliance committees in those cases.

However, codes with enforceable provisions constitute something akin to a 'co-regulatory' model. In these cases, compliance committees, where they are in place, will continue to play a role. In order to exercise the enforcement powers afforded to it in relation to these codes, ASIC would need to engage in supervision and monitoring. Given the efficacy of codes with enforceable provisions would hinge on the exercise (or potential exercise) of enforcement powers, ASIC's efforts would constitute the most important compliance and enforcement activities undertaken in relation to these codes. Nonetheless, other monitoring and compliance activities – for example, surveying and reporting[74] – would remain as residual responsibilities of the compliance committees.

ASIC could also liaise with industry-led code compliance committees, in monitoring and enforcing codes with enforceable provisions, so as to leverage intelligence these bodies may be able to provide.

Recommendation 15: Ongoing supervision and compliance monitoring of industry codes should be undertaken as a matter of course.

Recommendation 16: ASIC should be made responsible for ongoing and active supervision and compliance monitoring. It should assume full responsibility in the case of mandatory codes, and principal responsibility in relation to codes with enforceable provisions.

'Should there be regular reviews of codes? How often should these reviews be conducted?'

In line with our position on general regulatory monitoring and evaluation activities, we suggest that proper oversight and administration of any regulation should compel the regulator to conduct periodic reviews.

This perspective is strongly reflected in the Greiner review, which recommended that government review all regulation on a rolling basis, with the precise frequency of reviews depending on priority.[75] Likewise, one of the Commonwealth's guiding regulatory principles is that all regulation must be periodically reviewed to test continuing relevance and performance against policy objectives.[76] The NSW

Government's own equivalent, the *Better Regulation Principles*, take the same position.[77]

In relation to financial services codes specifically, we suggest that regular reviews across the industry are particularly appropriate for a number of reasons. Primarily, as this submission has explored, the Financial Services Royal Commission has uncovered unlawful and unacceptable practice across the length and breadth of the industry. In relation to industry codes, enhanced oversight, enforceability and monitoring are not just appropriate but plainly necessary; this perspective is certainly reflected in recommendations 1.15 and 1.16.[78] To satisfy these requirements, reviews should be undertaken on a regular basis. This would provide the regulator with sufficient powers to achieve these necessary objectives.

In the short term, Commissioner Hayne's 76 recommendations, if and when implemented by government, would also deliver a substantially altered regulatory landscape for the financial services industry as a whole. Reforms of this magnitude will likely warrant prompt review of industry codes, to assess the extent to which they have affected their function and role.

This submission has also touched on the technological disruption affecting small business credit – manifested most prominently in the increasing prominence of fintech lenders.[79] The insurance industry is experiencing similar, technology-driven upheaval.[80] With technology affecting business models across the financial services industry, an increased need for regular review of its governing regulation arises. This is particularly true of industry codes specifically – given they prescribe behaviours in a much more comprehensive and granular manner than legislation applying across the wider economy.

We suggest that reviews every three years would satisfy the need for regular reviews, and allow industry stakeholders time to adjust to any changes arising before a subsequent review. This timeframe could be adopted as standard, with more frequent reviews undertaken if and when circumstances compel more immediate action.

Recommendation 17: ASIC should review financial services industry codes under its remit no less than once every three years.

'Should ASIC have similar enforcement powers to the ACCC in Part IVB of the Competition and Consumer Act in relation to financial services industry codes?'

The OSBC is of the view that the enforcement powers afforded in Part IVB of the *Competition and Consumer Act* would be mostly appropriate for ASIC's regulation of financial services industry codes. The enforcement powers provided there are diverse, allowing the regulator to take action that is proportionate and targeted to the nature and gravity of an offence.

However, while these powers would be broadly satisfactory in form, Treasury should not adapt the relevant provisions without adjustment for the particularities of the financial services industry. Of most particular concern are the pecuniary penalties

afforded to the regulator under the *Competition and Consumer Act*. That legislation provides that the maximum penalty that may be incurred for breach of an industry code is 300 penalty units[81] - currently $63,000.[82] The ACCC has stated that these penalties are insufficient to allow it to effectively enforce industry codes under its jurisdiction, and that operators in industries regulated by codes under its remit simply factor in breach penalties as a cost of doing business.[83] Both the Commission[84] and the OSBC[85] have called for maximum penalties for contravention of these codes to be increased substantially. The report to the recent Parliamentary Inquiry into franchising also recommended reform to this effect.[86]

If a regime allowing for no more than nominal penalties is insufficient to support effective enforcement under codes prescribed or mandated by the *Competition and Consumer Act*,[87] it is wholly inappropriate for the financial services industry. The sector is the largest contributor to the Australian economy,[88] and includes almost 20 per cent of the largest public companies in Australia.[89] Indeed, the Financial Services Royal Commission and the ASIC Enforcement Review Taskforce have advocated for penalties considerably higher than those available under the *Competition and Consumer Act* to be provided for regulation of financial services businesses.[90]

The penalties available to ASIC to seek for contravention of financial services industry codes should reflect those available to the corporate regulator more broadly. In this respect, the OSBC notes and applauds the strong position the Commonwealth has taken in relation to this issue, through the *Treasury Laws Amendment (Strengthening Corporate and Financial Sector Penalties) Act 2019* (Cth). This instrument allows ASIC to seek penalties of up to 2.5 million penalty units ($525 million), or 10 percent of annual turnover, against corporations that have contravened prescribed civil penalty provisions.[91] These provisions include regulation applying to financial services businesses specifically.[92] It is appropriate that ASIC be given the equivalent in relation to financial services codes.

Recommendation 18: ASIC should be provided with powers to enforce compliance with financial services industry codes equivalent to those provided to the ACCC in Part IVB of the *Competition and Consumer Act 2010* (Cth).

Recommendation 19: The pecuniary penalties available to ASIC to enforce compliance with financial services industry codes should be equivalent to those provided by the *Treasury Laws Amendment (Strengthening Corporate and Financial Sector Penalties) Act 2019* (Cth).

'Are there other remedies that should be available in relation to breaches of enforceable code provisions in financial service codes?'

The OSBC is strongly supportive of reform to provide ASIC with enforcement powers equivalent to that afforded to the ACCC in Part IVB of the *Competition and Consumer Act*.

However, in relation to the support that Part IVB provides to the regulator to pursue enforcement action, we note one limitation. Section 82 of the Act establishes a right to pursue damages for losing arising from breach of the code on a strictly contractual basis.[93] That is, only the party suffering the loss may pursue damages.

Plainly, this precludes the same or similar action on the part of the regulator. However, it is well-established that the majority of small businesses are too poorly resourced to pursue such actions on their own behalf.[94]

For this reason, it is appropriate that remedies available for breach of financial services industry codes include a power for a court to order disgorgement. Disgorgement allows a regulator to seek an order that a party that has breached a regulatory provision must pay the regulator monies equivalent to the benefits arising from its wrongdoing. The power thereby allows a regulator to take direct action to negate the benefits of a party's misconduct, in a manner roughly equivalent to contractual damages.[95] This would be of particular utility in the common instance where a small business was unable to pursue damages.

Disgorgement powers are already widely available financial services regulation. Through the *Treasury Laws Amendment (Strengthening Corporate and Financial Sector Penalties) Act 2019*, the Commonwealth also provided ASIC with disgorgement power in relation to action taken by a corporation that contravenes prescribed civil penalty provisions relating to financial services businesses.[96] Moreover, disgorgement is a common enforcement mechanism for financial services regulators internationally. It is available to authorities in the United Kingdom, United States, Canada, and Hong Kong.[97]

Recommendation 20: ASIC should be provided with a disgorgement power to enforce compliance with financial services industry codes.

'How should the available statutory remedies for an enforceable code provision interact with consumers' contractual rights?'

In the OSBC's view, there need not be any 'interaction' between prescribed statutory remedies for breach of an enforceable financial services industry code provision, and contractual rights. This is so, at least, to the extent that such interaction might limit the capacity of either ASIC or a small business to pursue action against a financial services business for breach of a provision.

Given small businesses' limited time and resources,[98] and the scope of the misconduct uncovered by the Royal Commission, it is both appropriate and practically necessary for most action taken for breaches of codes to fall to the regulator. Further, most enforcement powers equivalent to those in Part IVB of the *Competition and Consumer Act*, as well as the disgorgement power, would, by design, be utilised mostly or exclusively by the regulator.[99]

We also acknowledge the particular difficulty that customers have had in seeking enforcement of provisions of financial industry codes as contractual terms.[100]

However, it is entirely unclear why any of these considerations should restrict the capacity of small businesses (or individuals) to take action on their own behalf - including by contractual means - should they elect to do so. We suggest that regulatory enforcement and private action, undertaken against the same act of misconduct, would typically be undertaken for distinct reasons. That is, the regulator seeks to penalise misconduct as an offence against the relevant industry and, by

extension, the community - as well as to discourage similar behaviour on the part of others. But a small business taking private action seeks redress for the negative consequences the misconduct has wrought upon it particularly. Both actions are equally appropriate, though with reference to separate objectives. That one has occurred should not inhibit pursuit of the other.

We note further that the findings of the Financial Services Royal Commission, relating to Recommendations 1.15 and 1.16, support the retention of options for customers aggrieved by breach of an industry code:

> "...*If financial services entities breach an enforceable code provision, customers and guarantors should be able to elect whether to enforce that breach through existing internal or external dispute mechanisms, or through the courts.*" [101]

Any restriction on the rights of small businesses or individuals to pursue contractual rights would thus represent a needless limitation imposed on those whose interests financial industry codes are intended to protect.

Recommendation 21: The provision of statutory remedies for breach of an industry code should not impact upon customers' rights in respect of the same misconduct (including contractual rights).

'Should only egregious, ongoing or systemic breaches of the enforceable provisions of an industry code attract a civil penalty?'

A prominent and recurring feature of the report to the Financial Services Royal Commission was the critique of the culture of regulatory disinclination to utilise penalty provisions.[102] Commissioner Hayne determined that even large penalties will not serve as an effective deterrent unless "*there is greater willingness to seek their application*".[103] The Commissioner further advocated that ASIC abandon its preference for resolving issues of misconduct by other means:

> "*When contravening conduct comes to* [ASIC's] *attention, the regulator must always ask whether it can make a case that there has been a breach and, if it can, then ask why it would not be in the public interest to bring proceedings to penalise the breach...Penalties are prescribed for failure to obey the law because society expects and requires obedience to the law.*" [104]

We note that the consultation paper provides no explanation for its suggestion that penalties might only be applied to financial services providers for 'egregious or systemic' breaches of a code. We presume it to stem from a passage in the Treasury's *Industry Codes of Conduct Policy Framework,*[105] given that document employs the same phrase in discussion of the same issue. However, the framework only suggests this position as an example of a position that an unspecified regulator of an unspecified industry might take. It also makes the comment in the context of stating that penalties *"should be considered in necessary and appropriate circumstances*".[106] The policy framework's comment is therefore of no appreciable value in relation to this matter.

As regards financial services regulation specifically, the weight of a Royal Commission suggests a more proactive and less restricted approach to the imposition of penalties is both necessary and entirely appropriate. The OSBC strongly supports adoption of the approach to the imposition of penalties recommended by the Commission. That is, far from being reserved for egregious or systemic misconduct, the regulator should consider pursuing penalties as its default approach to code enforcement.

Recommendation 22: ASIC should pursue the imposition of penalties as its preferred and default approach to enforcing industry codes.

'What issues may arise if consumers are not able to pursue matters through a court following a determination from the Australian Financial Complaints Authority?'

A wide variety of issues affecting individuals, small businesses, and financial services customers generally, are highly likely to arise if customers are restricted from pursuing a matter through court following determination of the same by the Australian Financial Complaints Authority (AFCA).

Small businesses state that the cost and time required to resolve legal disputes is a major concern.[107] But dispute resolution through AFCA's processes (and formerly those of the Financial Ombudsman Service) is, on average, much cheaper and more efficient than the alternative of litigation.[108] The scheme has therefore improved access to justice in relation to financial services industry codes.[109] Therefore, the fact that AFCA represents the first and final avenue for customer redress in most instances[110] is undeniably a positive outcome.

However, its considerable successes notwithstanding, AFCA's scheme should not be considered so effective, or so adaptable, as to restrict the option of redress through the courts. The AFCA scheme has limitations,[111] as do all alternative dispute resolution (ADR) mechanisms; for a wide variety of reasons, litigation remains preferable to ADR in a minority of instances.

As regards an affected customer's pursuit of a grievance under a financial industry code, a number of factors should be considered.

Most pertinently, it appears more than open to question whether AFCA representatives tasked with arriving at a determination will always be capable of exercising the same level of reasoning and expertise as their counterparts in the judiciary. Given the opaque quality of AFCA dispute resolution proceedings, it is not possible to resolve conclusively that customers will not be disadvantaged in this respect.

Further to this end, an aggrieved customer that has received an unfavourable outcome through AFCA may not have received – or may not perceive that it has received - an unbiased determination. The Financial Ombudsman Service ADR scheme has been the subject of concerns regarding the scope of its investigations, as well as a perceived predisposition to industry.[112] Given the financial services industry's dominant hand in the formation and funding of AFCA,[113] we suggest this is

unsurprising. The United Kingdom's equivalent service has faced the same issue of apprehended bias.[114]

In addition to individual redress, a number of issues would arise if a party that has brought a matter to resolution through AFCA's dispute resolution processes were prevented from participating in class action regarding the same issue.

While AFCA may offer investigation and referral services in relation to systemic issues,[115] its dispute resolution functions do not extend to collective complaints.[116] Commissioner Hayne explicitly acknowledged the shortcomings of the Financial Ombudsman Service in this regard.[117] We acknowledge that ASIC does possess powers to extract '*class-type settlements*'.[118] But any such action is taken at the regulator's discretion, primarily to protect the public interest. It is therefore recognised that these powers need to be complemented, including by way of a collective dispute resolution framework.[119]

At present, class action litigation is the most valuable and most direct means of dealing with collective complaints relating to financial services industry. Precisely this view was expressed by the Commonwealth Treasury, long before the Financial Services Royal Commission.[120] It is perhaps unsurprising that financial services are identified as the sector most likely to experience class action litigation in Australia[121] (though the total number of matters is dwarfed by those handled by the Financial Ombudsman Service[122]).

Ensuring unfettered access to class action litigation also confers a number of important social benefits – most particularly, enhanced transparency and scrutiny at both a public and jurisprudential level. Decisions arising out of class action constitute binding judicial precedent. This is particularly useful to small businesses and other consumers; decisions may be relied upon by parties that are affected by the issues subject to litigation, though not part of the class of litigants.[123] Such precedent can also influence the development of more widely applicable legal norms[124] - benefitting financial services customers throughout the economy. In sharp contrast, there are diverse views on whether decisions made by the Financial Ombudsman Service are even persuasive in contemplation of similar matters.[125]

Moreover, class actions typically attract considerable public scrutiny. This can greatly assist to raise awareness of an issue among affected parties,[126] as well as serve as a deterrent against similar behaviour for businesses not directly affected by litigation.[127] Because ADR is almost always undertaken in private, the same level of scrutiny is not possible.[128]

Finally, when members of an affected group who are not active litigants are accounted for, it is suggested that class action litigation may be the most efficient means of collective dispute resolution.[129]

'In what circumstances should the result of an AFCA EDR process preclude further court proceedings? To what matters should courts give consideration in determining whether they can hear a dispute following this process?'

As the OSBC has established, a myriad of issues would arise from any reforms which notably restricted small businesses or individuals from accessing court proceedings – including after an AFCA process had reached its conclusion.

We note further that the basic policy objectives of financial services industry codes further support recourse to the judiciary. That is, the industry has developed codes to govern its own behaviour, as a form of 'self-regulation'.[130] The reforms advocated in this submission would allow for a move towards mandatory regulation. But under either a self-regulatory or mandatory model, industry codes are intended to bond the industry for the purpose of protecting small businesses and other customers. Customers have not committed to abide by code provisions, nor would their conduct be the target of any mandatory code.

It is therefore appropriate that the current balance of rights, in relation to judicial recourse, be preserved to the full extent possible. That is, a decision under a code, arrived at through AFCA dispute resolution, should bind a financial services provider to acceptance. But small businesses and other customers should be free to reject any finding to pursue their right to an authoritative decision by the judiciary.[131]

We recognise that the Financial Services Royal Commission determined that "*resort to AFCA, or another external dispute resolution mechanism, will be treated as an election not to pursue court remedies unless good cause is shown to the contrary.*"[132] But given the overwhelming benefits of preserving access to the courts, we strongly support a restrained approach to implementing this finding.

Access to AFCA's dispute resolution scheme should never bar a financial services customer from litigating outright. Rather, the litigant should be required to establish, before the court, that it has good cause to have the substantive matter heard. To assist in this process, regulation could prescribe a list of reasons that constitute 'good cause'. Given that any number of circumstances might constitute 'good cause', according to the ordinary meaning of that term, should be non-exhaustive. Development of this list should include an additional, dedicated consultation – including with AFCA, other ADR practitioners, and small business representatives.

Furthermore, due to both the benefits of collection litigation, and the absence of a collective ADR scheme, a litigant should never be prevented from participating in a class action by virtue of having undergone AFCA dispute resolution individually.

Recommendation 23: An individual litigant that has undertaken dispute resolution through AFCA should not be preventing from litigating - but should have to establish good cause for doing so before the court. Regulation should prescribe a non-exhaustive list of what constitutes 'good cause'.

Recommendation 24: A party that has undertaken dispute resolution through AFCA should not, for that reason, be restricted from participating in class action litigation.

Next steps

The OSBC is determined to support reforms to realise the changes mandated by the Financial Services Royal Commission. Delivering an industry codes regime that is genuinely binding on industry, and genuinely reliable for customers, is a key component of this work. The OSBC therefore welcomes further engagement with the Commonwealth regarding the matters canvassed in the consultation paper, to ensure the efficacy of reforms arising from this process.

Should you have any questions concerning our submission, please contact James Davis, Advisor Advocacy & Strategic Projects, on (02) 8222 4883, or james.davis@smallbusiness.nsw.gov.au.

Yours sincerely

Robyn Hobbs OAM

NSW Small Business Commissioner

18 April 2019

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