COVID 19: PRESSURE POINTS: OPERATIONAL DISRUPTION IN FINANCIAL SERVICES IN THE AGE OF COVID-19 (AUSTRALIA)

04 June 2020 | Australia
Legal Briefings – By **Michael Vrisakis, Tamanna Islam and Sky Kim**

This article is the second in a series by our financial services team which will explore the practical implications of COVID-19 on the financial services industry and our client's businesses.

The series is part of our financial services' "Integrated Legal Enhanced Assisted Productivity (I-LEAP) Initiative" which examines various areas of business activity where we proffer legal solutions which can result in productivity gains and efficiencies.

COVID-19 has clearly had wide-ranging impacts on how financial services institutions conduct their businesses, ranging from the need for additional disclosure (dealt with in our previous disclosure module) to marketing and distribution, investment, valuation, administration and supply chain, and reporting in respect of financial products.

This module looks at how COVID-19 has impacted on these operational aspects, with particular focus on how institutions can overcome or mitigate the additional burden introduced by COVID-19.

MARKETING AND DISTRIBUTION

In circumstances where potential investors are largely house-bound, there has been a pronounced need to explore and utilise electronic commerce in financial services marketing and distribution.

In this context, it is useful to examine the extent to which applications for financial products have to be made and processed using traditional paper means with wet signature or alternatively, if and how non-paper forms of applications can be utilised.

A useful starting point is the application procedure provided for in the Corporations Act. The following requirements are set down by section 1016A of the Corporations Act, relevantly:

a. a restricted issue or sale of a financial product is effectively an issue of such a financial product where a PDS is required to be given in relation to the product sale. A relevant financial product is, for present purposes, a managed investment product, a superannuation product, an investment life insurance product, an RSA product, or a margin lending facility; and

b. for such issue, an eligible application is required. This is defined as an application which is made using an application form.

The application form must be included in or accompany the product disclosure statement or be copied or directly derived from such a form.

Importantly,

a. the requirements do not stipulate that the form must be signed; and

b. for certain products such as life risk products, there is no requirement for an eligible application form.

It follows from the above that an application for a relevant financial product could be set up on the basis that it is signed electronically by the applicant. In this regard, electronic transactions facilitation legislation is not necessary as a signature is not required. However, other legislation may require wet signatures.

COVID-19 also presents opportunities for financial services providers to pivot marketing and distribution to electronic and other digital channels, such as website, call centre and digital tools such as calculators and product comparison tools. In particular, there has been a shift towards self-directed channels, where customers are able to navigate the application process with minimal to no intervention from the licensee. This is particularly relevant as the parameters of “no advice” and “general advice” models continue to be explored and tested by financial institutions, ASIC and the courts.

CALL CENTRES

One of the inevitable consequences of COVID-19 has been the fact that many call centres have not been able to be staffed in the usual manner. Rather, call centre operations have been forced to become remote, with many call centre operations now being exclusively conducted by frontline staff working from home.

This has had implications in terms of ways in which call centre operations have been supervised, and the compliance framework governing call centre operations. In particular, recording of calls, which is a fairly ubiquitous compliance control, has been curtailed, given operational difficulties associated with call recording in circumstances where the call centre is operating remotely.

Importantly, the obligations of an Australian financial services licensee to ensure compliance with financial services law under section 912A of the *Corporations Act 2001* (Cth) (**Corporations Act**) continue during COVID-19 and similar disruptions. However, it is crucial to bear in mind that the Corporations Act is not prescriptive in this regard. Rather, it is up to the licensee to determine its compliance framework, having regard to its business operations and prevailing circumstances. For example, monitoring of call centre interactions via call recording may not be possible but other alternative compliance measures such as detailed scripts, FAQ documents, training, telephone mystery shopping and monitoring of sales data (eg cancellation or lapse rates) may be substitutes.

In changing circumstances, legislative standards of conduct, such as the obligation of an Australian financial services licensee to carry out financial services efficiently, honestly and fairly, can be affected. What is reasonable, for example, may well be at least partly affected by these changed circumstances. This topic will be explored in more detail in our following module dealing with Compliance and Governance.

ADMINISTRATION AND SUPPLY CHAIN

COVID-19 has caused major disruption to the administration and supply chain of many financial services providers, with significant impacts on back office operations. Offshore and onshore administration have, in many cases, been disrupted by shifts in working protocols. The impact is made more complex by varying government restrictions during the COVID-19 lockdown across the globe.

This in itself may cause delays or breaks in usual administration processes and time horizons. In turn, this may create disruptions in customer outcomes or issues with service providers. These disruptions can give rise to considerable uncertainty, increased costs and legal risks, particularly associated with an inability to perform under service contracts (either on time or at all). For APRA-regulated entities, this is a particular area of risk given the impact on prudential requirements, such as business continuity, liquidity, stress testing and governance.

In this context, contractual liabilities under services and supply agreements may arise due to such disruption, with contracting parties seeking modification of existing obligations that have become impractical or impossible to perform. Modifications can include delays or pauses in performance or payment obligations.

This is an area where the doctrine of force majeure may play a role. The application of force majeure will depend on the governing law of the contract and the terms of the contract itself. The key questions that arise in this context are:

a. whether COVID-19 appropriately falls within the concept of force majeure under the relevant contract (eg coverage for pandemics, Government-imposed quarantine or "Acts of God");

b. whether the force majeure clause applies to obligations that are only impossible to perform, or whether it extends to other obligations that have become impractical or uncommercial to perform;

c. what is the effect of the force majeure clause (eg is performance suspended)?

It may also be that contractual provisions may provide some relief or flexibility under the relevant service contract to renegotiate the material service standards or outcomes during the affected period. The doctrine of frustration may also provide some relief where the contract is incapable of being performed.

It is important to bear in mind that in the context of new administration or supply contracts being entered into, COVID-19 from now on is a foreseeable event that will not likely fall within the concepts of force majeure or frustration. As a result, new contracts should contemplate specific arrangements in the context of COVID-19, where applicable (eg expressly include it as a force majeure event). For more information on contracting during COVID-19, see our resources and tips available here and here.

The longer term impacts of this disruption are yet to be seen. However, we are seeing a shift, in some cases, towards less reliance on outsourcing and offshoring. A number of industry participants have been forced, or otherwise determined, to onshore their operations, as well as recruit additional staff to insource certain back office operations.

The above impacts are also compounded by the announcement of Government measures such as the early release of funds from superannuation schemes, and market demands for financial hardship arrangements (for example, in insurance). These measures are requiring licensees to ensure adequate resourcing (including reallocation of resources) to service these issues.

REPORTING

Similar to the area of pre-sale disclosure and ongoing significant event reporting as discussed earlier, ongoing investor reporting may well be affected by COVID-19.

In particular:

a. delays may be experienced in the communication process due to administration disruption discussed above;

b. related resultant data issues involving delays in obtaining data or inaccessibility of data.

Such delays may cause regulatory issues in terms of inability to comply with statutory reporting requirements or delays in being able to comply with such reporting requirements.

These potential compliance issues cause prospects and potential for seeking regulatory relief.

This relief might be formal or might be more informal. It may involve the relevant regulator being prepared to grant certain leniency in compliance timeframes or in the requirements which would otherwise apply.

It follows that financial institutions who are experiencing such issues should be alert to the prospects of and potential to engage with the relevant regulator to obtain concessions and/or relief from such normal compliance requirements.

This might be at an individual level or at an industry level.

INVESTMENT

Clearly COVID-19 has caused disruption of many aspects of funds’ investment. While investments have obviously continued to be made, markets have been disrupted, in many cases severely. This has led to the need for additional disclosure but also in many cases, adjustments to the investment options offered through the product.

It may have also meant investment options are being closed or being otherwise modified. In many cases, underlying fund managers are imposing redemption restrictions on investors (such as partial or complete suspension). In some cases, we have seen the source of the fund manager’s power to activate such restrictions is not immediately obvious.

This process often needs to be implemented and disclosed quickly.

Where existing disclosures do not cover these matters, disclosure implications arise often under:

a. section 1017B of the Corporations Act, which requires disclosure of material changes and significant events; or

b. in relation to managed investment schemes that have 100 or more members who acquired interests under a PDS, section 675 of the Corporations Act. This continuous disclosure obligation requires disclosure of information that is not generally available and which a reasonable person would expect, if it were generally available, to have a material effect on the price or value of the interests in the scheme.

Timing requirements under section 1017B vary, from advance disclosure in the case of fee increases to disclosure before the change or event or as soon as practicable after that but not more than three months after the change or event. The timing requirement under section 675 is “as soon as practicable”.

Typically product issuers will want to initiate changes quickly. This usually means:

a. quick form of disclosure; and

b. effecting the change before it is disclosed.

The Corporations Act allows for electronic disclosure which is potentially the quickest means of disclosure.

This could involve disclosure viz the website by relying on ASIC Corporations (Updated Product Disclosure Statements) Instrument 2016/1055 (**Instrument 2016/1055**) which allows product issuers to update information in a product disclosure statement (**PDS**) without issuing a supplementary PDS, provided that the updated information does not include any materially adverse information and the issuer discloses upfront that updated information can be found elsewhere (eg on the website). You can read further about the use of Instrument 2016/1055 in our first module here.

ASIC Corporations (Removing Barriers to Electronic Disclosure) Instrument 2015/649) can also be relied upon to give an electronic PDS where there is no PDS that is capable of being printed. Similarly, ASIC Corporations (Facilitating Electronic Delivery of Financial Services Disclosure) Instrument 2015/647 allows providers to make disclosures such as PDSs available digitally (eg on a website), and notify the client the disclosure is available, without the need for client agreement to receive the disclosure in that manner as long as clients have the ability to opt for the disclosure to be delivered in full to either an electronic address or to a postal address.

As far as implementation is concerned, implementing the change before disclosure is possible, although care has to be taken in terms of whether the change could render the PDS misleading or deceptive or otherwise mean it is not up to date.

VALUATION

Similar issues arise in the context of valuation.

Clearly changes to valuations must be made consistently with any procedures stipulated in the relevant product disclosure statement or trust deed.

Again, the timing of the valuation changes versus disclosure of the changes needs to be considered as canvassed above.

In relation to superannuation, a special feature of the legislative regime is that section 155 of the *Superannuation Industry (Supervision) Act 1993* (Cth) imposes not just an ability of a trustee to put a halt on redemptions but actually require a trustee to put a halt on redemptions if certain prescribed circumstances exist.

In particular the trustee is prohibited from redeeming interests in the superannuation entity where:

a. the trustee believes that the redemption price would not be fair and reasonable as between the redeemer and the other beneficiaries of the entity; or

b. the trustee cannot for whatever reason work out the price at which the interest should be redeemed under the governing rules of the entity,

except at a fair and reasonable price as between the redeemer and the other beneficiaries of the entity.

This provision could provide relief to superannuation trustees where valuation difficulties are caused or contributed to by COVID-19. In particular, the redemption price for existing investors might prove to be artificially high, leaving remaining investors worse off.

REGULATORY RECALIBRATION

The above-mentioned operational disruptions caused by COVID-19 present an opportunity for some industry-wide regulatory recalibration. While the financial services sector has been facing a number of types of disruption for many years, the impact of COVID-19 has been truly unique.

Some areas that would lend themselves to Government or regulatory intervention or relief include:

a. the **financial advice and disclosure** space where Statements of Advice could be shortened and simplified by facilitating incorporation by reference of material from a website. While some scope already exists to do this, further peel-back would be extremely beneficial to both financial services licensees and consumers;

b. the **product disclosure** space, which continues to be extremely onerous and inflexible. While short form product disclosure statements can be utilised, they are mostly not used because the regulatory requirements are less flexible compared to their long-form counterparts. For example, in the case of short-form PDSs, there is no ability to issue a supplementary PDS and so reliance on the website disclosure relief is the only alternative to reissuing the PDS (with such relief not being available for changes that are materially adverse);

c. the **digital calculator** space. Regulatory concessions exist for financial calculator tools to allow their use without triggering personal advice. But the conditions attaching to the relief are somewhat restrictive and clunky as they don’t readily allow reference to specific financial products. If consumers are clearly informed that the information spitting out from the tool is not personal advice, this should be enough to allow tools to make more mention of specific financial products; and

d. the circumstances in which **APRA** may exercise its **modification powers**. Sadly, a longstanding regulatory impediment has been statutory restrictions on the ability of APRA to modify key provisions of superannuation legislation. APRA cannot, for example, relax key provisions requiring members to make insurance elections on low balance accounts under the ‘Protecting Your Super’ and ‘Putting Members’ Interest First’ reforms, particularly in the context of members who need to remake elections once transferred to a new fund under a successor fund transfer.

Should readers have other examples where regulatory relief would be beneficial, we welcome your input.

OPERATIONAL RESILIENCE

All of the above are set in the context of operational resilience more generally during COVID-19. All business continuity plans and crisis management plans will have been activated and while those plans will have been drafted to account for shorter and longer periods of disruption, most financial service providers we are speaking to are encountering a need to enhance their operational resilience. There are a number of areas where enhancements are occurring. Aside from enhancements to technology capability to improve their capacity to operate in a remote environment on an ongoing basis (which was a critical focus for financial service providers early in COVID-19), the other key ones are:

a. **effective monitoring** of remote working staff both from an employment/HR perspective but also from a compliance monitoring and risk framework perspective. There has been an increased focus on enhancements to first and second line monitoring tools, particularly for those involved in the markets to monitor for insider dealing and market manipulation risks;

b. **updating policies and procedures** in a number of respects including controls for maintaining information security and confidentiality in the remote working environment (which is proving particularly challenging) and disposing of confidential information, around personal mobile phone use and appropriate secure forums for conducting meetings/connections; and

c. implementing **alternative solutions** for third party providers and others in the supply chain that are facing challenges with their business continuity programs or are unable to adapt to the changes that financial service providers are implementing.

In addition, financial service providers have needed to focus on capturing a wider set of information and new types of information, and to enhance their information flows in order to ensure appropriate oversight and governance during this time and in order to feed back into ensuring the ongoing business continuity plan is robust and tailored and stress tested.

OTHER ISSUES

There will no doubt be a range of other operational issues and indeed, this note may just skim the surface.

In addition to the examples you might have where regulatory relief would be valuable, the HSF Financial Services team values your input and experience and encourage you to email our team with any particular issue you are experiencing.

Click here to read the first article in our series

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If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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