Examining defective systems through the lens of the law relating to misleading and deceptive conduct

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A number of the case studies examined by the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Royal Commission) involved instances where a financial institution failed to deliver what it had sold to customers due to deficiencies in its systems or processes.

The Royal Commission highlighted that when financial products or services are not delivered in accordance with contractual promises, there may be occasions where such failures should "be examined through the lens of the law relating to misleading and deceptive conduct".[1]

This observation clearly resonated with the Australian Securities and Investments Commission (ASIC) which has since commenced investigations and litigation against major financial institutions in relation to system defects which meant customers did not receive what they had been promised.

In spite of ASIC's recent leadership changes, ASIC's new chairman, Joe Longo, and head of enforcement, Sarah Court, have both made it clear that the regulator remains focused on issues stemming from inadequate systems. In a nod to the Royal Commission, Mr Longo has observed that continuing system failures are so common among financial institutions that "Hayne was absolutely right to call it out".[2] Further, Ms Court has observed that ASIC is getting "breach reports from major institutions on a daily basis about systems errors and compliance errors that are causing widespread detriment to consumers".[3]

So how can defective systems give rise to a claim for misleading or deceptive conduct and what can financial institutions do to mitigate the risk of such a claim?

How can defective systems give rise to a claim for misleading or deceptive conduct?

When defective systems or processes lead to shortcomings in the provision of a financial product or service, two avenues may be open to ASIC under the Australian Securities and Investments Commission Act 2001 (Cth) (ASIC Act) to pursue a claim for misleading or deceptive conduct. A claim may be available under either or both of:

- s 12DA which proscribes conduct that is misleading or deceptive in connection with the supply or possible supply of financial services or
- s 12DB which proscribes the making of specified kinds of false or misleading representations in connection with the supply or possible supply of financial services

At one end of the spectrum a defective system may lead to a service provider making an express statement of fact which is plainly false or misleading and provides a clear basis for a claim. For example, assume that a bank offered a term deposit account with an interest rate of 3% per annum but a system error meant that some customers were credited with interest at a rate of 1% per annum. If the account statements issued to impacted customers referred by default to the payment of interest at a rate of 3% then plainly this would be a false representation.

The position is more complicated at the other end of the spectrum when defective systems cause processing or administrative errors that cannot be linked to an express statement of fact which is false or misleading. The balance of this article focuses on this scenario because it entails a significantly broader scope for liability than the more obvious scenario involving express statements of fact.

In the absence of a false or misleading statement of fact, a claim potentially can be constructed by reference to implied representations that may arise as a consequence of the making of contractual promises. Specifically, it has been held that a contractual promise will ordinarily amount to an implied representation that the promisor has both the *intention* and *capacity* to carry out the promise.[4] This means that if a financial institution publishes and enters into contractual terms and conditions for a financial service when it is unable to reliably

deliver the service in accordance with those terms it might contravene the prohibitions on misleading or deceptive conduct and false or misleading representations under ss 12DA and 12DB of the ASIC Act, respectively.

While there will usually be no question that a financial institution intended to abide by its terms and conditions, if the delivery of a financial product or service was hampered by a poorly designed system this may indicate that the service provider lacked the capacity to make good its contractual promises to its customers.

Assume, for example, that a bank offered a savings account which paid bonus interest when certain deposit criteria were met. Due to design flaws in the IT system that assessed whether the criteria had been met, the bank failed to apply the bonus interest entitlements reliably and a proportion of the account holders did not receive interest payments despite satisfying the qualifying criteria. In this example, even if none of the account statements incorrectly stated that bonus interest had been paid, the bank may still be liable for misrepresenting that it had the capacity to administer the product in accordance with its terms and conditions.

A claim for misleading or deceptive conduct under s 12DA involves an enquiry into whether the impugned conduct had the tendency to lead another person into error.[5] Therefore, it is not difficult to see how the making of a false representation as to capacity to perform a contractual obligation could give rise to liability under s 12DA.

Section 12DB is narrower in scope because it prohibits the making of specified kinds of false or misleading representations. This includes representations with respect to the "price"[6] or "benefits" of the service.[7] Therefore, if a system defect resulted in fees or charges being imposed incorrectly or meant that customers missed out on entitlements such as discounts, waivers or preferential rates, a claim may be available under s 12DB on the basis that the advertising materials and contractual documents associated with the service carried false or misleading representations as to the service provider's capacity to:

- charge the correct "price" for the service (in the case of incorrect fees) or
- ensure customers received the "benefits" they were promised (in the case of missed entitlements)

Although the breadth of s 12DA may mean that it provides a more straightforward route to liability in many defective systems cases, a claim under s 12DB will invariably be more attractive to ASIC from an enforcement perspective because it is a pecuniary penalty provision whereas penalties cannot be imposed for a contravention of s 12DA. Therefore, to achieve maximum deterrence ASIC would likely seek to identify the making of a false or misleading representation of a kind that would enliven a pecuniary penalty claim under s 12DB.

Representations as to present facts and future matters

The making of a contractual promise may give rise to two distinct implied representations as to the adequacy of the promisor's systems and processes to deliver what has been promised, as follows:[8]

- first, that the promisor *presently has* adequate systems to deliver what has been promised (a representation as to a present fact) and
- second, that the promisor *will continue* to maintain adequate systems (a representation as to a future matter)

If the promisor's systems are inadequate, a separate claim may be available in relation to the falsity of each type of representation (under either or both of ss 12DA or 12DB of the ASIC Act depending upon the facts of the case).

In relation to the first type of claim, a person who makes a false representation as to a present fact can be liable for the misrepresentation irrespective of whether they knew or ought to have known that the representation was inaccurate or untrue.[9] This highlights that it is critically important for a financial institution to ensure that its systems and processes are adequately designed and functioning correctly *before* bringing a new product or service to market.

Different considerations arise if a claim is directed at the second type of representation because a representation as to a future matter (eg, that adequate systems will be maintained in future) is neither true nor false at the time it is made. This is addressed by s 12BB of the ASIC Act which provides that if a person makes a representation in relation to a future matter and the person does not have "reasonable grounds" for making the representation, it will be taken to be misleading. This deeming provision operates unless evidence is adduced to the contrary (ie, evidence that the party making the representation *did* have reasonable grounds).

An enquiry into whether there were reasonable grounds for a representation as to a future matter essentially focuses on the degree of care taken by the person who made the representation. What matters is the information that was available and relied upon at the time the representation was made. Importantly, this means that an honest belief in the accuracy of a representation that turns out to be false will not necessarily mean that it was made on reasonable grounds.[10]

Consequently, a financial institution that launches a product without taking due care to design and test the systems, controls and monitoring processes that will support the administration of the product may have difficulty in establishing it had reasonable grounds for representing to customers it would maintain the capacity to deliver the product in accordance with its terms and conditions. Of course, if a financial institution was aware of actual or potential system defects and still launched the affected product or continued offering it to customers in spite of this knowledge, this would almost certainly make it more difficult to establish reasonable grounds. The latter conduct may also contravene the prohibition on unconscionable conduct in s 12CB of the ASIC Act, which a court would likely regard as a more serious breach warranting higher penalties.

What can financial institutions do to mitigate the risk of claims targeting defective systems?

A financial institution will not necessarily be exposed to the risk of a claim for misleading or deceptive conduct simply because its systems do not operate flawlessly. As Commissioner Hayne acknowledged in the Royal Commission's final report, no system for processing the number and variety of transactions offered by financial institutions will ever operate perfectly.[11]

Obviously, the most important step a financial institution can take to reduce the risk of this type of claim is to allocate sufficient time and resources to ensure that the systems and processes required to support each feature of a new product or service are carefully and robustly designed.

To promote this type of product governance the Federal Government has signalled its intention to strengthen accountability for the management of financial products and services through its proposed Financial Accountability Regime (FAR),[12] which is poised to replace the existing Banking Executive Accountability Regime. Under the proposed FAR, it will be mandatory for all entities regulated by the Australian Prudential Regulation Authority to implement clear lines of accountability for end-to-end product management, including all steps in the design, delivery and maintenance of products and services offered to customers. This proposed legislative change responds directly to a recommendation of the Royal Commission and seeks to address a finding that a key factor that led to the processing and administrative errors examined by the Royal Commission was an absence of end-to-end accountability for the relevant products or services.[13]

Other steps a financial institution can take to mitigate the risk of system failures or the risk of a claim for misleading or deceptive conduct if systems do fail include the following:

- Attention should be directed not only to IT systems but also to any manual processes that will be involved in ensuring that a product or service functions as intended. Manual tasks should be assessed to identify opportunities to reduce complexity and thereby reduce the scope for human error. In addition, employees must be adequately trained to ensure that operating processes are clearly understood and manual tasks can be performed effectively.
- Monitoring and complaint handling processes should be designed to detect trends and systemic issues that may be indicative of underlying system defects. When an error in the delivery of a product or service is linked to a system defect it is critical to take prompt action to remedy the root cause. If a system defect is remediated soon after detection this may help to mitigate the severity of the breach and reduce the risk of regulatory enforcement action.
- If a system defect cannot be fixed promptly it may be necessary to notify customers of how the issue may impact on the delivery of the product or service. If full disclosure is provided this should ensure that customers are not misled about the characteristics of the product or service while the underlying problem is remedied.

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Footnotes

1. KM Hayne, *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*, vol 1, Final report (2019) p 114.
2. M Pelly "We love litigation, say new ASIC chiefs" *The Australian Financial Review* 3 September 2021, viewed 4 September 2021, www.afr.com/companies/financial-services/we-love-litigation-say-new-asic-chiefs-20210831-p58nnz.
3. Above.
4. *Futuretronics International Pty Ltd v Gadzhis* [1992] 2 VR 217 at 239 per Ormiston J. Compare with *Concrete Constructions Group v Litevale Pty Ltd* (2002) 170 FLR 290; ATPR (Digest) 46-224; [2002] NSWSC 670; BC200204352 where Mason P

at [171]–[173] cautioned that it would be erroneous to read *Futuretronics* as stating that a contractual promise will always carry with it a representation of capacity to perform, and that there are policy reasons for restraint in inferring the making of or reliance upon a representation as to capacity to perform express contractual promises.

5. See, for example, *Australian Securities and Investments Commission (ASIC) v Westpac Banking Corp (No 2)* (2018) 266 FCR 147; 357 ALR 240; [2018] FCA 751; BC201804154 at [2216] and [2172] per Beach J; *Monroe Topple & Associates Pty Ltd v Institute of Chartered Accountants in Australia* (2002) 122 FCR 110; ATPR 41-879; [2002] FCAFC 197; BC200203308 at [74] per Heerey J.
6. Australian Securities and Investments Commission Act 2001 (Cth), s 12DB(1)(g).
7. Above, s 12DB(1)(e).
8. See, for example, *Re McGrath; Pan Pharmaceuticals Ltd (in liq) v Australian Naturalcare Products Pty Ltd* (2008) 165 FCR 230; (2008) 246 ALR 514; (2008) ATPR ¶42-213; [2008] FCAFC 2; BC200800143 at [135]–[138] per Allsop J.
9. *Hornsby Building Information Centre Pty Ltd v Sydney Building Information Centre Ltd* (1978) 140 CLR 216 at 228; 18 ALR 639 at 647 per Stephen J.
10. C Lockhart, *The Law of Misleading or Deceptive Conduct*, 5th edn, LexisNexis, Sydney, 2019, pp 162.
11. Above n 1, p 113.
12. The Australian Government, The Treasury, *Financial Accountability Regime — List of prescribed responsibilities and positions* Policy Proposal Paper (2021).
13. Relatedly, the need for effective product governance arrangements is also a core pillar of the new design and distribution obligations with which issuers and distributors of financial products must comply from 5 October 2021. The purpose of the design and distribution obligations is to help consumers obtain suitable financial products by requiring issuers and distributors to take a customer-centric approach to designing, marketing and distributing financial products (see the Parliament of the Commonwealth of Australia, Senate, *Revised Explanatory Memorandum for the Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2019* at 1.5).