Submission

to

Parliamentary Joint Committee on Corporations and Financial Services
Inquiry into Financial Products and Services in Australia

as a supplementary submission 2

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Refocusing FSRA away from FORM and towards SUBSTANCE.

This submission only focuses on the problems of regulatory focus being on FORM rather than SUBSTANCE for SoAs for investment advice.
A solution for is offered.
However, regulatory focus on FORM rather than SUBSTANCE pervades FSR regulation – and much more extensive reform is required.

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Executive Summary:

Corporations Law says that

- an SoA must:
  - contain *"information about the basis on which the advice is or was given;"* **Section 947B(2)(b)**
  - contain *"the level of detail about a matter that is required is such as a person would reasonably require for the purpose of deciding whether to act on the advice as a retail client."* **Section 947B(3)**
- that (**Section 945A**) the advisor must *"have a reasonable basis for the advice"* - and goes on to discuss what the advisor must do to satisfy those requirements.

Superficially, these requirements seem like motherhood obvious clauses that must be good for consumers. Unfortunately these clauses go to the heart of a some critically important problems in FSR. The reasons why these clauses are immensely problematic, at least for non-simplistic investment advice, is that the basis for any non-simplistic investment advice is huge – and would fill volumes. Therefore, even when the SoA is 70-140 pages, the SoA undoubtedly can be attacked for failing the FSR requirement that an SoA contains *"the level of detail about a matter that is required is such as a person would reasonably require for the purpose of deciding whether to act on the advice as a retail client."* Thankfully, there is now a growing acceptance that a 70-140 page SoA:

- is not good for consumers, because the SoA will not get read by many consumers – or understood, even though it might be arguably still too short to comply with the letter of the law, and
- unethical AFSLs use long AFSLs to hide the disclosures that must be made to consumers.

So clearly, the SoA must be reduced to a short "clear, concise and effective" document the consumer can read and understand. This supplementary submission therefore proposes:-

- that we accept that full disclosure the basis of investment advice is often not possible AND
- that **this requirement be replaced with the obligation that the advice must be defensible**. There must be a reasonable basis for the advice, and the AFSL must be able to defend the advice as and when the AFSL is required to do so – by FOS, ASIC or the client.
- Advisor can and should provide the consumer with some (preferably short) documentation on the basis for the advice – at a level *suitable to the consumer's needs*.

Removing the statutory obligation to document the basis for the advice, also forces us to accept the fiduciary obligations of a financial advisor. Because of the complexity of the issues subject to advice, necessarily many recommendations by advisors are accepted by clients on trust – rather than on the client properly understanding the full nature of the risks and strategy adopted.**(See Appendix F.)** **Under common law therefore, a lot of the AFSL conflicts of interests which are currently regarded as acceptable, need to be banned for AFSLs who have reps who seek to hold themselves out as an advisor.** Advisors must be held to the very high standards expected of fiduciaries.

- From what I can see, Storm Financial failed its fiduciary obligations. Storm had a range of conflicts of interest which were inconsistent with a fiduciary relationship

Finally, in Appendix E, I acknowledge **lawyer Peter Bobbin's response to my primary submission, where he argues that stricter definitions around salesman and advisers not needed** on the basis of District Court Judge McGill judgement where he says that if you are a product salesman you cannot call yourself a financial planner. I do not accept that Judge McGill's judgement will rectify this issue by itself and I provide a range of reasons why both regulatory and enforcement measures are required to fix this problem. Likewise Sir Anthony Mason says *"The need for improved regulatory protection extends to investors generally .... The emphasis in protection should be on preventive monitoring, rather than punitive enforcement."*

1. What is good investment advice?

To understand the FORM over SUBSTANCE problem with FSR's requirement of SoAs, we need first to define what good investment advice is. **What is good investment advice?** This paper only focuses on advice as it relate to investing – and not about risk products etc.

The law in Australia has some good tests that characterise the key elements and principles of good investment advice very well. What are the key tests found in the law?

- The common law requirements regarding negligence, misleading and deceptive conduct, due care.
- Corporations Law requirement that there was a reasonable basis for the advice AND the advice was reasonable in the circumstances. S945A.
- Corporations Law requirement that an SoA is "clear, concise and effective" s947B(6)
- Corporations Law requirement "do all things necessary to ensure that the financial services covered by the licence are provided efficiently, honestly and fairly" s912A(1)(a).
- The ASIC Act 2001 – Misleading or deceptive conduct. Section 12DA.
- The ASIC Act 2001 – False or misleading representations. Section 12DB.
- The ASIC Act 2001 – Requirements to apply due care and skill, and that advice is fit for the purpose. Section 12ED.
- PLUS disclosure of commissions and information that might influence the advice, as required under FSRA – helping consumers make informed decisions and helping consumers recognise conflicted advice.
- PLUS disclosure of any associations or relationships between the providing entity, any employer of the providing entity, the authorising licensee or any of the authorising licensees, or any associate of any of those persons, and the issuers of any financial products that might reasonably be expected to be or have been capable of influencing the providing entity in providing the advice

Some supplementary tests that are needed include:

- Is the advice likely to cause damage to the client?
- Are the fees and costs disproportionate to the likely benefit?
- Was the advisor & AFS Licensee seeking to act in the best interests of the client?
- Is the advisor providing advice that, if he/she was in the same position as the client, that he/she would feel happy to take?

2. How the current regulatory environment fails consumers.

> In his 26th February SMH article ("ASIC must stop dodgy advisers"), journalist John Collett in the says *"**The regulator's emphasis on tick-box compliance and disclosure is not enough and is failing investors.** Governments everywhere want citizens to make adequate provision for their retirement but how can they do this with confidence when they are confronted with salesmen masquerading as financial advisers?"*
>
> Sir Anthony Mason's March 2009 speech at the SPAA conference where he asks ***"Why has it taken us so long to clearly recognise that an adviser should put the client's interest ahead of his own interests?"*** See Appendix F. ***"Indeed, our system enables the product seller to adopt the disguise of a financial adviser and endows that disguise with the aura of legitimacy by calling him a 'licensed' financial adviser."*** Appendix E.

There are good and robust principals defined by the law (see above). However, the law fails consumers because of the way it has been implemented. In the implementation of the existing law, the overwhelming focus has been on the FORM of the ADVICE rather than its SUBSTANCE.

Unfortunately, as we have seen with **Storm Financial**, GOOD FORM can be the face of poor advice. Unfortunately:-

- **compliance with the Corporations Law has focused on checklists** of whether the form has be complied with, **rather than tests of whether the advice is good for the consumer** and
- this **focus on FORM has brought into existence an industry of FSR compliance people who cannot distinguish between good and poor advice** because their knowledge about investing is too shallow.
- In addition, **FSR's requirement to document the basis for advice leads many AFSLs to create huge standardised SoAs in an effort to manage business risk.** The basis for any non-simplistic investment advice is huge – and would fill volumes. Therefore, even when the SoA is 70-140 pages, the SoA undoubtedly can be attacked for failing the FSR requirement that an SoA contains *"the level of detail about a matter that is required is such as a person would reasonably require for the purpose of deciding whether to act on the advice as a retail client."* **Section 947B(3).** **This requirement results in huge unreadable SoAs that are not good for consumers.**
- Also it seems that advice is judged to be bad if a product fails. Rather, **the advice needs to be judged on whether the advice was defensible and whether it passes the tests above**. Necessarily, a percentage of investments will fail because risk is central to what investing is about. Each asset class and sector will fail from time to time. Sometimes many sectors fail at the same time. Sometimes individual investments fail in isolation. Investment risk is a huge topic in its own right – and **there is no place for documenting all the different aspects of risk in an SoA if the advice in to be kept concise and readable by ordinary consumers**. However, **under the current implementation of the law, some AFSLs feel compelled to insert in an SoA extensive documentation about risk**, to comply with possible interpretations of FSR's requirement that an SoA contains *"the level of detail about a matter that is required is such as a person would reasonably require for the purpose of deciding whether to act on the advice as a retail client."* **Section 947B(3). This requirement results in huge unreadable SoAs that are not good for consumers.**
  - **The US Securities Exchange Commission's (SEC) defines risk** as the possibility that you might lose your capital or that your investment might under perform your expectations. From the SEC's web-site (http://www.sec.gov/investor/pubs/roadmap/risk.htm) when defining investing the SEC said (May 2004):
    - *'When you "invest," you have a greater chance of losing your money than when you "save." You could lose your "principal," which is the amount you've invested. But then, how "safe" is a savings account if you leave all your money there for a long time, and the interest it earns doesn't keep up with inflation? The answer to that question explains why many people put some of their money in savings, but look to investing so they can earn more over long periods of time, say three years or longer. Though there are no guarantees, investing means you may earn much more money than by relying upon no-risk savings. Investors are not promised a return, but they do get the opportunity of making money that more than offsets the cost of inflation.'*
  - As one of my professional colleagues points out, **in investing there are many exotic low-probability risks that can damage our client. How far do we go in documenting these low probability risks?** Down to risks that have a probability less that 0.1%? How many advisors disclosed the risk of a global financial crisis of a scale last seen in 1930? Should advisors have documented that risk in their SoAs? This clearly was a risk that has caused catastrophic damage to many investors – yet most highly regarded experts did not see it coming. So what is a reasonable expectation of an advisor?

3. How to fix the current regulatory environment to produce a better result for consumers.

To get a good outcome for consumers, the implementation of the law needs to focus on the SUBSTANCE of the advice (not its FORM) – and the principles outlined above are a very robust place to start.

The role of regulating investment advice is very challenging.

- If implementation and enforcement of the law is to be about SUBSTANCE, the job of ASIC is much harder because SUBSTANCE is harder to measure. However **it only by travelling down the hard path that the consumer gets a better outcome for consumers**. There is no value in regulation that targets the wrong outcome. If targeting the right outcome is more difficult, we simply must work to overcoming those difficulties – rather than shirking our responsibilities by taking the "easy way out.". (The easy path is to focus on FORM, and we have seen that this path leads to failure.)
- ASIC's role is also difficult because investing is not simple and it is not easy.
  - Many have been lulled into thinking that investment is easy by the 1982-2007 bull market in shares. This long bull market has seen the birth of investment dogmas like:
    - ***"Time in the market rather than timing."*** This dogma is fine in a bull market, but otherwise dangerous – but this dogma has become accepted as a reasonable basis for advice. By the time the current crisis is over, I expect this dogma to have lost credibility. But the regulator need to able to stand above dogmas such as this – and to ensure adequate warnings are given to consumers. See Appendix B to see how share markets really behave.
    - ***"Just take more risk, ride the volatility and you will get a higher return."*** This dogma is fine in a bull market, but otherwise dangerous – but this dogma has become accepted as a reasonable basis for advice. See Appendix B to see how share markets really behave.
    - These dangerous dogmas are the simplistic mantras and tools of sales people and distribution channels – and not the stuff of a good advisor, whose job must be to be constantly inquiring into how to get a better result for his/her clients.
    - **Investing is a difficult** and imperfect discipline – and unfortunately timing does matter even though **this is a very unfortunate truth** for many fund managers and financial planners. If you examine the charts at **Appendix B**, it is obvious that market timing has a huge impact on investment outcomes. Market timing is difficult and very challenging but because it is so important to outcomes, it is not reasonable that it is ignored. **Good financial planners must grapple with this difficult timing problem in my opinion.**
    - One of the risks of a very long-bull market like we have seen, is that the regulator potentially becomes a captive of the major product providers, who have vested interests in the above investment dogmas being believed.
      - These dogmas help the product providers sell product – and these dogmas help the product provider keep the funds under management even into periods where it is not in the best interests of consumers.
      - The way in which **the regulator potentially becomes a captive of the major product providers** is because the:
        - cycling of staff between ASIC and major product providers
        - cycling of staff between ASIC and advisors to major product providers.(eg lawyers)
        - Finally, ASIC is vulnerable to capture by the major product provider because of the lack of staff with significant expertise and knowledge about long-term behaviour of investment markets. One small step has been taken to rectify this with the appointment of an investment banker as a commissioner over

recent days – but in my view this does not solve this problem.

4. Recommendation. Replace the requirement to document the basis for the advice, with a requirement that the advice must be defensible. The reasonable basis for the advice needs to exist and be able to be defended – instead of being documented in a lengthy 100-page Statement of Advice. Under this recommendation, the advice document can be short, consumer-friendly and readable documenting the advice and providing disclosure of factors which might influence the advice. **Appendix A** identifies the key requirements regarding **basis for advice.** **Appendix C provides a sample of our how the new standardised product-sales disclosure document might look.**

5. Benefits of implementing this recommendation.

The benefits of implementing the recommendation made in this submission are as follows:

- The recommendation enables **shorter consumer-friendly readable Statements of Advice**. Currently these documents are often long compliance-focused documents filled with untailored template material which most consumers will refuse to read. This makes it hard for consumers to find relevant material and material they should and need to read. See **Appendix C** for the basic standardised shape of a future Statement of Advice disclosure document.
- **Poor advice is more easily exposed if SoAs are short standardised documents like Appendix C.** Most importantly, advisors and AFSLs will not be able to hide poor advice behind high-quality FORM (of advice). Rather, the onus will be more heavily on advisors/licensees to defend the SUBSTANCE (and basis) of their recommendations – rather than defending the FORM of their recommendations. This change in emphasis is critical.
    - **Storm Financial'**s Statements of Advice superficially look impeccable (so a compliance check of the form of the advice comes up clean) – but if Storm had ever had to face the scrutiny of having to defend the substance of their strategy, the problem may have been nipped in the bud early.
    - A **Storm Financial** SoA that I have in my possession is **140 pages long**, and the client's have **initialled every page** to confirm that they have "read and understood this page". **Do you really think this Storm client had really read and understood each page?** It seems unlikely. This being the case, **this style of "advice" clearly has turned the FSRA into a farce** – and that is not good for consumers.
  - **Disclosure of conflicts of interests harder to hide in short disclosure documents.** (Sir Anthony Mason says *"Detailed and dense disclosure is often the most effective form of concealment."*) If we have short standardised disclosure documents like that in Appendix C, disclosure of important factors which might influence (including commissions, relationships and other conflicts of interest) would no longer be able to be hidden. Rather, disclosure of these factors should be documented in a standardised fashion and consumers should be assisted in understanding how these factors might taint the advice. Again please see **Appendix C** to see how this might be done.
    - **Consumer Education – Conflicts**. There needs to be a web site where consumers learn about how the financial planning industry works, about the conflicts which exist, and about how these conflicts can influence the advice.
    - **Consumer education – Investment Strategies.** There also needs to be a web site where consumers can learn about the pros and cons of different investment strategies and their risks.
      - This may have helped Storm Financial clients better understand the risks of a

highly geared strategy. Since the Australian share market average has fallen 50% four times over the last 100 years (and the USA 5 times – see **Appendix B**), the probability is very high that an investor who invests entirely in the Australian index fund and maintains gearing at 50%, will face 100% wipe-out at some point.

- On gearing, my understanding is that there are other financial planning groups that heavily promote gearing strategies – and ASIC should be focusing specific attention on these businesses at this time. Clearly, some of these businesses will undoubtedly been wiped out by the recent crash.
- Because of the evidence from historical data, I have to conclude that financial planning businesses that heavily promote gearing are likely to be product sales businesses rather than advice businesses.
- **The historical evidence leads me to believe that gearing is heavily over-promoted and that many of those who recommend gearing, do not have a reasonable basis for that advice.** My own modelling of the long-term historical data leads me to believe that in most cases, to make gearing work for you, you need to be a good market timer and/or a good stock picker, while keeping costs and tax down to an acceptable level. My view is that a large percentage of gearing strategies would not stand up to adequate scrutiny. Dominic McCormick also believes that gearing is oversold. http://www.moneymanagement.com.au/article/The-overselling-of-gearing/474675.aspx

- **Affordable advice for small investors.** If SoAs are short standardised documents like Appendix C, the cost of providing advice can be dramatically reduced, making good advice more available for consumers without a large sum of money.
- **Reduced business risks for competent, ethical independent advisors.** If SoAs are short standardised documents like Appendix C, a huge compliance uncertainty can be taken off the shoulders of advisors and AFSLs.

6. How is the consumer protected once this recommendations is implemented?

The consumer will be well-protected if ASIC adequately enforces the following aspects of law:

- The well established common law obligations in terms of negligence, duty of care; etc.
- The Corporations Act 2001 requirement that:
  - there was a **reasonable basis** for the advice and the advice was reasonable in the circumstances. Section 945A
  - a licensee must "do all things necessary to ensure that the financial services covered by the licence are provided efficiently, honestly and fairly" s912A(1)(a)
- The ASIC Act 2001 provision for protection in respect of:
  - Misleading or deceptive conduct. Section 12DA.
  - False or misleading representations. Section 12DB.
  - Requirements to apply "due care and skill", and that advice is "fit for the purpose". Section 12ED
- The requirement to disclose all factors which might taint the advice..Section 947 2(d) & 947 2(e) There currently is a very high level of non-compliance with these sections – unpoliced. This disclosure should be standardised to make it more consumer-friendly – eg along the lines of Appendix C.

7. FICS/FOS must be required to drop in line with this recommendation.

FICS/FOS also needs to be required to ensure that the AFS Licence has the opportunity to submit a written submission on why the advice that was provided was reasonable and what the basis for that advice was – and FICS/FOS should not be allowed to make a determination of a complaint simply on the basis of advice documents provided or created at the time of advice – otherwise we will be back with 140-page SoAs. This is a very critical element in making FSRA workable and making SoAs shorter, more readable and more consumer friendly.

<u>Appendix A. Regulatory requirements regarding basis for advice.</u>

Corporations Law says that

- an SoA must:
  - contain *"information about the basis on which the advice is or was given;"* **Section 947B(2)(b)**
  - contain *"the level of detail about a matter that is required is such as a person would reasonably require for the purpose of deciding whether to act on the advice as a retail client."* **Section 947B(3)**
- that (**Section 945A**) the advisor must *"have a reasonable basis for the advice"* - and goes on to discuss what the advisor must do to satisfy those requirements.

945A Requirement to have a reasonable basis for the advice

(1) The providing entity must only provide the advice to the client if:

(a) the providing entity:

(i) determines the relevant personal circumstances in relation to giving the advice; and

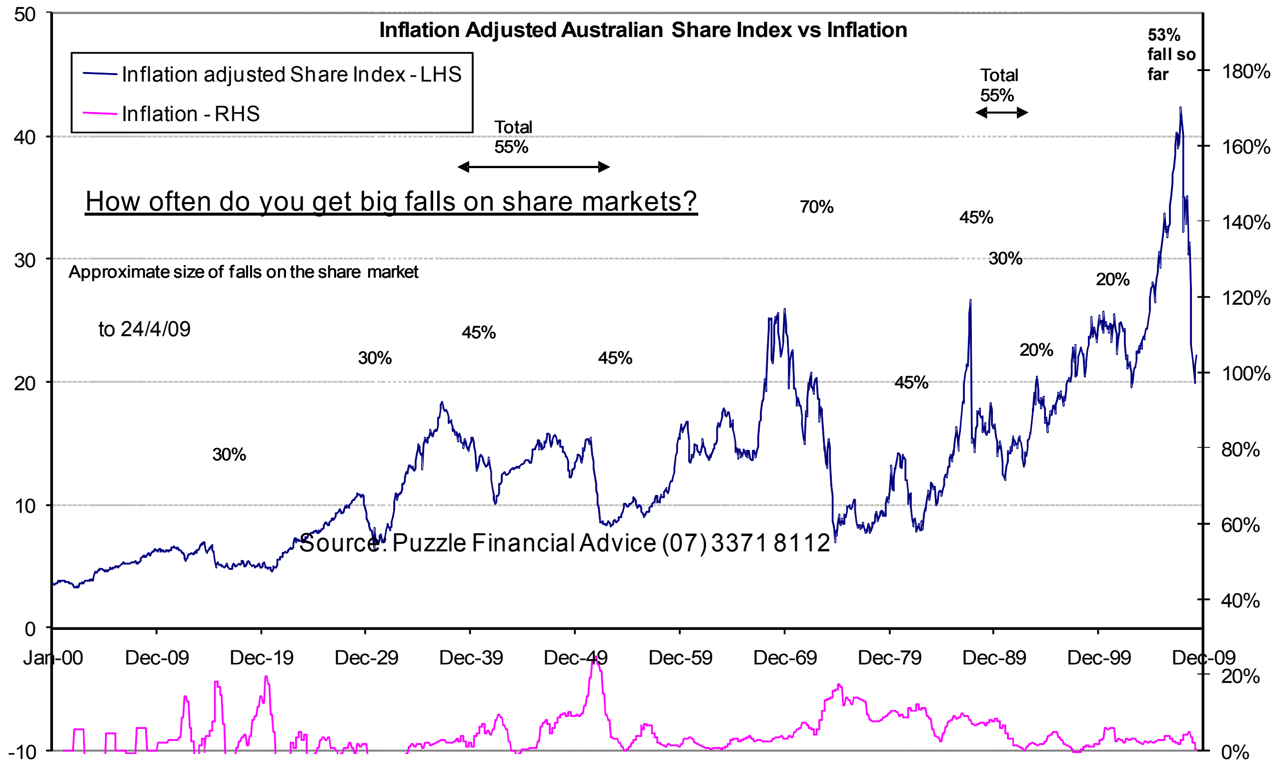
(ii) makes reasonable inquiries in relation to those personal circumstances; and

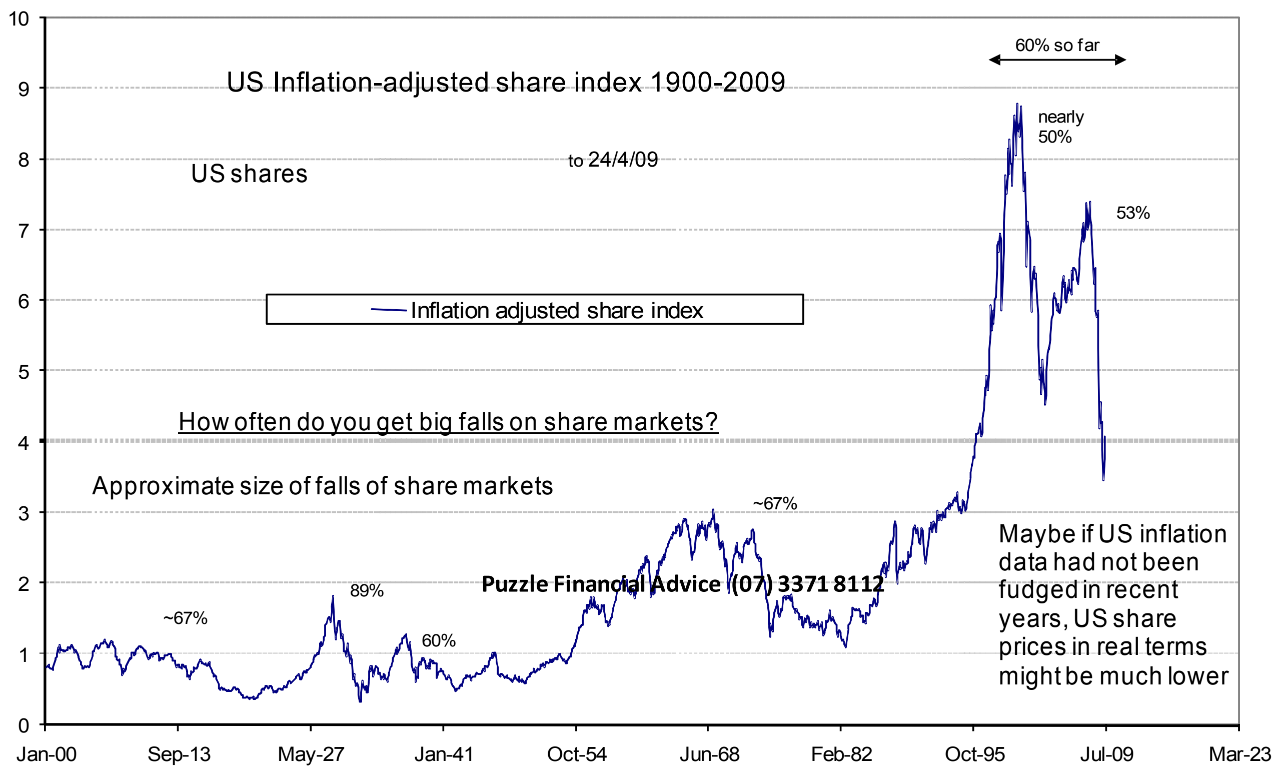
(b) having regard to information obtained from the client in relation to those personal circumstances, the providing entity has given such consideration to, and conducted such investigation of, the subject matter of the advice as is reasonable in all of the circumstances; and

(c) the advice is appropriate to the client, having regard to that consideration and investigation.

<u>ASIC</u> says *"**RG 175.97** Although all personal advice must comply with the suitability rule, the client inquiries requirement and the requirement to consider and investigate the subject matter of the advice are '**scaleable**'. 'Scaleable' means that these requirements vary depending on the circumstances, including the potential impact of inappropriate advice on the client, the complexity of the advice and the financial literacy of the client."*

Appendix B. US & Australian inflation-adjusted share price index 1900-2009.

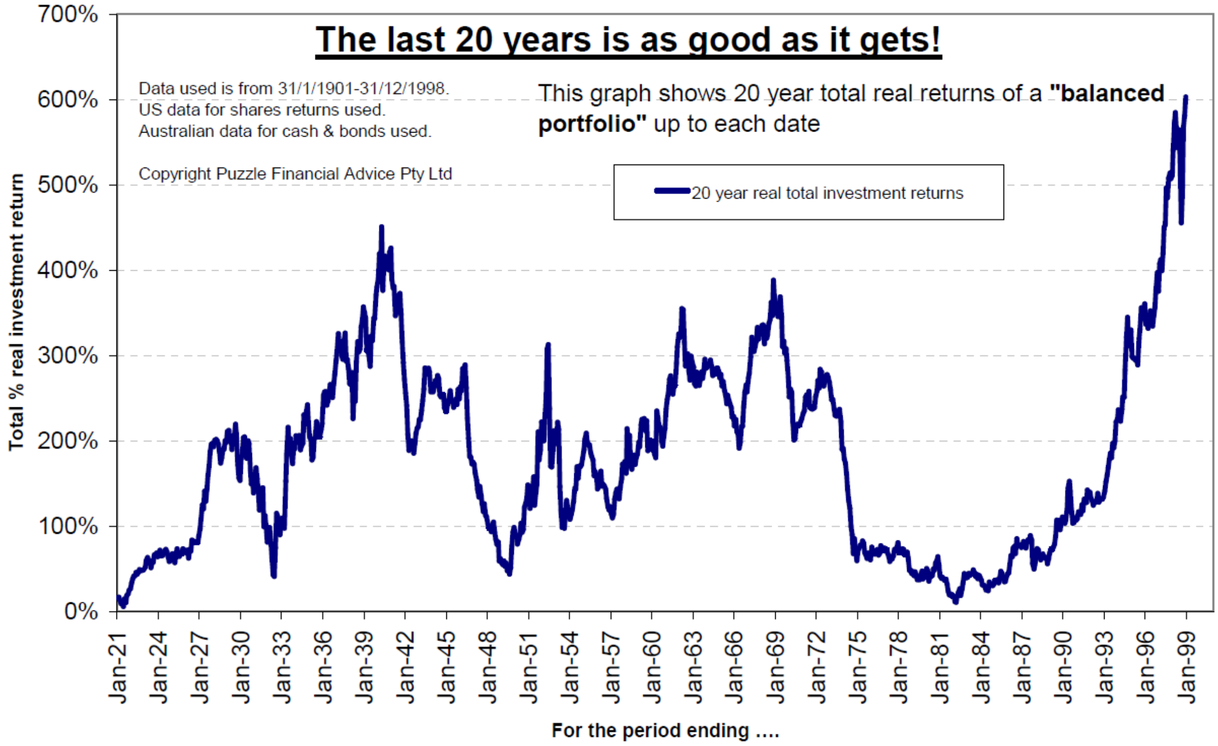




Another illustration of why market timing is important.

This is a chart from a long-term analysis completed in 1999.

Again, this illustrates why good financial planners need to grapple with the difficult problem of market timing.



Appendix C Conceptual Shape of future short SoAs – including standardised disclosure.

ABC Financial Services P/L
Australian Financial Service Licence 244450
Unit 100, 57 Hill Rd
Surrey Heights Qld 4999

11 May 2009

John & Mary Bloggs
54 Essendon Lane
Surrey Heights Qld 4999

Statement of Advice

Dear John and Mary

Scope of Advice: You have asked for a recommendation for a long-term investment strategy for your super fund.

Very brief summary of financial products recommended.
We recommend that you invest:-

- $200K into investment1Fund and
- $100K into investment2Fund.

Disclosure of Recommendations & factors which might taint the advice:

Investment	Amount	Commission received by AFSL&advisor (or AFSL & corporate authorised rep)		Management Expense Ratio - MER (Disclosure of MER is required if Product provider or platform provider has any direct or indirect relationship with the AFSL)	
		up-front	ongoing		
1. investment1Fund	$200K	$6000 &	$800pa	2.0%pa i.e.	$4000pa
2. investment2Fund	$100K	$3000 &	$400pa	1.5%pa i.e.	$1500pa
Total	$300K	$9000 &	$1200pa		$5500pa

Level of risk in the portfolio recommended: Low Medium High Very High

Level of likely volatility in portfolio recommended: Low Medium High Very High

Other factors which might taint (influence) my advice:

Note: Please consult the ASIC "Consumer Guide to Conflicts of Influence Tainting Advice" for discussion of how these conflicts of interest might taint my advice.

Potential factor which might taint/fluence my advice	Response
Is this AFS licencee or any related party owned (or partially owned) by any product provider or any related party to a product provider? (Note: A product provider includes a platform provider)?	Yes/No. If yes, the related product providers are .....
Other than clearly disclosed commission, does any product provider or related party provide any financial benefit to the AFS	Yes/No.

<u>Potential factor which might taint/fluence my advice</u>	<u>Response</u>
licencee or their representatives? Note: In this context, a related party to a product provider includes 3rd-parties with any relationship with product providers or their related parties including where the 3rd party is a conduit for volume bonus arrangements.	If yes, benefits received include: Volume bonuses (Yes/No), loans of any form (Yes/No), Marketing assistance (Yes/No), Training assistance (Yes/No), Shelf-space fees either for the approved list or for the platform (Yes/No), other financial benefits which are detailed below (Yes/No). The financial benefits the AFS licencee or representatives receive are as follows .....
Does the AFS licencee and the representatives of the AFS licencee fully disclose all financial benefits that they receive both directly and indirectly from all product providers, related parties to any product provider and any third-party which might have any arrangement (including volume bonus arrangements.)	Yes, no. If no, what financial benefits are being received and why are they not being disclosed? ....
Does this AFS licencee require any product provider to pay shelf-space fees (or any other fee) for either placing a product on either an approved list or on a platform?	
<u>Neutral advice compensation for the advisor.</u> When investment advice is provided, is the representative and AFS licencee going to be paid the same regardless of what (if any) products are recommended? Note: There are two primary ways to achieve neutral advice compensation: 1. No commission or financial benefits are provided by any product provider to the AFS licencee or their representatives. 2. If there is commission or financial benefits are provided by any product provider or related party, THEN the client receives credit of an amount equivalent to the commission or value of the financial benefits.	Is advice provided on a neutral-compensation basis? Yes/No.
Is the advisor given a “quota” of product to sell?	
Will the advisor lose their job if they do not sell a certain amount of product?	
More factors that might taint advice to be added.	

Yours Sincerely

Peter Stevens DipFinPlanning
<u>Representative, Peters Financial Product Sales Pty Ltd</u>

<u>Note:</u> For discussion about the recommendations above, please read the attached document titled “Basis for Advice”.

Appendix D. Four tips for ASIC on enforcement – Peter Townsend, Sir Anthony Mason.

On May 2, 1935, commenting in the House of Commons upon Hitler's definite declarations to Sir John Simon, **Winston Churchill** said :

> ***"When the situation was manageable, it was neglected, and now that it is thoroughly out of hand we apply too late the remedies which might have effected a cure.*** *There is nothing new in the story. It is as old as the Sybilline Books. It falls into that long, dismal catalogue of the fruitlessness of experience and the confirmed unteachability of mankind.* ***Want of foresight, unwillingness to act when action would be simple and effective, lack of clear thinking, confusion of counsel until the emergency comes, until self-preservation strikes its jarring gong these are the features which constitute the endless repetition of history."***

http://www.archive.org/stream/mrenglandthelife001387mbp/mrenglandthelife001387mbp_djvu.txt

Should we apply Churchill's counsel to ASIC, on not enforcing key aspects of Corporations Law to have prevented past consumer losses from problems such as **Storm Financial**?

Tip 1. **Lawyer Peter Townsend** argues that ASIC could have shut Storm down before the massive losses by Storm clients. http://www.townsendslaw.com.au/article.php?id=146 Peter's line of argument is that:

> *"The obvious constant between two of the biggest investment fund failures in the last few years, Westpoint and Storm Financial, was the high commission rates these products paid to financial planners."*
>
> *"ASIC have the necessary power for such investigations and the payment of outlandish commission rates and the connection of high rates with previous failures suggests that it should have checked those products earlier."*

Tip 2. **Sir Anthony Mason** said in presentation to the SPAA conference in March 2009.

"The need for improved regulatory protection extends to investors generally; *it is not confined to the superannuation industry. The emphasis in protection should be on preventive monitoring, rather than punitive enforcement. Reliance on enforcement after the horse has bolted results in complex and costly court proceedings frequently yielding substantial professional fees but little in the way of recovery and recompense for the unfortunate individual.* ***Some, at least, of the investment disasters we have seen in recent times have been disasters waiting to happen – Westpoint was an example - disasters which an alert and well-resourced regulator, with its eye on the ball, might well have alleviated by taking prompt action well in advance of the inevitable meltdown, if the emphasis was on prevention monitoring rather than enforcement after the horse bolted."***

Given that the Storm Financial situation was even more obviously a "disaster-waiting-to-happen", then Sir Anthony Mason's comments apply equally to Storm.

Tip 3. Journalist John Collett in the 26th February SMH says:-

"But ***the regulator moves only after investors have lost their money.*** *It needs to conduct spot audits if it suspects inappropriate, or sales-motivated, advice is being given to clients without regard to their circumstances."*

http://www.moneymanager.com.au/articles/2009/02/23/1235237554084.html

Tip 4. A tactic that ASIC could efficiently use weed out the bad apples is to "follow the money".

As indicated previously, it often becomes known in the industry who the dodgy dealers/advisors are – and ASIC needs to tap into that industry intelligence. But these sources of industry intelligence should not be the end of the trail – but rather the beginning of the money trail. For example, there is a widespread view that the same advisors who recommend one dodgy product (because of high commissions) will also recommend other dodgy products. When ASIC comes across such a situation it should follow the money trail in a number of directions, specifically:-

- where a financial planner has been found to have recommended a dodgy product (eg because of high commissions), ASIC should go to the product provider and get the list of advisors who are recommending that dodgy product. This is one line of investigation.
- ASIC should also look at the broader list of products recommended by this dodgy advisor, because this list is likely to contain other dodgy products. When the list of questionable products is determined, ASIC could go back to each of these product providers to see which other advisors are recommending those products.
- If ASIC pursues this strategy, fairly quickly, ASIC will be building up a lot of industry intelligence related to potentially unethical advice. A target list of high-risk advisors/dealers can quickly be drawn up, and these can be targeted by audits. I suspect ASIC could have a big impact in removing from the industry, a lot of the bad apples fairly quickly, if this approach was adopted.

Appendix E. Response to lawyer Peter Bobbin, who argues the law denies salespeople right to be called advisors.

Lawyer Peter Bobbin, points to a court judgement to make the point that

- *"Effectively, District Court Judge McGill is saying that if you say you are a financial planner then be one, if you are a product salesman then don't call yourself a financial planner."*
- *"If people who call themselves investment advisers are going to act as financial product salesmen, they need to make it quite clear to the people with whom they are dealing that that is what they are doing, or they will be held to the duty of care appropriate if they are reasonably relied on as giving objective advice,"* **District Court Judge McGill said in his judgment.**
- Based on this Peter Bobbin argues that stricter definitions around salesman and advisers not needed

The problems I have with Peter Bobbin's position on this are these:-

- First, if we simply look at the Roy Morgan research from the last few years (http://www.aph.gov.au/senate/committee/corporations_ctte/fps/submissions/sub15.pdf), **it is patently obvious that there are large number of AFSL reps who are holding themselves out as advisors, where they are actually sales reps. So if the law is strong enough, we have another case of failure to police adequately by the regulator.**
- Second, as previously discussed (http://www.aph.gov.au/senate/committee/corporations_ctte/fps/submissions/sub15a.pdf) **there clearly is a very large grey zone of AFSL reps who exhibit some of the characteristics of being sales people and some of the characteristics of advisors**. It would seem obvious that if the current regulatory environment was adequate and was adequately being enforced, this entire grey zone of AFSL reps would have to call themselves salespeople, not advisors. This clearly has not happened. So action is required on the regulatory level or on the enforcement level, probably both. **In my view, anyone who exhibits any of the characteristics of being a financial product sales rep, needs to call themselves a salesperson.** I suspect this would leave us with a lot of sales reps and very few advisors in Australia, until we see a behavioural change, a cultural change and probably an industry-wide structural change.
- Part of the problem is that maybe **some of the people who should be calling themselves sales reps, are currently no aware of that.** There clearly needs to be a definition of where the dividing line is. I have commenced the process of defining that dividing line in (http://www.aph.gov.au/senate/committee/corporations_ctte/fps/submissions/sub15a.pdf).
- I suspect that the circumstances of the case that Peter Bobbin discusses (on which Judge McGill made a ruling on), is an extreme case where the advisor was very clearly a salesperson rather than an advisor – and therefore **this case may not help the broader financial planning industry understand where the dividing line is between advisors and sales reps.** Further, there is an extremely widespread attitude among AFSL reps, that they ought to be able to use the terms "advisor" while they continue to exhibit product-sales characteristics such as accepting volume over-rides and other kick-backs from product manufacturers.
- Then we come to the **structural problem in Corporations Law,** where advisors are not individually licensed. As a result, **advisors are simply (under Corporations Law) mouth-pieces for the AFSL that they represent.** The AFSL is responsible for the actions of the AFSL rep. The AFSL therefore has the decision on whether the rep should hold himself or herself out as an advisor or a salesperson. **This decision on rep labelling therefore is a business decision by the AFSL rather than being a professional ethics decision by the AFSL rep. This is problematic, and it defeats any professional bodies seeking to promote professional and ethical standards.** Also clearly (from stories I have heard over the year) many AFSL reps find themselves in an ethical quandary, torn between their personal ethical standards and the requirements of their AFSL.

  Journalist John Collett in the 26th February SMH correctly says

  > "The problem for investors is that the regulatory regime misses the central issue: is the planner providing appropriate advice? Sound advice may involve keeping money in cash or investing in direct property - neither of which generate sales commissions.
  >
  > The way the advisory system is set up benefits the big financial institutions that

manufacture the products. **The model is about financial planners distributing those products and being rewarded to do so.** Although the system is riddled with conflicts of interest, it is unlikely the Government will dismantle it."

John Collett's point is well-made. And indeed, **the government does need to look at dismantling the regulatory regime and move to a regime of individually licensing advisors if it is to get the best outcome for consumers.**

A big part of the financial planning industry is about product distribution for the big product manufacturers. These big and powerful product manufacturers will fight tooth and nail to retain the current product distribution system of their mostly undifferentiated products, because **it enables them to avoid competing on price.** Breaking down these current product distribution systems will force greater price competition. The large product manufacturers will also fight tooth and nail to prevent their product sales force being labelled as salespeople, because exposure for what they are will make it more difficult to sell product – because the "aura of legitimacy" of the label "adviser" helps them to sell product.

- An interested related comment from highly regarded financial planner **Robert Keavney**. *"What we should do is adopt practices that stand up to scrutiny, yet foster the development of a healthy, profitable industry. (**I use the term 'industry' rather than 'profession' despite the existence of many first class professionals within it because a large number are still in the business of selling a product**, like any other retail industry.)"*
  http://www.moneymanagement.com.au/article/We-have-reached-a-tipping-point/480878.aspx

- Finally, I would like to leave the last word to **former Chief Justice Sir Anthony Mason.** In his presentation to the SPAA Annual conference in March 2009, he said:

  > *"Our system of regulation proceeds on the footing that the adviser may be a product seller. Indeed, **our system enables the product seller to adopt the disguise of a financial adviser and endows that disguise with the aura of legitimacy by calling him a 'licensed' financial adviser.** As such, he is required to disclose the conflict to the client. But how often is that disclosure meaningful? Often it is made as a small print item in a lengthy document expressed in impenetrable prolix prose to which the client's attention is not directed. **Detailed and dense disclosure is often the most effective form of concealment.** Three years ago ASIC said that its Survey suggested that 'disclosure . . . can only play a limited role in protecting consumers from inappropriate or conflicted advice.'"*

In summary, clearly the financial planning industry has a long way to go before we have truth-in-labelling of AFSL reps – and in my view, both regulatory and enforcement measures are required to rectify this.

http://www.moneymanagement.com.au/Article/Stricter-definitions-around-salesman-and-advisers-not-needed-Bobbin/478607.aspx

Stricter definitions around salesman and advisers not needed: Bobbin

27April 2009 | by Lucinda Beaman

The parliamentary inquiry into banking and financial services is sparking debate within the industry, with financial services lawyer Peter Bobbin responding to a submission recently made by a Queensland financial planner.

As reported by *Money Management* last week, Bruce Baker of Puzzle Financial Advice made a submission to the inquiry in which he suggested that regulations must ensure that "financially naïve" consumers be able to readily distinguish a "financial product salesperson from an adviser who is acting in the client's best interest".

"If Storm Financial was clearly identified as a financial product sales business … fewer consumers [might] have lost money," Baker said.

Baker agrees with the UK Financial Services Authority's view that consumers benefit from a differentiation between "independent investment advice and financial product sales".

But Bobbin has responded by saying that "more regulation is not needed", saying that existing law accounts for this need and as such "all the profession must do is follow the law".

Bobbin pointed to the November 2008 Queensland case of Evans vs Brannelly (a Westpoint decision). That case contained a quote which Bobbin believes negates the need for further regulations or definition around the roles played by financial product salesmen versus financial advisers.

"If people who call themselves investment advisers are going to act as financial product salesmen, they need to make it quite clear to the people with whom they are dealing that that is what they are doing, or they will be held to the duty of care appropriate if they are reasonably relied on as giving objective advice," District Court Judge McGill said in his judgment.

"In my view, this case is showing that the courts will put the flesh to the skeletal framework that [Financial Services Reform] was seven years ago," Bobbin said.

"Effectively, District Court Judge McGill is saying that if you say you are a financial planner then be one, if you are a product salesman then don't call yourself a financial planner."

As such, Bobbin said, "regulatory changes are not needed".

"The law already recognises the difference."

Bobbin believes this judgment should be "compulsory reading for all compliance professionals and advisers".

Appendix F. **Fiduciary responsibility** of financial planners and AFSLs.

Because of the complexity of issues on which financial advisors give advice, necessarily in a substantial proportion of cases there necessarily is a fiduciary relationship between client and advisor. Because of the complexity of the issues, necessarily many recommendations by advisors are accepted by clients on trust – rather than on the client properly understanding the full nature of the risks and strategy adopted. This is a central source of the advisor's fiduciary obligations.

Under common law therefore, a lot of the AFSL conflicts of interests which are currently regarded as acceptable, need to be banned for AFSLs who have reps who seek to hold themselves out as an advisor (rather than sales rep).

- From what I can see, **Storm Financial** failed its fiduciary obligations. I think it is also clear that Storm had a range of conflicts of interest which were inconsistent with having a fiduciary relationship – and these conflicts need to be banned for people holding themselves out as advisors.

http://en.wikipedia.org/wiki/Fiduciary_duty

On this important issue of fiduciary duty, it is again worthwhile to quote from Sir Anthony Mason's March 2009 speech at the SPAA conference where he asks **"Why has it taken us so long to clearly recognise that an adviser should put the client's interest ahead of his own interests?"** The section below is from Sir Anthony mason's speech.

'The ISN Media Release called for two reforms:

- The immediate abolition of sales commissions on superannuation; and
- **The extension of the fiduciary obligation required of super fund trustees to act "in the best interests of the client".**

The Media Release said:

"An obligation for a financial adviser to act in the 'best interests' of their client would require the adviser to scrupulously avoid any actual or perceived self-interest. A best interests obligation would require a financial adviser:

- **To give advice which is in the client's best interests;**
- **To ensure that they do not allow their own interests or the interests of an associate to conflict with the client's interest;**
- To receive fair time-based remuneration for the services provided to the client, which are concisely and clearly disclosed to the client and paid for by the client.

The Release went on to claim:

"Conflicted remuneration practices such as shelf or platform fees, trail commissions, up front commissions, ongoing adviser fees, adviser service fees and asset based adviser fees paid to financial advisers by product issuers ensure that there is always an element of sales in financial advice and are not consistent with a 'best interests' obligation".

ISN is not alone in calling for a “client-first” principle of responsibility. The Financial Planning Association of Australia has adopted a new code which operates as a condition of membership. The code incorporates the “client-first” principle. This principle involves a different and higher level of responsibility (described as a “fiduciary responsibility”) than the common law duty of care responsibility which, the Association asserts, involves no more than a duty to provide advice “on a reasonable basis”.

The imposition and adoption of a “client first” principle of responsibility is not only highly commendable; it is essential. **Why has it taken us so long to clearly recognise that an adviser should put the client’s interest ahead of his own interests?'**