Parliamentary Joint Committee
on Corporations and Financial Services

Inquiry into financial products and services in Australia

November 2009

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Members of the Committee

Current members

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Senator the Hon Brett Mason, **Deputy Chair**	QLD	LP
Senator Sue Boyce	QLD	LP
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Ms Sharon Grierson MP	NSW	ALP
Ms Julie Owens MP	NSW	ALP
The Hon Chris Pearce MP	VIC	LP
Mr Stuart Robert MP	QLD	LP

Other members during this inquiry

Senator the Hon Mark Arbib (until 10.03.09)	NSW	ALP
Senator Gavin Marshall (until 24.06.09)	VIC	ALP

SECRETARIAT

Dr Shona Batge, Secretary

Mr Andrew Bomm, Principal Research Officer

Ms Emina Poskovic, Executive Assistant

With assistance from:

Ms Toni Matulick, Secretary

Ms Sophie Dunstone, Senior Research Officer

Ms Clare Guest, Executive Assistant

Suite SG.64
Parliament House
Canberra ACT 2600

T: 61 2 6277 3583
F: 61 2 6277 5719
E: corporations.joint@aph.gov.au
W: www.aph.gov.au/senate/committee/corporations_ctte

Duties of the Committee

Section 243 of the *Australian Securities and Investments Commission Act 2001* sets out the Parliamentary Committee's duties as follows:

(a) to inquire into, and report to both Houses on:

(i) activities of ASIC or the Panel, or matters connected with such activities, to which, in the Parliamentary Committee's opinion, the Parliament's attention should be directed; or

(ii) the operation of the corporations legislation (other than the excluded provisions), or of any other law of the Commonwealth, of a State or Territory or of a foreign country that appears to the Parliamentary Committee to affect significantly the operation of the corporations legislation (other than the excluded provisions); and

(b) to examine each annual report that is prepared by a body established by this Act and of which a copy has been laid before a House, and to report to both Houses on matters that appear in, or arise out of, that annual report and to which, in the Parliamentary Committee's opinion, the Parliament's attention should be directed; and

(c) to inquire into any question in connection with its duties that is referred to it by a House, and to report to that House on that question.

Terms of Reference

On 25 February 2009 the Parliamentary Joint Committee on Corporations and Financial Services resolved to inquire into and report by 23 November 2009 on the issues associated with recent financial product and services provider collapses, such as Storm Financial, Opes Prime and other similar collapses, with particular reference to:

1. the role of financial advisers;

2. the general regulatory environment for these products and services;

3. the role played by commission arrangements relating to product sales and advice, including the potential for conflicts of interest, the need for appropriate disclosure, and remuneration models for financial advisers;

4. the role played by marketing and advertising campaigns;

5. the adequacy of licensing arrangements for those who sold the products and services;

6. the appropriateness of information and advice provided to consumers considering investing in those products and services, and how the interests of consumers can best be served;

7. consumer education and understanding of these financial products and services;

8. the adequacy of professional indemnity insurance arrangements for those who sold the products and services, and the impact on consumers; and

9. the need for any legislative or regulatory change.

On 16 March 2009 the Senate agreed that the following additional matter be referred to the Parliamentary Joint Committee on Corporations and Financial Services as part of that committee's inquiry into financial products and services in Australia, adopted by the committee on 25 February 2009 for inquiry and report by 23 November 2009:

> The committee will investigate the involvement of the banking and finance industry in providing finance for investors in and through Storm Financial, Opes Prime and other similar businesses, and the practices of banks and other financial institutions in relation to margin lending associated with those businesses.

In conducting its inquiry, the Committee made a decision to focus specifically on non-superannuation products and services.

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Chapter 1

Introduction

Terms of reference

1.1 On 25 February 2009 the Parliamentary Joint Committee on Corporations and Financial Services resolved to inquire into and report by 23 November 2009 on the issues associated with recent financial product and services provider collapses, such as Storm Financial, Opes Prime and other similar collapses, with particular reference to:

1. the role of financial advisers;
2. the general regulatory environment for these products and services;
3. the role played by commission arrangements relating to product sales and advice, including the potential for conflicts of interest, the need for appropriate disclosure, and remuneration models for financial advisers;
4. the role played by marketing and advertising campaigns;
5. the adequacy of licensing arrangements for those who sold the products and services;
6. the appropriateness of information and advice provided to consumers considering investing in those products and services, and how the interests of consumers can best be served;
7. consumer education and understanding of these financial products and services;
8. the adequacy of professional indemnity insurance arrangements for those who sold the products and services, and the impact on consumers; and
9. the need for any legislative or regulatory change.

1.2 On 16 March 2009 the Senate agreed that the following additional matter be referred to the Parliamentary Joint Committee on Corporations and Financial Services as part of that committee's inquiry into financial products and services in Australia, adopted by the committee on 25 February 2009 for inquiry and report by 23 November 2009:

> The committee will investigate the involvement of the banking and finance industry in providing finance for investors in and through Storm Financial, Opes Prime and other similar businesses, and the practices of banks and other financial institutions in relation to margin lending associated with those businesses.

Definitions of key inquiry terms

Financial product

1.3 Section 763A of the *Corporations Act 2001* sets out the general definition of a financial product as follows:

> (1)... a ***financial product*** is a facility through which, or through the acquisition of which, a person does one or more of the following:
>
> > (a) makes a financial investment ...;
> >
> > (b) manages financial risk ...;
> >
> > (c) makes non-cash payments ...
>
> (2) ... a particular facility that is of a kind through which people commonly make financial investments, manage financial risks or make non-cash payments is a ***financial product*** even if that facility is acquired by a particular person for some other purpose.
>
> (3) A facility does not cease to be a financial product merely because:
>
> > (a) the facility has been acquired by a person other than the person to whom it was originally issued; and
> >
> > (b) that person, in acquiring the product, was not making a financial investment or managing a financial risk.[1]

Financial service

1.4 Section 766A of the *Corporations Act 2001* identifies a financial service as follows:

> (1)... a person provides a ***financial service*** if they:
>
> > (a) provide financial product advice...; or
> >
> > (b) deal in a financial product...; or
> >
> > (c) make a market for a financial product ...; or
> >
> > (d) operate a registered scheme; or
> >
> > (e) provide a custodial or depository service...; or
> >
> > (f) engage in conduct of a kind prescribed by regulations made for the purposes of this paragraph. [2]

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1 The full text of the *Corporations Act 2001* is available at http://www.comlaw.gov.au/comlaw/management.nsf/lookupindexpagesbyid/IP200401854?OpenDocument (accessed on 17 September 2009).

2 The full text of the *Corporations Act 2001* is available at http://www.comlaw.gov.au/comlaw/management.nsf/lookupindexpagesbyid/IP200401854?OpenDocument (accessed on 17 September 2009).

Conduct of the inquiry

1.5 The inquiry was advertised in *The Australian* newspaper, *The Australian Financial Review* newspaper and through the internet. The committee invited submissions from a wide range of interested organisations, government departments and authorities, and individuals. The closing date for submissions was 31 July 2009, and the committee agreed to table its report on 23 November 2009. The Senate also set 23 November 2009 as the reporting date for the additional term of reference that was added to the committee's initial terms of reference, although the committee subsequently sought an extension of the Senate reporting date until 24 November in order to fit in with standard parliamentary administrative processes.

1.6 In conducting its inquiry, the committee made a decision to focus specifically on non-superannuation products and services.

1.7 The committee received 398 formal submissions and 37 supplementary submissions, as well as associated correspondence and supporting material. A list of individuals and organisations that made public submissions to the inquiry is at Appendix 1.

1.8 The committee held nine public hearings, in Canberra (four hearings), Melbourne, Cairns, Townsville, Brisbane and Sydney. A list of witnesses who gave evidence at the public hearings is at Appendix 2.

1.9 Some witnesses took questions on notice at public hearings. Answers received are published in Appendix 3.

1.10 A list of material tabled during the inquiry or provided to the committee as additional information is published at Appendix 4.

Acknowledgement and thanks to contributors

1.11 The committee thanks those organisations and individuals that made written submissions and gave evidence at the public hearings. In particular, the committee recognises the trauma experienced by many investors in Storm Financial, Opes Prime and similar collapsed providers and is grateful to investors who were prepared to share their experiences with the committee.

1.12 Across the program of public hearings, the committee's aim was to hear from a balanced selection of investors, advisers, product providers, finance providers, representative groups and individuals. Nevertheless, the committee acknowledges that there were many people who wanted to give evidence at hearings but who did not get the opportunity to do so. The committee thanks all of these people for their willingness to assist the committee in its work.

Note on references

1.13 References to submissions in this report are to individual submissions received by the committee and published on the internet.[3] References to the committee Hansard are to the official Hansard transcript of the public hearings, with the exception of the 28 October hearing, for which only a proof transcript was available at the time of writing.[4] Please note that page numbers may vary between the proof and the official Hansard transcripts.

Report structure

1.14 Chapter 2 summarises the current regulatory regime for financial services and products in Australia, particularly the provisions of Chapter 7 of the *Corporations Act 2001*, and the role of the regulator, the Australian Securities and Investments Commission (ASIC). This chapter also provides a current snapshot of Australia's financial advice sector.

1.15 Chapter 3 addresses the events surrounding the collapse of Storm Financial, the consequences of that collapse, and the evidence provided to the committee about what caused the collapse and why it has been so devastating for so many investors.

1.16 Chapter 4 presents the evidence the committee received regarding the collapse of Opes Prime, including the effect on investors, the evidence received by the committee about what caused the collapse, and the scheme of arrangement accepted by creditors to recover a portion of their money.

1.17 Chapter 5 highlights problems or issues in the provision of financial products and services that were drawn to the committee's attention during the course of its inquiry. Matters discussed include the sales-advice conflict; whether it is poor advice or poor products that lead to poor investment outcomes; the adequacy (or otherwise) of the current regulation of financial advice provision, including the conduct and disclosure-based approach to managing conflicts of interest; the Australian Financial Services licensing regime; professional indemnity (PI) insurance arrangements; and financial literacy levels. The suggestion that the current regulatory regime is appropriate but is not effectively enforced is also discussed in this chapter.

1.18 Chapter 6 sets out a range of solutions or reforms that were proposed to the committee during the course of the inquiry. Suggestions for change in the sector that are canvassed in this chapter include raising standards of advice; making disclosure more effective; removing conflicted remuneration practices; ensuring better

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3 Submissions to the inquiry are available at the following link: http://www.aph.gov.au/senate/committee/corporations_ctte/fps/submissions/sublist.htm (accessed on 17 September 2009).

4 Transcripts of the committee's public hearings can be accessed at the following link: http://www.aph.gov.au/senate/committee/corporations_ctte/fps/hearings/index.htm (accessed on 17 September 2009).

transparency, competency and accountability through the financial services licensing system; reforming lending practices; limiting access to complex and/or risky investment products; and introducing a last resort statutory compensation scheme. The committee makes eleven recommendations in this chapter.

1.19 Chapter 7 summarises the committee's views and reiterates the committee's recommendations for change arising out of this inquiry.

Privilege issue

1.20 During the course of the inquiry, a matter of parliamentary privilege arose. A person who had made a submission to the inquiry drew the committee's attention to a letter in which they were threatened with a penalty as a direct result of making that submission.

1.21 The committee considered this to be a serious incident and took immediate action to resolve the matter, as detailed in Appendix 5.

Chapter 2

Current regulation of financial products and services in Australia

2.1 This chapter provides a broad overview of the current regulatory arrangements for financial products and services in Australia. It also provides a brief snapshot of the Australian financial services sector at the time of writing.

Financial services regulation in Australia

2.2 The regulation of financial services providers has been designed to maximise market efficiency, with minimal regulatory intervention to protect investors. The Australian Securities and Investments Commission (ASIC) informed the committee:

> The fundamental policy settings of the FSR regime were developed following the principles set out in the Financial System Inquiry Report 1997 (the Wallis Report). These principles are based on 'efficient markets theory', a belief that markets drive efficiency and that regulatory intervention should be kept to a minimum to allow markets to achieve maximum efficiency. The 'efficient markets theory' has shaped both the FSR regime and ASIC's role and powers.[1]

2.3 Regulation to protect investors is limited to conduct and disclosure requirements imposed on Australian Financial Services Licence (AFSL) holders. The purpose of these is:

> (a) conduct regulation – rules designed to ensure industry participants behave with honesty, fairness, integrity and competence, as well as rules relating to the settlement of disputes between market participants and investors; and
>
> (b) disclosure regulation – rules designed to:
>
> > (i) overcome the information asymmetry between industry participants and investors by requiring disclosure of information required to facilitate informed decisions by investors; and
> >
> > (ii) promote transparency in financial markets.[2]

2.4 ASIC described the system as designed to be 'largely self-executing', with ASIC's role being 'to oversee and enforce compliance'.[3] The financial services licensing system and the associated conduct and disclosure requirements are outlined in more detail below.

---

1 ASIC, *Submission 378*, p. 4.

2 ASIC, *Submission 378*, pp. 4-5.

3 ASIC, *Submission 378*, p. 5.

2.5 ASIC's role in administering the licensing process, or monitoring and enforcing compliance with licensees' regulatory obligations, does not include ASIC vetting licensees' business models or preventing the availability of complex or high risk financial products to unsophisticated investors. ASIC noted:

> Conduct and disclosure regulation does not involve any guarantee that regulated products and institutions will not fail and that promises made to retail investors will be met. Under a conduct and disclosure regime retail investors are still subject to risks.[4]

Licensing

2.6 Section 911A of the *Corporations Act 2001* (Corporations Act) stipulates that financial services businesses, including those who provide financial product advice, must hold an Australian Financial Services Licence (AFSL). As part of its responsibility for regulating the financial services industry, licences are issued and monitored by ASIC.

2.7 Section 766A of the Corporations Act states that the provision of a financial service includes the following:

- providing financial product advice;
- dealing in financial products;
- making a market for financial products;
- operating a registered scheme; or
- providing a custodial or depository service.

2.8 Section 763A of the Corporations Act defines a financial product as a facility where a person makes a financial investment, manages financial risk or makes non-cash payments.[5]

2.9 An AFSL imposes a number of obligations on licensees and their representatives, including the scope of the financial services the licensee is authorised to provide.[6] All financial services providers hold a single category of licence, though the conditions attached to their AFSL may vary between licensees. In accordance with section 914A of the Corporations Act, ASIC has the discretion to alter the conditions attached to AFS licences. This includes exemptions to particular licence conditions in certain circumstances.

4 ASIC, *Submission 378*, p. 18.

5 Sections 763B, 763C and 763D of the Corporations Act define these terms.

6 ASIC, *Submission 378*, p. 126.

2.10 Section 911A provides that authorised representatives or employees of AFSL holders (licensees) are not required to hold a licence themselves. The licensee is responsible for the financial service or advice delivered by their representative. If a person is providing a financial service or advice without supervision, if their conduct is not covered by someone else's compensation arrangements, or if client assets and payments are held in their name or paid into their account and commissions are received directly, then they are likely to require an AFSL in their own right.

2.11 Prospective licensees are required to undertake a number of steps in order to demonstrate to ASIC that they are going to be able to meet the conditions applying to licence holders. These include (but are not limited to) the requirements for licensees to provide the following information or documentation:

- details of the financial services business, including the nature of the services to be provided and to whom they will be offered, and an organisational chart;
- information on the prospective licensee's responsible managers to enable ASIC to assess organisational competence, including criminal and bankruptcy checks, references and qualifications against their role; and
- demonstrations that the prospective licensee has the necessary financial resources to carry on the proposed business, including financial statements and cash flow projections.

2.12 ASIC noted that it has limited grounds on which to deny an application for a licence:

> ASIC must grant an AFS licence if:
>
> (a) the application is made properly;
>
> (b) ASIC is satisfied that the applicant or the applicant's responsible managers are of good character;
>
> (c) ASIC has no reason to believe that the applicant will not comply with licensee obligations; and
>
> (d) the applicant has provided ASIC with any additional information requested for the purposes of assessing the application.
>
> ASIC cannot refuse an application for an AFS licence for reasons beyond the above-specified criteria (e.g. ASIC cannot refuse to grant a licence on the basis of the licensee's proposed business model). ASIC cannot refuse to grant a licence without giving the applicant an opportunity to be heard and a refusal to grant a licence can be appealed to the Administrative Appeals Tribunal (AAT).[7]

7 ASIC, *Submission 378*, pp 125-126.

2.13 The Corporations Act sets out a number of conditions or obligations applying to AFSL holders and their representatives. These include the following general obligations under section 912A:

- providing relevant financial services efficiently, honestly and fairly;
- arrangements to manage conflicts of interest;
- complying with licence conditions and relevant financial services laws, including taking reasonable measures to ensure that authorised representatives do this;
- having adequate resources;
- maintaining competence to provide the financial service, including training representatives to maintain their competence;
- adequate risk management systems; and
- a dispute resolution system and compensation arrangements for retail clients.[8]

2.14 Licensees must also meet other legislative obligations including:

- notifying ASIC of any likely breach of their licensee obligations (section 912D);
- disclosure requirements under the Corporations Act, including the requirement to provide clients with information on remuneration, commissions and other benefits derived from the advice being provided (sections 941-943 and 946-947);
- a requirement for personal advice to have a reasonable basis and be appropriate for the client (s945A);
- market conduct provisions in the Corporations Act; and
- consumer protection provisions of the ASIC Act.[9]

2.15 The conduct and disclosure requirements most relevant to this inquiry are explained in more detail below.

8 The compensation arrangements are to meet claims from the licensee's failure to meet their obligations under the Corporations Act, rather than for investment failure.

9 See Part 2, Division 2, Subdivision D of the ASIC Act.

Conduct obligations

2.16 Licensees authorised to provide advice about financial products are required to meet certain minimum legislative standards when advising clients.

2.17 The Corporations Act outlines the circumstances that constitute the provision of financial product advice, split into two categories: personal advice and general advice. Under section 766B(1) of the Corporations Act, financial product advice is defined as:

> ...a recommendation or a statement of opinion, or a report of either of those things, that:
>
> (a) is intended to influence a person or persons in making a decision in relation to a particular financial product or class of financial products, or an interest in a particular financial product or class of financial products; or
>
> (b) could reasonably be regarded as being intended to have such an influence.

2.18 Section 766B(3) of the Act defines personal advice as:

> ...financial product advice that is given or directed to a person (including by electronic means) in circumstances where:
>
> (a) the provider of the advice has considered one or more of the person's objectives, financial situation and needs...; or
>
> (b) a reasonable person might have expected the provider to consider one or more of those matters.

2.19 Section 766B(4) defines general advice as: '...financial product advice that is not personal advice.'

2.20 Advisers providing personal financial advice must ensure that there is a reasonable basis for that advice, often referred to as the 'suitability rule'.[10] Section 945A of the Corporations Act stipulates that:

> (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

10 ASIC, *Regulatory Guide 175*, 'Licensing: Financial product advisers – Conduct and disclosure', May 2009, p. 33.

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

2.21 In other words, the adviser must know their client, know the product and/or strategy they are recommending, and ensure that the product and/or strategy is appropriate to the clients' particular needs. This standard does not require that personal advice needs to be 'ideal, perfect or best'.[11] A more detailed explanation of the requirement to provide advice of a standard that complies with section 945A is included in ASIC's Regulatory Guide 175.

2.22 Section 949A of the Corporations Act requires that licensees providing general advice to clients warn them that the advice does not take into account their personal objectives, financial situation or needs.

Disclosure obligations

2.23 Part 7.7 of the Corporations Act requires licensees and their authorised representatives to provide certain disclosure material to retail clients.

2.24 All retail clients of financial services providers must be given a Financial Services Guide (FSG):

> The FSG provisions are designed to ensure that the client is given sufficient information to enable them to decide whether to obtain the financial services from the providing entity. An FSG must also include information about:
>
> (a) the kinds of financial services the providing entity is authorised to provide under its AFS licence;
>
> (b) who the providing entity acts for when providing the authorised services;
>
> (c) remuneration (including commission) or other benefits connected to providing the authorised services;
>
> (d) other interests, associations or relationships that might be expected to be or have been capable of influencing the providing entity in providing the authorised services; and
>
> (e) dispute resolution systems.[12]

2.25 Where a licensee provides personal financial advice to a retail client, a Statement of Advice (SOA) must also be provided:

---

11 ASIC, *Regulatory Guide 175*, 'Licensing: Financial product advisers – Conduct and disclosure', May 2009, p. 34.

12 ASIC, Submission 378, p. 129. See section 942B of the Corporations Act. Further information is available at ASIC, *Regulatory Guide 175*, 'Licensing: Financial product advisers – Conduct and disclosure', May 2009, pp 18-32.

An SOA must set out the advice and the basis on which it was given. It must also contain:

(a) the name and contact details of the provider of the advice;

(b) information about remuneration (including commissions) or other benefits that the provider and related or associated persons or entities may receive (these amounts must be disclosed in dollars unless otherwise permitted by ASIC relief); and

(c) information about other interests, associations or relationships that might be expected to be or have been capable of influencing the advice.[13]

2.26 These obligations require licensees and authorised representatives to disclose any potential conflicts of interest when providing financial advice, either because of their particular ownership or remunerative arrangements. Section 947B(6) of the Corporations Act states that the information provided in the SOA 'must be worded in a clear, concise and effective manner'.

Competency and training requirements

2.27 A general obligation for licensees under section 912A of the Corporations Act is to ensure that authorised representatives are adequately trained and competent to provide the relevant financial services. The level of training required of financial advisers is commensurate with the complexity of the products they advise on and whether the advice is of a general or personal nature.[14] Products are divided into Tier 1 and Tier 2 categories, with the latter being comprised of more straightforward products such as general insurance products and basic deposit products.[15] ASIC's Regulatory Guide 146 sets out in detail the various minimum training standards for advisers and how these can be met. The most arduous minimum training requirements, applying to financial advisers providing personal advice on more complex financial products, are equivalent to diploma level qualifications.[16]

Professional indemnity (PI) insurance

2.28 Section 912B of the Corporations Act requires that licensees have compensation arrangements for loss or damage caused by breaches of their legislative obligations under Chapter 7 of the Act:

---

13 ASIC, Submission 378, p. 132. See section 947B of the Corporations Act. Further information is available at ASIC, *Regulatory Guide 175*, 'Licensing: Financial product advisers – Conduct and disclosure', May 2009, pp 43-56.

14 ASIC, *Regulatory Guide 146*, ' Licensing: Training of financial product advisers', August 2008, p. 16.

15 ASIC, *Regulatory Guide 146*, ' Licensing: Training of financial product advisers', August 2008, p. 17.

16 ASIC, *Regulatory Guide 146*, ' Licensing: Training of financial product advisers', August 2008, p. 5.

> Under these arrangements, licensees must obtain PI insurance that is adequate having regard to the nature of the licensees business and its potential liability for compensation claims, or be approved by ASIC as alternative arrangements. In determining what is adequate insurance, ASIC will take into account what is available in the market.[17]

2.29 ASIC has established a transition period for the implementation of compulsory PI insurance:

> To achieve this objective, we will take a staged approach to administering these requirements:
>
> > (a) For an implementation period of two years after the requirements commenced on 1 January 2008, we consider it to be adequate for licensees to have PI insurance based on what is available in the market, provided it meets some minimum standards.
> >
> > (b) At the end of the two-year implementation period, we will expect licensees to have PI insurance that reliably delivers on all aspects of the policy objective (for the avoidance of doubt, licensees are not required to obtain automatic run-off cover from 1 January 2010).[18]

2.30 Compulsory PI insurance is intended to reduce the risk that retail clients are left without compensation because the licensee does not have sufficient resources to meet claims. However, PI insurance is limited in its ability to protect consumers, being designed to protect the insured (the licensee) against losses from providing non-compliant financial advice. It does not cover losses incurred where a licensee becomes insolvent and their policy consequently ceases to exist. Protection is also limited by the circumstances insurers are willing to include in the cover they offer licensees.

Margin lending

2.31 Margin lending refers to the practice of lending for the purpose of investing, usually in shares, with the loan secured against the value of the borrower's investment portfolio. When the value of the borrowers' equity falls below an agreed proportion of the value of their portfolio (the loan to value ratio, or LVR), a margin call is made requiring the borrower to rectify this by either contributing additional equity or selling some of their shares.

2.32 Prior to October 2009 margin loan products were not regulated as a financial product under the Corporations Act. Margin lenders were not therefore subject to the conduct and disclosure requirements of AFSL holders.

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17 ASIC, *Press release*, 'Updated compensation and insurance arrangements for licensees', 26 October 2009.

18 ASIC, *Regulatory Guide 126*, 'Compensation and insurance arrangements for AFS licensees', October 2009, p. 5.

2.33 On October 26 2009 the parliament passed a bill to amend the Corporations Act to ensure that margin loans are regulated as financial products under the Act, and anyone providing or advising on margin loans will be required to be licensed to do so, either by applying for an AFSL or varying their existing one. The bill also introduced a responsible lending requirement for margin lenders and clarified margin call arrangements.[19]

Enforcement

2.34 ASIC is responsible for ensuring compliance with AFS licence conditions, comprised of monitoring, surveillance and intervention measures. Enforcement action is tailored to 'encourage compliance with the law and raise business competence and conduct standards'.[20]

2.35 Non-compliance issues are brought to ASIC's attention via a number of means. These include mandatory breach reporting by licensees, complaints from external sources, targeted surveillance activities and document reviews.

2.36 Enforcement action may include administrative, civil or criminal action to address breaches. Administrative action available to ASIC includes suspending or cancelling the licence, banning the licensee from providing financial services or varying the conditions of the licence. ASIC also uses enforceable undertakings as an alternative to pursuing other remedies. Finally, ASIC may take civil and criminal action in accordance with the provisions of the Corporations Act dealing with breaches of the Act.[21]

2.37 ASIC is unable to take action in anticipation of a licensee not complying with its obligations.

2.38 In the financial year 2006-07, there were five ASIC-initiated licence cancellations; 20 in 2007-08; and 21 in 2008-09. ASIC also reported that most licences are granted with modification (88 per cent in 2007-08) and a considerable number are withdrawn during the application process (6 per cent in 2007-08).[22]

Financial services sector in Australia

2.39 The focus for this inquiry has been on retail investment in financial products (excluding superannuation) made on the basis of personal financial advice. This

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19 Corporations Legislation Amendment (Financial Services Modernisation) Bill 2009. Margin lending is subject to further discussion in Chapter Three in the context of Storm Financial. Chapter Six addresses the margin lending reforms covered briefly here in more detail. Securities lending, also covered under these reforms, is discussed in the context of Opes Prime in Chapter Four.

20 ASIC, *Submission 378*, p. 148.

21 ASIC, *Submission 378*, pp 158-159.

22 ASIC, *Submission 378*, pp 146-147.

includes investment in shares, non-superannuation managed funds and debt securities (including debentures). The total value of household investment in these products is around $350 billion, though this includes investment that was not made on the basis of advice.[23] ASIC indicated that around 34 per cent of retail investors who hold shares directly get advice from a financial adviser; debentures are infrequently sold via an adviser; while just over half the funds in managed fund products are placed through advisers.[24]

2.40 The most common method for providing financial advisory services in Australia is through one of the approximately 160 dealer groups currently operating in Australia. There are just over 18,000 financial advisers in Australia working for 749 advisory groups operating over 8,000 practices. The largest 20 dealer groups hold approximately 50 per cent of market share.[25] Around 85 per cent of financial advisers are associated with a product manufacturer, either as financial advisers working within the group and using the dealer's support services or as directly employed authorised representatives under that corporate entity's AFSL.[26]

2.41 ASIC explained the various business models used in the industry:

> (a) Medium to large sized 'dealer groups' that often operate like a franchise where the licensee offers back office support. The advisers operate as authorised representatives who retain a right to take clients with them if they move to another licensee. The licensee is paid a proportion of the remuneration made by the authorised representative. Example: AMP Financial Planning.
>
> (b) Institutional-owned financial adviser firms with employed advisers. Advisers in bank owned financial adviser firms are generally employed by the bank. Advisers are paid a proportion of the commissions earned or salaries or a combination of both. Example: Westpac Financial Planning.
>
> (c) Smaller firms that have their own licence and might outsource compliance functions to specialist dealer services providers such as Paragem Partners or to large dealer groups who provide dealer to dealer compliance services. Example: Securitor.[27]

2.42 Financial advisers are paid through a variety of remuneration models, including fee-for-service, commissions and bonuses. Fee-for-service charges are paid by clients to the adviser and may be an hourly rate or a proportion of funds under management (FUM). Commissions are paid by product manufacturers to advisers, usually as up-front payments as a proportion of the investment or as an ongoing

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23 ASIC, *Submission 378*, p. 101.

24 ASIC, *Submission 378*, pp 106-107.

25 ASIC, *Submission 378*, pp 108-109.

26 IBIS World Industry Report, *Financial Planning and Investment Advice in Australia*, May 2009, p. 7.

27 ASIC, *Submission 378*, pp 109-110.

trailing commission. Bonuses are generally paid by manufacturers to providers for meeting certain volume targets. ASIC described commission-based remuneration as the most common industry practice:

> Because an explicit fee for service would likely be perceived by retail investors as high in relation to the value of advisory services, most financial advisers tend to charge low or zero fees for service, in order to encourage business. They then get remuneration indirectly by receiving commissions from product manufacturers on the funds invested by retail investors. Product manufacturers recover the costs of commissions from the overall charges within the investment products.
>
> Trailing commissions (usually 0.6% of account balances) are the main remuneration method for financial planners, with seven in ten planners citing them as a form of remuneration. Other forms of remuneration include initial commission on new investment/contribution (up to 4-5% of contributions), volume bonuses (i.e. additional commission of up to 0.25% of account balances), and fee for service charged to the client (up to 1% of account balance, or a flat fee, perhaps related to the hours involved). These amounts would not all be paid at the maximum level.[28]

2.43 Only 16 per cent of total financial adviser revenue in 2008 came from fee-for-service charges. Independent advisers are more likely to earn a majority of their revenue from fee-for-service than aligned planners or bank planners, while affluent clients are more likely to pay fee-for-service than those in the low to mid-wealth range.[29]

2.44 The effect of the industry's ownership and remuneration arrangements on the quality and cost of financial advice is explored in detail in Chapter 5 of this report.

28 ASIC, *Submission 378*, pp 110-111.

29 ASIC, *Submission 378*, p. 111.

Chapter 3

The collapse of Storm Financial

Acknowledgement of effect on investors

3.1 The committee acknowledges the catastrophic effect that the collapse of Storm Financial has had on many investors, particularly those double-geared clients who were not afforded an opportunity to respond to margin calls; fell into negative equity; and were sold out of their portfolios in late 2008, at or near the bottom of the market. These investors now face great challenges in meeting living expenses, repaying debts and, in some cases, keeping their homes.

3.2 Some media reporting and some submissions to the inquiry have suggested that Storm investors were generally caught up by the promise of high returns and were motivated by greed to enter into risky investment arrangements. However, the committee has received evidence from many clients that their key aim in investing through Storm was simply to generate an independent income during retirement. Indeed, it was one of Storm's marketing strategies to appeal to this aim:

> Our aims were not to be rich but to be mostly independent in our older years and enjoy the company of our family.[1]
>
> … the plan was that we would do all this investment and be independent, never have to claim a pension off the government and be able to look after ourselves.[2]
>
> Like the majority of victims caught in this financial disaster, we were made vulnerable by our desire to be independent in our retirement. Sadly, at our initial consultation in 1997, we had set a time line for our investment portfolio of seven to 10 years. If we had not been persuaded otherwise we would not be here today. However, once in the Cassimatis system it was very hard to get out again …[3]

3.3 The committee has received in excess of 200 submissions (some on a confidential basis) from Storm investors. They are a variable group: some were nearing retirement; some are already retired and relatively elderly; some have young families to support well into the future. Many came from the same community or workplace, and many were referred to Storm by friends or family:

> Storm asked people considering them to talk to others who were current clients. People like to share prosperity and they talked positively, even in glowing terms, about how they felt when they were securing their future. Now, after the fact, there are whole families who are caught up together.

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1 Mr Francis Grainer, *Official Committee Hansard*, Cairns, 1 September 2009, p. 48.

2 Ms Margaret McClean, *Official Committee Hansard*, Cairns, 1 September 2009, p. 89.

3 Mrs Jill Dixon, *Official Committee Hansard*, Townsville, 2 September, p. 54.

> They have very few financial reserves that are not caught up in this to use to keep roofs over their heads. People feel morally devastated to have brought their beloved family and friends into such a terrible situation. This cross of financial loss is a big enough one to bear without additional concerns about having recommended it to others.[4]

3.4 Others were longstanding clients of financial advisers who joined Storm or whose previous firms were bought by Storm, particularly during recent years in the period when Storm was looking to launch an initial public offering (which ultimately did not go ahead). In these cases, clients migrated to Storm with their adviser, rather than actively seeking Storm out.

3.5 For many investors, the consequences of their involvement with Storm have been financially and emotionally devastating. Their losses have typically been magnified by the degree of leverage in which they were encouraged to engage. Some are now faced with trying to return to work at a time in their lives when it will not be easy for them to find work, or when doing so will be inconsistent with their current state of health.

3.6 The committee sincerely thanks those submitters and witnesses who have contributed to its deliberations and knowledge in relation to the collapse of Storm Financial.

Limitations of the committee's inquiry

3.7 The committee's understanding of Storm Financial's business model, the company's collapse and the subsequent impact on clients has been informed by a range of sources, including:

- submissions from affected clients, including from the Storm Investors Consumer Action Group (SICAG);
- submissions from financiers including the Commonwealth Bank of Australia (CBA), Macquarie Bank, Bank of Queensland, ANZ Bank and MLC/NAB;
- submissions from former staff of Storm and CBA;
- a submission by the regulator, the Australian Securities and Investments Commission;
- submissions by industry bodies and professionals;
- evidence taken at public hearings;
- media reporting; and

4 Mrs Kate Maccoll, *Official Committee Hansard*, Cairns, 1 September 2009, p. 86.

- other information in the public domain, including on relevant web sites.

3.8 The causes of the collapse of Storm Financial are complex and contested. The committee's sources disagree in many details, including the true nature of the relationship between Storm and the banks (particularly but not solely the Commonwealth Bank); the processes for filling out loan documentation; the obligation (if any) of the banks to contact customers directly regarding margin calls; key meetings and events between September 2008 and January 2009; and the sophistication and understanding of risk by clients who entered into double-geared investment strategies under Storm's advice.

3.9 In the following sections, the committee summarises the range of information that has been put before it and comes to a view on the key lessons to be learned out of this collapse.

3.10 At the outset, it is important to emphasise that the committee is not a judicial body and has no power to make judgements in relation to individual claims that have been brought to its attention. It has also not been possible for the committee to resolve all the contradictions in the evidence put before it.

3.11 The committee's overall role, having regard to what it has learnt through the examination of this corporate collapse and others, is to make any necessary recommendations for legislative change or regulatory improvement to help guard against, or mitigate the effects of, similar collapses in the future. The committee's deliberations on the need for regulatory or legislative change in Australia's financial products and services sector are discussed in further detail in Chapters 5 and 6 of this report. In Chapter 6, the committee sets out eleven recommendations for change.

The Storm Financial business model

3.12 Storm Financial had a total of around 14,000 clients, of whom approximately 3000 were leveraged investment clients. Typically these investors, who included retirees or people intending to retire in the near future, were encouraged to take out loans against the equity in their own homes in order to generate a lump sum to invest in the share market, via index funds (primarily Storm-badged Colonial First State managed funds and Storm-badged Challenger managed funds). Clients were generally then advised to take out margin loans to increase the size of their investment portfolio.[5]

3.13 Mr David McCulloch, long-time group accountant for Storm Financial, summarised the business model as follows:

> … using debt, mortgaging the home, using margin lending and using only share market investments.[6]

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5 Mr Tony D'Aloisio, ASIC, *Official Committee Hansard*, Canberra, 25 February 2009, p. 183.

6 Mr David McCulloch, *Official Committee Hansard*, Townsville, 2 September 2009, p. 10.

3.14 All Storm advisers operated under direction from Storm's headquarters in Townsville. As Mr Gus Dalle Cort, director of Storm Financial (Nine) in Cairns, explained to the committee:

> Everything was directed back to the one system at Storm, from the way we developed our statements of advice to the process of quoting to banks. Everything was sent back to Storm central and farmed out from there. Our planning was done back-office, but our input from talking to a client and certainly a lot of our file notes were all sent to the one point.[7]

3.15 This description was corroborated by Mr McCulloch:

> No advisers were permitted to undertake their own financial planning modelling. Rather, their role was to explain the Storm financial planning model to clients who were interested and to ensure that clients who were not comfortable with this did not become a client. All modelling of plans were undertaken by Storm's compliance or cash flow modelling cell, headed up by Julie Cassimatis.[8]

3.16 Clients were charged an up-front fee of around seven per cent for the advice they were given by Storm. Before they became clients, they were required to participate in a number of 'education' sessions. The committee was told by Mr Gus Dalle Cort that it took on average 180 days to be accepted as a client:

> We had a dozen staff in Cairns, including me. We met existing clients and new clients, and we had a process. We tracked everything at Storm, and the process for a client to do business with Storm Financial took, on average, 180 days.
>
> …
>
> … That process entitled the client to a number of sessions… This involved finding out not only their personal position but also their financial position and right through to having a number of banks quote on the business, whether it was margin lending or equity lending…
>
> We as a business did not go out and invent any products. We went to the marketplace. We invested in a vehicle called 'index funds' … We then asked, 'How does one make more money to expand on one's capital base?'[9]

3.17 Mr Dalle Cort explained the education sessions to the committee as follows:

> We would show the clients the difference between shares, cash and property. We would show them volatility and educate them on how different markets react and give them a broad based information session—only an information session. No advice was given on these evenings, just pure information. Should clients decide to come back and have a chat to us,

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7 Mr Gus Dalle Cort, *Official Committee Hansard*, Cairns, 1 September 2009, p. 4.

8 Mr David McCulloch, *Official Committee Hansard*, Townsville, 2 September 2009, p. 4.

9 Mr Gus Dalle Cort, *Official Committee Hansard*, Cairns, 1 September 2009, p. 2.

> they did that on an individual basis and we would explore their individual circumstances after that.[10]

3.18 For those attendees who ultimately signed up to become Storm investment clients, margin loans were organised with a loan to value ratio (LVR) of around 80 per cent, with a buffer of 10 per cent. There were some variations in these figures, depending on the finance provider and individual contract, but as a generalisation Storm clients were put into margin loan facilities with more generous LVR and buffer provisions than was the industry standard.

3.19 Storm tendered out the client's requirements to a number of banks with which it did business and claims to have made a selection on the basis of service and conditions offered. Home lending was organised through a range of banks; margin loans were largely (although not exclusively) through either Colonial Geared Investments, which is wholly owned by the CBA, or through Macquarie Investment Lending.

3.20 From time to time, clients were encouraged to 'take the next step' and further increase the size of their portfolio, by applying for additional margin loans or increasing their existing margin loans. On occasions, additional borrowing was carried out on the basis of increased value in an underlying property. In the wake of Storm's collapse, use of the CBA's VAS system to revalue Storm client's houses has been a particularly contentious matter. This is discussed further below, starting at paragraph 3.66.

3.21 The completion of loan forms for Storm clients has emerged as a troublesome area. The committee has been told by many investors that they signed blank loan applications; that they discovered after the collapse that they had additional loans that they were not aware of taking out; and that copies of forms provided by the banks post-collapse show overstated income figures or asset values that led to grossly inaccurate portrayals of their capacity to repay the loans. This matter is also discussed further below, starting at paragraph 3.57.

3.22 In a rising market, leveraged investment strategies magnify financial gains. However, the converse is also true: in the case of a sudden market fall, losses will be magnified too. Unfortunately, as the market collapse of late 2008 unfolded, Storm's strategy ultimately proved catastrophic for many.

Events surrounding the collapse of Storm Financial

3.23 As the world's financial markets collapsed across 2008, the value of Storm clients' investment portfolios decreased. It is this decline in value and investor equity, compared with the static value of the loans held, that took the clients' accounts into margin call territory. In evidence to the committee, Mr McCulloch reflected that:

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10 Mr Gus Dalle Cort, *Official Committee Hansard*, Cairns, 1 September 2009, p. 14.

> In retrospect, the telling period for Storm clients appears to be around early October 2008…What appeared to be the strength in the Storm modelling now became its Achilles heel, that is, the margin call at 90 per cent …Under normal margin lending arrangements, as existed with most or all other planners around the country, that is, 75 per cent to 80 per cent margin call ratios, at this time clients would have been margin called and at the very worst would have had about 20 per cent equity left in their portfolios—enough in most cases to clear home loan debts—but of course leaving Storm alone to account for lost values and client dissatisfaction.[11]

3.24 There is substantial dispute about what in fact happened to Storm and to the accounts of Storm clients during the closing months of 2008. The following claims, some of which are inconsistent with each other, have all been made in the voluminous evidence put to the committee:

- Many Storm investors should have received a margin call or calls but were not notified of any such call, either by their adviser or by the relevant bank.
- Some Storm clients do recall being contacted by their bank(s) but instructed the banks to deal through their adviser.
- Many clients would have been able to rectify their position if given a chance to act on margin calls at an appropriate time. Instead, many found out in December that they had moved into negative equity and that their portfolios had been sold down at some time during October and November, without their knowledge and at or near the bottom of the market, thereby crystallising and maximising their losses. Clients remain unclear as to who sold their portfolios and at whose direction.
- Storm staff claim that the information they were receiving from banks during these critical weeks and months was inaccurate and out of date and that there was no way for them to check whether client accounts were in margin call.
- Bank staff (from more than one bank) claim that their efforts to work with Storm to resolve accounts in margin call were not successful and that requests were not being dealt with in a timely fashion. They also note that they used the same approach to margin call management with all the advisory groups they deal with, yet Storm Financial clients are the only group who *en masse* failed to be appropriately notified by their advisers of the true status of their accounts.
- The banks claim that their responsibility in the event of a margin call is to inform the intermediary, the financial adviser, whose responsibility it is to then work with the client to determine how to resolve the margin call within the required time frame.

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11 Mr David McCulloch, *Official Committee Hansard*, Townsville, 2 September 2009, p. 7.

- Storm staff contest this by claiming that, based on the management of margin calls that occurred in 2002, it was their understanding that the banks were responsible for informing clients directly.

- Many clients question why, if the banks were not getting satisfactory responses from Storm in relation to margin calls, they did not make more substantial and effective efforts to contact clients directly.

3.25 There are also differing accounts of some key events occurring at the executive and regulatory levels during this period, particularly:

- a meeting between Mr Emmanuel Cassimatis and senior Commonwealth Bank staff in early December, at which Mr Cassimatis attempted to make an arrangement to consolidate client debts into a large corporate debt facility; and

- a December attempt by ASIC to get Storm to agree to an Enforceable Undertaking (EU). Although all parties now agree that this EU was never signed, at critical periods during December and January clients were refused advice when they tried to find out the current status of their portfolios and were led to understand this to be due to an ASIC gag order.

3.26 According to Mr McCulloch, at the meeting with CBA staff Mr Cassimatis offered to transfer the client debt and take it on as a corporate debt, to be repaid over a three to four year period:

> The choice for the bank was to seek money from the clients. The debt was already out there. Instead of the debt being owed to 400 people, Storm undertook to have the debt owed to itself. It would be Storm that would take on the commercial risk of that $40 million or whatever the magic figure was. But Colonial was more worried about the margin lending negative equity than anything else. They were not worried about the home loans that were associated with it. They just wanted their money back for the negative equity.[12]

3.27 The CBA characterised the meeting in the following terms:

> As best we understand it, the intention was that money would be borrowed by Storm from the Commonwealth Bank to meet the margin calls of its clients.[13]
>
> The arrangement that was being proposed, as we understand, was that the bank lend further money to Storm and Storm in some fashion—frankly, this proposal did not go far, for fairly obvious reasons—would fund customers to meet their margin calls. I know some importance has been attached to this by various witnesses, but it was actually against the interests of the Commonwealth Bank and it was against the interests of our shareholders. In

12 Mr David McCulloch, *Official Committee Hansard*, Townsville, 2 September 2009, p. 25.

13 Mr Ian Narev, CBA, *Official Committee Hansard*, Sydney, 4 September 2009, p. 92.

> fact, the liquidator of Storm has reported that Storm was insolvent in early December; [meaning] a further loan to Storm in those circumstances had all sorts of legal and insolvency implications.[14]

3.28 In discussing the proposed EU, Mr Dalle Cort clarified for the committee that the instruction not to talk with clients in the closing days of 2008 came not from ASIC but from Storm's directors:

> …by the directors Julie and Emmanuel Cassimatis. We were instructed by them not to talk to our clients.[15]

3.29 Furthermore, Mr Dalle Cort acknowledged that the EU that ASIC presented to Storm was not agreed to: 'It was never signed'.[16]

3.30 Of note, Mr Emmanuel Cassimatis, founder and former CEO of Storm, believes the collapse of the company was due to the actions of the CBA:

> … despite the large amount of conjecture around the issue, the reason Storm collapsed, when you boil it down, was that the Commonwealth Bank—the major supplier of credit to Storm and its customers—withdrew the credit suddenly, without notice and, most importantly, without justification or indeed without the power to do so under the margin lending contracts.
>
> Despite the fact that the CBA caused a great deal of damage, it exercised its power simply because it could and chose to wreck rather than support Storm and our mutual clients as it had done in the past. The decision by Mr Norris and his colleagues at the Commonwealth Bank of Australia to withdraw credit was made with full knowledge of the devastating consequences such an action would cause. Without this action, the margin lender customers would undoubtedly have suffered some losses, but they would have retained at least some of their assets and would not be in the devastated financial condition that most are in today.[17]

3.31 There were several more events of note leading up to the collapse, including:

- A $2 million dividend paid to founders Emmanuel and Julie Cassimatis in December 2008 was successfully frozen in February 2009, following ASIC-initiated court action. This freeze was later extended by further court action by Storm's liquidators.[18]

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14 Mr David Cohen, CBA, *Official Committee Hansard*, Sydney, 4 September 2009, p. 93.

15 Mr Gus Dalle Cort, *Official Committee Hansard*, Cairns, 1 September 2009, p. 12.

16 Mr Gus Dalle Cort, *Official Committee Hansard*, Cairns, 1 September 2009, p. 12.

17 Mr Emmanuel Cassimatis, *Official Committee Hansard*, Brisbane, 3 September 2009, p. 3.

18 See http://www.theaustralian.news.com.au/business/story/0,,25307584-17044,00.html; accessed on 30 October 2009.

- Attempted court action by Storm against the CBA was interrupted when Storm went into administration on 9 January 2009.[19]

3.32 Liquidators were appointed to Storm in March 2009.

Issues of concern

One-size-fits-all advice

3.33 The overwhelming characterisation of Storm's operations is that the majority of Storm clients were given the same, or substantially similar, financial advice:

> The big issue would appear to be that Storm was giving the same advice, irrespective of the client circumstances. It was often margin loans which possibly exceeded their capacity to pay or even their need for the underlying investment. It would appear Storm were doing a one-size-fits-all approach to advice. Everyone was doing the same, getting the same advice and clearly, whilst they might have been doing the right thing around disclosure and so on, that is not in line with section 945A of the Corporations Act where there has to be a sound basis for the advice.[20]

3.34 The committee's impression that Storm's investment clients were all given the same or substantially similar advice was confirmed in an exchange between the committee chairman and the former CEO of Storm Financial:

> **CHAIRMAN**—It appears that everybody got the same advice and, in the end, everyone was put into a particular fund, used a particular type of leverage and used a particular number of lending institutions. They all seemed to be using the same model. As you describe it, it all seemed to be very much like a factory but everyone had the same outcome in the end.
>
> **Mr Cassimatis**—Yes, it was a unique offering—like a motor car. There was one particular model of vehicle … Those who wanted that could buy it …[21]

3.35 Mr Graham Anderson told the committee that he had become aware that many of the Statements of Advice issued by Storm advisers contained clauses in common, regardless of whom the advice was being issued to:

> My understanding of financial advice is that it is independent and it is suited to my needs. Since I have been involved with the committee of SICAG, I have found out that this is not the case and that two clauses appear on every statement of advice. They basically say:

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19 See http://www.abc.net.au/news/stories/2009/01/08/2461406.htm ; accessed on 30 October 2009.

20 Mr Michael Davison, CPA Australia Ltd, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 62.

21 *Official Committee Hansard*, Brisbane, 3 September 2009, pp. 5 – 6.

> We have identified that your current asset base is not large enough to fund the lifestyle that you desire now, or in the future. You have sought our advice on ways to expand your income streams so that you can become more financially independent from work and have lifestyle choices in the future. To improve the provision of capital growth and income for the future, the size of your asset base should be increased.
>
> Attempting to purchase assets solely by using your surplus income would result in a relatively small change in the size of your assets base; hence there would be an excessive delay before your investment delivered a substantial change to your income or delivered significant growth.
>
> We recommend that you mobilise your existing assets to produce an increase in the size of your asset base. This could be achieved effectively by purchasing liability and offering your existing assets as security for the loans. The liability would in turn be used to purchase high quality assets to provide capital growth. This capital growth will be converted to income streams over time. In doing so, you would be effectively purchasing the capital base that you require for real wealth creation.
>
> Care must be taken that these liabilities are kept at levels that are safe and that the servicing of the liabilities is easily manageable, and both of these aspects have been of paramount importance in the construction of these recommendations.
>
> To me, if that is on everybody's statement of advice, I have a problem with that.
>
> …
>
> … the fact that everybody got the same advice shows the cookie cutter mentality. That annoys me, and the fact that the financial adviser is basically being controlled by the directors of Storm. I find that a bit of a conflict as well.[22]

Committee view

3.36 The committee cannot reconcile the practice of financial advisers giving all their clients the same advice, regardless of their life stage and circumstances, with the existing section 945A obligation to give advice that is appropriate to individual personal circumstances. In particular, the committee is not persuaded by Mr Cassimatis's explanation that Storm clients 'self-selected' after being told what the investment model was.

3.37 The committee is firmly of the opinion that, for at least a subset of Storm's investment clients—namely, clients on average incomes at or near the end of their working lives—the advice to engage in an aggressive leveraged investment strategy was clearly inappropriate.

Insufficient client understanding of product, risk and protection

3.38 Some of Storm's clients did not understand, or fully understand, that by borrowing against the equity they had in their family home they were, effectively, putting their ownership of that home at risk.

3.39 The committee has been told that Storm advisers strongly downplayed the risk of losing the family home:

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22 Mr Graham Anderson, *Official Committee Hansard*, Brisbane 3 September 2009, p. 71.

> We were told that the risk was minimal and that the world would have to fall in before that happened, which it obviously did. But, yes, we were told that there was a minimal risk.[23]
>
> … we were told that we could not lose our home—[24]
>
> Storm Financial advisers had always told us that our home and investments would be safe, and we felt secure in that from day one. That stemmed from the fact that our adviser had worked with us prior to him coming to Storm. So we had a system there with him already before he went to Storm. Storm Financial advisers always told us that our home and investments would be safe. It did not happen that way.[25]
>
> We were advised that, having paid off our house, we had a certain amount a month that we could use for investing. They called it getting equity out of our home, which at the time we did not realise meant that it was another mortgage.[26]

3.40 Some investors have acknowledged that they signed authority for Storm to manage their accounts in the event of a margin call, on the understanding that the following would take place:

> If we were to receive a margin call, we were told that some of our portfolio would be sold down to cover the margin call and that everything would be taken care of.[27]

3.41 Some investors report being reassured by the fact that Storm held a professional indemnity insurance policy:

> This was our first venture into investing in the stock market and it was all new to us but Mr. Dalle Cort advised us that we were in safe hands and that even if the market went "egg shaped", there was a Storm indemnity insurance policy that would ensure that our original investment would be covered.[28]
>
> … at the seminars … Emmanuel Cassimatis would say, 'You are perfectly safe with us. If we were to give you the wrong advice you could sue us, because we have insurance to cover that.' Those were not his exact words, but it was something like that.[29]

3.42 There has also been some acknowledgement by some that they did not truly understand the investment strategy they were buying into:

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23 Mr Quentin Bates, *Official Committee Hansard*, Cairns, 1 September 2009, p37.

24 Mr Francis Grainer, *Official Committee Hansard*, Cairns, 1 September 2009, p. 60.

25 Mr Jack Dale, *Official Committee Hansard*, Cairns, 1 September 2009, p. 63.

26 Mrs Jill Dixon, *Official Committee Hansard*, Townsville, 2 September 2009, p. 54.

27 Mr Francis Grainer, *Official Committee Hansard*, Cairns, 1 September 2009, p. 51.

28 Jack and Frances Dale, *Submission 121*, p. 1.

29 Mrs Jill Dixon, *Official Committee Hansard*, Townsville, 2 September 2009, p. 55.

> We trusted our adviser and we thought his advice was well founded … We thought we understood. This was the problem. A lot of the clients thought they understood and signed off on that.[30]
>
> Unless you were a financial expert, I do not think anybody completely understood the model. I think it was … too complicated and far too difficult. It all looked simple. When they tried to break it down or seemed to be breaking it down for people, you thought you understood. But when you look back at it, you did not understand at all.[31]

Committee view

3.43 The limited understanding that some Storm clients had of their financial arrangements is of concern to the committee. The committee acknowledges that some of these clients admit they did not have a strong understanding of the leverage and margin loan arrangements that they signed up to. Indeed, some explained that it was out of awareness of their limited knowledge that they sought the guidance of, and acted on the recommendations of, professional financial advisers.

3.44 Accordingly, there is a multifaceted problem to solve here:

- There is a need to improve the standard of advice offered to consumers, whether that be through enhanced legislative requirements about the standard of advice required or enhanced enforcement of existing standards, or both, so that consumers can be confident about the advice received.
- There is a need to better inform consumers about the products signed up for, so that consumers can take a higher degree of responsibility for financial decisions and only buy products that entail a comfortable level of risk.
- There is a need to ensure that advisers are better informed about the products being sold.

3.45 The committee addresses these matters in a broader context in Chapters 5 and 6 of this report.

The nature of the relationships between Storm and the lenders

3.46 The committee was told by several banks that Storm had firm ideas about how it wanted the relationship to proceed:

> We found that the approach Storm wanted to adopt with the bank was that they effectively were the central manager of the client relationship. They requested the bank to respond to their requests for loan approvals or renewals and for the bank to take Storm's advice directly around 100 point checks and so on, which are part of our normal procedures, and that they

30 Mr Francis Grainer, *Official Committee Hansard*, Cairns, 1 September 2009, p. 58.

31 Ms Margaret McClean, *Official Committee Hansard*, Cairns, 1 September 2009, p. 91.

> would manage the customer interaction. The bank has a procedure where we will not do that. Our approach is that we have to contact our customers direct … We … have to have direct contact with the clients.
>
> … We were also not prepared to act on Storm's instructions around rollovers or account maintenance …Having had a meeting with them, having gone through this, the bank declined to have a formal relationship with Storm and Storm said that they would not deal with ANZ. [32]

3.47 Notwithstanding comments from the Commonwealth Bank about the routine nature of its arm's length business relationship with Storm Financial, this is not necessarily how the relationship was seen by—or portrayed to—Storm's investment clients.[33] According to SICAG:

> Evidence before this committee shows patently that the Commonwealth Bank had what can only be described as an umbilical connection with Storm Financial, one that has endured for many years. A key factor in the decision by the majority of our members to engage in the Storm strategy was the strength of the Storm connection with the Commonwealth Bank and its funds management division, Colonial First State.[34]

3.48 The CBA did not see the relationship in the same light. According to senior executives of the bank:

> It was not a relationship that ran to the highest levels of CBA. It was an association whereby Storm did refer customers to the CBA … The relationship was no more than a referral of business to us, and we in turn serviced the business.[35]

3.49 Mr Ralph Norris, CEO of the CBA, put the relationship with Storm in the context of the bank's overall business:

> My view is that this was not a tight relationship. From the organisation's perspective—from my perspective, from the board of the bank's perspective—we are talking about an organisation where the revenue from Storm itself was less than $10 million per annum and, when we look at that in the context of around $14 billion of revenue per annum, this was relatively, in relation to the overall bank operations, quite small.[36]

3.50 The CBA does acknowledge, however, that there may have been a strong relationship at a local level:

32 Mr Graham Hodges, ANZ, *Official Committee Hansard*, Melbourne, 26 August 2009, pp. 43 – 44.

33 Mr Matthew Comyn, CBA, *Committee Hansard*, Sydney, 4 September 2009, p. 62.

34 SICAG, *Official Committee Hansard*, Brisbane, 3 September 2009, pp. 69 – 70.

35 Mr Matthew Comyn, CBA, *Committee Hansard*, Sydney, 4 September 2009, p. 62.

36 Mr Ralph Norris, CBA, *Official Committee Hansard*, Canberra, 28 October 2009, p. 27.

> Although the intent was genuinely to assist customers, the local relationship with Storm was sometimes too close, and on occasion we lost objectivity.[37]

3.51 Other banks may also have had close relationships with Storm at a local level. For instance, the majority of Bank of Queensland home equity loans for Storm clients originated through the North Ward branch.[38] Furthermore, BOQ admits that in approving at least some of these loans, officers failed to check financial information directly with the client and instead relied on information provided through a third party, that being the Storm financial adviser. This approach was outside BOQ's lending policy.[39]

Committee view

3.52 The committee is concerned that close relationships and integrated systems, at least at the branch level, and perhaps in combination with bank sales and lending targets discussed at paragraph 3.54, may have caused some bank staff to lose sight of who their true customer was and to fail in their obligations under the Code of Banking Practice to exercise prudence and diligence in their lending decisions.

3.53 The committee therefore welcomes the acknowledgement by several banks that compliance with lending policy needs to be improved. The committee also welcomes the expected imposition of responsible lending provisions on credit providers under National Consumer Credit Protection Bill 2009.

Increases in bank sales and lending targets

3.54 The committee received suggestions that increases in sales and lending targets affected bank behaviour. Mrs Carmela Richards, who worked for the CBA for 20 years until she left to work with Storm in January 2000, commented:

> I started with the CBA when I was 15 years old and I never thought I would work anywhere else, but the bank changed dramatically in my last five years or so and there was an extreme sales culture that left little time for client service, which was a major deciding factor in my decision to resign.[40]

3.55 Mrs Richards and Mrs Devney told the committee that increased targets caused many staff to leave the bank and that there had been a change from a service culture to a sales culture:

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37 CBA, *Submission 357*, p. 1.

38 *Official Committee Hansard*, Canberra, 16 September 2009, pp. 32 – 33.

39 *Official Committee Hansard*, Canberra, 16 September 2009, pp. 33 – 34.

40 Mrs Carmela Richards, *Official Committee Hansard*, Townsville, 2 September 2009, p. 27.

> …people left the bank because they were not happy with having to have those sales targets and those pressures put on. A lot of people believed that service would bring referrals, and I believe that is the case as well.[41]

3.56 When it was suggested to Mr Ralph Norris, CEO of the CBA, that increased sales targets in the Townsville region may have skewed the behaviour of CBA staff and caused a rapid growth in the relationship with Storm, he defended the CBA's sales and service program:

> The selling process and the sales and service program that we have in the Commonwealth Bank is based around what is called a needs analysis process, which is identifying the needs of a customer and providing products that meet those needs.
>
> …
>
> … from my perspective, I think that our sales and service program has actually done a lot for our customers and certainly improved our relationships. I think it is also important to note that we run a balanced scorecard—it is not all about sales; it is about making sure that risk factors are looked at; and it is about making sure that our people surveys are of a high level from the point of view of engagement.[42]

Inaccurate figures on loan applications, leading to inappropriate lending

3.57 The committee received considerable conflicted evidence about who filled out loan documents on behalf of clients. The committee received many written submissions from individuals stating that they signed blank forms, discovered post collapse that they had loans they did not even know about, or belatedly discovered that information on loan documents—particularly relating to income and assets—was inaccurate:

> It was either Storm or the banks were putting their own figures on the forms. We obviously signed the loan applications to get the loans, but—
>
> …
>
> We signed the forms at Storm Financial.
>
> …
>
> They were blank.[43]

3.58 Mr Dalle Cort of Storm (Nine) in Cairns told the committee that the documents were filled out by the banks:

> Loan documents were done by the banks, not by Storm … They were bank documents …If they came from the bank, they were all filled out and they

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41 Mrs Kristy Devney, *Official Committee Hansard*, Townsville, 2 September 2009, p. 35.

42 Mr Ralph Norris, CBA, *Official Committee Hansard*, Canberra, 28 October 2009, p. 36.

43 Mr Quentin Bates, *Official Committee Hansard*, Cairns, 1 September 2009, pp. 38 – 39.

> just needed a signature from the client. So they were all filled out by the banks.[44]

3.59 Mrs Carmela Richards, speaking in her capacity as a former CBA employee, confirmed that bank staff completed these forms but denied that they lied about critical figures:

> The staff did not lie about income or assets. Anything that was told to the bank was advised to us by the clients and with appropriate supporting data provided to back this up.[45]

3.60 The forms were apparently *not* filled out by staff at Storm headquarters in Townsville:

> We did not complete bank applications. We would send our own form of advice listing the client's position. As far as I remember, all of the banks—and we have had discussions with them on many occasions over the years—were adamant that their credit policy was that they had to confirm with the client, and that was perfectly acceptable. We understood they would either do a face-to-face interview depending on the bank or they would do it over the phone … There was feedback to suggest that was occurring so I am a little bit surprised to hear that it maybe was not.[46]

3.61 Many investors question why the banks did not take greater responsibility for ensuring a borrower's ability to repay their loans:

> I do believe that the banks have some responsibility in our demise, as not once did Colonial meet with us or interview us regarding our loans or how we intended—at our age—to repay approximately $1.6 million. If things went bad, as they did, we were as we are. Not once did they contact us regarding a margin call, and we were given no opportunity or say in the matter. The first contact we had with Colonial was on 8 December, and by that time everything had been sold down. That, consequently, left us with nothing.[47]

3.62 Several banks have explained to the committee that, for margin loans, standard industry practice is to simply use the value of financial assets such as shares, cash or managed funds to secure the loan.[48]

Committee view

3.63 The committee is concerned by the bulk of evidence received that suggests there may be a gap between bank policy and practice regarding the approval of loan

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44 Mr Gus Dalle Cort, *Official Committee Hansard*, Cairns, 1 September 2009, p. 25.

45 Mrs Carmela Richards, *Official Committee Hansard*, Townsville, 2 September 2009, p. 27.

46 Mrs Carmela Richards, *Official Committee Hansard*, Townsville, 2 September 2009, p. 30.

47 Mr Quentin Bates, *Official Committee Hansard*, Cairns, 1 September 2009, p. 35.

48 See, for example, Macquarie Group Limited, *Submission 396*, pp. 13 – 14.

applications. The evidence that the committee received from Storm and bank staff about approval processes did not match up with the evidence the committee received from investors about inaccurate and misleading data on their loan forms. The committee has some doubt about the degree to which banks were acting ethically, appropriately, morally and prudently in their decisions to grant loans to some Storm customers.

3.64 The committee is also concerned by the number of people who indicated that they signed blank forms or documents that they had not read. The committee reminds consumers that their ability to protect themselves from poor decisions or poor advice will be increased by them exercising greater caution and diligence before agreeing to sign any documents.

3.65 The committee notes the expected passage through parliament of the National Consumer Credit Protection Bill 2009. This imposes responsible lending conduct provisions on lenders, who for the first time will have a legislative obligation to ensure that loans are not unsuitable for clients. This will provide a new layer of protection for clients entering into the full range of lending arrangements with banks and other credit providers.

Misuse of valuation assessment system (VAS)

3.66 The committee has heard some suggestions that local CBA staff sought additional business by proactively and inappropriately using their desktop computer home valuation assessment system (VAS) to revalue Storm client's houses, thereby making them eligible to borrow more against the new, higher value.

3.67 CBA executives contested this suggestion:

> Effectively, Storm was selecting customers who were Commonwealth Bank loan customers. They would approach the bank under the pretext of their customer wanting to take out additional borrowing against their home. They were not solicited or sourced by the bank … we were told the customers were supplying their owners' equity—the value that they put on their own home—and VAS was used to decide whether a valuation was required to verify that valuation. The only spreadsheets that I have seen are spreadsheets that came in from Storm, where we used the VAS system to identify whether an external valuation was required. The results of those were then sent back to Storm.[49]

3.68 The CBA has, however, admitted that its staff did not always use VAS appropriately:

> We have discovered that, when it came to providing loans, mostly secured by property, we failed at times to follow our own policies and lending practices. Additionally, a property valuation assessment system known as

49 Mr Matthew Comyn, CBA, *Official Committee Hansard*, Canberra, 28 October 2009, p. 29.

> VAS was misused on occasion by some staff with the effect that loans against some properties were larger than they would otherwise have been.[50]

3.69 This was disputed by Mr Andrew Jackson, a former CBA employee:

> I would argue that the staff working in the team did not use VAS in any way that is not standard practice by almost every lender in Australia …there is no override button. If there was a problem with how they were using VAS then this would have been an issue for every lender in Australia.[51]

Poor management of margin calls by multiple parties

3.70 That breakdowns in handling and resolving margin calls during September – December 2008 had a catastrophic effect for many of Storm's investment clients is not in dispute. What is in dispute is who is responsible for this failure.

3.71 Many investors have expressed understandable frustration to the committee that delays in Storm receiving or acting on margin calls led to them being in a much worse position than would otherwise have been the case:

> If we had been sold down early enough then there would have been enough cash in that accelerator cash account to cover the margin loan and there would have been enough money for us to live on—to pay our bills and petrol; the lot—while the market was doing its thing.[52]

3.72 Mr David McCulloch told the committee:

> Advisers were specifically told not to contact the margin lenders, leave it to Storm Central, as Colonial Margin Lending and Storm Central preferred one point of contact as resources were thinly stretched.
>
> We now know the share market had temporarily recovered by around 15 per cent in late October to early November, and if ever the margin lenders were going to act now was the time. The fact they did not—and with assurances from the principals they were working closely with the lenders—gave assurances in the advisers' day-to-day client dealings. The rest, sadly for all concerned, is history. I have met many ex-clients who are now emotionally and financially destroyed. My personal situation is no different from many clients.[53]

3.73 According to evidence from Storm staff, Storm directors Emmanuel and Julie Cassimatis strongly believed that Storm's investment model should have been able to ride out the crisis, if margin calls and buffers had been triggered appropriately. Mr David McCulloch explained to the committee that:

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50 CBA, *Submission 357*, p. 2.

51 Mr Andrew Jackson, *Official Committee Hansard*, Townsville, 2 September 2009, p. 30

52 Mr Jack Dale, *Official Committee Hansard*, Cairns, 1 September 2009, p. 75.

53 Mr David McCulloch, *Official Committee Hansard*, Townsville, 2 September 2009, p. 8.

> … the advisory team at Storm received many assurances from the senior executive that, whilst these were worrying times, the Storm model had stood up in previous testing times, the banks knew this, and clients who remained steadfast came through the process in a stronger position …
>
> We were constantly assured during the falls of early to mid-2008 that the business's cash buffers and reserves in place would be tested and used up to support clients approaching danger levels or needing living allowance support from Storm. Whilst downward share market pressure existed from December 2007, this was explained to advisers as normal share market volatility. In any event, should downwards share market pressure persist, we were informed, and advised clients accordingly during 2008, that there were a number of levels of comfort available to Storm clients. These were pretty generous buffers to margin call, 90 per cent as agreed with Colonial Margin Lending, and 85 per cent with Macquarie Bank. If someone was sitting at 60 per cent in early 2008—and I believe most were; and that is after the market had already fallen 15 per cent—they still had protection against a further market fall of around 35 per cent before a margin call would occur. At this time no-one was predicting a fall of this magnitude. Even if they did, along the way, client cash reserves could be used to support the portfolio. Failing this, we were advised that some of the portfolio could be converted to cash temporarily, with an undertaking by Storm to support clients re-entering the market by providing its own funds as supplementary margin loan security once a recovery appeared underway. After all, this is exactly what happened for some clients in the 2002-03 downturn and it worked well.[54]

3.74 Mr Dalle Cort is of the clear view that the difficulties experienced by Storm clients resulted from a failure of the banks to advise Storm of margin calls in an appropriate and timely fashion:

> Storm Financial would still be in business today had our clients actually got a margin call.[55]

3.75 When asked what he was doing to monitor the falling market and whether he was asking the banks appropriate questions about customer accounts during the period in question, Mr Dalle Cort told the committee that the banks were not able to provide accurate information about account status during this critical period:

> … when one gets a margin call one should be informed. But it was impossible for one to be informed when at that point in time—in this case for over a month—the data being received directly from the banks, being Macquarie and Colonial Geared Investments, simply did not show that.
>
> …
>
> … the data coming through from the banks was bizarre. It certainly was not showing what was real.[56]

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54 Mr David McCulloch, *Official Committee Hansard*, Townsville, 2 September 2009, pp. 6 – 7.

55 Mr Gus Dalle Cort, *Submission 153*, p. 14.

3.76 Mrs Carmela Richards, compliance manager for Storm, explained to the committee how Storm generally managed margin calls:

> We did not have a written process for what we would do, but the process was that, if we were advised that a client was in margin call, we would have a look at it in the compliance area from the information that we had on the file already to see what we could do to fix it quickly and easily. As well as that, we would let the adviser know and ask the adviser to talk to the clients about it and see if they had any resources or anything they could do to fix it as well. That was the general process. However, somewhere in the middle of October we had 600 clients theoretically go into margin call. If you looked at the Colonial Geared Investments website for any period after that for a number of weeks there were 600 clients in margin call, but that information was not correct. Colonial themselves, as far as I recall, did not give me any information on clients that were in margin call for that period for a good three weeks. Were we issued with margin calls? Yes, generally we were advised. Was it reliable to look at their website and understand who was in margin call and who was not in that period? No, it was not. Was Colonial actively following up on the margin calls during that period? No, they were not … The normal process is easy. You let us know, we will deal with it, we will let the client know, we will have the adviser talk to them and we will give some advice about how to fix it and we will put it in writing once that advice is formalised … But it was not normal in October.[57]

3.77 Mr Cassimatis claims there was a deliberate strategy by the CBA not to issue margin calls to Storm:

> Despite the multiplier effects of [the global financial] crisis, the directors of Storm firmly believe that its risk management strategies would have ensured that the company and clients would still have been standing, albeit somewhat battered and bruised, had the CBA issued its borrowers the margin calls as it had always done in the past. For some reason unknown to us, this protocol had been switched off. We know that each day the CBA system produces letters to be sent to customers. These letters were the bank's notices of margin calls. We know that someone decided not to send these letters.
>
> … CBA's data feeds to Storm, and hence its website on which the customers and Storm were supposed to be able to check their positions, were deeply and hopelessly flawed. [58]

3.78 There seems to have been an unacceptable degree of confusion and abdication of responsibility in relation to communicating margin calls to clients. Mr McCulloch put this responsibility firmly with the banks:

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56 Mr Gus Dalle Cort, *Official Committee Hansard*, Cairns, 1 September 2009, p. 5.

57 Mrs Carmela Richards, *Official Committee Hansard*, Cairns, 1 September 2009, p. 43.

58 Mr Emmanuel Cassimatis, *Official Committee Hansard*, Brisbane, 3 September 2009, p. 3.

> From my experience, the margin lenders always made margin calls to clients …[59]

3.79 Mrs Carmela Richards echoed this understanding of the situation:

> Colonial Margin Lending has stated that it was Storm's responsibility, not theirs, to action margin calls. The last time Storm had to deal with margin calls was in 2003 and then only a relatively small number. The bank's procedure at that time was to issue a margin call in writing to the clients and to advise Storm as well. If the procedure had changed so much, someone should have let us know what our perceived obligations were and provided training on how to deal with them to ensure that both of us were on the same page. I find it incredible that when the risk was so much with the bank, when they were the ones that stood to lose if not managed correctly, they would release so much control and responsibility without being sure that each party clearly understood/agreed their role and had the systems and training in place to deal with it.[60]

3.80 In their joint submission to the committee, Storm staff members Mrs Richards and Mrs Devney state:

> The Commonwealth Bank has stated that Storm was adamant that as the customer's financial adviser it was its responsibility, not theirs, to action margin calls. This is not true.
>
> …
>
> Whilst Storm has always been happy to assist clients in Colonial with the margin call process, we understood the bank had their own processes for advising clients of margin calls.[61]

3.81 But the evidence of these Storm staff is contradicted by the statement of another staff member, Mr John Fuller, who clearly states his understanding that the margin calls would come to Storm, not to the clients:

> I was educated from the outset within Storm Financial that no client would ever receive a margin call direct from their margin lender. If maximum LVR's were breached or threatened, the margin lender would direct the call through Storm Financial and the problem would be dealt with by both bank and advisory body according to client position.[62]

3.82 In response to these contradictory claims, the Commonwealth Bank acknowledges a change in process since 2002-03 regarding the management of margin calls:

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59 Mr David McCulloch, *Official Committee Hansard*, Townsville, 2 September 2009, p. 11.

60 Mrs Carmela Richards, *Official Committee Hansard*, Townsville, 2 September 2009, p. 28.

61 Mrs Carmela Richards and Ms Kristy Devney, *Submission 386*, p.6.

62 Mr John Fuller, *Submission 281*, p. 2.

> In 2002 and 2003, the process for margin calls was that the dealer—the adviser—would actually notify the client and that would be followed up by letter from Colonial Geared Investments, which would typically arrive four or five days later.[63]

3.83 In contrast, the situation in 2008 was described as follows:

> Our practise undoubtedly in the business at the time, with 7,000 dealers, was to make margin calls through the dealers. I can say that, in the October 2008 to December 2008 period, 15,000 margin calls were made to customers outside Storm from the Colonial Geared Investments business. To the best of my knowledge, having made inquiries of my team, every one of those was made through a dealer. So our understanding was certainly that the margin calls for Storm customers would be made through Storm, as the financial adviser, and three files a day of information were provided to Storm to this end.[64]

3.84 The CBA contends that this is standard industry practice:

> … the industry practice in this type of business was for the conduct of margin calls to be made firstly to the dealer group and then the dealer group of the financial adviser would in turn contact the customer. That was a process that was industry wide. It was a process that operated throughout the 7,000 dealers that CGI had a business with.[65]

3.85 Somewhat to the dissatisfaction of the committee, the CBA was not able to confirm at what point between 2002-03 and 2008 CGI ceased sending written notification of margin calls to clients:

> I know this will not be a satisfying answer, but we cannot point to the exact time the policy was changed. What we can say is that to our knowledge it was significantly in advance of the events of 2008 and certainly not at all related to the events of 2008.[66]

3.86 The CBA's evidence conflicts with Mr Cassimatis's claim that no margin calls were being received:

> During October we received over $600 million worth, effectively, of action in response to margin calls from Storm. It was very, very clear that Storm was acting on margin calls. Storm was passing on margin calls to customers because that was the way the industry was operating and that was the way Storm had operated with us.[67]

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63 Mr Ian Narev, CBA, *Official Committee Hansard*, Sydney, 4 September 2009, p. 65.

64 Mr Ian Narev, CBA, *Official Committee Hansard*, Sydney, 4 September 2009, p. 65.

65 Mr David Cohen, CBA, *Official Committee Hansard*, Sydney, 4 September 2009, p. 75.

66 Mr Ian Narev, CBA, *Official Committee Hansard*, Canberra, 28 October 2009, p. 33.

67 Mr David Cohen, CBA, *Official Committee Hansard*, Sydney, 4 September 2009, p. 75.

3.87 Later in their evidence, the CBA directly countered Mr Cassimatis's position that he thought, as in 2003, the bank would contact the customer directly in relation to margin calls:

> … we simply cannot agree with that characterisation. We have documents from Storm that make it very clear that Storm was acting on margin calls by passing on the margin calls that CGI was making to Storm …
>
> Storm was highly active in responding to margin calls …
>
> … It was very clear to us that Storm was active processing calls. There was no silence from Storm; there was action on Storm's part. However, what concerned us was that the speed of response and the action taken in response to margin calls declined significantly through November. It was at that point that we decided that we had to take direct action.[68]

3.88 The CBA insisted that Storm was well aware of its current policy in relation to the handling of margin calls:

> I accept that there is contradictory evidence. What I can say is that, based on my own review of discussions internally et cetera, I would be very surprised if, going into 2008, Storm could have been under the impression that Colonial Geared Investments' practice was to contact clients directly. Also, it would have been the only one of 7,000 dealers that we had that policy with. I think that, as you have heard from Macquarie, they had the same policy. I would find it very difficult to understand … that there was any misapprehension about that at the time we are talking about.[69]

3.89 As further clarified by Mr Cohen:

> There were occasions—not many, admittedly—prior to 2008 when Storm did respond to margin calls using this model, so I do not think there could have been any doubt on Storm's part given that they had responded in this fashion previously.[70]

3.90 Macquarie Bank, another major provider of margin loans to Storm investment clients, similarly told the committee:

> … our approach to margin calls was to notify the intermediary … We did this across our entire loan book. In addition, we provided both clients and the intermediaries, including Storm, with access to a secure Macquarie website which was updated daily with all relevant loan information including the current LVR and whether the loan was in margin call. So every client had the opportunity to access their own website with up-to-date daily information on their investments and their margin loans.
>
> During October 2008, we became aware that there was a breakdown in margin call loan notifications within Storm. Storm was apparently not

68 Mr David Cohen, CBA, *Official Committee Hansard*, Sydney, 4 September 2009, p. 76.

69 Mr Ian Narev, CBA, *Official Committee Hansard*, Canberra, 28 October 2009, p. 33.

70 Mr David Cohen, CBA, *Official Committee Hansard*, Canberra, 28 October 2009, p. 34.

> passing them on to their clients. We responded by immediately investigating the situation and by late October we had commenced direct notification of margin calls to clients. We continued to be in daily contact with Storm to notify them of client margin calls during this period, and daily updates on the website were maintained. The intermediated margin call process continued to operate satisfactorily during this period with other dealer groups that we were dealing with.[71]

3.91 Macquarie Bank also emphasised to the committee that a margin call is a risk that Storm clients should have been well aware of:

> … there has been public discussion suggesting that margin calls operated or were designed to operate as a stop loss for the benefit of the borrower. Our product brochures … disclose margin calls as a risk for the client; they are not a stop loss. This risk was identified in our documents that, if an investor did not act in response to a margin call, the lender might sell the investment …[72]

Committee view

3.92 The committee finds it somewhat surprising and highly concerning that there was such lack of clarity around this critical facet of the Storm model. The leveraged investment strategy was sold to clients on the basis that there were sufficient buffers and triggers in place, as well as cash reserve funds, to ensure that any margin call situation could be appropriately managed. It seems remarkably careless, from Storm's point of view, to leave any room for doubt around this process.

3.93 Equally, the lenders carry the risk of default on the loans and have a clear interest in ensuring that all parties to the transaction are fully aware of their obligations and the agreed processes to be followed in the event of margin calls.

3.94 While the committee acknowledges the banks' contention that their legal obligation was to inform the intermediary financial adviser, who in turn was obliged to consult with the client about how to resolve a margin call, the committee nevertheless believes the banks had a moral obligation to attempt to make direct contact with the loan account holders once it became clear that, for whatever reason, Storm was not functioning successfully as an intermediary to clear the margin calls.

3.95 The committee heard in evidence that the CBA first made margin calls on Storm clients on 18 September yet did not make direct contact with clients until December—an elapsed time of approximately 11 weeks.[73] Even noting the CBA's evidence that it received some 'action' from Storm during October, the committee

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71 Mr Richard Sheppard, Macquarie Group Ltd, *Official Committee Hansard*, Canberra, 28 October 2009, p. 3.

72 Mr Richard Sheppard, Macquarie Group Ltd, *Official Committee Hansard*, Canberra, 28 October 2009, p. 3.

73 *Official Committee Hansard*, Canberra, 28 October 2009, p. 30.

views the length of the delay on the CBA's part as inexcusable, and it contrasts poorly with evidence from Macquarie Bank that it moved to make direct contact with clients within two weeks of realising that Storm was not notifying their clients.[74]

3.96 The committee therefore welcomes the commitment made by the CBA that, following an internal policy revision, it will now notify all clients of margin calls directly, rather than through an intermediary financial adviser.[75] This is discussed further below, starting at paragraph 3.104.

Limited oversight and regulatory gaps

3.97 Investors feel substantially let down by bodies that they believed would help to protect them from events of this nature:

> Before joining Storm, we checked to see whether they were members of the Financial Planning Association, as we believed this gave them credibility. After sending the FPA a copy of a letter of complaint, the response we received from them was extremely disappointing. We also believed that the government watchdog, ASIC, was there to protect investors, yet we now feel that this is not the case.[76]

3.98 The Financial Planning Association (FPA) told the committee:

> … as an association we certainly accept responsibility for the fact that Storm Financial was a member of the FPA and we certainly wish that we could have acted early and we wish that we could have prevented some of the losses that have occurred. We acted very swiftly when we became aware of the issues in October last year through a complaint that we made against Storm as a result of a letter that they had sent to their clients … In summary, Storm promoted a very aggressive investment strategy which carried significant risk.
>
> There are a number of reasons why we believe that Storm failed and there are a number of actions that are under way, including margin lending and credit regulation, which will address some of those issues. We as an association have made some changes and are moving to make some more changes to improve the nature of our audit process and to introduce a whistleblower policy so that staff, clients and financial planners in the community feel that they can blow the whistle in a safer environment … We believe that we all have a lot to learn as a result of Storm.[77]

3.99 There has been significant criticism by investors of ASIC for not identifying the risks posed by Storm's one-size-fits-all financial advice model before the collapse

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74 *Official Committee Hansard*, Canberra, 28 October 2009.

75 Mr Ralph Norris, CBA, *Official Committee Hansard*, Canberra, 28 October 2009, p. 25.

76 Mr Francis Grainer, *Official Committee Hansard*, Cairns, 1 September 2009, p. 49.

77 Ms Jo-Anne Bloch, Financial Planning Association, *Official Committee Hansard*, Canberra, 28 August 2009, p. 27.

occurred. ASIC does not have a role in assessing business models for risk per se, but it does have a role in ensuring compliance with current *Corporations Act 2001* (Corporations Act) requirements in relation to standards of advice, including the section 945A requirement that advice takes account of the personal circumstances of each client and is appropriate for that client. More effective risk-based auditing processes might have assisted ASIC in recognising Storm's practices as being problematic at an earlier point in time. This matter is the subject of further discussion, in a broader context, in Chapter 6 of this report.

3.100 Critically for Storm investors, at the time of the collapse of Storm Financial, margin lending facilities did not fall within the definition of a financial product within Chapter 7 of the Corporations Act. Consequently, these products did not lie within ASIC's regulatory responsibilities and were not regulated at the national level. Because they were generally purchased for investment strategies, they also fell outside state-based consumer credit laws.

3.101 This regulatory gap has now been closed, following the October 2009 passage through parliament of the Corporations Legislation Amendment (Financial Services Modernisation) Bill 2009. This bill explicitly defines margin loans as financial products for the purposes of the Corporations Act and sets out a range of requirements on financial product providers and advisers when selling these products to clients. The measures in this bill are intended to substantially enhance protection for investors and to provide ASIC with powers to take action where these facilities are not offered or managed in accordance with the law.

3.102 This legislation will provide a new layer of protection for future investors in margin loans and margin loan-like products. Treasury explained to the committee:

> The main change that we have made in the legislation is that, regardless of what advice you get from your financial planner, at the end the responsible lending requirement rests on the bank or the lender. The lender has to make an independent assessment of whether this loan is not unsuitable for a particular client regardless of what the financial planner has said. So there is a second line of defence.[78]

Committee view

3.103 The committee welcomes the passage of this legislation and, through such mechanisms as its regular oversight hearings with ASIC, will monitor its implementation and impact in the marketplace, particularly its ability to further protect investors from inappropriate advice or inappropriate product sales.

3.104 The committee remains concerned about the process for notifying clients of margin calls. During late 2008 when the market was falling rapidly, there were unacceptable delays in clients being made aware of their true position, such that by the

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78 Mr Michael Lim, Treasury, *Official Committee Hansard*, Canberra, 28 August 2009, p. 15.

time many became aware of their circumstances they either no longer had the capacity to take their accounts out of margin call or had had their portfolios sold down without their knowledge. The banks have indicated to the committee that they followed standard industry practice of notifying the intermediary financial adviser of margin calls and assuming that they would take responsibility for notifying the client and actioning a response to the call.

3.105 The new legislation requires that, unless a client specifically elects to have the bank deal only with their adviser, the lender is required to notify both the adviser and the ultimate customer when their account falls into margin. This is an improvement on the current (unregulated) situation but the CBA, among others, has suggested that it would prefer to see a situation where banks *must* contact the client in all circumstances. The committee agrees that this may need to be the subject of future legislative amendment, to further strengthen client protection. This matter is considered further in Chapter 6 of this report.

Lender responses to the Storm collapse

3.106 On 17 June 2009 the Commonwealth Bank issued a press release acknowledging that it carried some responsibility for the situation in which Storm clients who were also customers of the bank found themselves.[79] Notably, Chief Executive Officer Ralph Norris made the following apology to Storm investors:

> "In some cases we have identified shortcomings in how we lent money to our customers involved with Storm Financial," Commonwealth Bank CEO Ralph Norris said.
>
> "We are not proud of our involvement in some of these issues and we are working toward a fair and equitable outcome for our affected customers."
>
> "Our customers can be assured that where we have done wrong, we will put it right. I am committed to the identification and resolution of all issues relating to the Bank's involvement with Storm Financial," he said.
>
> Mr Norris said the Bank would meet its obligations to those customers identified as being in financial difficulty as a result of any shortcomings identified in the Bank's lending practices.
>
> "However, the Bank is not responsible for the financial advice provided independently by Storm Financial to the Bank's customers. That was clearly the responsibility of Storm Financial, a licensed financial advisory company," he said.

3.107 These sentiments were repeated in the bank's first public appearance before the inquiry:

> … I echo Mr Norris's statement that we are not proud of the bank's involvement in some of the issues faced by those customers … customers

79 See http://www.commbank.com.au/about-us/news/media-releases/2009/170609-news-storm-financial.aspx; accessed on 30 October 2009.

> can be assured that, where we have done wrong, we will put it right … Both before and since that announcement we have been taking action to put wrongs right. First, our customer assistance program established with customers on the ground in Townsville and, second, our innovative resolution scheme.[80]

3.108 Bank executives identified steps taken in the wake of the Storm collapse:

> … the bank has learned from mistakes that we have made in relation to some of our lending to Storm customers. Amongst the steps we have taken to remedy the situation, we have improved our valuation decisioning tool, known as VAS, … we have tightened our loan approval processes, and we have augmented our compliance and audit checking processes.[81]

3.109 In acknowledging mistakes made, however, the CBA noted the involvement of other parties:

> … it needs to be recognised that there are other parties significantly involved in the hardship suffered by Storm clients. CBA is not responsible for either those parties or their contribution to the hardship being experienced.[82]

3.110 At the committee's final public hearing for the inquiry, Mr Norris and senior CBA executives provided an update on the resolution scheme the bank has established to assist CBA customers who were also Storm customers:

> At this point, around 2,300 people have registered to participate in the scheme, which is a little over 80 per cent of all the people who had relationships with the Commonwealth Bank. Approximately 100 offers of settlement are currently being considered by our clients, we have reached a resolution for 53 customers, and the independent panel is currently reviewing documents and will be providing evaluations and determinations soon. Another clear and important priority for the foreseeable future is to expedite as many offers and settlements as we can. We want to help as many customers as quickly as possible.[83]

3.111 At the same public hearing, Macquarie Bank told the committee:

> Macquarie has an established dispute resolution process and we have been using that process to respond to complaints made by Storm-advised clients who had margin loan facilities with us. We have made some payments for certain account errors where delays in our processing of redemptions or

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80 Mr David Cohen, CBA, *Official Committee Hansard*, Sydney, 4 September 2009, p.57.

81 Mr David Cohen, CBA, *Official Committee Hansard*, Sydney, 4 September 2009, p. 58.

82 Mr David Cohen, CBA, *Official Committee Hansard*, Sydney, 4 September 2009, p.58.

83 Mr Ralph Norris, CBA, *Official Committee Hansard*, Canberra, 28 October 2009, p. 24.

account closures may have contributed to financial detriment, but overall we have not identified any recurring or systematic errors.[84]

3.112 At an earlier hearing in Canberra, the committee heard from Mr David Liddy, CEO of the Bank of Queensland, that:

> … a number of BOQ customers were impacted by the collapse of Storm and are suffering financial hardship as well as real emotional hardship. We have every sympathy for those customers and have been actively contacting them about our hardship assistance package … we are working closely with a number of those impacted to provide assistance and have also made a commitment to work with those customers to keep them in their homes. Every customer and every case is different. As such, we are working with any customer suffering genuine hardship on a one-on-one basis to find the best solution for them.[85]

3.113 Mr Liddy stressed, however, that he is not aware of any fault on the part of BOQ:

> We do not believe we have acted illegally or dishonestly in our dealings with customers referred through Storm Financial.[86]

3.114 Through MLC representatives, NAB informed the committee at its Melbourne hearing:

> … we do share the committee's concern for Storm's customers … NAB has established an internal working group to fully assess its level of involvement with the Storm Financial group and any customer relationships that might exist between the two organisations. The working group is conducting a comprehensive review of all related processes and policies and this work is ongoing … NAB is cooperating fully with the regulator and is devoting all necessary resources to accommodate ASIC's requests.[87]

3.115 Also at its Melbourne hearing, the committee was informed of ANZ Bank's measures to assist Storm customers:

> ANZ did not have a formal relationship with Storm Financial, nor did we provide margin loans to our customers to invest through Storm. We noted in our submission around 160 customers who may have borrowed from ANZ, mostly via mortgages, to invest through Storm. We are continuing

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84 Mr Richard Sheppard, Macquarie Bank Ltd, *Official Committee Hansard,* Canberra, 28 October 2009, p. 3.

85 Mr David Liddy, Bank of Queensland, *Official Committee Hansard*, Canberra, 16 September 2009, p. 29.

86 Mr David Liddy, Bank of Queensland, *Official Committee Hansard*, Canberra, 16 September 2009, p. 30.

87 Mr Steve Tucker, MLC Limited, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 2.

> our review … and expect we will find additional customers who may have some connection with Storm …
>
> … so far we have identified a small number where lending decisions did not comply with ANZ's policies. We are contacting those customers and will treat them fairly. Our approach will include assessing hardship on a case-by-case basis and rectifying detriment that resulted directly from action on ANZ's part.[88]

Committee view

3.116 The committee acknowledges that each of these lenders has made a public statement of their position in relation to assisting Storm Financial clients. The committee encourages any other lenders with exposure to Storm's clients to make similar clarifying statements.

3.117 The committee also acknowledges Mr Ralph Norris's statement that:

> … we [the CBA] are the only organisation to stand up and comprehensively acknowledge its responsibilities.[89]

3.118 The committee certainly welcomes the CBA's readiness to admit its mistakes in the way it transacted business with Storm and Storm's clients who are also clients of the bank. The committee appreciates the bank making the effort to establish an innovative and fast-tracked resolution scheme for affected clients.

3.119 The committee encourages other lenders, who in some cases are still reviewing their internal policies, to be similarly candid about errors that may have been made and similarly constructive in the manner in which they engage with clients to redress those errors.

ASIC's response to the collapse

3.120 On 16 September 2009, ASIC updated the committee on its continuing investigations into Storm Financial.[90] As one of the largest investigations ever undertaken by ASIC, considerable progress is being made in scoping potential causes of actions and possible legal proceedings. However, ASIC intends to evaluate material from all of the committee's public hearings and the liquidator examinations that commenced on 24 September 2009 before making any public announcements about its next steps.[91]

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88 Mr Graham Hodges, ANZ, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 35.

89 Mr Ralph Norris, CBA, *Official Committee Hansard*, Canberra, 28 October 2009, p. 25.

90 Mr Tony D'Aloisio, ASIC, *Official Committee Hansard*, Canberra, 16 September 2009, pp. 2- 3.

91 Mr Tony D'Aloisio, ASIC, *Official Committee Hansard*, Canberra, 16 September 2009, pp. 2 -3.

3.121 Importantly, ASIC confirmed that investors who participate in the CBA settlement scheme will still be able to benefit from any actions that ASIC may bring.[92]

Committee view

3.122 The committee appreciates that the regulator needs to ensure that its investigations and potential recommendations for actions are not compromised by premature public statements. However, the committee emphasises the extraordinary public interest in these matters and the continuing hardship being suffered by Storm investors, and urges ASIC to advance the investigation as a top priority. The committee also urges ASIC to make timely and appropriate public announcements regarding the progress of its investigations.

Committee conclusions

3.123 All share market investors were exposed to the dramatic market fall of late 2008, and many realised losses on their portfolios. However, few now find themselves in such dire circumstances as Storm Financial's former investment clients.

3.124 As the events of 2008 demonstrated, Storm's model was not capable of withstanding a severe market downturn. Its success was predicated on the market continuing to rise indefinitely. The buffer and LVR settings proved to be such that, when the market fell rapidly, there was insufficient time and capacity to put accounts back into order before they fell into negative equity. The responsibility for this failure to resolve margin calls may well be shared between several parties, but that does not change the fact that the strategy failed.

3.125 The committee is of a clear view that Storm's aggressive leveraged strategy, in combination with the failure of multiple parties to appropriately monitor and manage margin calls at the height of the market volatility, were of disastrous effect for Storm's investment clients. The effects are greatest on those for whom this strategy simply cannot be considered appropriate advice—that is, those who were at or near the end of their working lives, with limited capacity to rebuild from scratch in the event that all their assets were lost and they found themselves in negative equity. This is not to detract from the losses of other investors; they have also suffered markedly from the combination of circumstances that occurred.

3.126 It is not the role of the committee to make findings of blame. It notes, however, a recent statement by Mr Ralph Norris, CEO of the CBA:

> In truth, a degree of responsibility rests on the shoulders of banks, individuals and the regulator to a greater or lesser degree, and primarily on Storm Financial, who provided the financial advice as a licensed adviser.[93]

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92 Mr Tony D'Aloisio, ASIC, *Official Committee Hansard*, Canberra, 16 September 2009, pp. 2 -3.

93 Mr Ralph Norris, CBA, *Official Committee Hansard*, Canberra, 28 October 2009, p. 25.

3.127 The committee also records its serious concerns with regard to the following matters:

- the apparent provision of one-size-fits-all advice to Storm's investment clients, without the appropriate regard for their personal circumstances (including their life stage and asset base) that section 945A obligations require of advisers;
- the unacceptable confusion or disagreement between Storm and its lenders about how margin calls would be managed and who was responsible for which parts of this process; and
- the inappropriate and ultimately devastating delay or failure, particularly by the CBA, to make direct contact with margin loan clients when it became apparent that Storm was not successfully acting as an intermediary to clear margin calls.

3.128 Claims that the banks were unable to provide accurate information about the status of margin loan accounts during the period of extreme market volatility are also deeply troubling. However, the committee notes evidence from the banks that they used the same approach to margin call management with all the advisory groups they dealt with (numbering in the thousands), yet Storm Financial clients were the only group who *en masse* failed to be appropriately notified by their advisers of the true status of their margin loan accounts. This points the committee towards the inescapable conclusion that there was something about Storm— be it their staffing and resourcing levels, their computing systems, the degree of leverage in their model, their understanding of their responsibility in relation to margin calls, or a combination of these and other factors—which led to an inability to receive, handle and resolve margin calls during the critical period before their customers went into negative equity and were sold out of the market. The committee does recognise that the rate at which market conditions were changing, taken together with the number of client accounts that would have been going into margin call at the same time, would create a formidable administrative burden. However, Storm is alone among the advisory groups in having ended up in a situation characterised by such catastrophic losses for its clients.

3.129 Finally, the committee acknowledges that it is not necessarily appropriate to recommend reform in response to a particular collapse or event. Isolated corporate failures, no matter how painful their impact for those caught up in them, are not necessarily indicative of, or caused by, regulatory failure. The mass of evidence the committee has received in relation to the collapse of Storm Financial has, however, contributed to the committee's broader understanding of the current operation of Australia's financial products and services sector and of the provision of financial advice. In Chapter 5 of this report the committee considers problematic issues in the sector in a broader context, and in Chapter 6 the committee makes a series of recommendations for reform, which are in part informed by the committee's extensive deliberations on the collapse of Storm.

Chapter 4

The collapse of Opes Prime

Acknowledgement of effect on clients

4.1 The committee acknowledges the devastating effect that the collapse of Opes Prime has had on a range of clients who entered into an Australian Master Securities Lending Agreement (AMSLA) with Opes Prime Stockbroking Limited. When Opes Prime was put into administration, these clients had no legal title over shares that many believed they still owned, and they had no opportunity to redeem their financial positions.

4.2 Media reporting about the collapse may have created a general impression that the majority of Opes Prime's clients were sophisticated, high-wealth individuals or corporations who understood the risk that they were taking in entering an AMSLA. However, evidence before the committee suggests that this is an erroneous oversimplification of the situation. According to Mr Robert Fowler:

> … they [Opes Prime's clients] are a disparate grouping, from corporate high flyers who knew exactly what AMSLA's were, went into dealing with Opes up to their ears in stock lending, down to the small retail investors who were put into Opes by their brokers who were anxious to scalp a half a per cent commission on the margin loan interest plus an introduction spiv.[1]

4.3 Following the collapse, the ANZ Bank has acknowledged the diversity of people caught up in it:

> Since the collapse of Opes Prime, ANZ has come to understand that Opes Prime's customer base was diverse … However, throughout ANZ's dealings with Opes Prime, Opes Prime consistently described its clients as high net worth individuals and sophisticated investors, as well as several stockbroking firms and fund managers. [2]

4.4 Although the committee has received far fewer submissions on Opes Prime than in relation to the collapse of Storm Financial (perhaps because more time has elapsed since the collapse occurred), the submissions that have been received paint a grim picture of the effect on individual clients.[3]

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1 Mr Robert Fowler, *Submission 120*, p. 8.

2 ANZ*, Submission 379*, p. 24.

3 See the following submissions for examples: *Submission 93, Submission 94*, *Submission 95*, *Submission 97*, *Submission 98*, *Submission 120*, *Submission 197,* and *Submission 271*.

4.5 The committee also received a number of confidential submissions that further detail distressing consequences of the decision to enter an AMSLA with Opes Prime, including loss of retirement savings, forced sales of family homes, breakdowns in personal relationships and ill health.

4.6 The committee sincerely thanks those submitters and witnesses who have contributed to its deliberations on the collapse of Opes Prime.

Limitations of the committee's inquiry

4.7 The committee's understanding of the Opes Prime business model, the company's collapse and the subsequent effect on clients has been informed by a range of sources, including:

- submissions from affected clients;
- a submission by the ANZ Banking Group;
- a submission by the regulator, the Australian Securities and Investments Commission;
- evidence taken at public hearings;
- media reporting; and
- other information in the public domain, including on relevant web sites.

4.8 The causes of the collapse of Opes Prime, and the consequential effect on unsecured creditors, are complex and contested. The committee's sources disagree in many details, including the true nature of the business conducted by Opes Prime, the relationship between Opes Prime and ANZ Bank, the obligation (if any) of ANZ Bank to Opes Prime customers, and the sophistication and understanding of clients who entered into AMSLAs with Opes Prime.

4.9 In the following sections, the committee summarises the range of information that has been put before it and comes to a view on the key lessons to be learned from this collapse.

4.10 It is important to emphasise that the committee is not a judicial body and has no power to make criminal findings or to make judgements in relation to individual claims that have been brought to its attention. It has also not been possible for the committee to resolve all the contradictions in the evidence put before it.

4.11 It should also be noted that the committee's terms of reference focus on financial products and services. A broader array of issues surrounding the collapse of Opes Prime, including market supervision aspects and the operation of the voluntary administration provisions, will not be reported on explicitly.

4.12 The committee's overall role, having regard to what it has learnt through the examination of this corporate collapse and others, is to make any necessary recommendations for legislative change or regulatory improvement to help guard against the occurrence of similar collapses in the future. The committee's deliberations on the need for regulatory or legislative change in Australia's financial products and services sector are discussed in further detail in Chapters 5 and 6 of this report.

The Opes Prime business model

4.13 Having considered all the information put before it, the committee understands the operation of the Opes Prime business model as set out in the following paragraphs.

4.14 Opes Prime provided securities lending (including equity finance) facilities to its clients. These facilities have been described to the committee as follows:

> In general terms, securities lending refers to the transfer of securities from one party to another in return for cash or other securities ("collateral"). The party who receives the securities is generally obliged to return them (or equivalent securities) either on demand or at the end of an agreed term, subject to repayment of the collateral.
>
> Equity finance is a particular subset of securities lending in which the value of the cash collateral advanced to the party providing the securities ("customer") is generally less than the value of the securities received by the party providing the cash collateral ("financier").
>
> The principal distinction (from a legal perspective) between margin lending and equity finance is that with the latter the customer transfers all legal and beneficial interest in the securities to the financier.[4]

4.15 Opes Prime Stockbroking offered clients a version of an Australian Master Securities Lending Agreement (AMSLA).[5] Under this agreement, beneficial ownership and interest in the securities passed from the original owner to Opes Prime in exchange for cash collateral.[6]

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4 ANZ*, Submission 379,* p. 22.

5 As noted by Justice Finkelstein in Beconwood Securities Pty Ltd v Australia and New Zealand Banking Group Limited [2008] FCA 594, at paragraph 14, 'The term "securities lending" under these agreements is factually incorrect. The transaction that is referred to as "lending" is in terms an outright disposal of the securities lent, linked to a subsequent acquisition of equivalent securities. In other words the agreements provide that title to the securities on loan, as well as to any collateral that is received by the lender, passes from one party to the other. On the other hand, the economic benefits of ownership are "manufactured" back to the lender by the terms of the securities loan agreements.'

6 This understanding of the AMSLA is supported by Justice Finkelstein's judgement; see Beconwood Securities Pty Ltd v Australia and New Zealand Banking Group Limited [2008] FCA 594.

4.16 Opes was then able to do what it wished with the shares. This included using some of them as collateral for finance, from ANZ Bank and from Merrill Lynch, but also lending stock on to hedge funds for short selling or shorting the stocks directly, thereby exerting downward pressure on stock values.[7]

4.17 A point of difference between Opes and other providers of similar facilities was that Opes did not restrict the range of stocks in which clients could invest:

> Opes Prime allowed clients to invest in more speculative shares than many other providers of loans for share purchases, thereby adding to the risk of the business.[8]

4.18 ASIC has characterised the product on offer from Opes as follows:

> The distinctive feature of the Opes business model was that it enabled retail clients to engage in securities lending, an arrangement that is usually only entered into between wholesale parties. From the clients' perspective the securities lending arrangement with Opes had the same commercial effect as a margin loan, that is, the clients accessed cash, using their securities as 'collateral'. However, the legal effect was quite different because title to clients' securities was transferred to Opes, rather than mortgaged in favour of Opes. The use of securities lending, by retail investors, as a means to access cash, using securities as collateral is not common.[9]

4.19 Under the terms of the AMSLA, when Opes Prime was put into administration, financiers of Opes Prime including ANZ Banking Group and Merrill Lynch sold down the securities that they were holding as collateral for the finance advanced to Opes Prime. The original owners no longer held the title to these securities and had no opportunity to redeem their financial position.

Events surrounding the collapse of Opes Prime

4.20 ANZ has portrayed the collapse of Opes Prime in the following terms. More details are contained in ANZ's submission to the inquiry.[10] These events are broadly in accordance with what has been reported by the Australian media.

4.21 In early 2008 ANZ implemented a revised loan to value ratio (LVR) model and put agreements in place with Opes Prime that they would migrate their accounts to reach this new standard, with the first milestone due to be reached in mid March. In March 2008 ANZ was advised that Opes Prime would not be able to meet the agreed milestone, due to two significant events:

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7 Michael West, 'Scramble of the despondent and the damned', *Sydney Morning Herald*, 2 April 2008.

8 Professor Ian Ramsay, 'Ope Prime: who understood?', *The Age*, 1 April 2008.

9 ASIC, *Submission 378*, p. 121.

10 Please see *Submission 379*, available online at the following link: http://www.aph.gov.au/senate/committee/corporations_ctte/fps/submissions/sub379.pdf .

(i) the discovery of 'irregularities' in a major customer's account, whereby 'ANZ was told that it appeared that Opes Prime's records had been manipulated to make it seem that the customer was within margin, when in fact this was not the case';[11] and

(ii) a customer request for the redelivery of securities worth approximately $95 million.[12]

4.22 ASIC has explained that Opes was not well placed to withstand such demands:

> … Opes was not well capitalised and, as a result, when a number of its clients faced significant losses in the market downturn, it was not able to cover the shortfall.[13]

4.23 ANZ agreed to an emergency support plan to assist Opes Prime, including a $95 million loan and a seven-day 'stand-still' on margin calls. In return, amongst other conditions, ANZ appointed Deloitte as an investigative accountant to work with Opes's financial adviser, Ferrier Hodgson, in assessing Opes Prime's situation in detail. The documentation for this agreement was executed on 20 March 2008.

4.24 Once Deloitte and Ferrier Hodgson commenced their assessment, it became apparent that 'there were further issues and irregularities in Opes Prime's business'.[14] The directors of Opes Prime appointed Ferrier Hodgson as voluntary administrators on 27 March 2008. On the same day, ANZ appointed Deloitte as receivers and managers pursuant to a registered charge.[15]

4.25 Critically for those Opes Prime clients who had signed an AMSLA, ANZ's understanding of their position after the appointment of the administrators is as follows:

> Upon the appointment of administrators to Opes Prime, its customers lost the ability to recall securities that they had transferred to Opes Prime, and instead became unsecured creditors for any 'netted' amounts owed to them under their Equity Finance arrangements with Opes Prime.[16]

4.26 This understanding of the consequences of the AMSLA has been supported by a Federal Court test case, in which Justice Finkelstein found on 2 May 2008 that Beconwood Securities (a client of Opes Prime) did not have a legal claim to recover

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11 ANZ, *Submission 379*, p. 25.

12 See ANZ, *Submission* 379, pp. 25 – 26. See also: Katrina Nicholas and Andrew White, 'The Man Who Sank Opes Prime', *Australian Financial Review*, 12 April 2008.

13 ASIC, *Submission 378*, p. 6.

14 ANZ, *Submission 379*, p. 26.

15 ANZ, *Submission 379*, p. 26.

16 ANZ, *Submission 379*, p. 26.

its shares. His Honour found that the AMSLA in place was such that full title to the shares had passed from the original client to Opes Prime and that the Opes Prime client did not retain a beneficial interest in those shares.[17]

4.27 When Opes Prime went into administration, ANZ Bank and Merrill Lynch acted to protect their positions by selling the shares they held as collateral against the finance advanced to Opes Prime. Clients of Opes Prime who had AMSLAs subsequently discovered (if they were not already aware) that they no longer had any entitlement to the shares they had borrowed against and were not able to redeem their position.

4.28 Opes Prime was wound up and put into liquidation in October 2008.[18]

Client understanding and perspective

The nature of the lending agreement

4.29 In the immediate aftermath of the collapse, many clients seemed to be genuinely unaware that they had entered into a securities lending agreement with Opes Prime. They were under the belief that they had taken out a standard margin loan and that they, rather than any other party, retained beneficial ownership of all shares. This meant that when ANZ exercised its contractual right to sell the securities, clients believed that 'their' shares had been 'stolen' from them.

4.30 Some submitters noted that they were long-time successful users of margin lending arrangements to gear their portfolios and, when entering into arrangements with Opes Prime, were assured that they were entering a similar retail margin loan agreement and would retain ownership of their shares:

> …the broker stated that our previous Leveraged Equities Margin Loan account Manager … had moved employment to OPES PRIME STOCK BROKING and had assured us and broker that the OPES PRIME Margin Loan facility is a normal margin loan secured by equities… At all times we were assured we were beneficial owners of our shares.[19]

4.31 In this submitter's view, their savings have been 'confiscated' by the ANZ.

4.32 The committee has been told that the Opes Prime Stockbroking Financial Services Guide (FSG) and the Trader Dealer website advertised margin lending products at a favourable loan to value (LVR) ratio 5 to 10 per cent higher than those

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17 See Beconwood Securities Pty Ltd v Australia and New Zealand Banking Group Limited [2008] FCA 594.

18 Patrick Durkin, 'Hundreds left angry as Opes Prime is wound up', *Australian Financial Review*, 16 October 2008.

19 Name withheld, *Submission 95*, p. 1.

being offered by other providers.[20] The committee has also heard of financial advisers promoting Opes Prime as a provider of margin loans.[21]

4.33 Some submitters have acknowledged that they clearly did not sufficiently understand the product for which they signed up:

> I had read through the fine print of Opes Prime's lending facility terms at the back of their FSG before signing up, and although I found it to be quite complicated in parts I had not noticed anything particularly untoward. I now however realise that I had quite obviously not understood some critical parts of this agreement.
>
> … For example, there was absolutely no mention whatsoever about the Australian Master Securities Lending Agreement (AMSLA) at the rear of this FSG that we were all unwittingly signing, whilst thinking it was a fairly standard margin lending agreement instead.[22]

4.34 Other clients have made similar statements:

> I am an investor who has suffered significant financial loss as a result of the collapse of Opes. I am not a greedy person attracted by the promise of high returns …, rather I am an educated, financially literate person (at the time I entered into the Opes agreement I was working as a Licensed Adviser), who was misled and deceived by Opes personnel as to the true nature of their 'margin lending' product.
>
> …
>
> … as far as I am aware, no effort was made by Opes personnel to inform or educate investors as to the unique differences and higher risk of their product versus the traditional margin lending arrangement. Opes would certainly have been aware that the majority of the retail clients transferring to them were moving their accounts from traditional margin lenders.
>
> Opes clients were not sufficiently apprised of the key features of the AMSLA that they were entering into, with the majority of Opes clients believing that they were entering into a standard margin lending arrangement.[23]

4.35 Submitters indicated that they did not become aware of the true nature of the agreement they had entered into until after Opes had been put into administration:

> We discovered that our securities, lodged through Opes into ANZ Nominees were not held in trust on our behalf but had been used as security for Opes to conduct an AMSLA arrangement with the ANZ. This information was never communicated to us at any time.

20 Name withheld, *Submission 97*, p. 1.

21 Mr Patrick Loughnan, *Submission 271*, p. 1.

22 Name withheld, *Submission 97*, p. 1.

23 Name withheld, *Submission 197*, pp. 1-2.

> The news filtered out that this was an absolute transfer of title to the Bank and that our only claim was against Opes Prime stockbroking. My world had effectively ceased to exist.[24]

The role of the ANZ Bank

4.36 Submitters expressed their view of the ANZ's role in the collapse and, particularly, its aftermath:

> I … have been absolutely dismayed at the lack of regulatory response to the despicable nature of the banks in this Opes Prime affair. I have lost a substantial amount of money, some of it cash, lost a fiancé and lost my job over this. The lack of any empathy [from] ANZ has been bluntly disgusting … To then put a proposal forward where if successful, relinquishes the right of everyone seeking to prosecute the ANZ in the future is an outrage.[25]

4.37 Others acknowledged that they failed to sufficiently understand the nature of the arrangement they entered into with Opes but still consider the bank failed in its duty of care:

> My wife and I invested shares and capital in that agency [Opes] in the belief that it operated as a Margin Lending Business …
>
> OPES operated with the support of ANZ at a time when it was failing in its fiduciary duty to its clients.[26]

4.38 There has been strong criticism of the bank's quick action in selling off the securities held against the loans. There is some belief that the bank had a moral, if not a technical, obligation to the Opes Prime clients who viewed the bank's involvement as an endorsement of the Opes operation:

> Many investors were using the Opes product reassured by the prominence of ANZ in their marketing materials, replete with ANZ logo describing them as 'banker and custodian bank' …
>
> The precise role of ANZ i.e. that they were in the position of providing finance to Opes in exchange for Opes clients stock was never made clear.
>
> … ANZ … seized and indiscriminately sold down the Opes book, with no regard for the many underlying clients who would have re-financed their margin loans given the opportunity. This would then have left ANZ to pursue those Opes clients who should have been margin called and never were. I find it hard to believe that the outcome of a more orderly rundown of the Opes book by ANZ could have possibly resulted in a worse situation than the one in which they now find themselves; and it would certainly

24 Mr Robert Fowler, *Submission 120*, p. 3.

25 Name withheld, *Submission 93*, p. 1.

26 Name withheld, *Submission 94*, p. 1.

have avoided the reputational damage, bad press and litigation that they have now incurred.[27]

4.39 It is the contention of some that they were intentionally misled:

> In short, Opes Prime and ANZ Bank duped us into believing that we maintained "beneficial ownership" of our shares brokered with them, only for the latter (along with Merrill Lynch) to swipe them when the circumstances suited and "fire-sale" them into the market back in March 2008, leaving our financial positions in tatters.[28]

The position of the ANZ Bank

4.40 It is ANZ Bank's clearly stated position that its relationship with Opes Prime was purely a business relationship, as a finance provider, and that it had no direct relationship with, or knowledge of, Opes Prime's customers:

> ANZ's own involvement with Opes Prime was limited solely to its capacity as a financier to Opes Prime. In respect of its dealings with Opes Prime, at no time did ANZ have any relationship with Opes Prime's customers.[29]

4.41 Furthermore, although ANZ recognises the difficult financial circumstances many former Opes customers now find themselves in, the bank does not consider it is responsible for these circumstances:

> ANZ acknowledges the hardship faced by many clients of Opes Prime as a result of their relationship with the stock broking firm advisory group and the impacts of the global financial crisis and the significant downturn in world debt and equity markets. While ANZ does not consider this to have resulted from its actions, ANZ recognises that at times there were deficiencies in the management of its equity finance business and its relationship with Opes Prime.[30]

4.42 When asked to explain what happened in the Opes Prime case, ANZ made the following statement:

> Customers of Opes Prime are understood to have signed agreements providing for the transfer of ownership of securities right at the outset. This had consequences for them when Opes Prime went into administration. Opes had in the meantime disposed of some of those securities to ANZ. To recover in part the funds advanced to Opes Prime ANZ sold the securities at the best price it could obtain. This is quite different from margin lending, where customers retain ownership of the securities and may sell them to

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27 Name withheld, *Submission 197*, p. 3.

28 Name withheld, *Submission 98,* p. 1; see also comments by Mr Robert Fowler, *Submission 120*, p. 1.

29 ANZ, *Submission 379*, p. 2.

30 ANZ, *Submission 379*, p. 2.

> recover their loan obligations. This difference was not widely reported and ANZ suffered considerable reputational damage as a result.[31]

4.43 The ANZ also made comment on this matter in its written submission to the committee:

> While customers of Opes Prime are understood to have signed agreements providing for the transfer of ownership of securities, when a broker such as Opes Prime becomes insolvent, ANZ is seen to be, and in fact is, holding the securities that Opes Prime's customers may have expected would be returned to them. In realising these securities to protect its position, ANZ is regarded by some (including customers of Opes Prime) as acting in its own interests and at the expense of the customers of Opes Prime.
>
> Some of Opes Prime's customers assert that they regarded their arrangements with Opes Prime as some form of margin lending. Some claim that they did not understand that theirs was a full transfer of legal and beneficial title in securities to Opes Prime, and that Opes Prime was then free to deal with these securities without restriction, including transferring them to ANZ.[32]

4.44 ANZ's ability to protect its own position by selling the securities was reduced due to the fact that Opes held many small, speculative stocks on its books (e.g. mining exploration companies). The ANZ acknowledged this problem in verbal evidence to the committee:

> … we did not cover ourselves in glory. We took stocks as security that were outside ASX200. Another one of the financiers to Opes Prime, Merrill Lynch, was able to liquidate the stocks it had as security much more quickly, as we believe, because they confined themselves largely to ASX200 stocks.[33]

4.45 The bank maintains that, because it had no direct relationship with Opes Prime customers who entered into securities lending agreements, it has no knowledge of the communication that occurred between Opes Prime and its customers:

> We do not know exactly what disclosures were being made between Opes Prime and its customers.[34]

4.46 Furthermore, the bank has told the committee that it did not receive information about who the Opes Prime customers were:

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31 Mr Graham Hodges, ANZ Banking Group, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 35.

32 ANZ Banking Group, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 37.

33 Mr Bob Santamaria, ANZ Banking Group, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 50.

34 Mr Bob Santamaria, ANZ Banking Group, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 38.

> ANZ did not have a direct relationship with Opes Prime customers. ANZ was not party to the contracts between Opes Prime and its customers and, where securities were transferred to ANZ, ANZ was not provided with documents evidencing the identity of the person from whom Opes Prime obtained the relevant securities.
>
> ANZ's knowledge of Opes Prime's customer base was necessarily limited given that ANZ did not have a direct relationship with Opes Prime's customers. Given that Opes Prime held legal and beneficial ownership of the securities, Opes Prime was not obliged to inform ANZ of the identity of the person from whom they had obtained the securities that it transferred to ANZ.[35]

4.47 ANZ executives outlined to the committee the steps that the bank took following the Opes Prime collapse:

> ANZ undertook a review of the securities lending business, chaired by ANZ CEO Mr Mike Smith, who was assisted by respected company director David Crawford. … The review found that at times there were deficiencies in ANZ's identification and management of risks within the securities lending business. A remediation plan was instituted and six staff and two senior executives left the bank.[36]

4.48 The ANZ review has been made public at the bank's website and can be viewed online.[37]

4.49 ANZ Bank has admitted to making mistakes in relation to the business it conducted with Opes Prime:

> …our understanding of that business was less than it should have been within the bank …[38]
>
> … Our internal processes were inadequate … I do not think we properly studied and appreciated that in … a falling market this product would operate differently from margin lending.[39]

4.50 However, ANZ Bank also sought to put the Opes Prime collapse in the context of economic cycles and the circumstances leading up to the global financial crisis:

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35 ANZ*, Submission 379*, p. 24.

36 Mr Graham Hodges, ANZ Banking Group, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 35.

37 The Securities Lending Review is also published as part of the ANZ submission to this parliamentary inquiry – see http://www.aph.gov.au/senate/committee/corporations_ctte/fps/submissions/sub379.pdf

38 Mr Graham Hodges, ANZ Banking Group, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 37.

39 Mr Bob Santamaria, ANZ Banking Group, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 40.

> The collapses of Opes Prime, Storm and other similar businesses followed 17 years of strong economic growth and booming equity and property markets. Cycles turn and people tend to lose sight of the fact that asset prices fall regularly as well as go up. Regulation will not change that.[40]
>
> My broad observation would be that clients of both Storm and Opes were very much caught up in the times and people were generally seeing everything going up and nothing going down in terms of value. I suspect people lost sight of the fact that markets are volatile, economies do go up and down and did not appreciate the risk they were getting into. In that sense … they were not alone. The world was caught up in that to a large extent.[41]

4.51 ANZ Bank executives also told the committee:

> There were various factors that led to Opes Prime's collapse. One was that the market was going down along with the value of the shares tendered as security. There were also perceived to be some irregularities within the Opes Prime business.[42]

4.52 ANZ does not believe that the Opes collapse is a result of regulatory failure:

> ANZ is not aware of any evidence that the collapse of Opes Prime stemmed from any deficiency in the regulatory framework.[43]

4.53 The bank does not take any responsibility for the degree of gearing Opes Prime clients engaged in:

> That was their model and what they were doing with their clients—not to do with the bank.[44]

4.54 Perhaps the starkest acknowledgement from the ANZ that its involvement in Opes Prime represented poor judgement is the bank's decision to withdraw from all securities lending:

> When you ask about our experience with this, it is summed up in one of the central conclusions of our published securities lending review: we are out of that business. We are not continuing to provide funding to that sort of business.
>
> …

40 Mr Graham Hodges, ANZ Banking Group, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 36.

41 Mr Graham Hodges, ANZ Banking Group, Official Committee Hansard, Melbourne, 26 August 2009, p. 48.

42 Mr Bob Santamaria, ANZ Banking Group, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 39.

43 ANZ, *Submission 379*, p. 2.

44 Mr Graham Hodges, ANZ Banking Group, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 42.

> We believe it is not the sort of business that a bank should be in. We have admitted very publicly that it was not. It was a type of model that was always, in retrospect, prone to misunderstanding. We have admitted we made a mistake there and we have quit that business. To the extent that we acted sloppily, we have imposed sanctions on the people who were involved in that and the sanctions were very serious right up to two of the direct reports to the managing director.[45]

4.55 During 2009, ANZ reached agreement with the liquidators to implement a scheme of arrangement between ANZ, Merrill Lynch, Opes Prime, and related parties and creditors. This scheme will return to creditors a portion of the amounts owed to them by Opes Prime, as a result of ANZ and Merrill Lynch contributing to a settlement fund in excess of $250 million. This scheme of arrangement, including the conditions attached to it and responses to it, is discussed further in subsequent sections.

The position of the regulator

4.56 ASIC has been constrained in the information and comment it has been able to provide to the public inquiry process:

> We are not able to go into a lot more detail because of the investigations. …We do want to assist the committee but at the same time we cannot risk prejudicing those investigations, in particular prejudicing retail investor actions or potential parties that could be involved.[46]

4.57 The committee acknowledges the paramount importance of ASIC being able to take unencumbered legal action if it has evidence to suggest that there is a case to be made against any of the parties to the Opes Prime stock lending operation. ASIC's investigations into the conduct of directors and officers of Opes Prime are continuing, as well as investigations into any other third parties that may have engaged in market misconduct before or after the collapse.

4.58 However, the committee notes the significant amount of time that has passed since the Opes Prime collapse and strongly urges ASIC, and in turn the Commonwealth Director of Public Prosecutions, to deal with any potential actions in a timely fashion.

4.59 ASIC has made the following general public comment in relation to the Opes model:

> … the securities lending and equity financing business operated by Opes Prime was based on a model traditionally used in the wholesale market in which participants are more sophisticated and have a clear understanding of their rights and obligations. Of concern to ASIC was that Opes took this

45 Mr Bob Santamaria, ANZ Banking Group, *Official Committee Hansard*, Melbourne, 26 August 2009, pp. 37-38.

46 Mr Tony D'Aloisio, ASIC, *Official Committee Hansard*, Canberra, 24 June 2009, p. 3.

model to the retail market where some investors may not have been aware of their rights and obligations.[47]

4.60 ASIC has also countered public criticism that it did not act to prevent Opes Prime from offering AMSLAs to retail investors or to ensure the provision of an accurate and appropriately clear product disclosure statement (PDS) to clients. ASIC commented on recent legislative changes and their effect:

> The FSR regime regulates disclosure in relation to financial products. Margin lending and securities lending under an AMSLA are not defined as financial products and accordingly the disclosure requirements (such as the PDS requirements) do not apply to these types of arrangement.
>
> Under the Corporations Legislation Amendment (Financial Services Modernisation) Bill 2009, margin loans (including securities lending) will be regulated as financial products under the Corporations Act. ASIC welcomes this Bill. When the Bill commences, a PDS will be required for margin loans (including security lending).[48]

Opes Prime scheme of arrangement

4.61 ASIC was involved in multi-party talks that led to a settlement offer put to, and ultimately accepted by, Opes Prime creditors (including customers who signed AMSLAs). The terms of settlement included an agreement by the regulator not to pursue ANZ and Merrill Lynch for an alleged contravention of the managed investment provisions of the *Corporations Act 2001* (Corporations Act). ASIC also agreed not to pursue directors of ANZ for civil penalty and compensation claims under section 181 of the Corporations Act.[49] In accepting the scheme of arrangement, the Opes Prime liquidators and clients also renounced all claims and legal proceedings against Merrill Lynch and ANZ.[50]

4.62 In August 2009 ASIC welcomed Federal Court approval of the scheme of arrangement, starting that:

> ASIC believes that the settlement accepted by the creditors and approved by the Court, achieves the purpose of the mediation and makes commercial sense. Importantly, it avoids the need for costly litigation by the liquidators and the clients of Opes Prime.[51]

4.63 The estimated dividend to creditors is 37 cents in the dollar.

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47 ASIC Media Release 09-37, 'Opes Prime: proposed settlement and ANZ enforceable undertaking', 6 March 2009.

48 ASIC, *Submission 378,* p. 177.

49 ASIC Media Release 09-37, 'Opes Prime: proposed settlement and ANZ enforceable undertaking', 6 March 2009; and 09-135, 'Opes Prime schemes of arrangement approved', 4 August 2009.

50 09-135, 'Opes Prime schemes of arrangement approved', 4 August 2009.

51 ASIC Media Release 09-135, 'Opes Prime schemes of arrangement approved', 4 August 2009.

4.64 The committee notes that not all parties are equally pleased with this outcome. In particular, it notes Mr Robert Fowler's unsuccessful appeal against Justice Finkelstein's decision to sanction the scheme.[52]

4.65 ASIC has also put in place an enforceable undertaking (EU) from ANZ. This includes an agreement from ANZ to improve compliance in various areas, including reconciliation processes, resourcing and risk management.[53]

Lessons to be learned

Inappropriate provision of a sophisticated product to retail investors

4.66 The following statement by a submitter sums up the committee's understanding of what has occurred:

> A situation existed where a product – the Australian Master Securities Lending Agreement (AMSLA) – designed and intended for use by sophisticated corporate investors operating in wholesale markets – was on sold to unsophisticated retail clients for whom this type of product was inappropriate and who did not have, or were not provided with, sufficient education or guidance to appreciate the unique terms and conditions and higher risks of the AMSLA.[54]

4.67 Consequently, it has been suggested that consideration be given to restricting the availability of complex financial products designed for market counterparties, on the basis that such products may not be appropriate for the retail market.[55]

Committee view

4.68 The committee agrees that the AMSLA was not appropriate for many of the individual retail investors who signed up with Opes Prime. However, the committee does not believe it is necessary to interfere with the financial products market to the extent of banning certain products from sale to retail investors. Instead, the committee considers that a range of factors in combination will lead to the same effect of such products not being made available to an inappropriate customer base in the future:

- increased investor awareness and scepticism following recent collapses;

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52 'Bid to thwart Opes deal', *The Age*, 28 August 2009; 'With his life savings up in smoke, retired investor faces hefty legal bill', *The Age*, 4 September 2009; 'Court rejects appeal against Opes deal', *Australian Financial Review*, 4 September 2009.

53 ASIC Media Release 09-37, 'Opes Prime: proposed settlement and ANZ enforceable undertaking', 6 March 2009; and 09-135, 'Opes Prime schemes of arrangement approved', 4 August 2009.

54 Name withheld, *Submission 197,* p. 1.

55 Name withheld, *Submission 197*, p. 1.

- increased caution from banks with regard to engaging in the securities lending business;
- the passage of the Corporations Legislation Amendment (Financial Services Modernisation) Bill 2009, which amends Chapter 7 of the Corporations Act to capture products of this nature within the definition of a 'financial product', thereby extending the range of protections available to investors and the powers and responsibilities of ASIC; and
- increased obligations on financial advisers with regard to the standard of advice they give to their clients.

4.69 These matters are discussed further below and in Chapters 5 and 6 of this report.

4.70 The same submitter has questioned whether the personnel selling the Opes Prime product understood the product sufficiently:

> All investors and advisers relied on the Opes representatives who should be expected to know their product thoroughly. However they either did not – and so were unable to disclose the higher risk nature of the product – or they were fully cognisant of the higher risks but obscured them rather than jeopardise their sales commission.[56]

4.71 The concerns raised here go to such matters as the qualifications of advisers, the legislative obligations imposed on them with regard to the standard of advice they give, and the potential for commission-based remuneration arrangements to result in poor or conflicted advice being given. These issues, and proposed reforms to the obligations, licensing, remuneration and oversight of financial advisers, are discussed in detail in Chapters 5 and 6.

Ineffective disclosure

4.72 Some submitters have suggested that enhanced disclosure arrangements would have been of assistance, in that had they truly understood the product being offered by Opes they would not have entered into the AMSLA. For example:

> If a client had been required to sign a simple Risk Disclosure statement stating, for instance, that the client acknowledged that they had lost beneficial ownership of and legal title to their shares; and furthermore that their shares were being used as collateral by Opes for financing purposes – many people would not have signed.[57]

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56 Name withheld, *Submission 197*, p. 1.

57 Name withheld, *Submission 197*, p. 2.

Committee view

4.73 The effectiveness of disclosure in enabling investors to make informed decisions about their financial affairs was a central and recurring theme of the inquiry. Many submitters to the inquiry raised the matter of whether risk was appropriately conveyed to, and in turn sufficiently understood by, clients of financial advisers. Some questioned whether financial advisers themselves had proper knowledge of the risks inherent in the products they were selling. Many commented that current disclosure documents are lengthy and confusing, and that they would gain clearer information from short-form, plain English documents. These matters are addressed in Chapters 5 and 6 of this report.

The need for federal regulation of margin lending

4.74 At the time of the collapse of Opes Prime, margin lending facilities and facilities of similar character to margin loans (including securities lending agreements marketed as being margin loans) did not fall within the definition of a financial product as set out in Chapter 7 of the Corporations Act. Consequently, these products did not lie within ASIC's regulatory oversight responsibilities and were not regulated at the national level. Because they were generally purchased for investment strategies, they also fell outside state-based consumer credit laws.

4.75 This regulatory gap has now been closed, following the October 2009 passage through parliament of the Corporations Legislation Amendment (Financial Services Modernisation) Bill 2009. This bill explicitly defines margin lending arrangements, as well as Opes Prime-style securities lending arrangements, as financial products for the purposes of the Corporations Act and sets out a range of requirements on financial product providers and advisers when selling these products to clients.

4.76 These measures are intended to increase protection for investors and to provide ASIC with powers to take action where these facilities are not offered or managed in accordance with the law.

Committee view

4.77 The committee welcomes the passage of this legislation and, through such mechanisms as its regular oversight hearings with ASIC, will monitor its implementation and effect in the marketplace, particularly its ability to protect investors from the inappropriate sale of complex securities lending products.

Chapter 5

Issues raised during the inquiry

5.1 Before outlining specific regulatory concerns the committee examines two broad issues behind the debate on the regulation of financial products and services. The first relates to the industry's historical beginnings, particularly the emergence of financial advisers as a sales force for product manufacturers, which is a legacy potentially inconsistent with contemporary expectations that financial advisers provide a professional service that meets their clients' best interests. The sales-advice conflict frames the committee's later examination of the effect of sales imperatives on the quality of financial advice, and whether the current regulatory framework needs to better reflect the expectation for professional, unbiased conduct in the industry.

5.2 The second broad issue concerns the question of whether advice about financial products, or the financial products themselves, are responsible for poor investment outcomes. This question is important because the answer dictates whether the focus of regulation needs to be on improving the quality of financial advice, or identifying and restricting the sale of poor financial products.

5.3 The committee then canvasses various claims about deficiencies in the current regulation of financial product advice, principally with the conduct and disclosure-based approach to managing conflicts of interest. There were also contributions critical of the minimal competency requirements of the licensing regime; a lack of regulation over margin lending; and deficiencies with professional indemnity (PI) insurance as a consumer compensation mechanism. Suggestions for reform stemming from these concerns are contained in Chapter 6.

5.4 The alternative view that the content of the regulatory regime requires little or no change is also discussed in this chapter. Those advocating this position called for recent problems in the financial services industry to be put in perspective, claiming that inadequate regulatory enforcement has been responsible for failing to protect investors from rogue elements giving poor financial advice, rather than the entire regulatory system failing consumers.

5.5 Finally, the committee notes concerns about poor financial literacy amongst consumers and discusses the extent to which the regulation of financial product advice should intervene on this basis.

A sales or advice industry?

5.6 The financial advice industry has significant structural tensions that are central to the debate about conflicts of interest and their effect on the advice consumers receive. On one hand, clients seek out financial advisers to obtain professional guidance on the investment decisions that will serve their interests, particularly with a view to maximising retirement income. On the other hand, financial advisers act as a critical distribution channel for financial product manufacturers, often through vertically integrated business models or the payment of commissions and other remuneration-based incentives.

5.7 Australian Securities and Investments Commission (ASIC) noted the historical basis for the links between manufacturers and advisers:

> Remuneration of distributors of financial products was historically set by the product manufacturer. It was based on the value of products sold and deducted from the amount paid by the consumer for the product. These remuneration settings encouraged product distributors to sell certain products.
>
> As the market for financial advice services has grown, the historic connection with product manufacturers and this remuneration structure has conflicted with investors' needs for quality unbiased advice and their perception that this is what financial advisers provide.[1]

5.8 ASIC described the industry as still being characterised by its distributive function:

> Today financial advisers usually play a dual role of providing advice services to clients and acting as the sales force for financial product manufacturers. Approximately 85% of financial advisers are associated with a product manufacturer, so that many advisers effectively act as a product pipeline. Of the remainder, the vast majority receive commissions from product manufacturers and so have incentives to sell products ... This structure creates potential conflicts of interest that may be inconsistent with providing quality advice and these conflicts may not be evident to consumers.[2]

5.9 The conflicts of interest inherent in these arrangements are currently subject to disclosure and conduct regulation that seeks to manage these conflicts and protect investors from poor advice, while maintaining market efficiency (see paragraph 2.2). The regulatory framework has not compelled the industry to shift from acting as a distribution network to providing a professional, unbiased service. Instead, the transition from product sales to professional advice seems to be occurring gradually as a consequence of some sections of the industry's desire to improve consumer confidence in their services. In evidence to the committee, MLC commented that the FSR regime does not reflect the industry's increasing focus on advice:

> It is a product-based regime. We are really moving into the advice world and trying to rearrange the way we focus on the customer away from the product in the conversations that are going on out there between advisers and clients.
>
> ...

1 ASIC, *Submission 378*, p. 48.

2 ASIC, *Submission 378*, p. 38. See also Industry Super Network, Submission 380, p. 4 and p. 8.

> ...for the last many decades the industry has been based on product, distribution and sales of manufactured services. In the last seven or eight years it has quite significantly changed. Now advisers are concentrating on giving quality advice to the client; that is separate to the product outcomes in many cases and we just need to continue that journey.[3]

5.10 Australasian Compliance Institute (ACI) noted: 'Quality financial advice is intended to be about financial strategy and not just individual products'.[4] The Institute of Chartered Accountants in Australia (ICAA) expressed a similar view:

> The Institute's view is that the primary role of financial advisers is to provide financial advisory services, the emphasis is on providing financial advice and that the "sale" of a product is a potential end by-product of the process. The service to the client is advice. The investing in a investment product or setting up an insurance policy while a legitimate outcome of the advice it is not the principal objective. Specifically the role of the financial adviser is to provide strategic advice and this advice revolves around personal goals and objectives, structuring, taxation, wealth creation, wealth protection, estate planning, risk management and not the sale of products.[5]

5.11 These comments support the view that the need for greater professionalism and a focus on clients' interests should be reflected in a regulatory regime that matches these objectives. That is, the tension between the industry's dual sales and advice functions should be clearly resolved in favour of regulations that mandate a higher level of professionalism and better protect consumers from the negative consequences of conflicted advice. Others argued that the present system has generally worked well for consumers and that the entire industry should not be overhauled in response to the actions of fringe elements. This debate is explored later in the context of the adequacy of the regulations managing conflicts of interest (beginning at paragraph 5.24), and the deficiencies with enforcement of the existing regime (beginning at paragraph 5.104).

5.12 The committee notes that poor advice can have varying consequences, from catastrophic losses to sub-optimal returns from poor investment performance or excessive fees. Industry Super Network's submission described the varying effects of conflicted financial advice:

> The examples of Storm Financial and other collapses present the committee and the broader community with the most egregious examples of the effects of conflicted financial advice on the savings of Australians. However, ISN submits that the 'slow burn' effect of commissions and conflicted advice on the superannuation savings of millions of working Australians, demonstrates that these scandals are not isolated examples of poor practice

3 MLC, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 4

4 ACI, *Submission 397*, p. 5.

5 ICAA, *Submission 363*, p. 6.

> but evidence of the “structural corruption” caused by conflicted remuneration practices.[6]

5.13 This report will consider the extent to which the sales and distribution function of the industry is harmful to Australian investors seeking professional advice, and the most appropriate regulatory measures to address poor financial advice.

Poor advice or faulty product?

5.14 The other central issue relates to the question of whether poor or catastrophic investment outcomes are due to a failure of financial advice, or the products in which clients invest.

5.15 Financial Planning Association of Australia (FPA) suggested that advisers and their clients can be the victims of misinformation from product providers:

> ...a financial planner is there to provide advice and to necessarily recommend a product based on what they know and what they understand around that product at that time. Mostly those products fulfil their obligations. They fulfil what it is they said they were going to do, but there are instances ... where the product promised has not been delivered, and the managed investment scheme examples are two good points. They were robust investments where the corporate entity made certain decisions which were not fully disclosed and were not fully understood. The financial planner was not privy to what was going on and the company itself ended up collapsing and taking everything with it.[7]

5.16 Boutique Financial Planning Principals Group (BFPPG) also claimed that planners can be victims of poor products:

> ...a product provider can misrepresent a poorly designed investment product, a research house can rate the product well, and a financial planner can recommend the product to a client based on the manufacturer’s misrepresentation and the research houses’ ratings.[8]

5.17 ASIC emphasised that it has no power to intervene to prevent people from investing in risky or flawed products:

> Consistent with the economic philosophy underlying the FSR regime, ASIC does not take action on the basis of commercially flawed business models. A significant feature of the recent collapses leading to investor losses, is flawed business models, that is, models that could only prosper if asset prices continually rose and debt markets remained open and liquid.

6 Industry Super Network, *Submission 380*, p. 11

7 FPA, *Official Committee Hansard*, Canberra, 28 August 2009, p. 47.

8 BFPPG, *Submission 251*, p. 12.

> Responsibility for flawed business models lies with management and the board.[9]

5.18 Preventing such investment losses is the role of the financial adviser, rather than the regulator. Indeed, most agreed that the crux of the problem is the advice that accompanies a decision to invest in certain products. The consequences of product failure will be greatly mitigated if the investment is only one part of a diversified portfolio that matches the client's tolerance for risk.

5.19 For instance, MLC argued that products are generally safe as long as clients are advised to invest in them appropriately.[10] CPA Australia told the committee that the regulatory focus needs to be on the advice attached to investment products:

> ...products range from a simple bank account term deposit through to some very sophisticated structured products. Those sophisticated structured products may be appropriate for particular sophisticated investors who have advice. Whilst there are questionable products and structures out there, it is really about whether or not people are being put into those or recommended those products appropriately or not. It is a question of appropriate advice.[11]

5.20 Mr Peter Worcester of Worcester Consulting Group agreed with this view:

> ...the whole thing needs to be client focused. For that client is that total mix of product appropriate? If you think about it, who cares whether you buy share fund A, share fund B or share fund C? It is not going to make an actual material amount of difference. But if you are geared 200 per cent in share fund A versus having 50 per cent in share fund A and 50 per cent in cash, then your starting focus is on the client issue.[12]

5.21 The committee has focussed mainly on the regulation of advice given about investment products, rather than the products themselves. Some discussion is given to the possibility of restricting certain kinds of products to sophisticated investors (see paragraphs 6.166 to 6.169).

Regulatory issues

5.22 The committee received evidence suggesting that the current regulatory arrangements are failing to protect consumers from poor financial advice and its consequences. The following issues were of particular concern:

- Current disclosure and conduct standards are inadequate mechanisms for managing financial advisers' conflicts of interest.

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9 ASIC, *Submission 378*, p. 20.

10 MLC, *Official Committee Hansard*, Melbourne, 26 August 2009, pp. 14-15.

11 CPA Australia, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 65.

12 Mr Peter Worcester, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 98.

- The licensing system is deficient, in that competency requirements for licensees and/or their authorised representatives are too low, oversight of individual advisers is too diffuse, and consumers are unable to readily identify varying capabilities.

- Lending practices by institutions lending for investment purposes have been below community expectations and not subject to appropriate regulatory control.

- Professional indemnity insurance is designed to indemnify advisers, and is unsuitable for compensating investors that have suffered losses as a consequence of poor advice that does not comply with the adviser's legislative obligations.

5.23 These issues are examined below. The perspective of those who believe the problem is one of proper enforcement, rather than the regulatory settings themselves, is considered further on beginning at paragraph 5.104.

Managing conflicts of interest

5.24 Conflict of interest was a consistent policy concern raised during the inquiry. Many were of the view that the existing legislative requirement to disclose conflicts of interest and provide advice to a standard that is appropriate to the client has not been effective. That is, the efficient markets approach has not prevented advice conflicted by remunerative or ownership arrangements from manifesting itself as poor quality or inappropriate advice to consumers.

5.25 ASIC commented that the Wallis inquiry approach may no longer be appropriate given the breadth of retail investors today:

> [ASIC is] querying whether it has gone far enough in protecting retail investors, given the important role, which was not foreseen by the Wallis inquiry, that retail investors would play in the market. They had not foreseen and could not have foreseen the impact that the superannuation levy has had on investment in our markets. In that situation, you have a much broader range of retail investors and retirees. You have groups of people who lose money at the wrong time in their life and it is no answer to them to say: ‘Well, it was a risk, you know. There was disclosure. You should have read the disclosure statement.’ The fact is that they cannot easily come back into the workforce.[13]

5.26 ASIC's submission added:

> While increased intervention could impact on market efficiency, the benefits it will deliver, in terms of increased investor protection from loss

13 ASIC, *Official Committee Hansard*, Canberra, 16 September 2009, p. 7.

> and increased investor confidence causing retail investors to re-enter the market, may outweigh the costs...[14]

5.27 Australasian Compliance Institute told the committee that efforts to ensure affordable advice should be balanced against the need for investor protection:

> The remuneration model for financial advisers is acknowledged as problematic and potential conflicts of interest that may be present in the model are often justified on the basis of making the advice affordable for consumers, who would not be able to or perhaps not want to pay upfront the 'real' cost of the advice.
>
> However, many of the investors currently receiving advice may be considered some of the most vulnerable in the market (i.e. they have a low understanding of the market and its various products and are heavily reliant on the advice they receive) and so considerations for their protection are important.[15]

5.28 The debate about the effect of remuneration and ownership-based conflicts was extensive, and is included in the following section of the report. The committee then outlines evidence to the inquiry on the effectiveness of disclosure and conduct regulations in managing these conflicts.

Remuneration-based conflicts

5.29 A significant conflict of interest for financial advisers occurs when they are remunerated by product manufacturers for a client acting on a recommendation to invest in their financial product. There are a number of ways in which advisers can be remunerated directly or indirectly by product manufacturers for their clients' financial decisions. They include:

- trail commissions charged at ongoing intervals (usually annually) as a percentage of assets;
- up-front commissions charged as a percentage of the initial investment;
- volume bonuses and sales target rewards; and
- 'soft dollar' incentives.[16]

5.30 These payments place financial advisers in the role of both broker and expert adviser, with the potentially competing objectives of maximising remuneration via product sales and providing professional, strategic financial advice that serves clients'

14 ASIC, *Submission 378*, p. 11.

15 ACI, *Submission 397*, p. 5.

16 Soft dollar incentives refer to non-monetary rewards such as holidays, tickets to sporting events, golf days etc.

interests. The committee received considerable evidence on the nature and effect of these conflicts, including on the quality and cost of advice, and whether it is possible for them to be managed appropriately.

5.31 In their submission, ASIC described the conflicts associated with commission-based remuneration. They noted that it can lead to advice that is not in the best interests of the client:

> Commission payments can create real and potential conflicts of interest for advisers. They could encourage advisers to sell products rather than give strategic advice (e.g. advice to the client that they should pay off their mortgage), even if this advice is in the best interests of the client and low risk. Commissions also provide an incentive to recommend products that may be inappropriate but are linked to higher commissions. Higher commissions might be provided for selling higher-risk products, perhaps because other advisers are unwilling to sell these products due to the high risk (e.g. Westpoint).
>
> Products that might be in the interests of the client but do not generate a high commission return (such as industry superannuation funds) might not be recommended to clients.[17]

5.32 Industry Super Network wrote:

> The dominant remuneration structure in the financial advice industry remains based on a commission or asset based fee payment made by a product provider to the financial adviser.
>
> While notionally a payment for advice, asset based fees are a de facto sales commission. Currently, the way that most financial advisers are remunerated means that their interests are more closely aligned with the sales and distribution function of large financial institutions than with their clients.[18]

5.33 They provided the committee with a comprehensive list of the problems associated with commissions:

> ISN submits that commission based fees are problematic because they:
>
> - Cause a conflict of interest because the adviser is paid by the product provider not the client, and so will only be paid for recommending a certain product and receives payment only after a recommendation is implemented
> - Are often combined with other conflicted remuneration structures such as shelf fees and volume rebates
> - Are anti-competitive in the sense that products with higher commissions are favoured; good products which do not pay a

17 ASIC, *Submission 378*, p. 50.

18 Industry Super Network, *Submission 380*, p. 8.

commission will seldom be recommended even if they are superior.

- Are economically inefficient in the sense that they are not tied to the provision of a quantity of advice – commissions are paid irrespective of ongoing provision of advice services.
- In some cases commissions lead to bad advice because they encourage the planner to steer consumers into strategies which inflate their investments or exposure, to increase up front commissions (for example, the gearing strategies used in the Storm cases)
- Are difficult for consumers to understand; this reduces the capacity for consumers to compare prices or to digest the financial impact that commissions have on their investments
- Are more erosive on retirement savings and other investments than one off advice fees (the longer term the investment, the more erosive commissions are)
- Are designed to suit the business models of financial advisers, rather than serve the needs of the client.[19]

5.34 Q Invest commented that remuneration-based conflicts have been practically difficult to manage:

> It is indeed a truism that "No man can serve two masters" – and this is more so in the financial planning industry. As an industry, financial advisers are at a crossroad and each of us needs to honestly decide: Who is our master – the client or the product issuer? Experience has shown us that attempting to serve both places the financial planner in an untenable position.[20]

5.35 CHOICE claimed that commission-based remuneration encouraged advisers to churn clients through investment products to generate the maximum amount in fees.[21]

5.36 Not all evidence to the committee regarding commissions was negative, though. Some argued that the conflicts commissions create can be managed and that consumers should be able to make an informed choice about the remuneration model that suits them, particularly when seeking affordable payment structures.[22] Commonwealth Bank of Australia (CBA) stated that commissions subsidise the cost of advice:

> Research commissioned by Colonial First State suggests that it costs advisers an average of $3,570 to produce a full service financial plan.

19 Industry Super Network, *Submission 380*, p. 9.

20 Q Invest, *Submission 374*, p. iii.

21 CHOICE, Submission 361, p. 9.

22 See for example, ING Australia, *Submission 383*, p. 6; AFA, *Submission 344*, pp. 8-9.

> However, few investors, in fact around just 3% of superannuation members who had recently switched super funds, were prepared to pay this amount.
>
> This reality results in subsidies being employed to ensure that consumers have sufficient access to advice. These subsidies take many forms and may include commissions and other payments by product manufacturers to either independent or aligned advisers; salaries paid to advisers employed by product manufacturers, including superannuation fund providers, or associates of product manufacturers and ownership of dealer groups by product manufacturers, superannuation funds or associates. These subsidies are present in most types of product/adviser relationships, including the retail investment and superannuation markets and the industry and public sector superannuation fund markets.
>
> The presence of subsidies provides net benefits to consumers by enabling the provision of cost effective advice.[23]

5.37 Other contributions also sought to emphasise that alternative remunerative structures are also capable of creating perverse incentives. Professional Investment Services claimed that:

> ...conflicts are inherent both directly and indirectly across the different remuneration methodologies, including instances like salaried advisers. There are conflicts associated with all the different types of remuneration methods, even to the extent that on an hourly fee base, if you have not dealt with lawyers or accountants over time where you think they have pushed the hours out to get greater fees, then I am sure you have not lived.[24]

5.38 AXA's submission included a similar view:

> ...fee for service charged on the basis of time has in some sectors resulted in unnecessary servicing. On the other hand, fixed fees can lead to under servicing and performance based fees can lead to unnecessary risks being taken.
>
> Ultimately, what is important is that customers understand and direct the costs they pay for advice, administration and products, both upfront and ongoing. Effective disclosure is essential to this.[25]

5.39 This debate is explored further in the following chapter, starting at paragraph 6.54, in the context of proposals to ban commission-based remuneration.

Ownership conflicts

5.40 The other conflict of interest for advisers stems from the relationship between product manufacturers and the adviser's licensee. Specifically, advisers who are

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23 CBA, *Submission 357*, pp. 6-7.

24 Professional Investment Services, *Official Committee Hansard*, Sydney, 4 September 2009, p. 112.

25 AXA, *Submission 385*, p. 10.

authorised representatives of licensed advisory groups owned by product manufacturers in a vertically integrated business model are conflicted.

5.41 Industry Super Network noted the dominance of large vertically integrated financial institutions in the financial planning industry:

> These large conglomerate institutions typically own all aspects of the financial services value chain from banking, wholesale funds management, product manufacture, administration and retail distribution including financial planning. The bulk of the financial planning industry is concentrated in the hands of relatively few institutions. Rainmaker Information reports that 73% of adviser groups are institutionally owned, if taken by adviser numbers, or 78% if taken from funds under advice. Many financial institutions operate a number of different sub-brands within their groups...

5.42 They added:

> The institutional ownership of the bulk of financial planning dealerships is significant because it reinforces the concern that financial advisers are compromised by the commercial imperative of selling and distributing the products manufactured by their parent or related party organisations.[26]

5.43 ASIC commented on the practice of re-branding aligned financial advisers and noted that 'consumers might not appreciate that they are getting advice from an adviser that is owned by a product manufacturer'.[27] On the disclosure requirements regarding ownership they said:

> In 2008, ASIC conducted a review of branding disclosure of 35 bank or institutionally-owned advisers and found that while advisers disclosed the relationship in the FSG as required by the Corporations Act, the information was often not prominently disclosed.[28]

5.44 BFPPG noted:

> Institutionally owned (or partly owned firms) such as Garvan, owned by National Australia Bank; Hillross, owned by AMP; BT, owned by Westpac; Ipac, owned by AXA etc, form the major portion of the industry. These firms serve as the distribution arm for their owners' products. Where the firm is not wholly owned by an institution there are usually financial arrangements in place that favour the distribution of the institution(s)' products. A key objective for the relevant institutions is to generate funds under management.[29]

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26 Industry Super Network, *Submission 380*, pp. 4-5.

27 ASIC, *Submission 378*, pp. 38-39.

28 ASIC, *Submission 378*, p. 39.

29 BFPPG, *Submission 251*, p. 6.

5.45 They suggested that a client being unable to recognise ownership bias is a 'bigger, and more subtle problem' than that created by commissions.[30]

5.46 ACI stated:

> Our members would ... question whether a company that issues a product should be licensed to provide personal financial advice to existing and prospective clients for just its own product and if in this instance this could genuinely be considered “advice”.[31]

5.47 Others claimed that the conflicts of interest associated with vertically integrated product/advisory models are outweighed by the benefits to consumers. For example, Investment and Financial Services Association (IFSA) commented that:

> ...while vertical integration in the financial services industry is common, and undoubtedly gives rise to potential conflicts of interest, it is important to also consider the significant benefits that consumers receive from this integration, namely:
>
> • Strong risk management – through imposing standards consistent with those across the group;
>
> • Security – through more substantial capital backing;
>
> • Economies of scale – through a larger organisation with more capital and purchasing power;
>
> • Accessibility – through more efficient processes supported by other parts of the group; and
>
> • Affordability – often vertically integrated businesses are able to cross-subsidise other parts of their business, reducing costs for consumers that access those subsidised services.[32]

5.48 ING Australia commented:

> While we understand that institutional ownership of advice groups brings with it an obvious conflict of interest, we believe the benefits of this structure outweigh an appropriately managed conflict...
>
> ING Australia believes that institutional ownership of financial advisory firms can assist in ensuring quality advice by providing the operational framework, expertise and support (both financial and professional). Large institutions are less likely to put at risk their reputation and brand and they have the scale and resources to ensure that their products and services meet a very high standard and comply with their legal obligations.[33]

5.49 AMP also emphasised the consumer protection associated with this model:

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30 BFPPG, *Submission 251*, p. 9.

31 ACI, *Submission 397*, p. 5.

32 IFSA, *Submission 317*, p. 21.

33 ING Australia, *Submission 383*, p. 3.

> As an integrated organisation AMP is better able to ensure consumer protection through higher standards of training, monitoring and supervision than the minimum standards prescribe. AMP is also vigilant in protecting its brand and reputation in the event of a failure in process.[34]

5.50 Guardian Financial Planning also suggested that the backing of large financial institutions offered clients protection:

> Financial institutions have the structures in place to ensure compliance with regulations, legislation and other internal checks, including business values. The outcome is that institutions tend to look after their brand and their customers. That sees advisers aligned to institutions protected and governed by explicit policies around hiring practices, supervision and compliance, education and professional development.
>
> The other critical element is capital backing. In those instances where the checks and balances fail institutions stand behind their mistakes. Having deep capital reserves adds another layer of protection for consumers.[35]

5.51 BFPPG responded as follows:

> It has been argued that there is an inherent weakness in small independent AFSLs because of a lower level of capital adequacy. In fact the most often quoted reason for using a small independent AFSL is the advantage of advisor independence, and typically the experience and personal service that goes with being small. Consumers see these important factors as being greater than the disadvantage that these businesses are less highly resourced and less capitalized.[36]

5.52 Highlighting recent poor practices from large licensees with a reputation to protect, they noted:

> The small AFSL often has family assets supporting the business, works longer hours, takes a lower level of income to build the business and has a closer and more personal relationship with clients. Reputation is even more important for the small AFSL because of the positive impact of referrals to the business from client advocates and the negative impact of one mistake that can put them out of business.[37]

Disclosure

5.53 Evidence to the committee strongly suggested that the current disclosure requirements had not been an effective tool for managing conflicts of interest.

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34 AMP, *Submission 367*, p. 2.

35 Guardian Financial Planning, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 87.

36 BFPPG, *Submission 251*, p. 11.

37 BFPPG, *Submission 251*, p. 12.

5.54 One problem is that the present arrangements enable or encourage licensees to take a risk-averse approach to compliance, rather than providing disclosure material that is focussed on informing consumers. In their submission ASIC noted that disclosure documents are often lengthy and complex, reflecting the nature of the products and providers' all-encompassing approach to legislative compliance. Such material is unlikely to serve informed decision-making where consumers are disengaged or unable to comprehend it.[38]

5.55 FPA suggested that excessive disclosure and the expense that accompanies it was a consequence of the industry's risk-averse approach to complying with FSR:

> ...financial services reform scared the pants off the whole financial planning industry and has led everyone to over-comply, to over-advise and to over-disclose in order to protect the most critical thing a financial planner and their licensee have—that is, their reputation. As I was going to mention earlier, this has created a real fear factor. We are continuously debating rigorously with ASIC on the interaction between principles based regulation, which we all support, and the black and white letter of the law, which is sometimes needed to try and understand what the principles are. So in an effort to deliver principles based regulation, which we continue to support, there have been grey areas: what is the difference between general and personal advice? What is limited personal advice? What is scalability of advice? What is the difference between a statement of advice, a record of advice and a statement of additional advice? These poor people sit there trying to deliberate while they service their clients. What they end up with is a one size fits all, highly costly, overregulated but very complying system.[39]

5.56 Argyle Lawyers also told the committee that disclosure had become too compliance-focussed:

> ...compliance documents that currently exist have become a mechanism for the licensee ensuring that it has met the act and will not breach the law rather than providing consumers with the ability to make an informed decision and make choices. The classic example of that is the statement of advice, which is 125 pages long and that nobody is going to read.[40]

5.57 BFPPG also described the risk-averse approach to disclosure:

> The requirements relating to SOAs have skewed advice so that emphasis is now on the protection of the financial planner against all possible future problems and then the production of those long, complicated SOAs in the most efficient manner. In other words, if in doubt, put it in the SOA – the result has been over complicated and extremely long SOAs that are of little value to the client. In addition, the cost of producing them in an efficient

38 ASIC, *Submission 378*, pp 58-59.

39 FPA, *Official Committee Hansard*, Canberra, 28 August 2009, pp 40-41.

40 Argyle Lawyers, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 112.

manner has put an unnecessary financial strain on financial planners and made the provision of simple one–off advice more costly.[41]

5.58 They argued that the motivations of advisers are not necessarily apparent to their clients:

> Currently, it is very difficult for consumers to identify whether they are dealing with a financial product salesperson or an independent financial planner committed to putting their interests first. There is ample evidence that financial product salespeople hold themselves out to be independent in a misleading manner so as to make it easier to make a sale...
>
> ...the sale of financial product is not, of itself, a problem. It is the sale of the product under the guise of independent advice by a salesperson with a vested interest in the sale itself that is the problem. Consumers should be able to ask the question 'Why am I being sold these products – Is it because the financial planner is putting me first or is he putting himself first?" and the answers should be clear and obvious.[42]

5.59 Argyle Lawyers criticised the emphasis on form over substance encouraged by the current framework:

> ...the regulatory system currently encourages a tick-the-box approach to compliance, without promoting an ethical or integrity foundation within financial services for the provision of advice. The evidence associated with the recent financial product and advisory collapses suggest to us the existing legal compliance frameworks alone are insufficient to pick up and identify systemic instances of unethical conduct within financial advisory firms.[43]

5.60 Other evidence suggested that there are inherent limitations on what disclosure can do to protect consumers, no matter what the disclosure regulations provide for in terms of brevity and clarity. ASIC's submission suggested that 'disclosure can be an inadequate regulatory tool to manage the conflicts of interest created by commissions'. They indicated that this is due to 'the strength of the conflict and consumers' difficulty in understanding their impact'.[44] In evidence ASIC commented on the difficulty of ensuring that complex remuneration structures are clearly disclosed:

> ...when you have multiple types of remuneration that are predominantly paid by the product manufacturer to the adviser and to the licensee for the sale of that product, on top of volume bonuses and potential conferences that you can go to, that complexity leads to the consumer's lack of understanding of how much it is costing them at the end of the day. So you

41 BFPPG, *Submission 251*, p. 14.

42 BFPPG, *Submission 251*, p. 18.

43 Argyle Lawyers, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 108.

44 ASIC, *Submission 378*, p. 51.

do come across people who believe to a large degree that, because they have not written a cheque, they have not had to pay for the advice that they have received.[45]

5.61 They also noted that disclosure, even if clear, is limited in its capacity to convey conflicts:

> Yes, I have disclosed it, but is it an informed consent? Or is it really that, as the investor, when I have seen these fees, I have turned my mind to the fact and said, 'Could this guy have distorted his advice because of these fees?' And that is extremely difficult for an investor to do unless they are really experienced, because the person you are with is a trusted adviser.[46]

5.62 In their submission ASIC also described the problem of consumers not understanding the restricted nature of the advice they may be receiving, notwithstanding the legitimate reasons these restrictions serve. ASIC stated:

> The scope of advice provided by an adviser may be restricted. For many reasons licensees restrict the range of products financial advisers can advise on e.g. through an approved product list. This restriction may be to ensure the products recommended meet minimum standards, to ensure the advisers are adequately trained on the products they advise on and to give the professional indemnity insurer comfort about the risks of negligent advice being given. The range of products that an adviser is permitted to advise on can also be influenced by which products are more profitable to the licensee (e.g. where there is a commission from a product manufacturer or a relationship with a product manufacturer). The restricted nature of the advice is often not evident to consumers.[47]

5.63 CHOICE told the committee that disclosure had in fact been counter-productive:

> The requirement to disclose conflicts is often more of a hindrance than a help. People are poorly equipped to identify, accept and account for the impact of conflicts on advice, mainly because consumers simply do not expect conflicts in the first instance. Disclosures are not sufficient to counteract a client's own understanding of the role of an adviser. There is also evidence to suggest that disclosing conflicts can perversely increase consumer confidence in the advice rather than act as a stark warning on the quality of advice.[48]

5.64 The Accounting Professional and Ethical Standards Board outlined the different adviser/client relationships:

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45 ASIC, *Official Committee Hansard*, Canberra, 16 September 2009, pp. 15-16.

46 ASIC, *Official Committee Hansard*, Canberra, 16 September 2009, p. 16.

47 ASIC, *Submission 378*, p. 38.

48 CHOICE, *Official Committee Hansard*, Sydney, 4 September 2009, p. 98.

> The first one is what I would call the broker agent salesman. This is where the adviser is authorised to act on behalf of another. The adviser clearly has a conflict of interest and he must fully disclose that. The second role is the steward, which is probably what many of the investment advisers are. In this case the adviser has agreed to act on another's behalf. There is a basis of trust and confidence, and the interests of the adviser should be aligned with those of the other party. You then have a third higher level, which is a fiduciary relationship. In that case the adviser has accepted a legal responsibility to act on another party's behalf. The adviser can have no conflict of interest whatsoever, which is typically seen in a trustee relationship, a director or a power of attorney.

5.65 They added that these relationships are not made clear to consumers:

> The current legislative framework misleads the public by not clearly differentiating these three roles. It enables the salesman in a profession effectively to pass themselves off as a licensed investment adviser, which enables them to gain the trust of their client.[49]

5.66 ACI recognised the difficulty of disclosing complex remuneration arrangements:

> ...some of these remuneration models are so complex in themselves that disclosure does not ensure that a client understands and can make a judgment about the effect of the fees on the advice they are being provided; the total of the fees; or how it affects their return on the investment.[50]

5.67 MLC agreed:

> ...there is a significant number of payments moving between parties in the industry that the client has no chance of being able to understand so they think that they might be getting an independent outcome when, in fact, they are not.[51]

5.68 MLC suggested that clients understood the proprietary, vertically integrated model, where advisers work for the manufacturer. They also understand independent advisers, but the confusion 'lies in the middle'.[52]

Conduct standards

5.69 The committee also heard that the legislative standard of advice provided under section 945A is insufficient to ensure advice is given in the clients' interests

49 Accounting Professional and Ethical Standards Board, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 73.

50 ACI, *Submission 397*, p. 6.

51 MLC, *Official Committee Hansard*, Melbourne, 26 August 2009, pp 5-6.

52 MLC, *Official Committee Hansard*, Melbourne, 26 August 2009, pp 4-5.

(outlined at paragraph 2.20). ASIC told the committee that the standard does not meet consumers' expectations:

> It appears that there is a mismatch between the client's expectation that the adviser is providing a 'professional' service (e.g. advice that is in their best interests) and the obligations of the adviser under the Corporations Act (that the adviser provides advice that is appropriate to the client and manages conflicts). Investors may see advisers as similar to lawyers and accountants in terms of duties and professionalism.[53]

5.70 ASIC told the committee that:

> ...the law at the moment is uncertain as to whether the fiduciary duty exists or not. We take the view that it may well exist, but it is unclear.[54]

5.71 Industry Super Network stated that the current standard allowed advisers to make recommendations knowing that there are better alternatives:

> To give a concrete example of the flaws in the reasonable basis test, a financial planning dealership might only have their own managed investment product on their approved product list. However, this product might be more expensive or offer a higher commission than most other managed investment products on the market. It would be possible in most cases for a planner to recommend their own product and demonstrate that it is appropriate for the client who needs a managed investment product, although the planner is aware that there are many other similar products which would be cheaper for the client or have less beneficial remuneration for themselves.[55]

5.72 Concerns have also been raised about the compatibility of the 'appropriateness' test with advice given under licensing arrangements where only one type of product may be recommended. The problem was highlighted during the committee's inquiry into agribusiness managed investment schemes (MIS), where the schemes were sold to investors through AFSL holders licensed to advise only on agribusiness MIS.[56]

5.73 During that inquiry, a number of people queried whether it was possible to provide appropriate advice to clients when a single product may be recommended, also raising concerns about the transparency of these limitations. ASIC informed the committee that it is technically possible to provide compliant advice in those

53 ASIC, *Submission 378*, p. 39.

54 ASIC, *Official Committee Hansard*, Canberra, 16 September 2009, p. 10.

55 Industry Super Network, *Submission 380*, p. 17.

56 Joint Parliamentary Committee on Corporations and Financial Services, *Inquiry into aspects of agribusiness managed investment schemes*, September 2009, pp 49-51.

circumstances, without commenting about specific examples.[57] In evidence to this inquiry, ICAA repeated their concerns:

> It is not possible to provide holistic advice if your only product solution is one particular product.[58]

Committee view

5.74 The committee is of the opinion that disclosure documents are too long and confusing for conflicts of interest caused by commission-based remuneration and vertical ownership structures to be properly understood by consumers. The documents are so inaccessible that they are probably not read at all by most people. There are also limits as to the usefulness of disclosure, however clear and concise, in an environment where clients have already committed in their mind to their trusted adviser's chosen strategy. Present conduct standards are useful in that they prohibit clearly inappropriate advice being given to consumers, but the threshold is low enough to allow advice that favours the adviser's interests above those of the client. Therefore, consumers are not necessarily getting advice that is in their best interests but, because of the limitations of disclosure, often do not realise this. Recommendations for improving the regulation of financial advisers to better protect investors are included in Chapter 6.

5.75 It should be recognised that the limitations of the current regulatory approach enable poor advice that is mainly incremental in its effect, rather than being catastrophic for investors. Conflicted advice that meets the current legislative requirements is more likely to lead to sub-optimal investment strategies or excessive fee arrangements, than to cause the sort of catastrophic outcomes described earlier in this report. Without making any particular judgement about specific cases, the committee is of the general view that situations where investors lose their entire savings because of poor financial advice are more often a problem of enforcing existing regulations, rather than being due to regulatory inadequacy. Where financial advisers are operating outside regulatory parameters, the consequences of those actions should not necessarily be attributed to the content of the regulations. Potential shortcomings of regulatory enforcement are discussed later in this chapter, starting at paragraph 5.104.

Competency under the present licensing system

5.76 Another area of regulatory concern was the competency of licensees and individual financial advisers under the present licensing arrangements. The major criticism of the current system is that licensees' minimum training standards for advisers are too low, particularly given the complexity of many financial products. ASIC's guidance on how licensees can meet the obligation to ensure

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57 Joint Parliamentary Committee on Corporations and Financial Services, *Inquiry into aspects of agribusiness managed investment schemes*, September 2009, pp 49-51.

58 ICAA, *Official Committee Hansard*, Sydney, 4 September 2009, p. 5.

authorised representatives are adequately trained and competent was outlined at paragraph 2.27.

5.77 ICAA commented on the increasing complexity of the financial services industry and suggested that deficiencies exist in the education framework for financial planners. They suggested that the current requirements are inconsistent:

> Currently the education requirements introduced through FSR are at a minimum level and the training courses available range from a few days to completion of a post graduate diploma or under graduate degree. All of these course options meet the regulatory requirement of a financial planner becoming compliant with ASIC Regulatory Guide 146. Australians cannot have a professional relationship with an adviser when there is such disparity in the education levels of the advisers in the industry.[59]

5.78 Association of Financial Advisers (AFA) agreed that 'the education bar needs to rise' to deal with an evolving profession.[60] ING Australia also stated that 'the current adviser training requirements are too low'.[61] Financial Ombudsman Service (FOS) told the committee that some complaints they receive indicate that the advisers in question do not understand the products they are selling.[62] AMP agreed:

> ...the minimum entry levels for financial advisers are too low and this is a significant contributing factor to advisers providing advice on products that they do not fully understand.[63]

5.79 They also noted industry inconsistencies:

> Each Licensee is left to set its own benchmark (at or above the prescribed minimum standard) for assessing adviser capability. Whilst some Licensees prescribe rigorous training standards, supplemented with 'on-the-job' supervision, there is inconsistency across the industry.[64]

5.80 Argyle Lawyers claimed that low competency levels correlate with unethical conduct:

> ...the minimum competency levels that exist within ASIC Regulatory Guide 146 at the moment are completely inadequate to allow advisers, for example, to position themselves to deal with the complex ethical issues they face when giving advice, and the younger and more inexperienced they are

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59 ICAA, *Submission 363*, p. 6.

60 AFA, *Submission 344*, p. 12.

61 ING Australia, *Submission 383*, p. 6.

62 FOS, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 27.

63 AMP, *Submission 367*, p. 7.

64 AMP, *Submission 367*, p. 7.

> the more likely they are to make the wrong decision and the more likely they are to be influenced by peers and superiors to take the wrong action.[65]

5.81 Others suggested that the competency requirements for licensees are also too relaxed. For instance, AXA claimed that it was too easy for prospective licensees to demonstrate that they can meet their obligations, without having the skills or resources to actually do so.[66]

5.82 ASIC made the following comment about their responsibility when granting a licence:

> ...we are required to grant a licence if the conditions in the legislation are met. The two substantive conditions are that the key people are of good fame and character and the other one is that we have no reason to believe that they will not comply with their licence conditions. The test of having a state of mind that somebody will not comply before they have even started business is extremely difficult...[67]

5.83 In their submission ASIC stressed that granting a licence in no way provides an endorsement of the applicant's business model. ASIC also noted that a high threshold must be reached for them to suspend or cancel a licence, and that it is difficult to remove licensees in anticipation of a breach of their conditions.[68]

5.84 The committee also received complaints suggesting that the licensing system enabled too many people with minimum competency to use the term 'financial planner' in a way that is misleading to consumers. FPA stated that 'there are too many people out there holding themselves out to be financial planners when in fact they are not; they are doing a whole range of other things'.[69] BFPPG also complained that the term is able to be used too broadly:

> The public can readily identify other professions: doctors, lawyers etc by their title. There are, however, thousands of individuals holding themselves out to be financial planners who meet the barest minimum training or ethical requirements. In most cases these people are associated with single product areas of advice or advice that is focussed strongly into one type of asset class or investment type. There are real estate agents who call themselves financial planners so that they can offer advice on the investment of excess funds after the purchase or sale of a property. There are property developers who call themselves financial planners so that they

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65 Argyle Lawyers, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 108.

66 AXA, *Submission 385*, p. 20.

67 ASIC, *Official Committee Hansard*, Canberra, 16 September 2009, p. 3.

68 ASIC, *Submission 378*, p. 26.

69 FPA, *Official Committee Hansard*, Canberra, 28 August 2009, p. 34.

> can package the sale of their property development into superannuation funds. There are many other examples.[70]

Committee view

5.85 The committee acknowledges concerns that the minimum qualification threshold for advisers is low. However, these concerns need to be considered in light of the requirement for licensees to demonstrate that their authorised representatives have the capabilities to provide the financial services covered by the conditions of their licence. Accordingly, licensees are required to ensure higher competency standards as the complexity of the advisers' role increases. Consideration also needs to be given to the affordability of advice should educational standards for advisers be increased, as well as the transition arrangements that would need to be implemented. These matters are discussed in Chapter 6, starting at paragraph 6.110.

5.86 The committee recognises that it is very difficult for ASIC to deny an application or cancel a licence if they think the licensee will be unable to meet their obligations, which somewhat undermines the safety provided by a licensees' requirement to ensure its authorised representatives have sufficient competence. The committee makes a recommendation with respect to this at paragraph 6.157.

5.87 There are also very legitimate concerns about the varying competence of a broad range of people able to operate under the same 'financial adviser' or 'financial planner' banner. The licensing system does not currently provide a distinction between advisers on the basis of their qualifications, which is unhelpful for consumers when choosing a financial adviser. These concerns are addressed by the committee's recommendation at paragraph 6.160.

Lending practices

5.88 The practices of some lending institutions that lent money for investment purposes were discussed during Chapter 3. This section addresses the problems with the regulation of margin lending more generally. ASIC's submission identified two main issues associated with lending institutions lending to fund retail investment. They are:

1. a lack of regulatory control over the provisions of credit for investing; and
2. corporate governance and risk management failures by lenders that encouraged high risk lending and meant that loans were poorly managed.[71]

5.89 On the first issue ASIC noted:

> ...lenders of investment credit such as margin lenders do not have the same obligations in relation to conduct and disclosure under the Corporations Act

70 BFPPG, *Submission 251*, p. 21.

71 ASIC, *Submission 378*, pp 87-88.

> as AFS licensees, and borrowers do not have the same protections as investors in financial products.[72]

5.90 ASIC also commented on relaxed lending practices when markets were rising:

> While Australian lending institutions have not engaged in some high risk lending practices that occurred overseas, recent retail investor losses have shown that in some cases Australian lending institutions may have failed to apply their usual standards in the bull market. This was particularly so where the retail investor dealt with the financial institution indirectly through an intermediary. In some cases this has resulted in higher risk lending to retail investors and inadequate management of existing loans.[73]

5.91 The submission also expressed concern about the risks inherent in lending institutions outsourcing suitability, risk management and monitoring responsibilities to intermediaries such as financial advisers.[74]

Committee view

5.92 The committee notes that these problems are reflected in the extensive evidence it received concerning the supply of margin loans to Storm Financial clients. Margin lending practices in this instance were below the sort of responsible conduct the community expects from lending institutions and beyond the scope of ASIC to regulate as a financial product under the *Corporations Act 2001* (Corporations Act). The gap in regulation to protect margin loan customers has been addressed in margin lending reforms that were passed by the parliament on 26 October 2009. These reforms are discussed further in the next chapter, starting at paragraph 6.161.

Investor compensation

5.93 In the event that consumers suffer catastrophic losses as a consequence of negligent advice, attention turns to the avenues available for investor compensation in these circumstances. Presently, there is no statutory compensation scheme for this purpose. The compulsory professional indemnity (PI) insurance regime provides only limited protection, and evidence to the inquiry suggested that it is not suitable, or indeed intended, for such a role.

5.94 ASIC confirmed that 'there are significant limitations on the effectiveness of PI insurance as a compensation mechanism for retail investors'. The consumer is not directly involved in the insurance contract, which provides licensees with insurance against losses owing to 'poor quality services and misconduct'. Insurance policies may exclude certain circumstances, depending on the extent of cover the insurer is willing

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72 ASIC, *Submission 378*, p. 88.

73 ASIC, *Submission 378*, p. 89.

74 ASIC, *Submission 378*, p. 89.

to provide. Fraud is generally not covered and contracts do not apply where the licensee has ceased business.[75]

5.95 Insurance Council of Australia also stressed that PI insurance has limitations as a guarantee mechanism:

> ...you cannot make a commercial product into a compensation mechanism. If there is the policy decision that a compensation mechanism is necessary to maximise the chances of a wronged consumer being paid compensation then you need to look at the pros and cons of a compensation fund.[76]

5.96 This suggestion is examined in the following chapter, starting at paragraph 6.171.

5.97 ACI also questioned the usefulness of PI insurance for consumers:

> ACI regards this benefit of PI insurance as being questionable for consumers. If the adviser is properly supervised then they should have limited scope to amass huge indemnity requirements. However, if there is a need to call on the PI cover then the PI cover must meet its purpose. It seems that frequently it is very difficult to claim against, suggesting that it simply adds costs for no consumer benefit. If this is the case there may be little point continuing with it in its current form.[77]

5.98 AMP agreed:

> In some of the recent collapses, PI cover has shown to be inadequate in providing sufficient levels of compensation for affected clients. Unscrupulous licensees can avoid their responsibilities and the existing compensation model tends to punish those that comply with the regulations while also failing the consumer.[78]

5.99 Maurice Blackburn Lawyers were particularly critical of PI insurance as a compensation mechanism:

> Some of the reasons for the inadequacy of PI insurance are as follows:
>
> 1. The effect of exclusion clauses forming part of PI insurance policies which limit the application of the policy, particularly where the exclusion pertains to one of the key financial services that the insured provides to consumers. Exclusions also often limit the application of the policy to financial products on an approved products list;
>
> 2. Monetary limits on liability which significantly limit the amount that can be recovered under PI insurance policies and, in particular, where such

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75 ASIC, *Submission 378*, p. 83.

76 Insurance Council of Australia, *Official Committee Hansard*, Canberra, 28 August 2009, p. 78.

77 ACI, *Submission 397*, p. 11.

78 AMP, *Submission 367*, p. 11.

> limits include the legal costs of defending claims brought against the insured; and
>
> 3. The requirements of a “claims made” insurance policy whereby notice of a claim needs to be made within the period stated in the insurance policy giving rise to the impediment that the notification period may already have expired before the client is aware that they have suffered a loss.[79]

5.100 Maurice Blackburn also complained of the difficulties clients face in obtaining information about relevant PI policies:

> As the law currently stands, there are very limited avenues available to plaintiffs to obtain information in relation to the insurance status of defendants or proposed defendants prior to the commencement of proceedings or throughout its conduct. This significantly hampers our ability to advise our clients on such aspects as recoverability and to properly assess the prospects of recoverability. Often it is not until considerable funds have been spent in pursuing an action that it is revealed that there is no responding insurance policy or there is a limit on the liability in a responding insurance policy.[80]

5.101 Compounding these limitations is a greater reluctance from insurers to provide PI on the terms it was previously available, due in part to the financial crisis and recent product/adviser failures. Association of Financial Advisers submitted that 'The increase in claim limits for external dispute resolution schemes such as the Financial Ombudsman Service (FOS) has resulted in higher claims being paid, resulting in a less profitable industry.'[81] Insurance Council of Australia told the committee that insurers had limited the amount of cover they are willing to provide and the conditions under which cover will be available.[82] ASIC confirmed that the market for PI insurance for financial advisers had 'hardened'. They indicated that premiums were to increase; new policies are excluding margin loans; automatic run-off cover will be limited; insurers are reviewing product lists and excluding certain products; and some insurers are not writing new cover or are withdrawing from the financial adviser market.[83]

5.102 Q Invest argued that the current requirements are too prescriptive:

> The current requirements, whilst innocuous at first glance, overlook certain commercial side effects which have a deleterious effect on competition, affordability and, ultimately, the cost of advice borne by consumers.[84]

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79 Maurice Blackburn Lawyers, *Submission 399*, pp 2-3.

80 Maurice Blackburn Lawyers, *Submission 399*, p. 3.

81 AFA, *Submission 344*, p. 13.

82 Insurance Council of Australia, *Official Committee Hansard*, Canberra, 28 August 2009, p. 74.

83 ASIC, *Submission 378*, pp 83-84.

84 Q Invest, *Submission 374*, p. viii.

Committee view

5.103 The committee notes that PI insurance is not intended to be a catch-all scheme designed to compensate investors whenever they have a successful claim against an adviser. It merely ensures that advisers can meet their obligations if a finding is made against them, if occurring in circumstances covered by the relevant insurance policy. Investors are not protected in a number of important situations, notably where the licensee has become insolvent, disappeared or behaved fraudulently. Alternative compensation mechanisms warrant consideration to address these shortcomings. The committee looks at these proposals in the next chapter, starting at paragraph 6.171.

Enforcement issues

5.104 In contrast to the perspective that regulatory deficiencies are causing a failure to protect investors from poor advice, there is a strong view that the present regulatory system is adequate and the failure is one of enforcement. The committee was told that some perspective is required when assessing problems within the sector, which are limited to the actions of a small number of rogue operators. Current conduct and disclosure regulations, properly enforced, are sufficient to address these issues.

5.105 FPA indicated that the current regulatory system had withstood a very challenging period:

> ...as a result of the global financial crisis financial services reform has been stress tested like you would never believe and it has withstood the tests of a very significant set of events. We believe therefore that financial services reform and its application to financial planning is robust.[85]

5.106 AFA also suggested that the problems exposed by Storm needed to be kept in proportion:

> ...if they operated outside the law and did not overlay their ethical and moral position, do we then want the other roughly 16,000 advisers who are doing the right thing to take a far more onerous path—those who have not had parliamentary inquiries created because of their conduct? I think there is a need to separate that out.[86]

5.107 CPA Australia also indicated that the problem needed to be kept in perspective:

> Overall the vast majority of advisers and licence holders are doing the right thing. The level of abuse or people breaking the rules is relatively small. Admittedly, we have had some pretty high, public incidences where advisers, business models or products have fallen over, with Storm and so

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85 FPA, *Official Committee Hansard*, Canberra, 28 August 2009, p. 27.

86 AFA, *Official Committee Hansard*, Sydney, 4 September 2009, p. 34.

on, but ... we are seeing serious issues with [only] a handful. The vast majority of our members are doing the right thing.[87]

5.108 AXA stated:

AXA believes that the failures which are the subject of your inquiry have resulted primarily from a combination of the excessive promotion of credit in conjunction with investing, poor and unethical business practices and in some cases poor advice. It appears that in many cases the investment strategies presented to clients included excessive levels of risk in the context of the client's personal circumstances and a level of risk that they did not fully understand as a consequence of gearing.

AXA also believes that these practices are not typical in Australian financial services, and do not point to a wholesale failure of the Australian financial system or the regulation thereof.[88]

5.109 Professional Investment Services expressed the same view:

Almost every industry has its bad eggs. In my time in the industry, the majority of advisers put their clients' interests first at all times ... Whilst it is important for the committee to focus on the terrible issues at hand, I would encourage them not to use a sledgehammer to crack a pea...[89]

5.110 They added:

...without quality advice to consumers, they would be left to their own accord and make many, many more costly mistakes.[90]

5.111 Similarly, Guardian Financial Planning noted that advisers tied to large dealer groups were not responsible for the sort of catastrophic advice that affected Storm investors:

The industry is made up of around 17,000 practitioners who fall into two broad camps—noninstitutional operators, known as independent financial advisers, and those that are backed by a financial institution, often referred to as aligned or tied advisers. The majority of advisers are said to be aligned to institutions such as AMP, AXA, the banks or businesses such as ours. Historically, they seem to have been the focus on media, professional bodies and regulators. However, it is a small number of non-institutional operators who have been at the forefront of the highest profile collapses. Those operators represent a small minority of advisers. For example, as best

87 CPA Australia, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 62.

88 AXA, *Submission 385*, p. 4.

89 Professional Investment Services, *Official Committee Hansard*, Sydney, 4 September 2009, p. 111.

90 Professional Investment Services, *Official Committee Hansard*, Sydney, 4 September 2009, p. 111.

> we understand the details, Storm Financial had around 13 advisers. The industry has some 17,000 advisers.[91]

5.112 They argued that the focus should be on identifying and weeding out fringe elements in the industry.[92]

5.113 IFSA warned the committee against 'overcompensating for the last mistake', stressing that section 945A of the Corporations Act 'is not an insignificant weapon to defend and advocate on behalf of consumers'.[93] CPA Australia also suggested that the problem has been one of adequate regulations not being enforced:

> Storm was giving the same advice, irrespective of the client circumstances. It was often margin loans which possibly exceeded their capacity to pay or even their need for the underlying investment. It would appear Storm were doing a one-size-fits-all approach to advice. Everyone was doing the same, getting the same advice and clearly, whilst they might have been doing the right thing around disclosure and so on, that is not in line with section 945A of the Corporations Act where there has to be a sound basis for the advice. I guess we fail to see if someone was looking at a licence holder, I would have thought serious questions would have been asked earlier as to how a one-size-fits-all advice model works for all their clients.[94]

5.114 They suggested that ASIC's approach of acting on complaints had been too reactive, possibly due to resource constraints:

> They really need to toughen up on the proactive, doing things earlier, and if that means more resources, and it would seem as though it would, then that is where the energies should be, because at the moment ... they seem to come in either after the fact or when they go in early we do not see anything actually happen that changes the course of events that subsequently follows.[95]

5.115 ICAA noted that the annual audit for AFS licensees does not include a proper examination of the advice being provided by their authorised representatives:

> Currently there are extensive requirements as to how a business applies for an AFSL and there are ongoing requirements and obligations. However it could be argued that there seems to be a gap in the on-going compliance requirements and what is included as part of the compliance audit. An AFSL is required to be audited that involves conducting both a financial and compliance audit to check whether the licensee is complying with its licence conditions and the requirements of the Act. Currently the audit and

91 Guardian Financial Planning, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 86.

92 Guardian Financial Planning, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 87.

93 IFSA, *Official Committee Hansard*, Canberra, 28 August 2009, p. 53.

94 CPA Australia, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 62.

95 CPA Australia, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 68.

> monitoring does not examine in depth the advice being provided by the representatives of the AFSL.[96]

5.116 Q Invest wrote:

> In our view, most participants in the financial services sector willingly comply and apply their best endeavours to meeting their obligations.
>
> We question whether additional disclosure obligations would have saved investors from the collapses we have witnessed.
>
> In our opinion, enforcement and appropriate action in terms of the spirit of those obligations is what was missing.[97]

5.117 They suggested:

> ASIC should strive for a primarily preventive function, through greater monitoring, supervision and enforcement of obligations imposed on AFS licensees and other entities falling within its jurisdiction. The reality is that there are enough laws in existence to cover every conceivable instance of misconduct within the financial services industry today. It needs to be recognised, therefore, that what we need now is a regulatory body who will be ready, willing and able to take the necessary steps to ensure that all the participants in the industry are complying with those laws.[98]

5.118 IFSA also told the committee that higher standards would not prevent non-compliance, with ASIC needing to be able to 'respond pre-emptively'.[99] However, ASIC told the committee that they have limited scope to intervene before breaches occur:

> The FSR regime is largely self-executing: AFS licensees and other participants are expected to comply with the conduct and disclosure obligations in the law. ASIC oversees compliance with these obligations and then takes appropriate enforcement action when there is non-compliance. ASIC's power to take action ahead of non-compliance is limited.[100]

5.119 ASIC reported that it will undertake targeted surveillance of randomly selected licensees to assess the quality of advice being provided, in addition to shadow shopping exercises.[101] Suggestions for a more targeted risk-based approach are examined in the following chapter, starting at paragraph 6.18.

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96 ICAA, *Submission 363*, p. 13.

97 Q Invest, *Submission 374*, p. ii.

98 Q Invest, *Submission 374*, p. viii.

99 IFSA, *Official Committee Hansard*, Canberra, 28 August 2009, p. 50.

100 ASIC, *Submission 378*, p. 20.

101 ASIC, *Submission 378*, pp 41-42.

5.120 The enforcement of disclosure requirements was also referred to in evidence. SDIA suggested that compliance documents of 70 pages and more cannot be considered clear and concise, as they are required to be.[102] BFPPG expressed the view that ASIC was not properly enforcing the requirement to disclose ownership conflicts:

> ASIC has not been rigorously enforcing the regulations in the key area of ownership. The regulations are clear: all financial planners must disclose their ultimate licensee ownership. It follows that the disclosure must be made in a manner that is meaningful for the client. The reality, however, is quite different. The majority of clients have no idea who the ultimate licensee is. In many cases they believe they are dealing with independently owned firms when in fact they are dealing with institutionally owned firms.[103]

5.121 ASIC noted that it cannot review all disclosure documents and that it 'adopts a risk based methodology to assist with which disclosure documents it should review'.[104]

Committee view

5.122 As the committee alluded to above, improved enforcement of existing regulations is essential in minimising catastrophic investment losses that occur as a consequence of financial advice that is manifestly poor and inappropriate. Current regulations already prohibit advisers from recommending an investment strategy that is inappropriate for their clients' circumstances and places them at risk of financial ruin. The committee is of the view that ASIC has been too slow in its enforcement of section 945A of the Corporations Act, which requires advisers to provide advice that is appropriate to clients' needs. Proposals for more effective, proactive enforcement and the committee's view on these are included in the following chapter, commencing at paragraph 6.18.

5.123 In making these comments, the committee does not preclude recommending legislative changes in the next chapter that will improve the overall quality of advice clients receive from financial advisers. Regulatory amendments will potentially complement improved enforcement measures designed to protect investors from advice that may have catastrophic consequences. They will also address the incremental yet pervasive detriment to consumers caused by poor, conflicted advice as described above at paragraph 5.75.

Financial literacy

5.124 Recent catastrophic investor losses demonstrate that many investors do not have the expertise to filter poor financial advice using their own knowledge about sensible investing. Many retail investors do not understand the nature of investment

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102 SDIA, *Official Committee Hansard*, Canberra, 28 August 2009, p. 66 and p. 70.

103 BFPPG, *Submission 251*, p. 22.

104 ASIC, *Submission 378*, p. 61.

risk and the importance of spreading risk across diversified asset classes, instead relying on third parties to steer them in the right direction. As was made apparent during evidence to this inquiry, many investors seek financial advice for the very reason that they have minimal financial literacy, and therefore place complete faith in the investment advice they receive.

5.125 ASIC agreed that many consumers do not have the levels of financial literacy needed under the current system:

> The FSR regime places the onus on investors to take responsibility for their own investment decisions. The onus is on the retail investor to recognise when they need to seek financial advice and to have a sufficient education, understanding and motivation to read and comprehend the disclosure documents they will receive when they receive advice and/or invest in products (e.g. SOAs, FSGs, and PDSs). This presumes that most Australians will have a reasonable level of financial literacy and understanding.[105]

5.126 Their submission stated that the requisite financial literacy to cope with investor information is often not present:

> ...the 2006 ABS Adult Literacy and Life Skills Survey found that 46% of Australians aged 15-74 do not have the level of literacy needed to understand narrative text, such as in newspapers or magazines, to the minimum level required to meet the complex demands of everyday life and work in the emerging knowledge-based economy. This suggests that many people would have difficulty understanding the disclosure documents they would receive when they invest or make other financial decisions.[106]

5.127 ASIC further noted that the infrequent nature of investment decisions mitigates the opportunity for people to develop financial literacy.[107]

5.128 IFSA also stated that 'we have had a whole generation of people forced to be investors' and many do not have any understanding of the complexities of their second largest investment, superannuation.[108] Their submission acknowledged that the literacy problem represents a 'complex and generational challenge', but emphasised its importance as a consumer protection mechanism:

> We believe that it is important to recognise that while improving financial literacy will almost certainly assist with consumer protection, initiatives focused on consumer protection are unlikely to address the complex and generational challenges associated with improving financial literacy.[109]

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105 ASIC, *Submission 378*, pp 75-76.

106 ASIC, *Submission 378*, p. 76.

107 ASIC, *Submission 378*, p. 77.

108 IFSA, *Official Committee Hansard*, Canberra, 28 August 2009, p. 57.

109 IFSA, *Submission 317*, p. 27.

5.129 MLC noted that poor financial literacy is the reason why financial planners are increasingly important:

> The big issue and gap that I see that needs to be addressed is the Australian superannuants' understanding of risk and the risk that they are taking with their retirement moneys. What we have seen through the crisis is a lot of people that are approaching retirement or are older and in retirement were probably more exposed to markets than they understood, or at least the impact of the market changes was much greater than they thought. That is a big challenge and it has led to our conclusion that the best way to do it is to get Australians to talk to a financial planner.[110]

5.130 FPA suggested that:

> We have a long way to go in helping consumers become more capable in terms of their financial obligations, responsibilities, preparation, planning and all those sorts of issues. There is a whole body of work in there.
>
> I think if you have a professional financial planner with a robust regulatory environment and an informed client, you are going to get the best outcome.[111]

5.131 ICAA warned against believing that consumers should be expected to protect themselves in the immediate term:

> Many people ... talk about consumer responsibility, saying that consumers should take more responsibility. The reality is that it is not going to happen in the current environment where you have got limited consumer literacy. So you cannot pass it off and say consumers need to take more responsibility. Yes, consumers need to increase their education and understanding themselves, but that is a generational issue. That will happen probably 10 or 20 years down the track when my kids are coming out of high school and so on.[112]

5.132 AFA commented that financial advisers are educators and need to be responsible in that role:

> There is a need, obviously, for consumers to take responsibility for the financial decisions that they make but equally there is for advisers, who are in a sense the client's first educator when they get into that relationship.[113]

Committee view

5.133 The committee notes that ASIC is presently delivering a number of financial literacy programs via initiatives such as school curriculum-based programs and their

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110 MLC, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 12.

111 FPA, *Official Committee Hansard*, Canberra, 28 August 2009, p. 45.

112 ICAA, *Official Committee Hansard*, Sydney, 4 September 2009, p. 12.

113 AFA, *Official Committee Hansard*, Sydney, 4 September 2009, p. 30.

own consumer information website, FIDO. While these are certainly useful approaches, the committee is of the view that ASIC could be doing more to target key, higher risk, older demographic groups by promoting sensible investment messages, including through the mainstream media. The committee makes a recommendation about investor education in Chapter 6.

5.134 Notwithstanding this, the reality is that better investor education is not the only answer to protecting investors from poor financial advice. It is a solution often proposed by those in the industry wishing to maintain the regulatory status quo, but is not in the committee's view effective at protecting the most vulnerable investors. The complexity of investment strategies leaves the prospect of clients determining the quality of financial advice they receive, through the filter of personal knowledge, beyond the capacity of many. Most clients quite legitimately trust in the knowledge and professionalism of their financial adviser to provide them with good advice, and do not have the confidence in their own understanding of the subject to challenge the advice they are given. Therefore the regulatory system should, to a reasonable extent, protect consumers from poor advice, rather than relying on consumer's being sufficiently financially literate to determine for themselves whether their adviser's recommendations are in their interests.

5.135 The next chapter examines proposals for the more effective regulation of financial services.

Chapter 6

Suggestions for regulatory reform

6.1 This chapter examines a number of suggestions for rectifying the regulatory deficiencies that are claimed to impede protecting investors from poor advice. In broad terms, the changes suggested relate to:

- raising standards of advice;
- making disclosure more effective;
- removing conflicted remuneration practices;
- ensuring better transparency, competency and accountability through the licensing system;
- reforming lending practices;
- limiting access to complex and/or risky investment products; and
- introducing a last resort statutory compensation scheme for investors.

Standards of advice

6.2 The previous chapter outlined concerns about the effect of conflicts of interest on the quality of advice provided by financial advisers. The committee heard a number of proposals to raise standards in this area, which fall within three categories:

- imposing a higher legislative standard through a fiduciary duty for financial advisers to place clients' interests first;
- providing consumers a distinction between sales-based advice and independent advice;
- improving enforcement of current advice standards through annual reports to ASIC and/or risk-based auditing.

Fiduciary duty

6.3 A number of witnesses appearing before the committee supported the imposition of an explicit fiduciary duty on financial advisers, requiring them to give priority to their clients' interests ahead of their own. Australian Securities and Investments Commission (ASIC) was amongst its proponents, claiming that a legislative fiduciary duty would overcome the inadequacy of disclosing conflicts:

> An additional legislative requirement to put the interests of clients first where there is a conflict would lead to a higher quality of advice and the emergence of a professional advice industry.
>
> It would mean that where there is a conflict between the interests of the client and the interests of the adviser, the adviser must give priority to the interests of their client. For example, under the current test, an adviser may have a reasonable basis to recommend a client invest in any of three different products. Of the three products, the adviser could recommend the product that delivers the adviser the greatest fee revenue, provided that this conflict of interest and the amount of the fee is clearly disclosed to the client. However, under the higher standard proposed above, they would be required to recommend the lower fee product because the adviser is required to prioritise the interests of their client (i.e. in paying the lowest fees possible) before their own interest in receiving higher remuneration.[1]

6.4 ASIC said that the imposition of a legislative fiduciary duty would likely change remunerative practices, even without a ban on commissions:

> ...once you are in a fiduciary relationship, if you are going to take commissions or some other benefit, that benefit belongs to your client. It is not yours; it is your client's, unless your client through disclosure but more importantly through informed consent allows you to keep it. The standard and the way you discharge that duty is that, if you are running a large organisation, for practical purposes you would be hard pressed to say, 'Yes, you can still have commissions,' because in each individual case you run a risk. So the change we would see to industry practice would be that a lot of the front-end, trail and ongoing commissions would probably not sit well with a clarification of that duty.[2]

6.5 ASIC noted that the higher standard would not require advisers to provide the 'best advice' to clients, or that every product available in the market would need to be considered.[3]

6.6 Professional Investment Services did not oppose the introduction of a statutory fiduciary duty, indicating that such a duty already exists.[4] Trustee Corporations Association of Australia argued that advisers should always place their clients' interests first:

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1 ASIC, *Submission 378*, p. 43.

2 ASIC, *Official Committee Hansard*, Canberra, 16 September 2009, p. 10.

3 ASIC, *Submission 378*, p. 44.

4 Professional Investment Services, *Official Committee Hansard*, Sydney, 4 September 2009, p. 113.

> ...it is just unthinkable to me that you can give advice to a client without giving it in the client's best interest and preferring your own interest over theirs. It is implicit in an advisory role.[5]

6.7 Industry Super Network recommended that section 945A be replaced by a requirement to act in clients' best interests:

> The key elements which this obligation will be:
>
> - It will be owed by an individual planner to his or her client. Licensees would also continue to hold responsibility for advisers operating under their licence.
> - The best interests obligation would require the planner to give clients their undivided loyalty, which means the financial planner must strive to avoid any actual or perceived conflict of interest.
> - The method of payment for financial advice must reflect the planner's undivided loyalty to their client. An individual adviser or a licensee cannot receive any payments from product providers or fund managers. Payment for advice must be made by the client and would ideally be based on the amount of time or advice provided. Up front commissions or fees would not be permitted.[6]

6.8 Industry Super Network stated that this requirement would force licensees to include a variety of product types on its approved product list and would preclude volume based payments.[7] They clarified that this requirement would require advisers to put their clients' interests ahead of their own, rather than selecting the best investment products:

> In order to satisfy the 'best interests' obligation, an adviser's work would be measured against a standard of reasonable skill, care and diligence to be expected of an ordinary prudent person acting in the capacity of a qualified adviser. However, the obligation to act in the client's best interests would not require financial advisers to predict the best or highest performing products. Superannuation trustees are subject to a 'best interests' obligation which does not expose them to liability for failing to pick the best performing investment managers for their fund in any year. The best interests obligation is not retrospectively evaluated based solely upon the performance results of the superannuation fund, but rather by examining whether the trustees exercised a reasonable standard of skill, care and diligence in selecting and monitoring investment managers.[8]

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5 Trustee Corporations Association of Australia, *Official Committee Hansard*, Sydney, 4 September 2009, p. 21.

6 Industry Super Network, *Submission 380*, p. 14.

7 Industry Super Network, *Submission 380*, p. 14.

8 Industry Super Network, *Submission 380*, p. 15.

6.9 Australasian Compliance Institute (ACI) supported a fiduciary duty being imposed on individual advisers.[9] FPA commented:

> ASIC has talked about attributing a fiduciary responsibility to the function of advice, and we think that that is going to be quite hard to monitor and manage. We would prefer that the role of fiduciary were attached to a person, not to a function or interaction. We believe the person should have that responsibility...[10]

6.10 Association of Financial Advisers (AFA) told the committee that the category 'financial adviser' should be legislatively defined before a fiduciary duty could be imposed by legislation.[11]

Dual standards of advice

6.11 Another possible reform involves applying different standards to advisers claiming to offer unbiased financial advice, as opposed to those whose primary objective is selling financial products. The notion of imposing different standards depending on how advisers identified themselves has been suggested previously. In 2006, the government floated a proposal to separate sales and advice by exempting those offering straight product recommendations/sales from the Chapter 7 requirements on financial product advice in the *Corporations Act 2001* (Corporations Act), subject to clear disclosure requirements.

6.12 Treasury explained to the committee that there were concerns about that proposal that meant it was not pursued further:

> One [issue] was that consumers may not necessarily appreciate the difference between the advice stream and the sales stream, and you would need to have very, very clear warnings or some kind of communication tool so that everybody would know precisely what it was that they were doing. And there was not confidence that we could come up with that.
>
> The second big issue was that, if that kind of structure were adopted, one outcome might be that the number of participants in the market going for the full advice model would decline significantly and that a lot would shift into the sales stream, because the sales stream would not be accompanied by the kinds of regulatory requirements in terms of training, competence and so forth. So there was a concern that an outcome that might occur is that there might be plenty of sales people out there but not many people who were offering the genuine advice. The concern that was mentioned earlier about real, genuine advice only being available to affluent clients was another issue.[12]

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9 ACI, *Submission 397*, p. 5.

10 FPA, *Official Committee Hansard*, Canberra, 28 August 2009, p. 34.

11 AFA, *Official Committee Hansard*, Sydney, 4 September 2009, p. 33.

12 Treasury, *Official Committee Hansard*, Canberra, 28 August 2009, p. 19.

6.13 ASIC also outlined this latter concern:

> Those who opposed this proposal suggested that most investors would use the 'sales' part of the industry (given the high concentration of advice businesses that are tied to product manufacturers) and therefore would receive lower quality 'advice'.[13]

6.14 The United Kingdom's regulator, the Financial Services Authority (FSA), has proposed that financial services firms be required to identify whether their services are either 'independent advice' or 'restricted advice'. Treasury explained this approach to differentiating different types of advice:

> The UK ... decided to focus on separating out independent advice and restricted advice. Independent advice means that you have to look completely across the market. So it is very broad. You have to give unrestricted advice. You have to basically have knowledge of all of the products that might provide suitable outcomes for your clients. The restricted advice model is where you are clearly stating that you are offering a lesser range of products, and you have to clearly articulate that upfront to the consumer.[14]

6.15 However, officials stressed that it was not easily transferable to Australia:

> Looking at the UK model, you cannot adapt it straight across to the Australian model because, for example, in the appropriate advice regime we do not require that every single product in the market be considered. So there is not an exact or straight translation.[15]

6.16 The Institute of Chartered Accountants in Australia (ICAA) commented that 'the introduction of a two-tiered model would just add further complexity and confusion for the consumer'.[16]

6.17 A number of proposals aired during the inquiry proposed imposing dual standards within the broader framework of a dual licensing system. These suggestions are discussed later in the report, starting at paragraph 6.105.

Risk-based audits

6.18 The previous chapter outlined the views of those who believed that problems with the quality of financial advice are mainly due to inadequate enforcement of the existing regulations, particularly section 945A of the Corporations Act requiring advice to be appropriate to the client. To improve enforcement in this area, some have suggested that ASIC take a more rigorous and targeted approach through risk-based surveillance activities. For example, AMP recommended that:

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13 ASIC, *Submission 378*, p. 47.

14 Treasury, *Official Committee Hansard*, Canberra, 28 August 2009, p. 8.

15 Treasury, *Official Committee Hansard*, Canberra, 28 August 2009, p. 8.

16 ICAA, *Official Committee Hansard*, Sydney, 4 September 2009, p. 11.

> ...an appropriately resourced ASIC adopt a risk based approach to monitoring and supervision to more effectively monitor and assess management of conflicts by Licensees.[17]

6.19 Similarly, the Investment and Financial Services Association (IFSA) recommended that ASIC:

> ...adopt a risk-weighted approach to monitoring and supervision based on improved benchmarking of industry practice to more effectively monitor and assess management of conflicts of interest by Licensees and Licence applicants.[18]

6.20 They suggested that the following factors be considered as part of a 'risk-weighted approach to monitoring and surveillance using its existing powers':

> ...in relation to Licensees that provide financial advisory services, the type of information which ASIC could consider to better assess this risk includes:
>
> • Extent to which ASIC has had prior constructive dealings with the Licensee
>
> • Prevalence of leverage across clients
>
> • Membership of professional or industry associations and their compliance history with such bodies
>
> • Details of management qualifications/experience
>
> • List of approved products and the basis for approval
>
> • Products most frequently recommended
>
> • Internal processes for the delivery of complex or high-risk advice strategies
>
> • Number of complaints lodged against the Licensee and their type
>
> • Number of advisers/authorised representatives
>
> • Number of Certified Financial Planners
>
> • Number of SoAs produced
>
> • Amount of funds under advice.[19]

6.21 AXA suggested that ASIC's monitoring activity was tilted too much towards larger licensees, and more attention should be given to 'other risk indicators such as complaints, the complexity of products being recommended and reports from industry participants'.[20]

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17 AMP, *Submission 367*, p. 12.

18 IFSA, *Submission 317*, p. 23.

19 IFSA, *Submission 317*, pp 29-30.

20 AXA, *Submission 385*, p. 16.

6.22 CPA Australia stated that: 'ASIC currently appears to employ a reactive rather than a proactive approach to enforcing the regulation'.[21] They recommended that ASIC use the information provided by applicants to target their enforcement:

> Whilst it is not ASIC's role or responsibility to approve a business model in order to approve an application for an AFSL, ASIC could use the Business Description core proof to evaluate the risk that an applicant may breach their obligations once licensed. Any applicant who was deemed to be at risk could be reviewed by ASIC within a 12 month period of being granted an AFSL. The review should include ensuring all relevant processes and licence requirements are still in place and a review of random selection of Statements of Advice (SOA). This will aid in identifying if the providing entity is making reasonable client inquires, if they are considering and investigating the subject matter of the advice as is reasonable in all the circumstances and if the advice is 'appropriate' for the client.[22]

6.23 CPA Australia further recommended that licensees be required to submit an annual return outlining information about their clients, recommended products and fees charged. The document could be lodged as part of existing AFSL reporting processes.[23] Noting that the one-size-fits-all strategy needed to be eliminated by enforcing section 945A, their submission stated:

> It is of concern that there is anecdotal evidence that many licensees who have been in practice for many years have had little or not contact with ASIC since being granted an AFSL. It is unrealistic for ASIC to audit each AFSL on an annual basis, however CPA Australia believe that there is still a need for ASIC to have regular contact with all AFS licensees.
>
> A more efficient and far-reaching solution would be for every licensee to complete an AFSL annual return. The annual return should cover key information and statistics, which ASIC would review and use to compare against industry averages and best practice. It would be an efficient method to identify an AFSL who may be at risk of breaching their obligations due to their business practices. For example, if there was a disproportionately high number of clients in one product type, this could be seen as a result to investigate further.[24]

6.24 In evidence to the committee they said that problems such as Storm Financial could have been identified earlier using these strategies:

> If ASIC had the information and you could see a licence holder was recommending a lot of margin loan products and it just turned out that a large proportion of their client base was retired, then that would warrant

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21 CPA Australia, *Submission 311*, p. 5.

22 CPA Australia, *Submission 311*, p. 6.

23 CPA Australia, *Submission 311*, pp 7-8.

24 CPA Australia, *Submission 311*, p. 7.

> grounds to go in and have a closer look, look at the basis for advice and whether it is appropriate or not.[25]

6.25 Commonwealth Bank of Australia's (CBA) submission also recommended that licensees be required to periodically report to ASIC standard information about their business models, with particular emphasis on the nature of advice given to clients.[26]

6.26 ICAA also suggested more extensive auditing of advice:

> A consideration could be to include an "advice audit" as a component of the compliance audit. This is not a preferred solution, as it would result in increased compliance costs. However it would provide a solution to monitoring the practical application of the compliance processes within the AFSL. In addition, it may well remove any real or perceived conflicts of interest that may occur within an AFSL operation between the compliance function and other divisions of the business.[27]

6.27 Australasian Compliance Institute (ACI) suggested that licensees be required to submit to an independent review of a proportion of advice cases annually, undertaken by a person accredited by a professional body. ACI also suggested that ASIC or a professional body 'engage in proactive activities like shadow shopping'.[28]

Committee view

6.28 The committee supports the proposal for the introduction of an explicit legislative fiduciary duty on financial advisers requiring them to place their clients' interests ahead of their own. There is no reason why advisers should not be required to meet this professional standard, nor is there any justification for the current arrangement whereby advisers can provide advice not in their clients' best interests, yet comply with section 945A of the Corporations Act. A legislative fiduciary duty would address this deficiency.

Recommendation 1

6.29 The committee recommends that the Corporations Act be amended to explicitly include a fiduciary duty for financial advisers operating under an AFSL, requiring them to place their clients' interests ahead of their own.

6.30 The committee draws no conclusion about whether such a duty would automatically preclude the payment of commissions to financial advisers. A recommendation on payments from product manufacturers to financial advisers is made at paragraph 6.101.

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25 CPA Australia, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 64.

26 CBA, *Submission 357*, p. 8.

27 ICAA, *Submission 363*, p. 13.

28 ACI, *Submission 397*, p. 4.

6.31 For reasons of complexity outlined in further detail below at paragraph 6.149 in the context of licensing, the committee does not support proposals to impose different standards of advice depending on whether someone is performing a sales function or offering 'independent' advice. The committee also recognises that a similar proposal has been previously discarded after concerns that the industry would become dominated by sales-based advisers.

6.32 The committee is firmly of the opinion that ASIC needs to undertake the enforcement of legislative standards of advice with a more rigorous and targeted approach. ASIC should perform effective risk-based surveillance on the advice provided by licensees and their authorised representatives, focussing particularly on licensees that have come to the attention of the regulator previously; recommend a high proportion of high risk products; have limited products on their approved product list; disproportionately recommend one type of product; or have limited experience or qualifications. The committee considers it important that ASIC establishes robust audit processes to be undertaken by suitably qualified field staff. The committee is also of the view that more regular, preferably annual, shadow shopping exercises should be conducted to identify breaches of the legislative standard and provide an important deterrent for licensees.

6.33 If additional funding is required to undertake these activities then it should be provided, particularly recognising the additional credit and market regulatory responsibilities ASIC will soon be required to perform.

6.34 The committee is not of the opinion that the benefits of receiving annual returns from licensees outlining advice practices would justify the administrative burden this would create for ASIC. There are more efficient ways of taking a risk-weighted approach to surveillance than receiving information from every licensee in Australia.

Recommendation 2

6.35 The committee recommends that the government ensure ASIC is appropriately resourced to perform effective risk-based surveillance of the advice provided by licensees and their authorised representatives. ASIC should also conduct financial advice shadow shopping exercises annually.

6.36 The committee also notes that the monitoring and enforcement of standards can be improved through the oversight of a professional standards body, which is the subject of a recommendation at paragraph 6.160.

Disclosure

6.37 Although there was a broadly held view that disclosure had been ineffective in managing conflicts of interest, necessitating other more robust measures, the committee did receive suggestions about what the purpose of disclosure should be and how it might be improved.

6.38 MLC was of the view that disclosure should complement the overriding requirement to act in the client's interests, rather than providing a cure-all solution. MLC summed up the opinion of many with the following comment:

> Acting in the client's interests has got to be the first and foremost driver of the client's outcomes, and disclosure needs to support that. The idea that we can find a 70-page document disclosing enough information to protect everybody's interests and give the client meaningful information is flawed.
>
> ...
>
> Clients get confused [by disclosure] ... at the end of the day what we have to be doing, as an industry and as an organisation, is acting in the client's interests. If you can combine that premise with disclosure that allows the client to make decisions or at least find more information if they want to, then you have a better regime than one that simply says, 'I've disclosed it so therefore the job is done.'[29]

6.39 Mr Peter Worcester of Worcester Consulting Group commented that disclosure documents could be simpler:

> I would like to use the idea of when you go to your doctor and he is going to operate on you. He gives you a two-page informed consent. He says what it is going to cost, what the procedure is, what might go wrong and what is the probability of it going wrong. I tend to believe that we should chuck out those 50-page statements of advice and have a two-page document.[30]

6.40 Boutique Financial Planning Principals Group (BFPPG) suggested that full disclosure should be replaced:

> There is a simpler approach that will provide the consumer with a better outcome:
>
> - Replace the requirement for full disclosure of the basis of advice with the requirement that the advice must be defensible. There must be a reasonable basis for the advice, and the financial planner must be able to defend the advice if required by the client, ASIC or FOS.
> - The advisor can then provide the consumer with documentation on the basis for the advice at a level that is suitable to the client's needs.[31]

6.41 The Commercial Law Association of Australia recommended that a mandatory one page disclosure document be required, containing information on product risk, the effect of major market fluctuations and fee costs.[32] ICAA suggested

29 MLC, *Official Committee Hansard*, Melbourne, 26 August 2009, pp 7-8.

30 Mr Peter Worcester, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 102.

31 BFPPG, *Submission 251*, p. 15.

32 Commercial Law Association of Australia, *Submission 389*, p. 3.

that consideration be given 'to ensure common fee terminology is used to assist comparability'.[33]

6.42 The committee is aware that the Financial Services Working Group (FSWG), comprised of Department of Finance, Treasury, and ASIC officers working with other industry stakeholders, is developing 'simple, standard and readable product disclosure for specific financial products'.[34] ASIC informed the committee that:

> The FSWG is now working towards achieving simplified, mandatory disclosure ... it is devising:
>
> (a) short and simplified PDS disclosure requirements for margin loan products, superannuation and ‘simple’ managed investment scheme products. This simplified form of disclosure will include:
>
> > (i) prescribed content requirements;
> >
> > (ii) a maximum page limit (4 pages for margin loans; 10-12 pages for superannuation and ‘simple’ managed investment scheme products);
> >
> > (iii) a new incorporation by reference regime identifying what information, when incorporated by reference, may be considered as part of the PDS; and
>
> (b) sample PDS documents as a guide for industry on the type of content and level of detail that would be expected in a shorter, simpler PDS.[35]

6.43 Treasury told the committee that the work of the Financial Services Working Group on disclosure was an alternative approach to the problematic task of separating sales from advice:

> That is one of the reasons that we turned to the concept of the Financial Services Working Group looking at the actual disclosure documents. It is taking it from a different direction. First, we were trying to separate them and then we said, ‘If we can’t separate, let’s make sure the consumer understands what they are getting into and understands what this is.’ If the documents are easy for them to read and they understand that a person is getting all these commissions and they will only offer you products of this sort and they understand exactly what they are getting into, at least we are one step closer to where we are trying to get to.[36]

6.44 Aside from the work of the FSWG, ASIC proposed that advisers be required to disclose more prominently restrictions on the advice they are able to provide consumers—in particular, the limited range of products an adviser tied to a product issuer is able to advise on. The submission stated:

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33 ICAA, *Submission 363*, p. 11.

34 ASIC, *Submission 378*, p. 62.

35 ASIC, *Submission 378*, pp 62-63.

36 Treasury, *Official Committee Hansard*, Canberra, 28 August 2009, p. 21.

Currently disclosure about relationships with product issuers tends to be buried in the fine print of a licensee's FSG and there is no legislative requirement for a financial adviser's marketing material (as distinct from FSGs and Statements of Advice (SOAs)) to disclose the association with a product issuer. Many advisers do not disclose this relationship on their website. By the time a potential client receives an FSG or SOA, they may have already gone a long way down the path to making a decision to use the services of the adviser.

In order to bring the potential conflict to the attention of the client before they make a purchasing decision about the adviser's services or a particular product, prominent disclosure in marketing material could be required, for example, on advertisements, shopfronts, letterhead, websites etc.

Advertising and marketing material could also state that the adviser can advise on a limited range of products and a list of these products is available on the adviser firm's website or on request.[37]

6.45 This proposal would seek to address ownership-based conflicts of interest by further clarifying for consumers the extent and effect of that relationship on the products able to be recommended by their adviser. It would also flag situations where advisers are permitted to recommend single products only (such as agribusiness MIS) as a licensing condition.

6.46 Another suggestion was for advisers to be required to conduct a personal stress test on clients to more effectively disclose product risk. Institute of Actuaries of Australia recommended:

Many financial planners already adopt a process of scenario analysis or stress testing when advising individual clients. The Institute's proposal is that this current "best practice" be required as mandatory practice for all financial planners.

A prescribed Personal Stress Test would provide customers with a simple objective measure of adverse outcomes as relevant to their individual circumstances. The adoption of standard assumptions and trigger events will ensure that the test will not be onerous for advisers.

The Institute believes that a Personal Stress Test would be a more effective means of communicating the risk associated with significant adverse outcomes.[38]

6.47 This suggestion was supported by Worcester and Resnik:

We believe that an appropriate way for a financial planner to ensure that a (gearing) investment strategy is appropriate is to apply a stress test to both:

• The client's assets and liabilities, including their home, and home mortgage, and

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37 ASIC, *Submission 378*, p. 45.

38 Institute of Actuaries of Australia, *Submission 319*, p. 5.

- The client's income and expenditure, both at the consumption level (salary and living expenses, including mortgage payments) and at the investment portfolio level (dividend income and margin loan costs).[39]

6.48 IFSA was of the view that undertaking a risk assessment was an inherent part of providing appropriate advice to clients:

> The central objective of conducting a risk assessment is reaching a clear understanding about how much risk of financial loss a client is willing to accept to achieve their financial goals.
>
> Appropriate advice therefore involves calibrating an individual's financial goals against their risk profile.[40]

6.49 Australasian Compliance Institute called for the implementation of a risk rating system for financial products, applied consistently across the industry.[41]

Committee view

6.50 The committee suggests that the Corporations Act be amended to require advisers to disclose prominently in marketing material the restrictions on the advice they are able to provide consumers and any potential conflicts of interest. This is particularly important in the case of advice from vertically integrated financial institutions, where conflicts of interest attributable to the ownership structure will exist even if commission payments to advisers are eliminated as a form of remuneration.

Recommendation 3

6.51 The committee recommends that the Corporations Act be amended to require advisers to disclose prominently in marketing material restrictions on the advice they are able to provide consumers and any potential conflicts of interest.

6.52 Although disclosure is somewhat limited in the extent to which it can protect consumers from poor financial advice, clear and concise disclosure is still an important tool to assist consumers to recognise conflicts of interest and understand the cost of advice. The committee supports the current efforts of the Financial Services Working Group to reduce the length and complexity of disclosure material. The committee understands the high cost of compliance and is of the view that, along with other measures recommended in this report, the government should direct the Financial Services Working Group to develop mechanisms to reduce compliance costs over time.

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39 Worcester and Resnik, *Submission 293*, p. 3.

40 IFSA, *Submission 317*, p. 25.

41 ACI, *Submission 397*, p. 9.

6.53 The committee rejects proposals suggesting that financial products should be given a 'risk rating' by ASIC or any other government-authorised entity. It would be inappropriate for ASIC to be assessing and labelling the risk of financial products, not to mention a serious drain on resources.

Remuneration

6.54 The inquiry attracted considerable debate about whether banning commission-based remuneration is required to overcome the conflicts of interests it creates. Some argued that disclosure and conduct requirements have failed to adequately manage conflicts and a ban is now warranted, while others claimed that removing these payment methods would increase the cost and accessibility of advice for consumers. There was also discussion about whether enabling payments to be made as a percentage of funds under management represented an effective compromise between removing conflicts and maintaining affordability.

6.55 A number of contributors also proposed making the cost of financial advice tax deductible for consumers to make fee-for-service charging more appealing.

Bans on commissions

6.56 The committee received considerable evidence suggesting that the most effective way to improve the quality of financial advice for consumers is to remove conflicts of interest altogether by banning commissions and other conflicted remunerative practices. The regulation of remuneration practices was consistently raised during the inquiry.

6.57 ASIC submitted that commissions create conflicts of interest that are inadequately managed by disclosure, and suggested that the committee consider recommending a ban on a range of remunerative practices:

> While the reforms to clarify the fiduciary-style duty of advisers will have a significant impact on the ability to use commission remuneration, the Government should still assess changing the policy settings of the FSR regime so that advisers cannot be remunerated in a way that has the potential to distort the quality of advice given.
>
> This would mean that the following forms of remuneration would not be permitted, particularly in relation to personal advice:
>
> (a) up-front commissions;
>
> (b) trail commissions;
>
> (c) soft-dollar incentives;
>
> (d) volume bonuses;
>
> (e) rewards for achieving sales targets; and

(f) fees based on a percentage of funds under advice.[42]

6.58 ASIC proposed that people who do not hold themselves out to be advisers, or those providing execution-only services, be able to continue to receive commissions. ASIC also indicated that the government would need to consider whether to ban advisers receiving commission payments altogether, or permit them to return them to clients in full.[43]

6.59 This proposal was supported by a number of other submitters.[44] CHOICE supported a ban on 'remuneration incentives that are inconsistent with fiduciary duties an adviser owes a client'.[45]

6.60 Quantum Financial Services called for the 'rivers of gold' to be turned off:

> It is a sad fact that, in financial planning, he who pays me is my boss. No-one would consider allowing lobby groups to pay fees to politicians, yet we allow product manufacturers to pay financial planners and dealer groups. By ‘rivers of gold’, we mean commissions and any other type of financial arrangement between product providers, platform and dealer groups and advisers. The only parties who resist this reform are those who financially benefit from the rivers of gold.[46]

6.61 Other evidence to the committee suggested variations on the proposal to ban commission payments entirely. MLC supported banning volume based arrangements; Axiom Wealth proposed that rebates from platform providers and volume-based rebates be banned, or refunded to clients in their entirety; Australasian Compliance Institute told the committee that it is essential that clients be given the ability to stop trail commissions; and Australasian Compliance Institute also recommended that product manufacturers not be able to advise on their own products.[47]

6.62 ICAA argued that the attachment between manufacturers and advisers needs to be removed:

> ...it is important that the remuneration models are based on the payment from the client and not from the product manufacturer. It is important that the linkage between the product manufacturer and the adviser is removed.[48]

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42 ASIC, *Submission 378*, p. 53.

43 ASIC, *Submission 378*, p. 54.

44 See for example Strategy First, *Submission 178*, p. 11; Symes Warne and Associates, *Submission 169*, p. 3.

45 CHOICE, *Official Committee Hansard*, Sydney, 4 September 2009, p. 99.

46 Quantum Financial Services, *Official Committee Hansard*, Sydney, 4 September 2009, p. 44.

47 MLC, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 7; Axiom Wealth, *Submission 394*, p. 4; ACI, *Submission 397*, p. 6 and p. 4;

48 ICAA, *Submission 363*, p. 8.

6.63 However, they stated that the issue should be resolved by the industry, rather than banned by legislative action. ICAA claimed that commissions would simply continue under another guise were this to occur.[49]

6.64 Treasury supported a shift away from commissions, indicating a preference for a self-regulatory approach but noting the possible drawbacks:

> ...we are certainly in favour of moving away from that area. But the question is: what is the best way of doing it? We are quite encouraged by the fact that the industry has already started to do that in its own right. But I note that, for example, what the FPA and IFSA are doing is not quite exactly the same. Obviously you would need a single system for that to work. Then the question would be: if they cannot cover the whole of the industry, and I think it would be necessary to cover the whole of the industry, what can the government do to assist to ensure that that is across the whole industry? If the government makes an assessment that the industry based system will not be effective then you have to move further down that regulatory line to make it more effective.[50]

6.65 BFBPG advocated that incentive-based commission payments be phased out gradually:

> BFPPG accepts that making a rapid change from a commission–based model to a fee–basis model could be detrimental to clients and the process should be managed over a short but definite time and, with all stakeholders involved, through the development of improved fee and remuneration models that drive down costs and improve transparency.
>
> There has been recent argument that commissions should be banned immediately rather than eliminated over a period. There are still many financial practices that rely on commissions for their income. It is reasonable to accept that banning commissions within a short time frame would jeopardise the continued viability of those businesses. The real risk, however, is that the clients of those practices would suffer as their financial planners struggled to replace their remunerations models.[51]

6.66 MLC noted that even if commissions are banned, they would continue to be embedded in existing investment products:

> The challenge in many legacy products and in history is that there are a lot of payments still being made from products and we cannot change the past. All we have tried to do is put a line in the sand and take a view that we can change going forward.[52]

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49 ICAA, *Submission 363*, p. 8.

50 Treasury, *Official Committee Hansard*, Canberra, 28 August 2009, p. 9.

51 BFBPG, *Submission 251*, p. 8.

52 MLC, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 10.

6.67 In contrast, the committee was also warned of the potential negative consequences from removing commission-based payments for advisers. In particular, it was suggested that mandating up front fee-for-service payments by banning commissions will make the cost of advice prohibitive to many. IFSA was one organisation that argued that removing existing fee structures would increase the cost to consumers:

> There are a number of subsidised arrangements that exist in the value chain of a financial product. Some of those have been widely criticised by some of the submissions here. But the reality is that if you begin to strip out some of the fees, such as volume based fees— which we support—you push more and more down directly to the consumer and you make it very expensive for them; you make it frighteningly expensive for them. That means that they simply will not seek the advice.[53]

6.68 Professional Investment Services emphasised the problems a sudden upheaval of remuneration structures could create:

> ...if you go and completely change the economics of the industry overnight it causes upheaval to many trusted relationships with those who are being charged correctly and whose interests are being looked after by their advisers.[54]

6.69 They also noted that a vertically integrated business supposedly removing commissions does not mean conflicts have also been removed:

> ...conflict also exists where advice is provided 'free' with no direct cost to the client, such as through a product provider, institution or industry fund. In these instances the cost of advice is subsidised by the product provider, institution or industry fund, which generates fees through the distribution of aligned products, or within the management fee for institutionally owned products. The conflict is not direct payment by the product provider, but indirect through employee remuneration (wage or bonuses) or through product placement restrictions, whereby the adviser can only recommend products included in the APL which may be restricted to institutionally aligned products. This indirect conflict operates in a similar fashion to those inherent in commission arrangements.[55]

6.70 The inference that may be drawn from this argument is that removing commissions would favour vertically integrated advisory firms over those that are not tied to a single product manufacturer but receive remuneration via commissions from various providers.

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53 IFSA, *Official Committee Hansard*, Canberra, 28 August 2009, p. 57.

54 Professional Investment Services, *Official Committee Hansard*, Sydney, 4 September 2009, pp 114-115.

55 Professional Investment Services, *Submission 336*, p. 12.

6.71 Guardian Financial Planning observed that banning commissions would not necessarily prevent inappropriate advice:

> ...Storm was charging a percentage amount, which was a fee on the amount of advice. They were not receiving a product commission of seven per cent ... the debate at the moment is about commissions or fees. That is actually not going to prevent that sort of behaviour in future. It is possible to be charged a fixed flat dollar fee independent of a product and still, through the unethical actions of an adviser, be ripped off or cause people to suffer a loss. Our concern would be that the focus on fees and commissions is not going to prevent this. We could outlaw commissions tomorrow and have everything as a flat dollar fee. Will that prevent another Storm occurring? No it will not.[56]

6.72 ING Australia supported the notion that consumers 'should be able to determine remuneration arrangements that suit them best, which are based on their circumstances and ability to afford the advice'.[57] AFA commented that 'banning commissions will take away a consumer's fundamental right to choose' and make advice less affordable:

> ...banning commissions may make comprehensive financial advice unaffordable for consumers at the very time they need it most, and that the fees versus commissions debate is fixated on price when it should be focussed on value and the quality of the advice provided. It is important that in considering the remuneration structures of advisers, recognition is given to the contribution the existing structures have made to facilitating access to advice.[58]

6.73 AFA also contended that perceived conflicts of interest are 'evident in both remuneration structures'.[59] Similarly, Axiom Wealth indicated that a pure fee-for-service model would discourage people from seeking advice, fearing their adviser would simply maximise the time they spend on the client. They cited practices in the accounting, legal and medical professions as examples of over-servicing encouraged by fee-for-service remuneration.[60] Financial planner Mr Dean Glyn-Evans explained some of the practical problems with fee-for-service:

> You run the risk of ending up in the unenviable position of many accounting and legal practices today. They have to regularly increase their fees to help cover the interest charged on the bank overdraft they are forced to take out in order to keep their business afloat, until clients eventually get around to paying their fees. This is not smart business and I am afraid that

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56 Guardian Financial Planning, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 88.

57 ING Australia, *Submission 383*, p. 5.

58 AFA, *Submission 344*, p. 8.

59 AFA, *Submission 344*, p. 9.

60 Axiom Wealth, *Submission 394*, p. 7.

> many financial planners who resort to fee-only advice, will eventually find themselves in a similar black hole.[61]

6.74 He also suggested that over-servicing would occur, mainly through frequent and unnecessary reviews of client portfolios.[62]

6.75 Alternatively, Mr Robert Brown acknowledged the problem of over-servicing, but considered it preferable to the alternatives:

> Some accountants and lawyers do pad timesheets, proving that conflicts of interest exist in all commercial transactions. The trouble with conventional financial planning is that complex and confusing conflicts exist on several levels, not just one. While time-related charging has its problems, at least the client is assured that the adviser is selling advice, not products, and that a third party is not in the mix influencing the outcome.[63]

6.76 The Institute of Actuaries of Australia also rejected complaints about expensive commission-free advice:

> ...the whole issue around those who are less affluent is a bit of a furphy. Who are we talking about for starters? We are talking about 90 per cent of people whose best investment advice is to pay off the mortgage or put money into super—none of which would give any sort of commission or trail to an adviser. So we are talking about that 10 per cent who are left—in which case they are more sophisticated and in which case people should know how much they are paying for advice. Advice is expensive. For a financial planner the hourly rates might look high, because there are overheads, research and that sort of thing. But I think people have to see what that advice is. The profession has to stand on its own two feet. People need to understand that this is the cost of that advice.[64]

6.77 They added that:

> Long term it is highly unlikely it would cost them more upfront. Asset fees are insidious. As actuaries we live on compound interest. If you look at the effect of a small asset fee on an asset over a long period of time then you will see that it is an enormous amount of money. Once it is in an investment there is a certain inertia and it will stay there. People will not know how much they are paying. It is an insidious way of pulling out fees.[65]

61 Mr Dean Glyn-Evans, *Submission 384*, p. 3.

62 Mr Dean Glyn-Evans, *Submission 384*, p. 4.

63 Mr Robert Brown, *Submission 342*, p. 5.

64 Institute of Actuaries of Australia, *Official Committee Hansard*, Canberra, 28 August 2009, p. 84.

65 Institute of Actuaries of Australia, *Official Committee Hansard*, Canberra, 28 August 2009, p. 85.

6.78 CHOICE acknowledged that up-front fees might discourage consumers, but stated that this problem could be overcome:

> [We] simply do not accept that the overall cost of advice will go up if we move to a fee-for-service arrangement. That does not mean that there is not this sort of 'money illusion' to overcome—this sense that people do not want to pay big lump sums for advice up-front. Again, I think this is part of the structural change in the industry. Through this process we will be holding the hands of consumers as well as holding the hands of financial advisers. Just because you are charging, for example, a lump sum fee for advice does not mean that a customer is in effect paying that all in one hit. You could easily have an arrangement where the payment is made over a period of time, as happens in other industries quite regularly. So there is the issue of the total cost of the advice, which I simply do not accept would go up, and then there is the issue of how it would be paid. I think there are all sorts of ways to accommodate the needs of both consumers and advisers.[66]

6.79 ASIC also downplayed the effect on the cost of advice:

> The exact impact of the proposal is difficult to predict without further regulatory impact analysis. However, at this stage, ASIC considers that it would probably cause some consolidation within the advice industry but that it is unlikely to increase the actual cost of advice (as opposed to the perceived cost of advice).[67]

6.80 The affordability of advice for the looming influx of people retiring with substantial superannuation lump sump payments has been of concern. Treasury informed the committee that efforts have been made to improve access to limited, affordable advice for retirees:

> ...[the] move we made to allow superannuation trustees to offer limited advice is specifically designed to target those kinds of investors who are often also older investors. Suddenly at age 55 they find themselves with a lump of money which they need to invest somehow, and they may not be well equipped to make the relevant decisions. So through the working group we have given that relief to superannuation trustees to provide certain categories of advice easily and cheaply to these investors.[68]

6.81 Citing the expense of providing compliant full personal advice, MLC urged the government to 'examine limited advice models, beyond superannuation, in consultation with the industry'. They added:

> Further, MLC recommends greater regulatory clarity around limited advice models in order to better facilitate the provision of low cost, effective advice to customers for whom this is the best solution.[69]

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66 CHOICE, *Official Committee Hansard*, Sydney, 4 September 2009, p. 105.

67 ASIC, *Submission 378*, p. 54.

68 Treasury, *Official Committee Hansard*, Canberra, 28 August 2009, p. 22.

69 MLC, *Submission 346*, pp 31-32.

6.82 Finally, the committee received evidence about whether insurance products should be exempted from any ban on commissions (and other additional regulatory obligations), on the basis that insurance products are not responsible for catastrophic investor losses. National Insurance Brokers Association of Australia suggested that regulatory changes should not apply to their industry:

> Insurance brokers have a good track record in relation to regulatory compliance and there is little evidence of consumers being adversely affected by insurance broker negligence, poor advice, fraud or bankruptcy. Insurance broker effectiveness is evident by the relatively few claims that are considered by their external dispute resolution (EDR) scheme IBD Limited (which became part of Financial Ombudsman Service, FOS, on 1 January 2009) and from the size of those claims.[70]

6.83 AFA also argued that life insurance should be excluded:

> One of the unique aspect's of Life Insurance is that it is not guaranteed that every person will be offered cover under the policy of their choice, if at all. Under non-commission based arrangements, the customer would be required to pay a significant upfront fee to the adviser for advice on their insurance. If the customer was subsequently declined cover by the insurance company, they would have incurred significant expense and arguably received no benefit in that they were declined cover. This is clearly an undesirable outcome for both the consumer and for the advice industry.
>
> The substantial increase in up-front costs that would result if commissions were prohibited will result in considerably less insurance being sold through advisers and a significant reduction in the number of people receiving advice on their insurance needs. The result will be a widening of the already significant protection gap in Australia.[71]

6.84 This argument was rejected by Quantum Financial Services:

> Historically insurance products have been sold via the commission model and many financial planning practices and insurance broking business are dependent on the continual flow of commissions to sustain the value of their businesses.
>
> In our opinion, this is not sufficient reason to exclude insurance products as supposedly a special case.
>
> We frequently hear the excuse that Australians are 'underinsured' as the reason for insurance products to be excluded for any proposed industry changes. We do not accept this argument. Insurance is a product like any other – it is subject to the same forces of demand and supply.[72]

70 National Insurance Brokers Association of Australia, *Submission 314*, p. 2.

71 AFA, *Submission 344*, pp 8-9.

72 Quantum Financial Services, *Submission 56*, p. 15.

Consumer choice and asset-based fees

6.85 Other recommendations made during the inquiry sought to balance these considerations by proposing payment structures that are affordable, while also meeting the objective of being explicitly set and agreed to between client and adviser. FPA told the committee that it is guided by the principle that clients should control the fees they pay for advice:

> ...payment for advice should come from the client and that that is the most important thing you could possibly do, and not only that payment must come from the client, that it must be aligned with a service and you should be able to switch that payment off if you are no longer getting that service. We have moved the debate to direct negotiation between client and adviser, which is where all our efforts are focused.[73]

6.86 A number of submitters indicated that asset-based fees could enable this. FPA commented:

> The reason we wish to preserve the role of an asset based fee, so long as it meets the premise that the client pays for it, the client negotiates, it is fully transparent and so forth, is that we are very concerned that middle Australia, the large bulk of the population who could very well do with advice or want advice, will not be able to afford advice if it is purely delivered on an hourly basis ... We need some flexibility for people to choose how they pay for the advice and to choose how they can access that advice and therefore be able to afford advice.

6.87 They added:

> ...if we are forced into an hourly basis, as in the legal and accounting professions, which are different from financial planning in terms of the work transacted, then indeed we will find it very difficult to deliver that advice to a vast number of Australians who will be priced entirely out of the market.[74]

6.88 MLC explained to the committee that there is a clear difference between a fee agreed to by the client and a commission built in to the investment product:

> The client can simply decide to stop paying the fee. They can contact the institution and the fee will stop being paid, whereas the only way to stop the commission being paid in many products is to remove yourself from the product altogether.
>
> With a one per cent fee and a one per cent commission people say to me that it is just a commission by another term. It is not, because the one per cent fee is agreed, but the one per cent commission is not necessarily. The one per cent fee is seen by the client, but the one per cent commission is not necessarily. The one per cent fee can be stopped by the client, but the

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73 FPA, *Official Committee Hansard*, Canberra, 28 August 2009, p. 31.

74 FPA, *Official Committee Hansard*, Canberra, 28 August 2009, pp 31-32.

> commission cannot necessarily; and if the relationships falls away the fees stop as well, which is not the case with the commission. It is actually putting the client in much more control.[75]

6.89 Axiom Wealth also favoured this method:

> Where a client has chosen to have an on-going advice relationship with a planner, we believe advice fees based on funds under management (FUM) represent the most equitable arrangements for clients and advisers. We would argue that fees charged on this basis provide the best alignment of client and adviser interests, and remunerate adviser "proactivity" – which clients rate as a highly valued service.[76]

6.90 They added that FUM-based fees can be terminated 'without upsetting any of the underlying investment arrangements that might be in place'.[77]

6.91 However, ASIC did not support this approach:

> Remuneration based on the amount of funds under advice can also create conflicts of interest. Advisers who are remunerated by reference to funds under advice have an interest in selling investment products to their clients and encouraging their clients to borrow to invest.[78]

6.92 CHOICE did not support the argument for asset-based fees either:

> The problem with any asset based charge is that it carries the same taint of conflict as commissions. There are incentives on advisers to favour strategies that involve debt in gearing to build assets that generate fees for advisers. If the industry transitions from asset based commissions to asset based fees, the disclosure may be better and consumers should have the ability to turn off those fees, but the market distortions arising from asset based charges will remain.[79]

6.93 Mr Robert Brown also described the potential problems created by asset-based fees:

> Asset-based percentage fees for service remove the temptation to sell high commission products, but they still require a planner to sell a product or accumulate funds under management (whether or not the client needs this). In addition, asset-based fees for service give the appearance of independence, without actually being so. Therefore, in some circumstances they can be more dangerous than commissions, and can even can lead to the

75 MLC, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 11.

76 Axiom Wealth, *Submission 394*, p. 3.

77 Axiom Wealth, *Submission 394*, p. 7.

78 ASIC, *Submission 378*, p. 50.

79 CHOICE, *Official Committee Hansard*, Sydney, 4 September 2009, pp 98-99.

derivation of higher levels of remuneration than would be possible via a commission model.[80]

6.94 Q Invest considered it inequitable:

> We do not consider it appropriate for financial planners to base their remuneration on a percentage of assets as this necessarily results in different clients being charged differently for substantially the same level of service. This inequitable practice dilutes the value of advice by perpetuating the notion that financial planners are product distributors and it should be avoided.[81]

6.95 Industry Super Network also opposed asset-based fees, stating that conflicts of interest remain and such fees still encourage product sales ahead of strategic advice. They suggested that they would only be appropriate in the following circumstances:

> Where the client and adviser agree on an asset based fee, this must be agreed and approved by the client at least annually. ISN proposes that clients should opt-in, on an annual basis and in writing, to receive and pay for financial advice. This is typical in client-professional adviser relationships and ensures that consumers are only paying for advice that they desire and receive.
>
> Therefore, while a product provider can facilitate payment of the advice fee directly from the client's account; this must be based on a written authority from the client, with an annual renewal.[82]

Tax deductibility

6.96 There was also considerable support for fee-for-service advice payments to be made tax deductible. The committee heard that this would not only make this form of remuneration more affordable, but would provide equitable treatment to that applying to commission payments, which may be claimed as a business deduction presently. ICAA stated:

> ...it will introduce consistency and equity. In some cases the commission and the commission payments are actually deductible. You have a conflict there between deductibility of a commission remuneration versus fee for service. Also, from an administrative perspective, if you have a fee-for-service model then if I am providing advice I need to, as currently, put down the advice that I am actually providing and see what is tax advice and what is not tax advice and then I develop my invoice. So you have got some administrative issues there in terms of delivery of the service and, again, that adds to the costs associated with it.[83]

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80 Mr Robert Brown, *Submission 342*, p. 4.

81 Q Invest, *Submission 374*, p. iv.

82 Industry Super Network, *Submission 380*, p. 18.

83 ICAA, *Official Committee Hansard*, Sydney, 4 September 2009, p. 6.

6.97 BFPPG commented:

> In the continuing argument about commissions v fees it makes little sense for an upfront commission paid to a financial planner to be tax deductible to the product manufacturer but an upfront fee paid to a financial planner not to be tax deductible to the client.[84]

6.98 Q Invest supported the proposal:

> There is a clear public policy benefit to be gained by encouraging consumers to seek professional advice to prudently plan their financial future – and financial independence. Secondly, many remuneration structures which operate on a commission model effectively enable a tax deduction to be claimed for the commission payment, thereby providing an incentive to pursue the type of remuneration model associated with some of the recent collapses.[85]

6.99 The committee also heard support for this proposal from CHOICE, Axiom Wealth, AXA, Industry Super Network, Strategy First Financial Planning and MLC.[86]

Committee view

6.100 The committee notes that remuneration structures that are incompatible with a financial adviser's proposed fiduciary duty (Recommendation 1) should be removed. The committee acknowledges that some in the industry have already indicated a willingness to move away from commission-based remuneration practices. The committee welcomes this and recommends that government consult with and support industry in effecting this transition.

Recommendation 4

6.101 The committee recommends that government consult with and support industry in developing the most appropriate mechanism by which to cease payments from financial product manufacturers to financial advisers.

6.102 The committee is of the view that the proposal to make the cost of financial advice tax deductible for consumers has merit. It could potentially encourage more people to seek financial advice and would match the deductibility presently afforded to manufacturers paying commissions to advisory firms. However, the committee also recognises that tax deductions could represent a subsidy for financial advisers, with the market willing to bear higher costs knowing that a proportion will be returned at the end of the financial year. Nonetheless, the committee recommends that the

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84 BFPPG, *Submission 251*, p. 17.

85 Q Invest, *Submission 374*, p. ix.

86 CHOICE, *Official Committee Hansard*, Sydney, 4 September 2009, p. 110; Axiom Wealth, *Submission 394*, p. 3; AXA, *Submission 385*, p. 12; Industry Super Network, *Submission 380*, p. 15; Strategy First Financial Planning, *Submission 178*, p. 14; MLC, *Submission 346*, pp 33-34.

government consider the implications of this proposal as part of its response to the Treasury review (the Henry review) into the tax system.

Recommendation 5

6.103 The committee recommends that the government consider the implications of making the cost of financial advice tax deductible for consumers as part of its response to the Treasury review into the tax system.

Licensing

6.104 The committee received a number of suggestions to vary the current licensing arrangements for financial advisers. They included:

- more clearly conveying the conflicts and competencies of advisers through separate licensing arrangements;
- raising industry standards by increasing competency requirements, particularly the minimum educational qualifications for advisers;
- increasing licensees' capital adequacy requirements;
- licensing individual planners;
- introducing an industry-based professional standards body to establish, monitor and enforce standards for financial advisers; and
- enabling accountants to provide some limited advisory services restricted to licensees.

Separate licence categories

6.105 Recommendations for separate licence categories depending on the characteristics of the advisory business are closely related to proposals for a dual standard of advice discussed earlier at paragraph 6.11. The basis for this idea is that there would be one category of licensee where advisers working under that licence identify themselves as a product salesman if they receive payments from product manufacturers, and a higher category for those providing independent advice free from such a conflict of interest. The licence category would more transparently convey to consumers the nature of the advice they are receiving.

6.106 Suggesting that removing product alignment from the financial planning industry is impractical in the immediate term, Strategy First Financial Planning proposed that a clear distinction be created between 'financial product advisers' and 'financial advisers', accompanied by a public education campaign.[87]

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87 Strategy First Financial Planning, *Submission 178*, pp 8-9.

6.107 MLC provided a specific legislative proposal for the committee's consideration. They recommended that the regulatory regime provide for two separate models for financial advisory firms, either 'affiliated' or 'independent'. These would be 'categorised to reflect their operating structure and providing a meaningful descriptor for investors'. Individual advisers would also be required to identify as an 'affiliated financial planner' or 'independent financial planner'. These terms would be defined under the Corporations Act and regulated by ASIC.[88] In evidence to the committee MLC explained that under this model an 'independent' advisory firm and its authorised representatives would only be able to receive fees from clients. Those accepting payments from product manufacturers would be classed as 'affiliated'.[89]

6.108 MLC suggested that their suggested model could overcome the reason why many Australians do not seek financial advice:

> ...they find it difficult to understand the system and trust it. One of the reasons why they do not trust it is that there are confusing payments going on between different parts of the value chain, and it is hard for them to understand what influence that might have on the advice that they are getting. By clearly identifying the two different models the client can walk in the door with a NAB/MLC affiliated financial planner and they should not be surprised if they end up with some services from that group. It is also much easier to have the conversation: what does that mean; how does that impact on the advice that I am getting; am I happy with the advice that I am getting: I know that there is an association there. Right now the client has little chance of understanding the relationships that exist between the licensees, the advisers and the manufacturers in the current model.[90]

6.109 CPA Australia suggested that any distinction should occur on the basis that independent advisers may only be so-called if they have complete control over the products they can recommend, unrestricted by an approved product list determined by someone else.[91] However, CPA Australia speculated that independent advisers 'may very well become quite a niche market' and questioned whether they would provide affordable advice to the broader public.[92]

Raising competency standards

6.110 A considerable amount of evidence to the committee contended that the minimum training and qualifications for advisers should be raised, while many others warned about the increased costs for consumers if higher standards were to be imposed.

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88 MLC, *Submission 346*, p. 3.

89 MLC, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 7.

90 MLC, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 6.

91 CPA Australia, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 66.

92 CPA Australia, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 67.

6.111 ICAA advocated a minimum undergraduate degree level qualification including a practical and experience component.[93] MLC told the committee that new people entering the industry should be required to hold an undergraduate degree, with some financial planning qualification in addition to that.[94] Professional Investment Services suggested increasing both educational and training requirements:

> PIS supports increasing the minimum training and qualification requirements of those providing advice to include an undergraduate or postgraduate degree in a financial services related field, such as a Bachelor of Commerce or Business (financial planning) or Master of Financial Planning through tertiary education. Furthermore, a practical training and development year (akin to the practical legal training year completed by the legal profession or the professional year completed by chartered accountants) following tertiary education, involving continued training, mentoring and reflective supervision, during the first year of advising would also serve to increase professional competence and promote consumer confidence in the financial services industry.[95]

6.112 Argyle Lawyers recommended that mandatory ethics training be introduced for financial advisers, responsible managers and new entrants to the industry as part of ASIC's RG 146 requirements.[96]

6.113 There was some opposition to these proposals, though. Guardian Financial Planning argued that the current licensing arrangements already require that advisers be adequately qualified for their role:

> ...the legislation currently encourages a licensee ... to make sure that advisers are not authorised to advise on things that they are not competent to advise on, that their qualifications back that up and that their continuing professional development is targeted towards the competencies they need to discharge their duties to their client base. I would suggest most licensees probably operate in a very similar fashion, because the personal liability that one takes as being a responsible manager and an office holder of the licensee is fairly significant. I think most people take that very seriously.[97]

6.114 IFSA warned of restricting financial planner numbers when seeking to raise qualification standards:

> ...we need to take a view about appropriate transition periods to get there so that ... we do not compound this issue of availability of advisers in the market.[98]

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93 ICAA, *Submission 363*, p. 7.

94 MLC, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 13.

95 Professional Investment Services, *Submission 336*, p. 18.

96 Argyle Lawyers, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 108.

97 Guardian Financial Planning, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 91.

98 IFSA, *Official Committee Hansard*, Canberra, 28 August 2009, p. 56.

6.115 ICAA suggested that increasing educational standards for advisers would require a three to five year transition period.[99] Professional Investment Services contended that improved standards 'must be balanced against the existing regime', suggesting:

> Where the committee supports further education, it is recommended that the committee consult with the industry and industry bodies to assess the barriers, overall impact and benefit of increasing education requirements. This may require allowing for a 'grandfathering' process to promote smooth transition from the existing to the new regime.[100]

6.116 However, FPA challenged the notion that lifting standards would increase costs across the industry:

> From our point of view, our 9,000 practitioner members would probably meet all those requirements already. I am not sure that if you are talking about genuine financial planners you are asking them necessarily to increase their costs or commitments.[101]

6.117 IFSA also warned that:

> Any minimum entry level should not be set so high that it dramatically impacts on the cost of advice or the number of individuals that are able to provide financial advice – especially where the majority of advisers are trained to an appropriate level and operate within a robust structure that supports the advice they provide.[102]

6.118 Treasury told the committee that attaining the right balance between adequate training and affordable advice is difficult:

> ...we are hearing complaints that advice is too expensive, particularly for the mum and dad type investor with smaller amounts to invest and that for them it is too expensive getting access to advice. On the other hand, of course, we want to ensure that advisers are properly trained and know what they are talking about. That is the fundamental bind we, the policy and the law, are caught in here: striking that balance between making advice affordable and on the other hand ensuring that the advice is competent.[103]

6.119 ASIC informed the committee that they are reviewing RG146, 'with a view to improving training standards and will put forward proposals for change in consultation with industry and stakeholders'.[104] In evidence ASIC also indicated that

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99 ICAA, *Official Committee Hansard*, Sydney, 4 September 2009, p. 12.

100 Professional Investment Services, *Submission 336*, p. 18.

101 FPA, *Official Committee Hansard*, Canberra, 28 August 2009, p. 35.

102 IFSA, *Submission 317*, pp 33-34.

103 Treasury, *Official Committee Hansard*, Canberra, 28 August 2009, p. 11.

104 ASIC, *Submission 378*, p. 42.

there would need to be consultation with the industry about how the transition to higher standards could be managed, particularly for existing advisers.[105]

6.120 At the licensee level, IFSA recommended that change should be considered:

> Given the nature of some of the product and service provider collapses which have occurred, IFSA believes that it may be appropriate for ASIC to consider enhancing the financial services licensing process to ensure that Licensees and their Authorised Representatives are appropriately resourced and sufficiently competent to offer the range of financial services and products for which they have, or wish to obtain, a licence.[106]

6.121 AXA claimed that it was too easy for AFSL applicants to demonstrate that they can meet their obligations, without necessarily having the skills or resources to do so. They recommended:

> The process for obtaining an AFSL should be enhanced to require applicants to provide further detail and commitments regarding the establishment of governance processes and the systems and resources necessary to meet its responsibilities as a registered licensee.[107]

6.122 AXA also suggested that responsible managers be given greater authority and be held accountable for failures of the licensee to meet its obligations.[108]

6.123 ASIC recommended that legislative changes be considered to empower ASIC to deny an application, or suspend or cancel a licence, where there is a reasonable belief that the licensee 'may not comply' with their obligations in the future. This is a lower threshold than the current 'will not comply' and would allow ASIC to take a more proactive approach to prevent likely breaches of licence conditions before they occur.[109]

Capital adequacy requirements

6.124 Another proposal for protecting investors is to raise capital adequacy requirements for licensees. In their submission MLC indicated that adequate capital backing is the best protection for consumers where compensation is being sought for 'inappropriate adviser activity'.[110] AMP recommended that financial requirements be increased:

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105 ASIC, *Official Committee Hansard*, Canberra, 16 September 2009, p. 18.

106 IFSA, *Submission 317*, p. 14.

107 AXA, *Submission 385*, pp 20-21.

108 AXA, *Submission 385*, p. 21.

109 ASIC, *Submission 378*, pp 30-31. See sections 913B and 915C of the Corporations Act.

110 MLC, *Submission 346*, p. 3 and p. 16.

If all licensed entities were required to maintain a minimum level of Net Tangible Assets, a greater level of security could be achieved for all consumers.[111]

6.125 AXA supported increased capital adequacy requirements:

The Government and ASIC should consult with the industry to identify a more appropriate level of capital adequacy for licensees which would afford greater comfort that the risk management, compliance, and adviser training and supervision functions are fully resourced to the standard necessary to meet these enhanced obligations.

AXA considers the current capital adequacy requirements are too low, resulting in some licensees not having access to adequate resources to be able to discharge their duties.[112]

6.126 BFPPG argued against this proposal:

The way capital is employed is far more important than the size of the capital and we all know from experience that those with lesser capital tend to be better at managing their capital and spending their money. There is not much point in having sufficient capital to take clients on a Mediterranean cruise when, a short time later, the business collapses and those clients lose their wealth.[113]

6.127 ASIC told the committee that it is exploring options for reform, though they may be limited:

...ASIC is currently reviewing the financial resource requirements for non-APRA regulated AFS licensees, with a view to improving investor and systemic protection. However, ASIC is not a prudential regulator and ASIC is not able to set prudential requirements for AFS licensees. This will limit the type and nature of the financial resource requirements we can impose. At this stage of the project, it is too early to tell whether this limitation will prevent ASIC imposing appropriately rigorous resource requirements on some or all AFS licensees.[114]

6.128 In its previous inquiry into agribusiness MIS, the committee received evidence that prudential oversight of these schemes was needed to ensure they held sufficient working capital to meet existing commitments, without relying on new sales for that purpose. ASIC noted that the committee may consider extending prudential regulation to these entities, while Macquarie Agricultural Funds Management

111 AMP, *Submission 367*, p. 10.

112 AXA, *Submission 385*, p. 22.

113 BFPPG, *Submission 251*, p. 13.

114 ASIC, *Submission 378*, p. 30.

suggested that licensees be required to demonstrate they can meet current obligations without relying on new sales, as part of their licence conditions.[115]

6.129 The committee noted in its agribusiness MIS inquiry report that it would reserve recommended legislative changes until it had considered the product safety issues relevant to this inquiry.[116] The committee makes a recommendation in relation to agribusiness MIS at paragraph 6.154.

Licensing individual planners

6.130 One area of concern raised during the inquiry was the effectiveness of licensees being responsible for the actions of their authorised representatives. The committee heard that deficiencies in the oversight of individuals' conduct could be overcome via individual licensing for financial advisers.

6.131 Financial adviser Mr Benjamin Hancock expressed firm views on this issue:

> I believe that the legislative framework whereby financial advisers are nothing but representatives of corporate licensees impedes the elevation of the profession beyond that of the insurance salesmen of old.
>
> This is true regardless of the morality and ethical awareness of the financial advisers operating within this system, where the licencee itself sets the parameters and entrenches bias into the practices of their representatives.
>
> As with the accounting industry, I strongly believe that financial advisers should be individually licensed in much the same way as the Tax Agents' Board registers those accountants adequately qualified and experienced to act in that capacity.[117]

6.132 He noted that this arrangement would leave financial advisers responsible for their own ethical behaviour.[118]

6.133 Mr Ian Bailey also supported licensing individuals, stating that it would compel a more professional approach from advisers needing to demonstrate they are a suitable risk for PI insurers.[119] Mr Bruce Baker told the committee that individual licensing would provide a higher prevalence of 'real financial advisers'.[120]

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115 Joint Parliamentary Committee on Corporations and Financial Services, *Inquiry into aspects of agribusiness managed investment schemes*, September 2009, p. 38.

116 Joint Parliamentary Committee on Corporations and Financial Services, *Inquiry into aspects of agribusiness managed investment schemes*, September 2009, p. 47.

117 Mr Benjamin Hancock, *Submission 308*, p. 3.

118 Mr Benjamin Hancock, *Submission 308*, p. 3.

119 Mr Ian Bailey, *Submission 112*, p. 3.

120 Mr Bruce Baker, *Supplementary Submission 15g*, p. 8.

6.134 FOS was of the view that individual licensing would not represent good value for money:

> That is a huge undertaking and I wonder whether that would have significant benefits. You might be better off putting the resources somewhere else, because you can set up licences until the cows come home. Maybe putting the resources into being able to follow up more of the issues they identify through their information that comes into them, and also it might be cheaper for you to put the resources into something like a last resort compensation scheme and say, 'We're going to do the best we can on licensing. Most of the time it works pretty well, but when someone falls through all the cracks there will be a bit of a safety net there at the bottom.'[121]

6.135 Argyle Lawyers also noted that 'individual licensing of each and every financial adviser in Australia is impractical'.[122]

6.136 Instead of focussing on licensing all advisers, ASIC proposed that it be given extended powers to take action against individuals they deem to be operating at or near the fringes of the industry. ASIC sought the following 'negative licensing' powers:

> ASIC believes the Government should consider the merits of enhancing ASIC's power to act against individuals by amending the banning power in s920A as follows:
>
> (a) clarify that ASIC is able to ban an individual (after a hearing) where a person is 'involved' in a contravention of a financial services law by another person i.e. its authorising licensee or another person;
>
> (b) enable ASIC to ban an individual (after a hearing) where ASIC has reason to believe that the person is not a 'fit and proper' person to engage in financial services; and
>
> (c) replace the existing grounds for banning a person where ASIC has reason to believe that the person 'will not comply' with s 912A or a financial services law with the slightly lower standard of 'may not comply' or 'is likely not to comply'.[123]

6.137 Securities and Derivatives Industry Association argued that 'bad apples' reporting should be facilitated to protect both consumers and licensees:

> Unlike other countries, like the US and the UK, Australia has no proper regime for the reporting of misconduct by individuals on leaving a firm so that future employees and consumers can be protected from these individuals. SDIA has for years advocated a system of compulsory

121 FOS, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 33.

122 Argyle Lawyers, *Submission 322*, p. 8.

123 ASIC, *Submission 378*, p. 31.

> reporting of specified matters on termination and the protection for licensees in making and having access to those reports.[124]

Professional Standards Board

6.138 A more widely held view was that improved accountability for licensees could be achieved via the establishment of an industry-based professional standards body, also frequently referred to in evidence as a professional standards board (PSB). This entity would share responsibility with ASIC for establishing, monitoring and enforcing competency and conduct standards for financial advisers. Such an arrangement could also enable the use of terms such as 'financial adviser' and 'financial planner' to be restricted to those qualifying as members and prepared to comply with the conditions imposed by the PSB.

6.139 Tying a number of aspects of the debate together, FPA recommended that financial planners be defined in legislation and subject to higher standards through licence and professional oversight:

> We believe that the term ‘financial planner’ or ‘financial adviser’—they are interchangeable—should be defined. There should be a fiduciary responsibility attached to that person. There should be a competency level that is higher than Regulatory Guide 146 attached to that person. And there should be a professional obligation attached to that person through membership of a professional body—in other words, they have to meet with requirements over and above the law.[125]

6.140 Australasian Compliance Institute proposed that individual advisers be supervised by a professional body, or bodies, approved by ASIC. They suggested that these bodies be given following responsibilities:

- Maintenance of a register of advisers including details of qualifications and disciplinary actions taken against them by the professional body.
- Setting (with ASIC input) the standards for qualifications, skills and knowledge for advisers with the possibility of the establishment of “tiers” of skills/knowledge that correlated to levels of complexity and risk in financial products they are permitted to advise on.
- Supervision of training diaries/records.
- Requirement for adherence to a “Code of Conduct” with appropriate powers of disciplinary actions against advisers including those that may preclude them being able to continue to give advice.

124 SDIA, *Official Committee Hansard*, Canberra, 28 August 2009, pp 61-62.

125 FPA, *Official Committee Hansard*, Canberra, 28 August 2009, p. 34.

- Accrediting.[126]

6.141 AXA also advocated the benefits of such oversight:

> Professional bodies exist in financial services, but membership by licensees and advisers is not mandated. This could hamper the evolution of the industry towards becoming a profession, with more uniform standards and codes of conduct which would benefit consumers by improving the quality and consistency of financial advice. AXA submits that the current environment would be enhanced by requiring licensees to adopt a common framework on issues which go to the heart of professionalism, and by requiring advisers to belong to a recognised professional body.[127]

6.142 ING Australia also argued that a professional standards body was the appropriate mechanism for improving competence and standards in the industry:

> We believe that current adviser training requirements are too low and that standards could be raised via the establishment of a professional financial advice body recognised by the government. While the terms and conditions of membership would be a matter for the professional body, it should ensure that advisers are properly accredited and their professional standards monitored and elevated on an ongoing basis...
>
> Significantly, such a professional body would be empowered to expel members who do not meet its benchmarks for competence and code of conduct. Moreover, only planners that are members of the professional body should be able to call themselves a "financial adviser" or a "financial planner".[128]

6.143 BFPPG suggested that only members of a professional standards board be permitted to call themselves financial planners.[129] They argued that a professional standards board would provide more effective oversight than ASIC:

> The PSB would be more capable of managing the quality of advice and the standards of the profession than ASIC or such other organisation that can only administer the law. A professional body is not restricted to enforcing the law but can act in advance of problems whether they involve "legal" behaviour or not. A PSB can also receive intelligence from its members, develop meaningful standards, counsel members and use the threat of expulsion if members are in a position where they may bring the profession into disrepute.[130]

126 ACI, *Submission 397*, p. 3.

127 AXA, *Submission 385*, p. 16.

128 ING Australia, *Submission 383*, p. 6.

129 BFPPG, *Submission 251*, p. 21.

130 BFPPG, *Submission 251*, p. 19.

6.144 Quantum Financial Services recommended that an independent PSB be established 'to oversee the development of professional standards and act as a guardian of the public interest'.[131] It would introduce a compulsory code of ethics and only members would be permitted to call themselves 'financial adviser' or 'financial planner'.[132]

6.145 Mr Bruce Baker proposed two professional standards bodies:

> There is probably merit in having a Professional Standards Board for product sales people and a Professional Standards Board for independent advice providers, in recognition that these are two very different roles AND to help minimise the risk of the Professional Standards Board for independent advice providers becoming a captive of product providers.[133]

6.146 Treasury suggested that a professional standards body may have merit, subject to its relationship with ASIC:

> ...a major consideration we would have to take into account is how it would work in conjunction with the role of ASIC. You could see an overlay in roles; you could see confusion for industry and investors; and obviously it would occur additional costs. You also have to ask yourself: do you put it within ASIC or do you have it as a separate body, which means that ASIC and the body have to work closely together to try to avoid duplication? The fundamental question [is] are the additional costs of that warranted; will it particularly address the issues that are being raised?[134]

6.147 Officers also stated that such a body would need to build acceptance:

> ...any new organisation will have to build that confidence. They will not necessarily have the confidence from day one, and there is always a question mark as to whether they will build it. It depends on whether the industry, consumers and investors actually accept what they come up with.[135]

Accountants

6.148 Evidence to the inquiry also included a proposal to provide a licensing exemption for accountants providing limited advice. The Accounting Professional and Ethical Standards Board suggested that unlicensed accountants be able to provide 'incidental investment advice' to their clients as part of their broader service, in order

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131 Quantum Financial Services, *Submission 56*, p. 32.

132 Quantum Financial Services, *Submission 56*, p. 21 and p. 32.

133 Mr Bruce Baker, *Submission 15*, p. 6.

134 Treasury, *Official Committee Hansard*, Canberra, 28 August 2009, p. 17.

135 Treasury, *Official Committee Hansard*, Canberra, 28 August 2009, p. 17.

to 'break the grip of the product providers over the financial services industry'.[136] They indicated that the current restrictions applying to accountants are impractical:

> ...accountants have drilled into them that you cannot give investment advice otherwise you have no PI cover or anything else, particularly at the lower level. Certainly when you get into a more trusted adviser relationship I think a lot of people end up giving advice even though they are not supposed to. It is very hard to have a relationship with someone for 30 years where you know more about their affairs than they do and then tell them, 'Sorry, I can't give you advice on that.' Effectively a lot of advice gets given.[137]

Committee view

6.149 The committee does not support creating separate licensing categories to distinguish between advisers operating in a sales capacity or those offering 'independent' advice. This would create an added layer of complexity to the licensing system, would require an extensive public education campaign, and would potentially be confusing. The committee is of the view that bringing additional professionalism and transparency to the industry can be achieved more effectively through alternative recommendations contained in this report.

6.150 The committee is also of the view that licensing individual planners would be far too costly to justify any regulatory improvements that may result. However, the committee supports ASIC's recommendation (outlined at paragraph 6.136) that it be easier for the regulator to ban individuals operating at the fringes of the financial services industry, by bolstering ASIC's banning powers under section 920A of the Corporations Act.

Recommendation 6

6.151 The committee recommends that section 920A of the Corporations Act be amended to provide extended powers for ASIC to ban individuals from the financial services industry.

6.152 With regard to capital adequacy requirements, the committee is unconvinced that increased capital adequacy requirements for licensees would be of overall benefit to consumers. Although there may be some consumer protection advantages, with large entities potentially having better capacity to discharge their licensing duties and meet any compensation claims, any consolidation of the industry away from smaller boutique advisory firms would not necessarily be in consumers' interests. Further, ASIC is not a prudential regulator and the committee does not consider that the cost of AFSL holders being brought under APRA's regulatory jurisdiction is warranted.

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136 Accounting Professional and Ethical Standards Board, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 73.

137 Accounting Professional and Ethical Standards Board, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 77.

6.153 The committee also noted that it would discuss any need for additional capital adequacy oversight of agribusiness MIS in this report, having wanted to see if similar product safety issues emerged during this inquiry that might influence the committee's recommendation. Ultimately, the committee has concluded that improving the regulation of financial advice in relation to financial products is more effective than regulators attempting to ensure, through additional regulation, that products are 'safe' for investors. Notwithstanding this and the fact that ASIC is not a prudential regulator, the committee is of the view that the unique nature of agribusiness MIS warrant some regulatory intervention to ensure that these schemes do not, over time, develop a ponzi-like character by relying on new product sales to prop up existing schemes. Accordingly, the committee recommends that, as part of their licence conditions, ASIC require agribusiness MIS licensees to demonstrate they have sufficient working capital to meet current obligations.

Recommendation 7

6.154 The committee recommends that, as part of their licence conditions, ASIC require agribusiness MIS licensees to demonstrate they have sufficient working capital to meet current obligations.

6.155 A licensing exemption for accountants was also raised with the committee. While the committee understands that there are grey areas for accountants when interpreting and complying with the financial services carve-out, which limits the nature of the advice they are able to provide clients, the committee is of the view that accountants wishing to provide financial product advice as defined under the Corporations Act should obtain an AFSL to do so.

6.156 The committee recognises extensive support throughout this inquiry for increasing the minimum training and qualification standards for financial advisers, but also acknowledges that such a measure would potentially have implications for the cost of advice, and would need to overcome difficult transition issues with respect of people already established in the industry. The committee supports ASIC's consultation with industry over the most sensible way to raise training and qualification standards set by Regulatory Guide 146, in conjunction with the committee's recommendation on a professional standards board at paragraph 6.160. With respect to licensee standards, the committee also supports ASIC's recommendation that it be able to deny an application, or suspend or cancel a licence, where there is a reasonable belief that the licensee 'may not comply' with their obligations in the future, rather than the current legislative standard of 'will not comply'. The committee is of the view that this is an important measure to allow ASIC to be more proactive in preventing likely breaches of licence conditions before they occur.

Recommendation 8

6.157 The committee recommends that sections 913B and 915C of the Corporations Act be amended to allow ASIC to deny an application, or suspend

or cancel a licence, where there is a reasonable belief that the licensee 'may not comply' with their obligations under the licence.

6.158 Finally, the committee is of the opinion that a professional standards board (PSB) overseeing conduct standards for financial advisers should be established. This reform would increase professionalism within the industry by ensuring that those wishing to call themselves 'financial advisers' or 'financial planners' would be required to obtain PSB membership and adhere to its standards. An industry-based, independent PSB, working in conjunction with ASIC, would establish, monitor and enforce competency and conduct standards amongst members and have the power to sanction or remove those who do not comply. The committee considers that such an entity would be more effective at identifying and addressing problems early, receiving better intelligence at industry level and not being constrained by meeting high legislative thresholds before taking action.

6.159 ASIC would need to work in conjunction with a PSB to avoid duplication and overlap of their respective oversight functions.

Recommendation 9

6.160 The committee recommends that ASIC immediately begin consultation with the financial services industry on the establishment of an independent, industry-based professional standards board to oversee nomenclature, and competency and conduct standards for financial advisers.

Lending practices

6.161 The committee's examination of the Storm Financial and Opes Prime collapses raised a number of issues concerning the lending practices of some institutions, particularly margin lending and securities lending for unsophisticated retail investors. The previous chapter noted a lack of regulatory control over margin lending and loose practices by some lending institutions.

6.162 In June 2009 the government introduced a bill into parliament to amend the Corporations Act so that margin loans are regulated as financial products under the Act.[138] The bill was passed by the parliament on 26 October 2009. Accordingly, anyone providing or advising on margin loans will be required to be licensed to do so, either by applying for an AFSL or varying their existing one. The bill also introduced certain additional obligations on margin lenders. One is a responsible lending requirement:

> A new responsible lending requirement that applies specifically to margin loan lenders is imposed seeking to ensure that clients are not given loans which they are unable to service. Lenders will be required to assess whether a proposed loan is unsuitable for the client, such that in the event of a

138 Corporations Legislation Amendment (Financial Services Modernisation) Bill 2009. The amendments cover both standard margin loans and securities lending agreements.

> margin call the client would not be able to service the loan or would only be able to do so with substantial hardship. If a loan is assessed as unsuitable, it must not be provided to the client.[139]

6.163 The amendments also require margin call arrangements to be clarified, stipulating that 'lenders must notify clients when a margin call is made, unless clients explicitly agree to notifications being provided through their planner'.[140]

6.164 In their submission to the inquiry ASIC commented that margin lenders will be able to rely on information about borrowers' suitability that has been passed on from financial advisers.[141] CBA also raised concerns about the provision relating to the clarification of margin calls, suggesting that the amendments should simply have required lenders to directly notify borrowers of margin calls in all instances.[142]

Committee view

6.165 The government's margin lending reforms, in conjunction with a fiduciary duty for financial advisers and improved enforcement by ASIC, will assist in minimising the types of conduct that led to the catastrophic investment losses examined during this inquiry. The committee does acknowledge, though, that further improvements may be required should problems arise from the continuing role of financial adviser intermediaries in the margin lending process. Of particular concern is their role in passing on information about borrowers to the relevant lending institution, as well as being able to be granted responsibility by clients for informing them of margin calls on behalf of the lender. The committee expects the government to pursue necessary further amendments should these issues remain problematic.

Product limitation

6.166 Rather than bolstering the conduct and disclosure requirements for the provision of risky investment products such as margin loans, a contrary view was that they should not be available at all to unsophisticated investors. For example, Mr Peter Worcester of Worcester Consulting Group told the committee that margin loans are unsuitable for retail clients. He said:

> ...margin lending is the last resort when all else fails because it is the dumbest thing to do. It is the dumbest thing to do. Why? It is a high interest rate with no long-term horizon that you can control, for not necessarily the

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139 Corporations Legislation Amendment (Financial Services Modernisation) Bill 2009, *Explanatory Memorandum*, p. 14.

140 Corporations Legislation Amendment (Financial Services Modernisation) Bill 2009, *Explanatory Memorandum*, p. 14.

141 ASIC, *Submission 378*, p. 92.

142 CBA, *Proof Committee Hansard*, Canberra, 28 October 2009, p. 45.

> appropriate level of diversification. It is the last resort of good advice. It is certainly where you get the maximum amount of commission, though.[143]

6.167 The Institute of Actuaries in Australia indicated that some limitations should be considered:

> ...there are certain products that are complex, that are very difficult to communicate and that have certain risks in them that are outside the norm. One of the learnings out of this last period is that we need to think very carefully about which of those products should and should not be used and in what circumstances.[144]

6.168 The Commercial Law Association of Australia made the following comment:

> It may well be that some products should not be available to retail products no matter what the disclosure and advice given. We note that ASIC has indicated that it is considering whether the sale of some managed investment schemes should be restricted. We would support the examination of products generally to consider whether there are any which should be placed in a restricted sale category. We do however see the need to reconcile the requirement that ASIC be a registration body only on the one hand, with the concept that it be a 'gatekeeper' on the other.[145]

6.169 ASIC did not consider greater restrictions on margin lending products to be necessary:

> We note that the new margin lending regime is likely to be more liberal than that in some other jurisdictions. Some jurisdictions (including the US, Singapore, Hong Kong and Canada) impose specific restrictions on retail investor margin lending, such as limits on leverage. Other jurisdictions, such as the UK, do not have specific regulation, but general obligations mean that retail investors are not generally offered margin loans. At this stage, ASIC does not believe that these sorts of limitations, which are inconsistent with the fundamental settings of the FSR regime, are necessary in Australia.[146]

Committee view

6.170 The committee is of the opinion that it is not for the parliament or the government to determine for whom particular investment products are appropriate. This is a decision for individual investors, in consultation with a financial adviser bound by a fiduciary duty to put their clients' interests ahead of their own.

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143 Mr Peter Worcester, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 96.

144 Institute of Actuaries in Australia, *Official Committee Hansard*, Canberra, 28 August 2009, p. 87.

145 Commercial Law Association of Australia, *Submission 389*, p. 4.

146 ASIC, *Submission 378*, p. 92.

Investor compensation

6.171 The problems with PI insurance as a compensation mechanism, discussed in the previous chapter from paragraph 5.93, elicited a number of recommendations to establish a statutory compensation scheme for investors. Other suggestions for improving access to compensation are included below.

6.172 The committee notes that the UK has established a statutory compensation scheme. ASIC reported:

> ...the UK Financial Services Compensation Scheme (Compensation Scheme) was set up to assist retail clients who had suffered loss from bad investment advice, misrepresentation, or where a firm has gone out of business and cannot repay money owed to retail clients. The scheme covers transactions in relation to deposit-taking, investments, insurance and mortgages.[147]

6.173 The UK scheme investigates and determines eligibility for investors and is funded by levies that reflect the riskiness of their activities. Compensation is capped to leave investors with some exposure and encourage prudent investing.[148]

6.174 CHOICE supported a similar regime for Australia, stating that:

> A last resort compensation scheme is an essential element of the compensation regime. It would provide compensation where licensees have breached their licence conditions and are otherwise unable to compensate consumers—for example, due to liquidation. The scheme would bring Australia's financial services compensation arrangements into line with those of other international financial services hubs such as the United Kingdom and with other sectors of the Australian economy that already have schemes in place—for example, the Australian Stock Exchange.[149]

6.175 The FOS also argued in favour of a safety net of last resort compensation scheme, with establishment costs funded by government and operating using industry levies. They indicated that large events could provide compensation using borrowed money recuperated using post-event levies.[150] The committee received a detailed proposal for the establishment of a financial services compensation scheme, conducted by Professional Financial Solutions on behalf of FOS. It recommends the scheme be industry-based and approved by ASIC, funded by levying AFSL holders and backed by legislation requiring licensees to be members of the scheme. Additional funding after large compensation claims would be raised through special levies. Consumers would receive compensation from the scheme if they have received a determination against a licensee in their favour and that licensee is unable to meet the

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147 ASIC, *Submission 378*, pp 85-86.

148 ASIC, *Submission 378*, p. 86.

149 CHOICE, *Official Committee Hansard*, Sydney, 4 September 2009, p. 99.

150 FOS, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 25.

claim. To mitigate moral hazard issues, payments would be limited to a proportion of the compensation claim, decreasing as the claim rises beyond certain thresholds.[151]

6.176 Treasury outlined the costs and benefits of the proposal:

> ...there are obviously clear benefits for the consumer-investor. The question is: how expensive would that be? How expensive would it be to the industry? Therefore, how much extra cost would go onto the person receiving the advice? Therefore, would that cut back on the amount of advice that could be received? Again, it is a very major balancing decision.[152]

6.177 Securities and Derivatives Industry Association opposed such a scheme:

> Professional indemnity insurance is the best and most equitable method of ensuring consumers are adequately compensated. A centralised compensation fund would present the danger of moral hazard, where those guilty of misconduct are able to escape responsibility for compensating those affected by their actions.[153]

6.178 Insurance Council of Australia cautioned that a statutory compensation scheme would need to be designed carefully:

> It is important to identify the scope of the problem—for example, the actual number of consumers being left uncompensated—so that a compensation fund can be designed appropriately ... a fund based on overestimates of the problem to be addressed would be a burden for the government to administer and for the industry to fund, with consumers ultimately paying the cost.[154]

6.179 Alternatively, Professional Investment Services proposed that advisers be able to take action against failed product manufacturers on behalf of their clients:

> Licensees should be given the capacity to act on behalf of their clients and investors to undertake proceedings against financial services product providers for the recovery of damages for corporate misconduct and product failures, similar to ASIC's powers. At the moment, we have to wait for people to come to sue us before we can join a product provider who has actually failed in their duty. We do not have the authority to take them on ourselves.[155]

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151 Professional Financial Solutions, *Proposal to Establish a Financial Services Compensation Scheme*, October 2009. Provided as additional information to the committee by FOS.

152 Treasury, *Official Committee Hansard*, Canberra, 28 August 2009, p. 24.

153 SDIA, *Official Committee Hansard*, Canberra, 28 August 2009, p. 61.

154 Insurance Council of Australia, *Official Committee Hansard*, Canberra, 28 August 2009, p. 73.

155 Professional Investment Services, *Official Committee Hansard*, Sydney, 4 September 2009, p. 112.

6.180 Maurice Blackburn Lawyers proposed the following measures to improve the efficacy of PI insurance:

> 1. Consider making legislative provision for disclosure of details of PI insurance cover or extending the current regulatory provisions in respect of preliminary discovery to include third party discovery to enable the production of any relevant insurance policies held by defendants or proposed defendants at an early stage in litigation;
>
> 2. Consider legislating to make remedies available to third parties against insurers who fund unmeritorious defences, particularly where limits on liability exist in the insurance policies, to enable plaintiffs to have a right of recourse against such insurers;
>
> 3. Consider establishing a compensation fund from which compensation to consumers could be made;
>
> 4. Consider amending legislation to ensure regulation of requirements on licensed financial service providers and other professionals to have adequate insurance policies which do not contain exclusion clauses that exclude them from the provision of services which they are licensed to provide; and
>
> 5. Improve and enhance monitoring of compliance with regulatory procedures.[156]

Committee view

6.181 The committee recognises that the deficiencies of PI insurance make a last resort statutory compensation fund covering licensee wrongdoing appealing. There are, however, a number of significant issues that would need to be overcome in any scheme's design. Capping payments would largely address moral hazard issues, but of particular concern is the very difficult task of formulating an equitable levy system that does not compel licensees with a cautious approach to cross-subsidise riskier activity. There must also be concerns about the cost that would ultimately be passed on to consumers, and whether it would be justified by the protection it offers.

6.182 The committee is of the opinion that more work is needed to determine whether a tailored statutory compensation scheme would be desirable and cost effective in Australia. This should include consultation with industry about how levy arrangements might be designed to ensure they are fair and equitable across the industry.

Recommendation 10

6.183 The committee recommends that the government investigate the costs and benefits of different models of a statutory last resort compensation fund for investors.

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156 Maurice Blackburn Lawyers, *Submission 399*, pp 5-6.

Financial literacy

6.184 In paragraph 5.133, the committee noted its view that ASIC could be doing more to educate key, higher risk, older demographic groups—such as retirees—by promoting sensible investment messages.

Recommendation 11

6.185 The committee recommends that ASIC develop and deliver more effective education activities targeted to groups in the community who are likely to be seeking financial advice for the first time.

Chapter 7

Conclusion: Recommendations for reform

7.1 During the course of its inquiry, the committee has received and considered evidence from a broad range of sources, including investors (clients of financial advisers), banks and other financiers, individual advisers, advisory groups, product providers, industry bodies, consumer action groups, legal firms, regulatory bodies and government departments.

7.2 The committee's terms of reference for the inquiry identified the collapses of Storm Financial, Opes Prime and other similar collapses as being of particular concern, and many of the submissions made to the committee provided detailed information on the circumstances leading up to and after these collapses.

7.3 As expressed elsewhere in this report, it is important to emphasise that the committee is not a judicial body and has no power to make criminal findings or to make judgements in relation to individual claims that have been brought to its attention. It has also not been possible for the committee to resolve all the contradictions in the evidence put before it.

7.4 Furthermore, it should be noted that the committee's terms of reference focused on financial products and services. The committee's overall role, having regard to what it has learnt through the examination of these corporate collapses and all the other evidence put before it, is to make any necessary recommendations for legislative change or regulatory improvement to help guard against the occurrence of similar collapses in the future and improve the quality of financial advice Australian consumers receive. The committee's deliberations around the need for regulatory or legislative change in Australia's financial products and services sector have been discussed in detail in the preceding chapters of this report.

7.5 The committee acknowledges that it is not necessarily appropriate to recommend reform in response to a particular collapse or event. Isolated corporate failures are not necessarily indicative of, or caused by, regulatory failure. However, the committee believes that over the course of its inquiry it has collected sufficiently broad and consistent evidence to justify making a series of carefully considered recommendations which are designed to enhance professionalism within the financial advice sector and enhance consumer confidence and protection.

7.6 The committee notes that, during the course of its inquiry, some key legislation has been considered by the Australian Parliament. The expected passage of the National Consumer Credit Protection legislation will mean that, from 1 July 2010, consumer credit will be regulated under a single federal law for the first time. Under Financial Services Modernisation reforms that have already passed through the parliament, margin loans (and products with a similar character, including products like those sold to customers of Opes Prime) will be defined as financial products for the purposes of Chapter 7 of the *Corporations Act 2001*. These legislative changes will provide important protections that purchasers of certain financial instruments have not had previously.

7.7 Also during the inquiry time frame, the government announced its intention to transfer responsibility for supervision of real-time trading on Australia's domestic licensed markets from the ASX to ASIC. Pending the passage of necessary legislation during the first part of 2010, ASIC will be responsible for both supervision and enforcement of the laws against misconduct on Australia's financial markets.

7.8 The committee believes that these reforms will have a substantial impact on many of the matters discussed in this report. In particular, there will be regulation in place to protect future purchasers of margin loan and securities lending facilities—protection that was not available to the clients of Opes Prime or Storm Financial.

7.9 The committee has resisted making further recommendations for change in this area until there has been an opportunity to examine the practical consequences of the new legislation. Through its regular oversight hearings with ASIC, the committee will monitor the implementation and success of this legislation and may revisit this subject at a later date.

7.10 Having regard to all the evidence put before it, the material discussed in previous chapters of this report, and the legislation discussed above, the committee therefore reiterates its eleven recommendations for reform in this sector. It is the view of the committee that, if implemented, these changes will act in synergy to provide better outcomes and protections for consumers of financial products and services.

Recommendation 1

The committee recommends that the Corporations Act be amended to explicitly include a fiduciary duty for financial advisers operating under an AFSL, requiring them to place their clients' interests ahead of their own.

Recommendation 2

The committee recommends that the government ensure ASIC is appropriately resourced to perform effective risk-based surveillance of the advice provided by licensees and their authorised representatives. ASIC should also conduct financial advice shadow shopping exercises annually.

Recommendation 3

The committee recommends that the Corporations Act be amended to require advisers to disclose more prominently in marketing material restrictions on the advice they are able to provide consumers and any potential conflicts of interest.

Recommendation 4

The committee recommends that the government consult with and support industry in developing the most appropriate mechanism by which to cease payments from product manufacturers to financial advisers.

Recommendation 5

The committee recommends that the government consider the implications of making the cost of financial advice tax deductible for consumers as part of its response to the Treasury review into the tax system.

Recommendation 6

The committee recommends that section 920A of the Corporations Act be amended to provide extended powers for ASIC to ban individuals from the financial services industry.

Recommendation 7

The committee recommends that, as part of their licence conditions, ASIC require agribusiness MIS licensees to demonstrate they have sufficient working capital to meet current obligations.

Recommendation 8

The committee recommends that sections 913B and 915C of the Corporations Act be amended to allow ASIC to deny an application, or suspend or cancel a licence, where there is a reasonable belief that the licensee 'may not comply' with their obligations under the licence.

Recommendation 9

The committee recommends that ASIC immediately begin consultation with the financial services industry on the establishment of an independent, industry-based professional standards board to oversee nomenclature, and competency and conduct standards for financial advisers.

Recommendation 10

The committee recommends that the government investigate the costs and benefits of different models of a statutory last resort compensation fund for investors.

Recommendation 11

The committee recommends that ASIC develop and deliver more effective education activities targeted to groups in the community who are likely to be seeking financial advice for the first time.

Mr Bernie Ripoll MP

Chairman

Appendix 1

Submissions received by the committee

Submissions

Sub No.	Submitter
1	NAME WITHHELD
2	William K Lawson
3	CONFIDENTIAL
4	CONFIDENTIAL
5	Frederick Grima
6	Stanley Robinson
7	CONFIDENTIAL
8	Victor Ainslie
9	NAME WITHHELD
10	Sofronis and Anna Michaelidis
11	NAME WITHHELD
12	Richard and Jennifer Old
13	NAME WITHHELD
14	Raymond Bricknell
15	Puzzle Financial Advice Pty Ltd
16	NAME WITHHELD
17	CONFIDENTIAL
18	NAME WITHHELD
19	NAME WITHHELD
20	Charles Hugh Bannister
21	Graeme and Susan McDonald
22	Gregory Watts
23	Patricia Godwin and John King
24	Tony and Linda Ahern

25	NAME WITHHELD
26	John Walker
27	NAME WITHHELD
28	Walter B Taylor
	Response from Bernadine Frawley
29	G. K Lego
30	Sean and Paula McArdle
31	Carol O'Donnell
32	L S and A M Pataki
33	NAME WITHHELD
34	Australian Investors Association Ltd
35	Ken Kingsford
36	Richard and Barbara Wright
37	CONFIDENTIAL
38	Tupicoffs Pty Ltd
39	Waterfall Way Associates
40	Superworks Financial Pty Ltd
41	Dominic Alafaci
42	NAME WITHHELD
43	Peter Toohey
44	Mohsen Alirezai
45	Santo and Marianne Perna
46	CONFIDENTIAL
47	Bruce Kerr
48	NAME WITHHELD
49	NAME WITHHELD
50	CONFIDENTIAL
51	Peter William Hansen
52	Andrew Barrell

53	Runa Ross
54	Ron Jelich
55	David and Ann Lock
56	Quantum Financial Services
57	Leonie Crennan
58	NAME WITHHELD
59	CONFIDENTIAL
60	NAME WITHHELD
61	NAME WITHHELD
62	Norman Wills
63	Chris Robinson
64	Geoff and Heather Stanfield
65	CONFIDENTIAL
66	NAME WITHHELD
67	APT Strategy Pty Ltd
68	Mary O'Loghlin
69	CONFIDENTIAL
70	NAME WITHHELD
71	Geoffrey Hobbs
72	Tracey Richards
73	John Salmon
74	Andrew Groenwoldt and Jennifer Owens
75	Paramount Wealth Management
76	CONFIDENTIAL
77	CONFIDENTIAL
78	NAME WITHHELD
79	John and Merrilee Clark
80	Geoff Parker
81	CONFIDENTIAL

82	Quentin and Sandra Bates
83	Gregory and Corinne Kay
84	Robin and Cecily Herd
85	Bruce and Luciana Milburn
86	Debra Lawrence
87	Steve and Kimberley Parkin
88	Kay Robinson
89	Alan Tomlinson
90	Bernard Pristel
91	Mark Williams
92	Norman and Lynda Robertson
93	NAME WITHHELD
94	NAME WITHHELD
95	NAME WITHHELD
96	Leith Harveyson
97	NAME WITHHELD
98	NAME WITHHELD
99	Andrew Player
100	Justin and Jenny Clare
101	CONFIDENTIAL
102	Natalie Ferris
103	Murray Withers
104	Vince Mahon
105	NAME WITHHELD
106	Robert Reed
107	Gina Lazzarini
108	Troy and Mary McConnell
109	Stephen Wilson
110	Wayne Styles

111	Glenys Roberts
112	Ian Bailey
113	YourShare Financial Services Pty Ltd
114	CONFIDENTIAL
115	NAME WITHHELD
116	NAME WITHHELD
117	NOT ASSIGNED
118	Pauline M Allen
119	Cotulla Trust
120	Robert and Marie Anne Fowler
	Response from Chris Murphy
121	Jack and Frances Dale
122	Denis Kelart
123	Helen Chambers
124	Des and Margaret Peters
125	Lance Mayers et al
126	Tom and Joan Ruddell
127	Joe and Sue Malaponte
128	CONFIDENTIAL
129	Mario Romeo
130	Michael Haskins
131	Graeme and Judy Hill
132	Kaye Lowry
133	Frank and Sandra Grainer
134	Chris Farley
135	Robert Ross
136	Doug Bailey
137	Gordon and Shirley Heard
138	Insurance Council of Australia

139	CONFIDENTIAL
140	Desmond and Teresa Lockett
141	CONFIDENTIAL
142	NAME WITHHELD
143	Nelson R Hubbucks and Catherine F Moran
	Response from John Fuller
144	Peter Pola
145	NOT ASSIGNED
146	Kay Allman
147	NAME WITHHELD
148	NAME WITHHELD
149	Desley Quinton
150	Alain D'Hotman De Villiers
151	CONFIDENTIAL
152	Adriaan and Janis Boon
153	Gus Dalle Cort
154	AEC Group Limited
155	NAME WITHHELD
156	NAME WITHHELD
157	Thomas and Cheryl Walker
158	Paul Levy
159	NAME WITHHELD
160	Paul and Jill Dixon
161	Michael and Sharryl Whiting
162	Ron and Debbie Pearson
163	Jenny Skeggs
164	NAME WITHHELD
165	Philip Schurmann
166	Robert and Carolyn Hasemann

167	David and Isabel Dowling
168	Daniel Parry
169	Symes Warne & Associates Limited
170	Yvette Mansted
171	Jo and Al Harding
172	Mike and Isabel Kilkenny
173	Luke Vogel
174	John and Pauline Oldfield
175	Edward van Oort-Pieck
176	Richard and Gloria Turner
177	Stewart Partners
178	Strategy First Financial Planning Pty Ltd
179	NAME WITHHELD
180	Michael Legg
181	D W and C V Hogg
182	NAME WITHHELD
183	Graham MacAulay
184	Andrée and Kalvin Ernst
185	CONFIDENTIAL
186	Tarnia Coppers
187	Frank and Irene McGuirk
188	Bas and Ann de Wit
189	Frank and Annamaria Gasparini
190	Julian and Pamela England
191	NAME WITHHELD
192	Joe Nagy
193	NAME WITHHELD
194	NAME WITHHELD
195	Robert and Janis Lee

196	NAME WITHHELD
197	NAME WITHHELD
198	NAME WITHHELD
199	NAME WITHHELD
200	Greg and Phyllis Davies
201	CONFIDENTIAL
202	NAME WITHHELD
203	Ian Smith
204	Dale and Pamela Wust
205	Michael Scales
206	Lotta Mellows
207	NAME WITHHELD
208	Brian and Janet Zollner
209	Colin and Donna Smith
210	NAME WITHHELD
211	NAME WITHHELD
212	CONFIDENTIAL
213	David and Janet Chapman
214	Naomi Major
215	Raymond and Lorna Winkworth
216	Jean Yarlett
217	John and Aileen Osgood
218	Ruth Lennie
219	NAME WITHHELD
220	NAME WITHHELD
221	CONFIDENTIAL
222	Mentor Financial Services
223	Kenneth and Suzanne Jones
224	NAME WITHHELD

225	Wayne and Carol Styles
226	CONFIDENTIAL
227	NAME WITHHELD
228	Ian and Marion Meade
229	Kevin and Deb Walden
230	Brian and Carolyn Butler
231	Stuart and Cindy Cortis
232	NAME WITHHELD
233	Bryan and C.Maree Young
234	John Markwell
235	CONFIDENTIAL
236	William and Grace Westhead
237	Paul Goopy
238	John and Beverley Ellison
239	NAME WITHHELD
240	Salvatore and Audrey Perna
241	Todd Cranston
242	Tony and Deidre Purse
243	Sharron King
244	Gordon and Jane Zinn
245	Richard and Janice Kaczuk
246	CONFIDENTIAL
247	Barrie and Elizabeth Watts
248	NAME WITHHELD
249	NAME WITHHELD
250	CONFIDENTIAL
251	Boutique Financial Planning Principals Group
252	Janice Martin
253	Evelyn King

254	NOT ASSIGNED
255	Barrie Smout
256	Christine Bradstreet
257	Kevan C Williams
258	Jeff and Shirley Dunn
259	Patrick and Julie Doyle
260	NAME WITHHELD
261	Graham and Lesley Sealey
262	Julie Matheson
263	NAME WITHHELD
264	Trevor and Janet Power
265	Dennis Chapman
266	Lynette Murray
267	Donald and Valmai Emanuel
268	NAME WITHHELD
269	Anthony and Michelle Old
270	Garry and Marion Nosworthy
271	Patrick Loughnan
272	CONFIDENTIAL
273	Michael and Ann Burniston
274	CONFIDENTIAL
275	Terence and Karen Brett
276	Storm Investors Consumer Action Group Inc
277	Financial Planning Association of Australia
278	John and Paula Mottin
279	Hon Dr Bob Such
280	Mark and Ann Weir
281	John Fuller
282	Jason and Alessia Keech

283	Anne Tuit
284	Paul Little
285	Christopher and Sally Barnett
286	NAME WITHHELD
287	NAME WITHHELD
288	Doug Lye
289	NOT ASSIGNED
290	Julia Eastland
291	Martin McCullagh
292	Plan B Group Holdings Limited
293	Worcester Consulting Group
294	CONFIDENTIAL
295	Rob and Roxanne Davis
296	Errol Rose and Ann Giudicatti
297	Jacinta Grace
298	NAME WITHHELD
299	CONFIDENTIAL
300	CONFIDENTIAL
301	CONFIDENTIAL
302	Graeme and Kay Rasmussen
303	Una Robinson
304	Gregory and Lyn Becke
305	Paul and Elisabeth Reeve
306	NAME WITHHELD
307	NAME WITHHELD
308	Benjamin Hancock
309	CONFIDENTIAL
310	Fiona Alongi
311	CPA Australia

312 CONFIDENTIAL

313 Lorraine Kovacich

314 National Insurance Brokers Association

315 CONFIDENTIAL

316 Guardian Financial Planning

317 Investment and Financial Services Association

318 AUSSIE

319 The Institute of Actuaries of Australia

320 NAME WITHHELD

321 NAME WITHHELD

322 Argyle Lawyers Pty Limited

323 NAME WITHHELD

324 FinaMetrica Pty Limited

325 Kevin and Leigh Yates

326 Nick Bruining

327 Securities & Derivatives Industry Association

328 Robyn Toohey

329 NOT ASSIGNED

330 Finance Control

331 Perpetual Corporate Trust

332 Tom Crothers

333 CONFIDENTIAL

334 SMART Compliance Pty Ltd

335 NAME WITHHELD

336 Professional Investment Services

337 Trustee Corporations Association of Australia

338 John and Shirley Quinn

339 NOT ASSIGNED

340 Hayden Financial Services Pty Ltd

341	Sharon Pacey
342	Robert Brown
343	Intech Financial Planning Services
344	Association of Financial Advisers Ltd
345	CONFIDENTIAL
346	MLC
347	Paul Resnik
348	CONFIDENTIAL
349	Crawford Peter Hillis
350	Trust Company Limited
351	Financial Services Institute of Australasia
352	SEQUAL
353	Financial Ombudsman Service Limited
354	John Christie
355	NAME WITHHELD
356	John and Paula Mottin
357	Commonwealth Bank of Australia
358	Denise L Brailey
359	David Fotheringham
360	National Seniors Australia
361	CHOICE
362	Accounting Professional and Ethical Standards Board
363	The Institute of Chartered Accountants in Australia
364	Red Oak Financial
365	NOT ASSIGNED
366	Michael Smith and Rosslyn Myles
367	AMP
368	Millennium3 Financial Services Pty Ltd
369	Levitt Robinson Solicitors

370	CONFIDENTIAL
371	NAME WITHHELD
372	NOT ASSIGNED
373	NOT ASSIGNED
374	Q Invest
375	NAME WITHHELD
376	Allan McDonald
377	Keith and Diane Ensor
378	ASIC
379	ANZ
380	Industry Super Network
381	Roy and Janis Rogers
382	CONFIDENTIAL
383	ING Australia
384	Dean Evans
385	AXA
386	Carmela Richards and Kristy Devney
387	Kenneth Allan
388	The Treasury
389	Commercial Law Association of Australia
390	Panfilo Di Lullo
391	National Institute of Accountants
392	Interprac Limited
393	AFMA
394	Axiom Wealth Pty Ltd
395	Jim Stewart
396	Macquarie Group Limited
397	Australasian Compliance Institute
398	Michael Peters

399	Maurice Blackburn Pty Ltd
400	Finance Sector Union
401	Bank of Queensland Ltd
402	CONFIDENTIAL
403	Lurline Gibb
404	National Information Centre on Retirement Investments Inc
405	Australian Property Institute
406	Bernadette Marriner
407	Murphy Financial Solutions Pty Ltd

Supplementary Submissions

3a	CONFIDENTIAL
3b	CONFIDENTIAL
9a	Ruth Fontaine
9b	Ruth Fontaine
12a	Richard and Jennifer Old
14a	Raymond Bricknell
15a	Puzzle Financial Advice Pty Ltd
15b	Puzzle Financial Advice Pty Ltd
15c	Puzzle Financial Advice Pty Ltd
15d	Puzzle Financial Advice Pty Ltd
15e	CONFIDENTIAL
15f	Puzzle Financial Advice Pty Ltd
15g	Puzzle Financial Advice Pty Ltd
15h	Puzzle Financial Advice Pty Ltd
15i	Puzzle Financial Advice Pty Ltd
15j	Puzzle Financial Advice Pty Ltd
21a	Graeme and Susan McDonald

30a	Sean and Paula McArdle
34a	Australian Investors Association
38a	Tupicoffs Pty Ltd
54a	Ron Jelich
67a	APT Strategy Pty Ltd
73a	John Salmon
109a	CONFIDENTIAL
119a	Cotulla Trust
167a	David and Isabel Dowling
173a	Luke Vogel
179a	CONFIDENTIAL
182a	NAME WITHHELD
182b	NAME WITHHELD
276a	Storm Investors Consumer Action Group Inc
322a	Argyle Lawyers Pty Limited
367a	AMP
369a	Levitt Robinson Solicitors
396a	Macquarie Group Limited

General responses to adverse comment

1	Financial Planning Association of Australia
2	APRA

Appendix 2

Witnesses who gave evidence at public hearings

CANBERRA, 24 JUNE 2009

Australian Securities and Investments Commission

BIRD, Ms Joanna, Senior Executive Specialist, Strategic Policy

COOPER, Mr Jeremy, Deputy Chairman

D'ALOISIO, Mr Tony, Chairman

ERSKINE, Mr Alex, Chief Economist

RICKARD, Ms Delia, Senior Executive Leader, Consumers and Retail Investors

MELBOURNE, 26 AUGUST 2009

MLC Limited

McINERNEY, Mr Dallas, Manager, Government and Regulatory Affairs

NUNN, Mr Richard, Executive General Manager, Advice and Marketing, MLC and NAB Wealth

TUCKER, Mr Steve, Chief Executive Officer

Financial Ombudsman Service

MAYNARD, Ms Alison, Ombudsman, Investments, Life Insurance and Superannuation

ANZ Banking Group

COHEN, Mr Geoff, Managing Director, Investment and Insurance

HODGES, Mr Graham, Deputy Chief Executive Officer

NASH, Ms Jane, Head of Government and Regulatory Affairs

SANTAMARIA, Mr Bob, Group General Counsel

CPA Australia Ltd

DAVISON, Mr Michael, Senior Policy Adviser, Superannuation

DRUM, Mr Paul, General Manager, Policy and Research

Accounting Professional and Ethical Standards Board

BLACK, Mr Stuart, Director/Board Member

DAY, Mr William, Director/Board Member

WIJESINGHE, Mr Channa, Technical Director

Guardian Financial Planning

BROWNING, Mr Steven, Executive Manager

CARTER, Mr David, Executive General Manager, Advice Solutions Suncorp

FinaMetrica Pty Ltd and Worcester Consulting

RESNIK, Mr Aaron Paul, Chief Executive Officer

WORCESTER, Mr Peter Alan, Managing Director

Argyle Lawyers

SMITH, Ms June, Principal

ARMSTRONG, Professor Anona, Private capacity

CANBERRA, 28 AUGUST 2009

Treasury

LIM, Mr Michael, Analyst, Investor Protection Unit, Corporations and Financial Services Division

MILLER, Mr Geoffrey, General Manager, Corporations and Financial Services Division

PARKER, Ms Cherie Rebecca, Analyst, Investor Protection Unit, Corporations and Financial Services Division

SELLARS, Mr Andrew, Senior Adviser, Corporations and Financial Services Division

SEWELL, Mr Mark Francis, Manager, Corporations and Financial Services Division

Financial Planning Association

BATTISTELLA, Mr Julian, Certified Financial Planner and Member

BLOCH, Ms Jo-Anne, Chief Executive Officer

CHONG, Mr Seng Wing, Member and Chair, Regulations Committee

SANDERS, Mr Deen, Deputy Chief Executive Officer and Head of Professionalism

Investment and Financial Services Association Ltd

BROGDEN, Mr John, Chief Executive Officer

CODINA, Mr Martin, Senior Policy Manager

O'REILLY, Mr David, Policy Director

Securities and Derivatives Industry Association

CLARK, Mr Douglas, Policy Executive

HORSFIELD, Mr David, Managing Director and Chief Executive Officer

Insurance Council of Australia

ANNING, Mr John Melville, General Manager Policy Regulation

THOMPSON, Ms Catherine Louise, Member Professional Indemnity Insurance Committee

Institute of Actuaries of Australia

COOK, Mr Anthony, Chairman, Wealth Management Committee

RAFE, Mr Barry Edwin, Vice President

CAIRNS, 1 SEPTEMBER 2009

DALLE CORT, Mr Gus (Gildo), Private capacity

BATES, Mr Quentin Michael, Private capacity

BATES, Mrs Sandra, Private capacity

DALE, Mr Jack Kenneth, Private capacity

DALE, Mrs Frances Norinne, Private capacity

Open Microphone Session

BOTH, Mr Mark, Private capacity

FOWLER, Mr Jason Robert, Private capacity

GRAINER, Mr Francis John, Private capacity

GRAINER, Mrs Sandra Alice, Private capacity

MACCOLL, Mrs Kathleen (Kate), Private capacity

McCLEAN, Ms Margaret Teresa, Private capacity

TUCK, Ms Joanne Mary Alice, Private capacity

WEIR, Mr Mark, Private capacity

TOWNSVILLE, 2 SEPTEMBER 2009

McCULLOCH, Mr David Robert, Private capacity

DEVNEY, Mrs Kristy Lee, Private capacity

RICHARDS, Mrs Carmela, Private capacity

QUINTON, Ms Desley, Private capacity

ABDY, Ms Lorna, Private capacity

DIXON, Mr Paul, Private capacity

DIXON, Mrs Jill, Private capacity

POWER, Mr Trevor Mark, Private capacity

JACKSON, Mr Andrew, Private capacity

Open Microphone Session

LYNHAM, Mr Graham, Private capacity

REYNOLDS, Mr Steve, Private capacity

AHERN, Mr Anthony Harry James, Private capacity

SCOTT, Mrs Cheryl Diann, Private capacity

RASMUSSEN, Mr Graeme Jorgen, Private capacity

BRISBANE, 3 SEPTEMBER 2009

CASSIMATIS, Mr Emmanuel, Private capacity

Australian Investors Association

FORSYTH, Mr Jolyon, President

McKENZIE, Mr Scott, Vice-President

KING, Ms Sharron, Private capacity

Storm Investors Consumer Action Group

ANDERSON, Mr Graham John, Secretary/Treasurer

O'BRIEN, Mr Noel Terence, Co-Chairman

WEIR, Mr Mark Robert, Co-Chairman

JELICH, Mr Radomir (Ron), Private capacity

McARDLE, Mr Sean, Private capacity

Stonehouse Wealth Management

HANCOCK, Mr Benjamin William, Partner/Senior Adviser

SYDNEY, 4 SEPTEMBER 2009

Institute of Chartered Accountants in Australia

ELVY, Mr Hugh, Head, Financial Planning

WHITE, Mr Lee, General Manager, Leadership and Quality

Trustee Corporations Association of Australia

ATKIN, Mr John, Managing Director, Trust Company Ltd; and Executive Committee Member

FITZGERALD, Mr Anthony George, Managing Director, State Trustees Ltd; and National President

Association of Financial Advisers Ltd

BATEMAN, Mr Dennis, National Treasurer

KALANTZIS, Ms Christina, Co-chair, Government and Policy Committee, Association of Financial Advisers; and Principal, Alexis Compliance and Risk Solutions Pty Ltd

KLIPIN, Mr Richard, Chief Executive Officer

NOWAK, Mr Michael, Queensland Chair, GenXt Committee, and Adviser

TAGGART, Mr James, National President

Quantum Financial Services Australia

MACKAY, Mr Tim, Director and Certified Financial Planner

MACKAY, Ms Claire, Director and Certified Financial Planner

Commonwealth Bank of Australia

COHEN, Mr David Antony Keith, Group General Counsel

COMYN, Mr Matthew Peter, Executive General Manager, Equities and Margin Lending

FRENCH, Dr Brendan James, General Manager, Customer Relations

GUNNING, Mr Timothy James, General Manager, Commonwealth Financial Planning

McEWAN, Mr Ross Maxwell, Group Executive, Retail Banking Services

NAREV, Mr Ian Mark, Group Executive Manager, Business and Private Banking

CHOICE

FREEMAN, Ms Elissa, Senior Policy Officer

Professional Investment Services

EVANS, Mr Grahame, Managing Director

PETRIK, Miss Bianca, Corporate Development Manager

CANBERRA, 16 SEPTEMBER 2009

Australian Securities and Investments Commission

BIRD, Ms Joanna, Senior Executive Specialist, Strategic Policy

D'ALOISIO, Mr Tony, Chairman

HANRAHAN, Dr Pamela, Senior Executive Leader, Investment Managers

KOROMILAS, Ms Deborah, Senior Executive Leader, Financial Advisers

MEDCRAFT, Mr Greg, Commissioner

RICKARD, Ms Delia, Senior Executive Leader, Financial Literacy and Consumers and Retail Investors

Bank of Queensland

KANGATHARAN, Mr Ram, Chief Financial Officer

LIDDY, Mr David, Managing Director and Chief Executive Officer

CANBERRA, 28 OCTOBER 2009

Macquarie Bank Limited

SHEPPARD, Mr Richard, Managing Director and CEO

VAN DER WESTHUYZEN, Mr Peter, Executive Director

Commonwealth Bank

COHEN, Mr David, Group General Counsel

COMYN, Mr Matthew, Executive General Manager, Equities & Margin Lending

FRENCH, Dr Brendan, General Manager Customer Relations

NAREV, Mr Ian, Group Executive, Business & Private Banking

NORRIS, Mr Ralph, Chief Executive Officer

Transcripts of the public hearings were published on the inquiry webpage at:

http://www.aph.gov.au/senate/committee/corporations_ctte/fps/hearings/index.htm

Appendix 3

Answers to questions taken on notice

ASIC (Canberra hearing, 24 June 2009)

ASIC 1 - Hansard p. 13

Senator MASON—I accept that. The Chairman also mentioned that there are certain training obligations. Could you outline what the training obligations are.

Ms Bird—Once you have got through the gate you have to comply with certain obligations. One of those is—

Senator MASON—Sorry to interrupt. 'Through the gate': so you have been given a licence.

Ms Bird—Then there are a whole lot of obligations that are imposed upon you. The licensee has to have the resources to do its job, it has to be competent and it has to ensure that its representatives are competent. For most licensees that is quite a general obligation; it is really up to the licensee to take the responsibility to ensure that the people performing the role are competent. However, in the advice area ASIC does set down minimum standards of training.

Senator MASON—What are they?

Ms Bird—I can tell you what the policy guide is. Essentially they are for financial advisers. I would have to take it on notice because there is a diploma level—we have divided it up between two sorts of products: there are simple products and there are more complex products.

Senator WILLIAMS—Can you do that course online over a period of six weeks or so?

Ms Bird—There are different forms of courses. There are two ways to comply. The main way that people comply is by doing a course that is on what is called the ASIC training register.

Senator WILLIAMS—Can you do that online?

Ms Bird—I cannot answer whether any of the courses can be done entirely online, but there is an ASIC register that sets out all the courses that you have to do. They are approved courses.

Mr PEARCE—It is all outlined under PS146.

Ms Bird—Yes, 146 has got the lot of it.

Mr D'Aloisio—We will check the online issue.

Senator MASON—That is fine, if you could take that on notice.

Mr D'Aloisio—We will take it on notice.

Answer: ASIC 1 - Hansard p. 13

Training obligations

Under the Corporations Act, AFS licensees need to ensure that their representatives are adequately trained and competent (s912A(1)(f)). ASIC has imposed licence conditions which require AFS licensees to ensure that any person who provides financial product advice to retail clients on behalf of the licensee:

(a) has completed appropriate training courses approved in accordance with Regulatory Guide 146 *Licensing: Training of financial product advisers* (RG 146); or

(b) has been individually assessed as competent by an assessor approved by ASIC; or

(c) in respect of financial product advice on basic deposit products, facilities for making non-cash payments that are related to basic deposit products or First Home Saver Accounts issued by an authorised deposit-taking institution (i.e. FHSA deposit accounts), has completed training courses that are or have been assessed by the AFS licensee as meeting the appropriate level.

Minimum standards for financial advisers

Minimum training standards for financial product advisers are set out in RG 146. The standards comprise sets of knowledge and skill requirements that must be satisfied at either Tier 1 or Tier 2 education level. The Tier 1 education level is broadly equivalent to the 'Diploma' level under the Australian Qualifications Framework and the Tier 2 education level is broadly equivalent to the 'Certificate III' level under the Australian Qualifications Framework.

The requisite knowledge and skill requirements and the education level is dependent upon whether the adviser gives general or personal advice and what products the adviser gives advice on. Tier 2 is the lower education standard and applies to a specified list of basic products being: general insurance products except for personal sickness and accident; consumer credit insurance; basic deposit products; non-cash payment products; and FHSA deposit accounts. The higher Tier 1 standard applies to all other products.

Whilst it is possible to complete a course online over a period of six weeks, this diploma level course provides only the basics to be able to provide advice in the industry and many licensees prefer that advisers complete higher levels of training.

Not all courses are online and approved courses typically use a variety of teaching methods including face-to-face teaching in conjunction with online components.

As outlined in ASIC's submission to the PJC Inquiry on Financial Services and Products (ASIC's submission) at [133]-[134], ASIC is reviewing RG 146 with a view to improving training standards and will consult on proposals for change with industry and other stakeholders.

ASIC 2 – Hansard p. 18

Mr PEARCE—I have one last question on the licensing issue. Have you any idea of the proportion of AFSL holders who have an affiliation with an FPA, for example, or an AFA or something else that imposes further qualification requirements?

M D'Aloisio—I would like to take that question on notice because it is a significant question and I am aware we have actually looked at that. Rather than try to recollect, I would like to take it on notice, because there are a substantial number of individual licensees, for example, who would be members of the FPA. The corporates are also members of FPA and IFSA and so on. So we can actually get you that information.

Answer: ASIC 2 – Hansard p. 18

Membership

There are various industry associations that offer membership and professional development services to participants in the financial advice industry. ASIC has been provided with membership data from four key industry associations:

(a) Financial Planning Association (FPA): 7939 practitioner members and 480 member firms;

(b) Association of Financial Advisers (AFA): 1300 members;[1]

(c) Investment and Financial Services Association (IFSA): 90 full member firms;[2] and

(d) National Insurance Brokers Association (NIBA): 476 member firms.

1 According to the AFA's corporate profile, 26% of members hold an AFSL. 74% of members are part of a larger AFSL and include individual members.

2 IFSA also offers supporting membership to companies involved in the retail funds management and life industry in a service capacity, e.g. legal and accounting firms, asset consultants and information technology providers.

In terms of the proportion of AFSL holders that are affiliated with an industry association, the FPA have advised ASIC that the 480 member firms that are members of the FPA represent nearly 90% of the advice industry. Where a licensee is a member of the FPA, the obligations associated with membership extend to all advice personnel, including authorised representatives who are not individual members of the FPA.[3]

Further qualification requirements

All members of the FPA are subject to continuing professional development (CPD) requirements. Member firms are required to ensure that their practitioners adhere to the FPA's CPD policy. Of the 7939 practitioner members, 5693 are qualified as certified financial planners (CFPs) and 2246 are associate members. The CFP program consists of five units of study with an underpinning bachelor degree. Associate members may be studying toward their CFP qualification. All CFP members must undertake 120 points (approximately 40 hours) of CPD per triennium (minimum 35 point per financial year) to retain the qualification. Associate members are required to undertake 90 points per triennium (minimum 25 points per financial year). All members must undertake 3 points on ethics and 3 points on compliance.

Individual members of the AFA have ongoing education requirements as a condition of membership. The AFA reports that its members undertake a range of education through professional associations (including the AFA and FPA), their licensees and public education providers. The AFA itself offers the Fellow Chartered Financial Planner qualification, which consists of four units each taking 12 weeks to complete. The current courses offered for this qualification are fully subscribed. It also offers courses via alliances with training organisations and universities, as well as national roadshows and conferences.

IFSA does not require that its members undertake ongoing professional development in order to maintain membership. However, it does offer a range of voluntary education options.

While NIBA membership is held at the licensee level, NIBA also operates an educational facility called the NIBA College. There are 2477 individual members of the NIBA College. Members may be either affiliate members (members that do not hold a formal broking or risk qualification) or practitioner members (members that hold formal broking or risk qualifications). There are five classes of practitioner members depending on the particular level of qualification. The vast majority of the members (2072) hold the Qualified Practising Insurance Broker qualification, requiring completion of a Diploma of Financial Services undertaken over 12-24 months as well as practical broking experience of at least four years. All members

[3] The FPA also provided some membership data to the PJC at the hearing of the Inquiry into Agribusiness Managed Investment Schemes on 15 July 2009. See pp 38 and 45 of the transcript of the hearing: http://www.aph.gov.au/ hansard/joint/commttee/J12132.pdf.

must undertake 25 hours of CPD annually. The education options offered by the College are also open to non-members.

ASIC 3 – Hansard p. 19-20

Senator MASON—I want to talk about monitoring activities. An option the committee will be considering is whether, if ASIC were to upgrade and make more comprehensive their monitoring activities that would lead to better advice and companies acting more honestly and appropriately. That is the policy decision we have to come to. Are you happy that your monitoring activities are sufficient?

M D'Aloisio—You are never happy that your monitoring activities are sufficient, because if there are problems in the market you always worry about them. It is not a system that we have an approach where, for example, if there are 4,800 licensees, over a three-year period we would have carried out a surveillance on each of them. So you necessarily have to be selective in what you do. In being selective you are necessarily making judgments about risk and so on.

I come back to your question about whether we can do more than we are doing. At the moment, in the way we have restructured ASIC and the resources we have put in in terms of stakeholder teams, specifically in the case of financial advisers—leaving other AFSL licence holders out for the moment—we have a dedicated team of about 30 people now that is concentrating on that industry. One of the key priorities of that group, headed by Deborah Koromilas, whom I think you have met, is essentially around surveillance, compliance, quality of advice and so on. They have programs that they will run over each year to carry out that work.

We are always glad to receive more resources and to expand, and clearly we are pleased to look at that.

The other side of these surveillances and how you do them is that you do not want to do them for the sake of it, because they are extremely costly to ASIC and they are costly to the organisation that is involved. So you really want to be quite focused and achieve a result. I do not know at this stage—and we can take the question on notice and look at it further. If we are carrying out whatever number of surveillances in this area and we double or triple them, what do we think the net gain will be? I am happy to think about that. Off the top of my head it is hard to give you an answer, because I think that is where you are headed.

Answer: ASIC 3 – Hansard p. 19-20

It is very difficult to categorically state the beneficial effect of increasing surveillance activity. The effectiveness of surveillance activities is limited by resources and

ASIC's powers to take action based on the intelligence gained through the surveillance activity.

While we would always want to improve and increase ASIC’s monitoring of the market, given that at 3 August 2009 there were 4,797 AFS licensees and 52,814 authorised representatives, there is a limit to how many people ASIC can have contact with and how many documents we can review. We also devote substantial surveillance resources to the illegal and unregulated area. We do not have sufficient resources to meet with every licensee (let alone every financial services provider) nor can we review every disclosure document. Therefore we have conducted targeted surveillances aimed at higher risk activities or issues we have already identified so that our surveillance activities can have greater impact.

Often contacting or meeting with a licensee or authorised representative will lead to a regulatory outcome in itself, such as where the licensee improves its compliance processes or rectifies a breach. However, in some cases, surveillance activities of themselves do not bring about a regulatory result and in those cases the impact of the activity will be limited by the action that ASIC is able to take based on the intelligence gained from the surveillance. If the intelligence is that the licensee is charging high fees, for example, then there is no breach of the Act for ASIC to take action.

Further information on ASIC’s forward program in respect of surveillance activity can be found in Appendix 3 to ASIC’s submission at [566] – [584].

<u>ASIC 4 - Hansard p. 22</u>

Senator BOYCE—Are there any comparisons you could make between those groups of people you are talking about—the ones who might use financial advisers versus stockbrokers et cetera? Are they different in any way?

Mr D’Aloisio—Well, they should not be, in terms of advice and their obligations.

Senator BOYCE—No, I am talking about the individuals, the investors. I am trying to get a sense of who investors are and if there is anything distinctive we can be saying about retail investors.

Mr D’Aloisio—We can take that on notice and give you a break-up as best we can. But generally speaking people might go to a stockbroker because they feel they want to invest in shares and get advice on funds management and so on, so it will vary, but we will see if we can get you that information, if it is available.

Senator BOYCE—I am just wondering if they are perhaps a less wealthy group, a less sophisticated group—well, I know sophisticated has an actual meaning, but perhaps it is a less sophisticated demographic that we are talking about here.

CHAIR—You will take that on notice, Mr D’Aloisio?

Mr D'Aloisio—Yes, we will.

Answer: <u>ASIC 4 - Hansard p. 22</u>

In answering this question, ASIC has relied on data from the ANZ Survey of Adult Financial Literacy in Australia ('the survey') published in October 2008.

Generally, the available data does not indicate that there is a relevant marked difference in the levels of sophistication of investors consulting financial advisers versus investors consulting stockbrokers. The data collected on both relative disadvantage and financial literacy of respondents, two measures that may be considered to be indicative of the sophistication of an investor, was largely consistent between investors consulting stockbrokers and those consulting financial advisers.

The survey did indicate that respondents who had consulted stockbrokers were more likely to own their home outright (57%) than respondents who had consulted a financial adviser (45%). Users of stockbrokers had an average household income of approximately $94,000 compared to users of financial advisers who had an average household income of approximately $82,000. These figures are, however, possibly influenced by factors other than the sophistication of the particular respondent and it is not necessarily accurate to equate wealth with sophistication in this context.

<u>ASIC 5 – Hansard p. 22</u>

Senator BOYCE—I have just one other question in that area. Is there anything specific that you might be able to tell us about ethnic or geographic groupings of investors?

Mr D'Aloisio—It will be hard, but we will try. We may be able to with Indigenous Australians. It will be a lot harder for ethnic communities and so on in Australia, but we will have a look and see what is available.

Senator BOYCE—Thank you.

Ms Rickard—There are some gender issues there, too.

Senator BOYCE—And gender, please.

Ms Rickard—It is more likely to be males than female who are using these advisers.

Mr D'Aloisio—Do you want to comment on that a bit more?

Ms Rickard—It is basically that more men will be using them than women. We have the stats, which we can provide you with.

Answer: ASIC 5 – Hansard p. 22

In answering this question, ASIC has relied on data from the ANZ Survey of Adult Financial Literacy in Australia (‘the survey’) published in October 2008.

It is difficult to draw specific conclusions from the data available on ethnic groupings of investors. 85% of respondents to the survey identified as only speaking English at home. The data available on investors speaking languages other than English is accordingly very limited. For example, the second highest single ethnic group[4] (by language spoken at home) was Italian, which constituted 2% of the total sample.

The data available on Indigenous investors is likewise limited. Only 2% of respondents were of Aboriginal or Torres Strait Islander descent.

In terms of gender, investors who had used a stockbroker were more likely to be male (59% of male respondents had consulted a stock broker, versus 41% of female respondents.) Users of financial advisers were generally evenly split between male and female (49% of male respondents versus 51% of female respondents).

In terms of geographic distribution, users of financial advisers were more likely to live in capital cities (67% in capitals versus 33% in non-capitals) than users of stockbrokers (57% in capitals versus 43% in non-capitals).

ASIC 6 –Hansard p. 23-24

CHAIR—Can you tell the committee when was the first time that ASIC was made aware, through any means—complaints or otherwise—of problems with Storm Financial?

Mr D’Aloisio—I gave a statement to Senate estimates in February where we had initially gone through our files of where the contacts were, and I can refer to that. What we said we would do and are doing is having all our files looked at and assessed and, as I said earlier, we will provide you with that complete chronology, because we are as anxious as you are to get this off our plate.

CHAIR—Not a problem—that is fine. I accept that. That is why I said ‘can you’. If you cannot, that is not a problem.

Mr D’Aloisio—Okay. You will have it. We will discuss the confidentiality issue around it.

4 3% of respondents spoke an Asian language (other than Cantonese, Mandarin and Vietnamese) and 3% of respondents spoke a European language (other than Spanish, Greek, Italian and German).

CHAIR—Were the people who ran or operated Storm and other companies, people of interest or people who had previously come across your system or under your oversight at any other point in time? Had these people come onto your radar, as it were, previous to their incarnation as Storm, for example?

Mr D'Aloisio—Again, it is not a question that it is appropriate to go into, because we are investigating—

CHAIR—Not a problem. That is fine.

Mr D'Aloisio—I will take it on notice but I cannot answer that.

Answer: ASIC 6 –Hansard p. 23-24

ASIC has reviewed its interactions with Storm prior to commencement of its formal investigations, including a review of complaints received about Storm. The findings of this review are set out in Appendix 5 to ASIC's submission, which was provided to the PJC on a confidential basis to avoid prejudicing our ongoing investigations in relation to Storm. Further information is provided in the confidential letter sent by ASIC to the Secretariat of the PJC of 28 August 2009.

ASIC 7 – Hansard p. 29

Senator MASON—Did you ever monitor Storm Financial's advertising?

Mr D'Aloisio—We would have to take that on notice.

Answer: ASIC 7 – Hansard p. 29

ASIC has reviewed its interactions with Storm prior to commencement of its formal investigations, including a review of monitoring and surveillance activities conducted by ASIC in relation to Storm. The findings of this review are set out in Appendix 5 to ASIC's submission and, which was provided to the PJC on a confidential basis to avoid prejudicing our ongoing investigations in relation to Storm.

ASIC 8 –Hansard p. 30-31

Senator MASON—But I just want to make sure this is clear. You do not monitor all advertisements?

Ms Rickard—No, we don't.

Senator MASON—And that is a resource issue rather than an issue of integrity. So ASIC would not have asked Storm in that case to correct or rectify—you have the powers to do this with advertising. That clearly never happened?

Mr D'Aloisio—I am not aware that we have taken any—we have powers for corrective advertising.

Senator MASON—I know that, but did you use those?

Mr D'Aloisio—I am not aware. We will look at it, but I do not think so. I do not recollect that we took action—as I say, we are struggling here to actually remember whether there were any ads to start with.

Senator MASON—Sure. Can you take that on notice?

Answer: ASIC 8 –Hansard p. 30-31

ASIC has reviewed its interactions with Storm prior to commencement of its formal investigations. The findings of this review are set out in Appendix 5 to ASIC's submission, which was provided to the PJC on a confidential basis to avoid prejudicing our ongoing investigations in relation to Storm.

ASIC 9 – Hansard p. 33

Senator MASON—How many times in, let's say, the last 12 months have you used coercive powers to remedy misleading advertising?

Mr D'Aloisio—When you say coercive powers, are you saying—

Senator MASON—How many times have used your powers? There may just be a friendly reminder or they may be coercive.

Mr D'Aloisio—We will take that on notice and give you a list, from really tough down to just a warning or something.

Answer: ASIC 9 – Hansard p. 33

How ASIC deals with false, misleading or deceptive advertising and marketing material

Both the Corporations Act and the ASIC Act contain offence provisions in relation to advertising and marketing material. See Table 17 in Appendix 2 to ASIC's submission.

ASIC has a number of regulatory options for dealing with advertising and marketing material which breaches or potentially breaches these conduct provisions. For example, ASIC can:

(a) stop the advertisement by way of an injunction or stop order;

(b) enter into an enforceable undertaking with the offending party;

(c) initiate a claim for compensation e.g. compensation for any loss suffered by a consumer as a result of being misled;

(d) apply for punitive orders requiring the publication of corrections or adverse publicity about the offending promoter;

(e) apply for a community service order or probation order;

(f) apply criminal charges; and

(g) cancel a promoter’s AFS licence or adding more licence conditions following a hearing.

The regulatory response that ASIC uses will depend on the particular provision that has been breached. Often we can reach a regulatory result without using our coercive powers, e.g. where the promoter agrees to change its advertising.

ASIC deterrence in relation to advertising or promotional material

Over the last year, ASIC's Deposit Takers and Insurers team (DTI) has taken action 15 times in relation to advertising and marketing material for financial products including bank accounts, insurance and credit. Outcomes from this action include entities withdrawing their advertising, changing their advertising to comply with the law or in some cases taking other steps to address ASIC's concerns. For example, in 2009, ASIC raised concerns with Westpac Banking Corporation that some advertising for the Westpac Choice account was misleading, or likely to mislead, because it gave the impression that the promoted offer of no monthly fees would apply to all customers. In fact, the offer only applied to new customers. Westpac took a number of steps to address ASIC’s concerns including making their offer available to all customers.

Over the last 12 months, DTI has also undertaken targeted monitoring of advertising for financial products such as bank accounts. In one case, this monitoring identified advertising concerns that were widespread across industry and a broader approach was adopted by ASIC to address these concerns, including writing to relevant peak industry bodies to distribute our concerns to their members.

<u>ASIC 10 – Hansard p. 34</u>

CHAIR—No, I mean giving people specific verbal advertisements, verbal advice such as, ‘Our fund does XYZ’—marketing promotion in a verbal sense. At a seminar, for example, you do not provide advice through any written form but you say: 'Our product is 100 per cent safe. Our product is absolutely secure. Our product never loses.' All I am asking is: do you take that as seriously—

Mr D'Aloisio—Of course we take it seriously. The issue is: how do you come to know about it? For example, if you are playing golf—

CHAIR—I am not asking you how you come to know about it. I am saying: once you do know about it, lots of people already know about it. I know about it, others know about it and others go to seminars where they hear about it. Do you then take action against those people who provide that verbal promotion, advertising, marketing—whatever you want to call it?

Ms Rickard—I think the answer to that is yes. We would need to go back and check but I am fairly confident that there are a number of issues, particularly in the seminar area, where we have. But we would need to confirm that and provide you with details.

Answer: ASIC 10 – Hansard p. 34

ASIC monitors seminars as a part of its ongoing compliance and surveillance activities. Where ASIC becomes aware of a seminar that it considers warrants further investigation, e.g. following an advertising campaign or a complaint, it may decide to send a staff member to anonymously review the content of the seminar. Further information is available in Appendix 3 to ASIC's submission at [566] – [576].

The content of seminars may be analysed to determine, e.g.:

(a) whether advice is being given without a licence;

(b) if advice is being given, whether the advice is limited to general advice and the appropriate warning is given; and

(c) whether the information being delivered is false, misleading or deceptive.

There is unlikely to be any action ASIC can take immediately in relation to a seminar if personal advice is not given and participants are given a warning that they are only getting general advice.

ASIC does not have all the relevant information to comment on how many times it has informally engaged with entities to reform seminar content and promotional strategies. However, a number of examples are provided on formal proceedings in which ASIC has achieved an outcome for investors.

In 2005, ASIC successfully obtained court orders against 21st Century Academy Pty Ltd and Mr Jamie McIntyre requiring both parties to stop or change the way they arrange, promote and hold live seminars in Australia.

In 2004, ASIC took action in four separate cases against entities promoting and presenting seminars:

(a) ASIC obtained undertakings from Vision Pursuit Pty Ltd (Vision Pursuit), the promoter of American Robert Allen's "One Minute Millionaire" seminar in Sydney. Neither Vision Pursuit nor Mr Allen held an Australian financial services licence (AFSL). Vision Pursuit undertook not to provide financial product advice other than in accordance with the Corporations Act.

(b) ASIC obtained undertakings from Inguz Pty Ltd (Inguz), trading as Pow Wow Events, the promoter of American John Burley's "Winning the Money Game" and "Automatic Wealth" seminars in Sydney. Neither Inguz nor Mr Burley possessed an AFSL. Inguz undertook not to provide financial product advice other than in accordance with the Corporations Act.

(c) ASIC obtained orders against Jack C. Weavers, the promoter of wealth creation seminars, and his company Oneworld Seminars Pty Ltd (Oneworld). The orders prohibit Mr Weavers and his associates from providing financial advice and specialised courses in contravention of the Corporations Act.

(d) ASIC obtained orders against five parties involved in the promotion and presentation of wealth creation seminars. The parties included Giann & Giann Pty Ltd, trading as Break Free Events (BFE), CTC Professional Services Pty Ltd and JTC Group Pty Ltd. The seminars promoted investment strategies based on exchange traded options and options indices and were held in Melbourne, Sydney, Perth, Adelaide, Brisbane and the Gold Coast. The Federal Court declared that representations made by BFE were false and misleading. The Court also made orders for corrective advertising and restraining similar future conduct by the parties.

A recent example of ASIC's seminar surveillance activity occurred in April 2009. Two ASIC officers attended a promotional session held by a licensed operator following an internal complaint. The seminar concerned the promotion of an educational tool to assist investors in forecasting market movements up to a year in advance. While it was considered that the seminar involved puffery as to the profits that could be made, the sessions were education-based and did not involve provision of financial advice.

As a part of its forward program, detailed in ASIC's submission, ASIC is committed to thematic reviews of advertising, including reviewing seminars. The program includes a campaign targeted at CFD and other over-the-counter derivatives. ASIC officers will be attending CFD seminars as part of a project directed at reviewing the way CFDs are advertised and sold to retail investors and comparing this information with complaints data. ASIC also has several enforcement matters and compliance projects focused on unacceptable conduct in the promotion of various products and trading systems.

Financial Ombudsman Service (FOS) (Melbourne hearing, 26 August 2009)

FOS 1 - Hansard p. 25

Mr PEARCE—Senator Mason has just touched on one of the areas that I was going to talk about. I visited the UK funds when I went to the UK a number of years ago. You talked about the need for some initial government funding or seed funding to establish it. That is what happened in the UK, isn't it? Did the government set it up there and then the industry took it over progressively? Have you had a look at that structure and an application in Australia?

Ms Maynard—Yes, we have.

Mr PEARCE—What sort of funding would be required to establish that?

Ms Maynard—I cannot remember the figures off the top of my head. Can I just refer to my documents?

Mr PEARCE—Yes. You could take it on notice and come back to us.

Ms Maynard—Yes, I will take it on notice.

Answer: FOS 1 - Hansard p. 25

As indicated in your email, I took a question 'on notice' in relation to the costs of a financial services compensation scheme and wish to take this opportunity to answer that question.

Specifically, The Hon. Chris Pearce MP asked, 'Have you had a look at that [United Kingdom Financial Services Compensation Scheme] structure and an application in Australia?...What sort of funding would be required to establish [a scheme]?'.

FOS's proposed financial services compensation scheme to assist vulnerable retail clients falls squarely within the Committee's Terms of Reference, having particular relevance to:

• Term of Reference 2 - the general regulatory environment for these products and services;

• Term of Reference 5 - the adequacy of licensing arrangements for those who sold the products and services;

• Term of Reference 8 - the adequacy of professional indemnity insurance arrangements for those who sold the products and services, and the impact on consumers;

• Term of Reference 9 - the need for any legislative or regulatory change. In answer to the question taken on notice:

• a short summary of our research into the costs of establishing, operating the fund, and compensating retail clients is set out in this letter;

• a comparison between the UK compensation scheme and proposed Australian compensation scheme forms Annexure A to this letter;

• a detailed Proposal to establish the Financial Services Compensation Scheme (October 2009) forms Annexure B to this letter; and

• research into Australian, United Kingdom and other compensation arrangements in the report entitled Retail Client Compensation for Financial Services Licensees (July 2007) forms Annexure C to this letter.

2. Failure of AFS licensees to compensate retail clients

(a) Enhancing consumer protection and restoring consumer confidence

In 2006, it became increasingly apparent to FOS (then the Financial Industry Complaints Service) whilst receiving complaints against licensees arising after the collapse of Westpoint, that consumers require particular protection where a licensee has become insolvent.

As FOS has stated in its first submission to the Inquiry, the current professional indemnity insurance arrangements for those who sell financial products and is not designed to provide full compensation. The Westpoint and Storm Financial collapses provide ample evidence of the severity of the impact of inadequate compensation arrangements on consumers.

FOS recommends that a compensation scheme be introduced to ensure that retail clients are compensated in the event that the AFS licensee from whom they purchased a product or service has become insolvent or disappears.

(b) Development of the proposed compensation scheme

In 2007 we commissioned an extensive research report into:

• Limitations of Professional Indemnity insurance as a consumer protection mechanism;

• Alternative compensation arrangements such as compensation schemes and mutual funds that are in place in Australia and in other countries;

• A compensation scheme that could be implemented to build upon PI, and to better protect consumers.

Over 2008 and 2009, we have continued to undertake extensive research to refine the design of the Compensation Scheme, including:

• Economic modelling on funding of a Compensation Scheme through a levy on licensees;

• Meeting with and collecting detailed data from the United Kingdom Financial Services Compensation Scheme;

• Cost estimates for the compensation and operating costs that the Compensation Scheme would be required to meet.

3. Outline of the proposed compensation scheme

FOS proposes a compensation scheme that would protect consumers and enhance their confidence. It would be:

• An industry-based scheme operated by an entity governed by the key stakeholders: industry and consumers;

• Funded by licensees through regular levies;

• Subject to approval by the Australian Securities and Investments Commission;

• Supported by the Government through the passage of legislation to require all AFS licensees to become members of the compensation scheme; and

• A scheme that covers gaps left by the reliance of the current protection regime on PI insurance by compensating retail clients in the event that a licensee becomes insolvent up to a level that reflects the financial jurisdiction of EDR schemes.

Further details of the proposed compensation scheme are included in Annexure B to this letter.

FOS believes that such a compensation scheme would help restore consumer confidence in the financial services sector, and would provide a fundamental plank in the consumer protection mechanisms afforded by financial services regulation.

4. Estimated costs of the compensation scheme

(a) Estimated ‘average’ annual compensation costs

It is estimated that compensation claims during an ‘average’ year would be in the order of $12 million.

This estimate is based on an analysis of our data on successful claims against Australian Financial Services (AFS) licensees that were not paid because the AFS licensees became insolvent. This assumes that in an ‘average’ year the compensation scheme would be required to pay about 180 compensation claims of an average of about $65,000 each.[5]

(b) Estimated costs of establishing and operating a compensation scheme

It is estimated that the total costs of establishing and operating a scheme to the end of Year 1 would be $2.3m. This comprises $1.1m estimated establishment costs and $1.2m operating costs to the end of Year 1.

This estimate assumes that significant leverage would be achieved from the relationship between the compensation scheme and FOS[6] and that the compensation scheme would operate, with a core staff, for six months of Year 1.[7]

If claims were to continue to stay steady at about $12million, it would [be] reasonable to assume that operating costs for the full 12 months of Year 2 would be in the order of $2.4.

5. Funding of the compensation scheme

(a) Levy on industry

It is intended that the compensation scheme would be funded by industry through the following mix of pre-funding and post-funding:

- Operational costs and ‘average’ compensation costs would be pre-funded; and
- Exceptional compensation costs would be post-funded through a special compensation levy.

An economic model has been developed which demonstrates the way in which the levy would be distributed across AFS licensees.

This economic model shows that the levy can be carefully managed through various ‘levers’: the proportion of the total levy that is pre-funded and post-funded, the proportion of the levy that is imposed on those licensees that provide the same financial service as the licensee that is insolvent, the number of years over which the levy is struck; and the ‘floor’ and ‘ceiling’ levies.

5 These assumptions are based on an analysis of our data over the past 2½ years. This data indicates that we made 78 awards which were not paid to the client due to the insolvency of the licensee. Based on anecdotal evidence there were a further 70 unpaid claims, and the FOS receives only about one third of the total claims.

6 It assumes that we would provide, at a fee, space within the existing FOS premises and essential support services.

7 For the first six months of the compensation scheme’s operation, it is assumed that the compensation scheme would employ a Chief Executive Officer and a core staff of six, and includes the Board expenses.

For example, using the estimated Compensation Costs and Year 1 Costs set out above, industry would fund $12 million in claim payments and a further $2.3 in establishment and operational costs of the compensation scheme, that is, $14.3 million in total.

The parameter values used to calculate a levy of $14.3 million are:

• The levy applies to the whole industry;

• $250 minimum levy per annum;

• a $150,000 maximum per annum; and

• A single levy applies for one year.

The calculated levy, as a percentage of the 2007 revenue of AFS licensees is 0.023% of revenue per annum.

(b) 'Stress testing' of large claims

In addition to estimating the claims for compensation that the compensation scheme would receive in an 'average' year we have also 'stress tested' various other scenarios to establish how affordable a larger levy would be for AFS licensees.

For example, our economic modelling indicates that if the compensation scheme received notice of $200m in claims in Year A required to be funded over three years, and a further $100m in Year B which was also required to be funded over three years, then this would give rise to a levy just over 1% of AFS licensee revenue in each of the three funding years.6

(c) Other sources of funding

Eventually, the compensation scheme could recover some funds as a creditor in the winding up of AFS licensees. In order to do this the compensation scheme would make the payment of compensation to a retail client conditional upon an assignment of rights to pursue a recovery against the AFS licensee. If a claim under the AFS licensee's Professional Indemnity policy were successful, then this sum could become available to the compensation scheme in the usual course of the winding up.

In order to maximise the compensation scheme's flexibility to manage its cashflow, it would also have the power to borrow where necessary.

CPA (Melbourne hearing, 26 August 2009)

CPA Australia 1 – Hansard p. 67

Senator MASON—Tier two would not be subject to fiduciary duty, but it would still be subject to 945A.

Mr Davison—Yes. The tier one advisers may very well become quite a niche market. The question then is whether the public, as a whole, is going to have access to affordable advice.

Senator MASON—You are right. That is right for a policy issue. I just want to scheme out in my own mind how we are going to go. You can see where the evidence this morning has led us. You can see that you have two tiers, one with a fiduciary duty—fee for service—and then the other one. Do you follow this?

Mr Davison—You are going to have a full independent financial adviser who gives you financial advice independent of product and the second group will be product advisers that will sell you a product for your need.

Senator MASON—Without a fiduciary duty that still would meet the current Corporations Act.

Mr Drum—We are happy to have a look at the Hansard regarding what was said this morning and follow up with some written comments. We can take it as a question on notice if you like because it is from the hip, off-the-cuff remarks at the moment in understanding the detail.

Answer: CPA Australia 1 – Hansard p. 67

CPA Australia is supportive of the principle behind the tiered advice concept, that is, ensuring that the consumer understands the service they are being offered and that the advice is in the best interests of the consumer. However we believe that consumers are confused about who can provide them with financial planning advice. Introducing a new tiered advice model that would include further industry specific terminology and concepts will only add to this confusion. Therefore pursuing this option would need to be given careful consideration. It would also need to take into account any added cost, as this will ultimately be borne by the consumer.

A more appropriate option in our view would be to introduce a clear and concise disclosure statement similar to that currently under consideration by the Financial Services Authority in the UK. We believe this may offer a simpler and more cost effective alternative.

Under this proposal a financial planner who is restricted on what products they can recommend to a consumer would be required to provide a disclosure statement verbally to the client prior to any engagement.

The disclosure statement could simply be:

I am a [Firm X] adviser. The advice I can provide will be based on an assessment of your needs, however as part of that advice should I need to recommend a product, I am restricted to only recommending products from [name of provider].

It is important to note that financial planning requires the financial adviser to consider the client's objectives and take into account their client's specific circumstances in order to be confident that any advice they provide is in the best interests of the client, and will effectively aid the client in achieving their goals.

Product recommendations will form part of this advice process, but only after suitable investment vehicles and asset mixes have been identified and discussed. While the financial adviser may be restricted in the products that they can recommend to the consumer (for example limited to recommend products from a limited number of companies only), the restriction should not affect or influence the advice and strategy developed for the consumer.

This is an important and necessary distinction to demonstrate the value of the advice and show that the advice is independent from the recommendation of product.

For consistency and to avoid any possible confusion, CPA Australia would be supportive of prescribing a mandatory form of words for firms to use when they are explaining the restrictions in what products they are able to recommend.

Treasury (Canberra hearing, 28 August 2009)

Treasury 1, Hansard p. 14

Topic: STORM FINANCIAL

Senator McLucas asked:

Senator McLUCAS—I know you are not the compliance unit, in terms of ensuring that licensing regulations are there, but can you tell me when Treasury became aware that there was a problem with Storm?

Mr Miller—If you want an exact date we will have to take that on notice because we do not have the information with us.

Senator McLUCAS—I understand that. Also, can you tell me about the nature of the information that you received at that time?

Mr Miller—We will take that on notice as well.

Answer: Treasury 1, Hansard p. 14

Treasury became aware there was a problem with Storm on the morning of 17 December 2008 when the Office of the Minister for Superannuation and Corporate Law drew our attention to an article in the Townsville Bulletin of that date.

FPA (Canberra hearing, 28 August 2009)

FPA 1 – Hansard p. 39

Senator McLUCAS—How many members have you expelled from the FPA since its inception?

Mr Sanders—I can certainly attest to the fact that, in the last quarter alone, we have expelled five members. We have somewhere between 21 and 50 investigations that have progressed over the quarter. We have a range of sanctions and penalties available, of which expulsion is obviously the ultimate impact. We have had terminations of a further eight members, as I recall—and I think that data it is in our submission. We have an active investigations portfolio now. It is perhaps one of the busier aspects of the FPA's activity.

Senator McLUCAS—I make no judgment on that. It is just interesting to note the quantum of membership closures.

Ms Bloch—We certainly provided those statistics in relation to Westpoint, and our investigation process there has been completed. For the last two years we have been publicly publishing information on our complaints and disciplinary process. I am happy to provide the committee with the results for the last quarter or the last year if that would be of interest.

Answer: FPA 1 – Hansard p. 39

Thank you for giving us the opportunity to respond to Sen. McLucas's question on notice (FPA1 – Hansard p. 39). The Senator asked about the FPA's disciplinary statistics, with particular regard to expulsions. In response, we offered to provide the statistics on our complaints and disciplinary process, which we make available publicly in Financial Planning magazine.

Each quarter, the FPA publishes statistics and information on investigations and discipline for the preceding quarter. Statistics on investigations include the number of ongoing investigations as at the beginning of the quarter, the number of new investigations initiated during the quarter, the number of investigations closed during the quarter, and the number of investigations ongoing as at the end of the quarter. Information on discipline includes the number of members suspended, the number of members expelled, and the number of members subject to other sanctions, as well as the names of members subject to each form of discipline.

Information is also provided on the general nature of some particular breaches under investigation and/or for which a member is subject to discipline. We have attached excerpts from Financial Planning magazine, which contain discipline statistics for periods covering the financial year ending June 2009. In summary, fourteen (14) members were expelled over the course of the year, with five (5) expelled in the most recent quarter prior to the hearing in August.

Gus Dalle Cort (Cairns hearing, 1 September 2009)

Dalle Cort 1 – Hansard p. 13

Senator McLUCAS—So when your business was purchased by Storm, did all your clients move from your business?

Mr Dalle Cort—No.

Senator McLUCAS—What proportion didn't?

Mr Dalle Cort—Ninety-eight per cent of them.

Senator McLUCAS—So how many clients moved from MLC to Storm in that transition? I am just trying to get an understanding of the growth of the business over time from the point where the business was re-badged as Storm.

Mr Dalle Cort—I do not know. I would have to check the actual numbers.

Answer: Dalle Cort 1 – Hansard p. 13

It is not possible for me to answer this question as I do not have access to any information from Strom Nine that operated the Cairns Business.

I answered the question as if I had access to the available data.

I am sorry I was unable to assist any further.

Commonwealth Bank of Australia (Sydney hearing, 4 September 2009)

<u>CBA 1 – Hansard p. 93</u>

Senator WILLIAMS—Did you lend Storm $10 million in October just prior to that?

Mr Cohen—There was a drawdown of an existing facility in, I believe, September or October.

Senator WILLIAMS—To pay out a facility they had with Macquarie Bank?

Mr Cohen—I am not aware of the reason.

Senator WILLIAMS—Macquarie says in their submission that in October a facility was paid out to Macquarie. I believe it was a $10 million facility that you lent Storm in October 2008. You might be able to check on that for us.

Mr Cohen—We can certainly take that on notice.

<u>**Answer:** CBA 1 – Hansard p. 93</u>

During CBA's appearance at the Sydney hearing on Friday 4 September, Senator Williams raised a question (p CFS 93) about a $10M loan facility that CBA provided to Storm.

I can confirm the loan facility to Storm was approved by CBA to payout Macquarie Bank and provide funding for future acquisitions. The loan amount of $10.165m was funded on 29th October 2008.

Professional Investment Services (Sydney hearing, 4 September 2009)

PIS 1 – Hansard p. 118

Senator McLUCAS—What happened between the lender, yourself as the adviser and the client in terms of advising of the margin call?

Mr Evans—From my understanding, this was a situation where the lender advised both the client and the adviser. The reason the adviser likes to know is if there is a requirement to sell an asset people need to actually understand which asset they should be selling particularly around tax considerations and the type of investment. My understanding—and this may be wrong; I am not working day-to-day next to them—from the advisers I have spoken to is that the provider has actually contacted both the client and the adviser so they could then talk to them about which asset they would have to actually sell to prop up their current loan.

Senator McLUCAS—This is interesting. I wonder if you could do us a favour and confirm with the committee that that is accurate, because that would be very useful information.

Mr Evans—We will.

Senator McLUCAS—When you say the lender contacts the adviser and the borrower, how do they contact them? Is it a telephone call? Is it an email? Is it a letter in the mail?

Mr Evans—I would have to check on that. I remember being in a taxi coming back to an airport and actually having an adviser ring me about a particular issue. The phone call had been made to the client directly from the lender on that issue. But I would like to check to see whether that is actually common practice or whether that is just one instance where it actually happened that way.

Answer: PIS 1 – Hansard p. 118

Further to the committees request during Professional Investment Services' appearance at the Inquiry into financial products and services on Friday, 4th of September 2009 please find enclosed a sample of our margin lending experiences shared by members of the advisory network. The experiences have generally been quite inconsistent across the margin lenders with BT generally being the only margin lender to consistently contact clients (by way of mail, whilst also contacting advisers), whilst St George generally only contacted clients via phone in the instances in which they were unable to reach the adviser.

Colonial Geared Investments and Macquarie Leveraged Equities did not contact the client, only the adviser.

Margin Lender	Client Contacted by Margin Lender?	Adviser contacted by Margin Lender?
Macquarie/Leveraged Equities	No	Yes, via email
BT Margin Lending	yes via mail	Generally No
St George	Generally no, unless St George was unable to contact the adviser (in that instance they would contact the client)	Yes
Colonial Geared Investments	No	yes

ASIC (Canberra hearing, 16 September 2009)

ASIC 1 – Hansard p. 20

Ms GRIERSON—If there is a tighter regulatory regime, and if people breach that regime, what do you envisage would be the action, enforcement measure or penalty that might flow from that?

Ms Rickard—In terms of reverse mortgages—

Ms GRIERSON—I just mean generally in terms of the recommendations before us. I am talking about if they do not meet the provisions for mandatory advertising, if they do not have a disclaimer on their advice or if they do not meet the disclosure provisions.

Ms Bird—The details I will have to take on notice. The new credit bill which is before the parliament involves licensing and special obligations such as responsible lending. It is a licensing regime so it would give ASIC all the administrative powers that come with a licensing regime as well as other enforcement remedies. I am not familiar enough with the bill to be able to tell you what all the remedies are for the various forms of breaches of the legislation.

Answer: ASIC 1 – Hansard p. 20

ASIC's recommendations in its submission to the PJC Inquiry on Financial Services and Products (ASIC's submission) are not intended to increase the penalties for breach, but rather to strengthen the underlying regime. For example, ASIC has recommended that ASIC's powers to act against individuals be enhanced by amending the banning power in s 920A of the Corporations Act (see ASIC's submission at [91] – [98]).These recommendations, if implemented, would strengthen the regime by enhancing ASIC's ability to identify and ban individuals who are likely to cause investor losses and would result in ASIC's banning power being more like a 'negative licensing' power. They do not seek to change the form or substance of the penalty imposed i.e. the banning order.

There are already a range of penalties under the Corporations Act. Broadly, the penalties fall into one of three categories: criminal, civil or administrative.

(a) Criminal actions: criminal penalties can range from a fine to a period of imprisonment, or both.

(b) Civil actions: civil remedies include the imposition of civil penalties for serious contraventions of specific provisions (e.g. breach of director's duties), injunctive relief to restrain specific conduct or compel compliance with the law, corrective action to address misleading information and compensatory action to recover damages or property.

(c) Administrative actions: ASIC may undertake a range of administrative actions, including action to: disqualify or ban a person (after a hearing); issue a stop order notice for defective disclosure documents; or enter into an enforceable undertaking with a person.

Further information on ASIC's deterrence activities is available in Appendix 3 to ASIC's submission at [587] – [588].

The new credit regime will also implement a range of new penalties for which ASIC may take action within these broad categories. For example, ASIC may take:

(a) civil penalty proceedings in relation to a number of specific obligations on credit licensees including: failure to make reasonable inquiries about, and take reasonable steps to verify where appropriate, a consumer's requirements and objectives in relation to a credit contract and their financial situation before providing credit assistance; and failure to assess whether a credit contract will be unsuitable in light of particular circumstances, including the consumer's ability to service their obligations under the contract; and
(b) administrative action to ban a person from engaging in credit activities if they have contravened any credit legislation or been involved in such a contravention.

There is also a significant range of criminal penalty provisions that ASIC may refer to the Commonwealth Director of Public Prosecution for action.

Bank of Queensland (Canberra hearing, 16 September 2009)

BOQ 1 – Hansard p. 48

Mr Liddy—Initially in a loan application process there would be a statement of assets and liabilities given and a statement of income and outgoings as part of the normal loan process.

Mr ROBERT—Does any of that documentation require me, using that same hypothetical situation, to keep you abreast if my assets and liabilities fundamentally change?

Mr Liddy—To be honest, Mr Robert, I am not sure. I will take that question on notice and come back to you.

Answer: BOQ 1 – Hansard p. 48

Refer to the attached excerpt from our standard loan contract terms and conditions - Section 14, paragraph (k). In summary, the customer may commit an act of default but there is no positive obligation for them to advise the Bank if their circumstances materially change.

BOQ 2 – Hansard p. 55

Senator McLUCAS—Thank you for your earlier comments about how you deem who is going to be banker of the year. You indicated that it was on the range of sales of different products and deposits and the five elements of the bank's principles. Could you take on notice for me and provide me in writing how that is applied. How much is around—

Mr Liddy—The weightings?

Senator McLUCAS—The weighting on deposits, the weighting on integrity and how you measure those five separate elements.

Mr Liddy—We will provide that information to you.

Senator McLUCAS—Thank you.

Mr Liddy—There are certain gate openers. If you fail your audit or you fail your credit risk review, you do not get considered, regardless of what your sales performance is.

Senator McLUCAS—I do not know that we have time to go through it now, so if you can provide it on notice that would be great.

Mr Liddy—Certainly.

Answer: BOQ 2 – Hansard p. 55

The 'Branch of the Year' award is one of the sales and performance awards given as part of the Bank's annual recognition program. There are a number of awards as part of this program, which can be separated into two "buckets" - leadership and excellence awards, and sales and performance awards.

In line with the Bank's Code of Conduct, sales and performance awards are not considered in isolation from regulatory compliance requirements. There is no strict weighting on these criteria, except for the requirement that audit and compliance requirements must be passed for the year in question.

Sales awards in general are awarded to individual and team performers in Retail and Business Banking who have reached "Star" status through:

- their achievement of key performance indicators
- continuously 'living' the Bank's core values
- achievement of the core criteria of the award

These are assessed by the Executive team of the Bank, based on the year in question's sales results, any criteria such as the audit and compliance results for the year, and the Executive and senior management's personal knowledge of staff and their subjective view of their performance with respect to the Bank's values (passion, achievement, courage, integrity and teamwork). Given the small size of our organisation and the subsequent very high levels of personal interaction between Executives and senior management with all staff, this approach has been appropriate.

The specific criteria for the 'Branch of the Year' award is that it is given to the No. 1 branch for branch sales performance (as per the internally published leaderboard), that has also passed audit and compliance requirements. Assessment of the audit and compliance requirements are any branch audit reports for the year in question, and the regular branch "health checks" undertaken by the Regional Management teams.

"Sales performance" takes into account performance in the following areas: personal lending, home lending, business lending, equipment finance, deposit growth, insurance product sales, credit card sales, merchant facility sales and net customer number growth.

North Ward was awarded the "Branch of the Year" award in 2008. Declan Carnes has separately been awarded the "Branch Manager of the Year" in 2006 and 2007.

Macquarie Bank (Canberra hearing, 28 October 2009)

Macquarie Bank 1 – Hansard p. 9

Mr van der Westhuyzen—Our Ts and Cs say that we will seek to contact you or your nominated representative.

Mr ROBERT—Are those the exact words?

Mr van der Westhuyzen—They are not the exact words but that is the general thrust of the statement.

Mr ROBERT—Could you provide a copy of the exact words?

Mr van der Westhuyzen—Sure.

Answer: Macquarie Bank 1 – Hansard p. 9

Clause 5 of the Macquarie Investment Lending (MIL) Loan and Security Agreement deals with margin calls. Clause 5 does not, however, specify who will be contacted in the event of a margin call although it does make it clear that a borrower is liable to pay a margin call irrespective of whether or not any notice to pay is given by the Bank (clause 5.8). Clause 5 can be found at pages 24 and 25 of the attached brochure.

While the issue of contact in the event of a margin call was not specified in the Loan and Security Agreement, the following form of words does appear on page 15 of the attached brochure:

“A margin call requires prompt action. Macquarie will seek to contact you in the case of a margin call, but may take the action described below if we are unable to contact you. You can also nominate a Secondary Contact in case you are not contactable when a margin call occurs.”

In addition, Section 11 of the application form ("Your Authorised Representative") says:

"The Bank will contact this person for instructions in relation to your Margin

Loan facility in the event that you are uncontactable, including if a margin call is made and dealing instructions are required”.

<u>Macquarie Bank 2 – Hansard p. 13</u>

Senator MASON—You notified Storm. How many clients directly?

Mr van der Westhuyzen—From the end of October we started to notify Storm clients directly. From that point through to the end of November, to give you a comparative period, there were 359 notifications directly to Storm clients.

Senator MASON—And of those margin calls how many were satisfied within 10 days?

Mr van der Westhuyzen—I could not tell you off the top of my head here but we can take that on notice.

Senator MASON—The committee would like to know that. Can you find that out and let the committee know.

Mr van der Westhuyzen—Yes.

Answer: <u>Macquarie Bank 2 – Hansard p. 13</u>

Of the 359 margin call notifications to Storm advised clients made between the end of October 2008 through to the end of November 2008, 348 margin calls were satisfied within the 10 day period.

<u>Macquarie Bank 3 – Hansard p. 21</u>

Senator BOYCE—I just have one question that you may have to take on notice. You mentioned earlier, Mr van der Westhuyzen, that there had been margin calls throughout 2008 on Storm client accounts. Could you just give us a list, month by month, of how many there were each month for 2008?

Mr van der Westhuyzen—I can either take that on notice or provide that information to the committee.

Senator BOYCE—I think that would be best on notice, thank you.

Answer: Macquarie Bank 3 – Hansard p. 21

Below is a table setting out month by month margin calls for Storm advised clients versus the total margin calls for Macquarie Investment Lending clients for the calendar year 2008:

Month	Storm	Total	Storm as % of Total
Jan-08	12	4,054	0.3%
Feb-08	0	1,728	0.0%
Mar-08	14	3,288	0.4%
Apr-08	1	724	0.1%
May-08	1	685	0.1%
Jun-08	3	2,708	0.1%
Jul-08	342	4,170	8.2%
Aug-08	81	1,738	4.7%
Sep-08	134	3,678	3.6%
Oct-08	921	11,133	8.3%
Nov-08	355	8,153	4.4%
Dec-08	47	1,894	2.5%
Total	**1,911**	**43,953**	**4.3%**

As confirmed to the Committee, at the end of October 2008, Macquarie had approximately 1,050 margin lending clients who were advised by Storm out of a total of approximately 22,000 margin loan clients.

Commonwealth Bank of Australia (Canberra hearing, 28 October 2009)

Commonwealth Bank 1 – Hansard p. 30

Senator MASON—Particularly in the period September through to October—I do not know if you can answer this, but we have got 2,600 all up between the beginning of October and the end of December—how many were addressed within the five-day limit response time?

Mr Cohen—I do not have the answer to that, and I am not too sure if any of my colleagues do?

Mr Comyn—No.

Mr Cohen—Perhaps we can take that on notice?

Answer: Commonwealth Bank 1 – Hansard p. 30

1) Of the clients who went into margin call between 1 October 2008 and 31 December 2008, what proportion were actioned within 5 business days?

In our submission of 31 July 2009, we acknowledged that we over relied on Storm to do the right thing. However, in respect of margin loans we do not believe it is reasonable to suggest that we sat idle for 11 weeks between October and December 2008.

We believe the following factors are relevant:

Ø As at 3rd October 2008, only 48 clients were in margin call with the average Storm LVR being approximately 71%.

Ø During the period 1 October 2008 to 31 December 2008 our records indicate that Storm would have received margin calls for almost all of their clients who had a margin loan with us and whose loans passed the margin call trigger point

Ø Storm wrote to its clients on 8 October 2008 advising them that it 'may be necessary to recommend that you switch up to 100% of your portfolio to cash.' Further, 'Should you go into margin call, the margin lender is likely to sell you down completely and pay down debt. This removes the ability of the portfolio to recover whilst you are still in buffer. The losses then are very real'

This communication by Storm to its clients was, in any reasonable view, a tangible indication that it was going to manage a measured sell down, as it had in the past, to the potential margin calls.

Ø While it will be the task of our Resolution Scheme to review the data on a case-by-case basis, our initial investigations indicate that most margin calls were responded to by Storm within 5 business days. Storm was initially very active, arranging two major tranches of redemptions in October 2008 totalling more than $700 million. This represented approximately 65% of all Storm funds under advice. We believe the redemptions could have been sufficient to clear the margin calls had the market not continued to deteriorate.

Ø Of those which were not actioned within 5 business days a significant proportion were delayed due to the freezing of the managed index funds in which the loans were invested.

Ø These funds were managed by a range of financial services organisations, including Colonial First State. The freezing of redemptions was considered necessary by the responsible entities of the relevant funds to ensure that all investors were treated equally.

Ø From September to November 2008, we and Storm remained in constant communication on the status of the outstanding margin calls. We were assured by Storm that they were taking appropriate steps to manage the margin call process.

Ø In November 2008, Storm was sending us daily resolutions for margin calls. They were addressing clients in negative equity as a priority and promising to address any residual margin calls. Storm provided further resolutions totalling more than $13 million in the first two weeks of November, and promised a further $8 million.

Ø When it became apparent that the action taken by Storm was insufficient, and, despite Storm's requests to the contrary and advising their clients not to cooperate with us, we commenced the unusual step of calling clients directly in December 2008.

Ø Consistent with the fact that clients dealt almost exclusively with Storm, further delays were encountered when numerous clients, verbally and in writing, advised they would not deal with us until they had consulted with Storm.

Our initial investigation concluded that the historic market volatility during this same period necessitates a case-by-case approach to assessing each customer's situation. For example, in many cases a delay in actioning redemptions resulted in investors actually receiving a higher price than if they had been redeemed within 5 business days.

As we stated before the Committee, to the extent to which our customers' hardship is a result of our shortcomings, they will be fairly recompensed via our Resolution Scheme.

Commonwealth Bank 2 – Hansard p. 33

Senator McLUCAS—Can you help the committee by providing us with some advice about when that change of policy was communicated, and how, to Storm Financial?

Mr Narev—I cannot give you any details. I would have to take that question on notice. I have not been able in my inquiry to determine exactly when the policy was changed.

Answer: Commonwealth Bank 2 – Hansard p. 33

2) When did we alter our policy of not notifying clients directly of a margin call? How was this change in policy notified to Storm?

During our 10 year association we were advising Storm directly if their clients entered margin call. Operational staff from both the Bank and Storm interacted on a daily basis in monitoring customer positions and dealing with margin calls, when they arose. Storm was in fact reticent for us to contact their clients directly as they wanted to control the relationship. They were also best placed to advise their clients on what was the appropriate action to take as they were the only party who had complete visibility of their client's financial situation and who was licensed to provide financial advice.

We advised Storm, as opposed to the customer, which is consistent with industry practice, the law and our terms and conditions that every customer is required to sign when applying for a margin loan. Our practice was to offer to the adviser that we also send written confirmation direct to their client, however this offer was rarely accepted.

Clarity around Storm's responsibility to contact their clients in relation to margin calls is supported by the submission to the Committee of a former Storm adviser and shareholder, Mr John Fuller. Mr Fuller provides evidence that, 'I was educated from the outset within Storm Financial that no client would ever receive a margin call direct from their margin lender. If maximum LVR's were breached or threatened, the margin lender would direct the call through Storm Financial.'

Commonwealth Bank 3 – Hansard p. 48

Mr Narev—In terms of how much of this was germane to Storm, in the period that we spoke about when we made just over 2,500 margin calls between October and December to Storm customers, we made over 16,000 through the same business to clients through other dealers.

Senator BOYCE—Are they proportionate? Are those 16,000 customers the same percentage as the 2,500 is of the Storm customers?

Mr Narev—I would have to take that on notice.

Answer: Commonwealth Bank 3 – Hansard p. 48

3) For other third party advisers which CGI also dealt, did the same proportion of their clients enter into margin call during the period 1 October 2008 and 31 December 2008?

As stated before the Committee, CGI deals with approximately 7,000 third parties. In the historic volatility of last year we had an issue with only one party. Further, we also understand that during this time there was only one financial planning group which had a catastrophic failure across its client portfolio. In both cases it was Storm. We believe that this is clear evidence that the problem lies with Storm, not the industry generally or us specifically.

Our customers who were advised by Storm went into margin call in proportionately far higher numbers than the approximately 40,000 other financially advised clients within CGI.

Appendix 4

List of tabled material and key additional information provided to the inquiry

Canberra, 24 June 2009

Australian Securities and Investments Commission –

- Issues and Legal Context relevant to each Terms of Reference
- Sale and distribution of investment products to retail investors

Melbourne, 26 August 2009

Peter Worcester – Comparison of All Ordinaries Accumulation Index and Total Margin Loans (source ASX and RBA)

Australia and New Zealand Banking Group Limited – Mr Geoff Cohen

- Securities Lending Review
- Australia and New Zealand Banking Group Limited – Mr Graham Hodges
- ANZ Financial Planning

Canberra, 16 September 2009

Australian Securities and Investments Commission – Options for regulatory change to shift the balance in favour of retail investors

Key additional information

1. FPA briefing note re parliamentary inquiry
2. FPA Code of Ethics
3. FPA discussion paper on financial planners' remuneration (for FPA members)
4. Material provided by the Financial Ombudsman Service canvassing the possible development of a compensation scheme of last resort

Appendix 5

Report on a matter of parliamentary privilege

1.1 As noted in the first chapter of this report, a matter of parliamentary privilege arose during this inquiry.

1.2 Senate Parliamentary Privilege resolution 1(18) provides that:

> Where a committee has any reason to believe that any person has been improperly influenced in respect of evidence which may be given before the committee, or has been subjected to or threatened with any penalty or injury in respect of any evidence given, the committee shall take all reasonable steps to ascertain the facts of the matter. Where the committee considers that the facts disclose that a person may have been improperly influenced or subjected to or threatened with penalty or injury in respect of evidence which may be or has been given before the committee, the committee shall report the facts and its conclusions to the Senate.

1.3 A submitter to the inquiry drew the committee's attention to a letter dated 18 August 2009 that she had received from the Chair of an Association of which she is a Director. The letter indicated that, as a Director, in making the submission the submitter had breached her duties under the Board's Charter, the Director's Code of Conduct and possibly the *Corporations Act 2001*. The letter further indicated that, at its September meeting, the Board would discuss measures to be imposed on the submitter as a result of these breaches.

1.4 On 24 August 2009 (and without making reference to the 18 August letter), the submitter sought confirmation from the committee secretariat that her submission had been received as a personal submission, not a submission on behalf of an organisation. The secretariat provided this confirmation on the same date.

1.5 In subsequent email correspondence between the submitter and the association of which she is a Director, it was explicitly stated that the conduct concerns related solely to the submission, not to other actions taken (or not taken) by the submitter in her role as a Director. Clarification that the submission was a personal submission did not dissuade the Association from its plans to take action against the Director.

1.6 This body of correspondence was brought to the attention of the committee on 10 September 2009.

1.7 The correspondence received by the committee provided clear evidence that the person who had made the submission was being threatened with a 'penalty or injury' as a direct result of making that submission.

1.8 The committee met to consider this matter on 14 September 2009 and, as a matter of urgency, directed the committee secretary to write to the person who wrote the letter that threatened the submitter, to warn them that the letter may constitute a contempt of Parliament and a criminal offence. This letter was sent on 14 September 2009.

1.9 On 15 September 2009, the committee received a response advising that the original letter of 18 August 2009 had been unreservedly withdrawn. The response confirmed that no action would be taken against the submitter as a consequence of her submission, either at the September Board meeting or at any later date.

1.10 The committee considers this to have been a serious incident. However, the committee has concluded that the purpose of the parliamentary privilege resolutions, which is to protect witnesses, has now been fulfilled. As such, the committee does not consider that any further action in relation to this matter is warranted.

1.11 For the completeness of the record, the committee has attached copies of correspondence received and sent in relation to this matter in the following pages.

Mr Bernie Ripoll MP

Chairman

FPA

Financial Planning Association
of Australia Limited
ABN 62 054 174 453

Level 4, 75 Castlereagh Street
Sydney NSW 2000

GPO Box 4285
Sydney NSW 2001

Tel: 02 9220 4500
Fax: 02 9220 4580

Member Freecall: 1800 337 301
Consumer Freecall: 1800 626 393
Fax: 03 9627 5280

fpa@fpa.asn.au
www.fpa.asn.au

18 August 2009

IR/JM 20090818

PRIVATE & CONFIDENTIAL

ATTENTION Ms Julie Matheson

Dear Ms Matheson

Your duties as a Director of the FPA

It has come to the Board's attention that as a Director of the Financial Planning Association of Australia Limited (**FPA**), you have not fulfilled your obligations, at all times, to comply with the spirit, as well as the letter, of the law and of the principles of the FPA's Board Charter (**Charter**), the Director's Code of Conduct (**Code**) and the Deed of Access and Indemnity (**Deed**) most recently signed by you on 30 January 2007.

Your conduct set out below appears to the Board to conflict with the interests of the FPA.

1. Best interests of the FPA as a whole

   As to your recent submission to the Parliamentary Joint Committee on Corporations and Financial Services dated 29 July 2009 (**Submission**), it is clear that some of your views are not supported or shared by the FPA. However, you qualify yourself in your Submission as a Director of the FPA and you do not provide a disclaimer that this is a personal submission and that the views are not the views of the FPA.

2. Reporting to the Board

   Under section B3 of the Charter, you are required to report regularly to the Board concerning the authority exercised and matters which come, or may come, within the scope of the matters reserved for the Board.

   In making a Submission without reporting to or consulting with the Board, you are likely to be in breach of section B3 of the Charter.

3. Interests of other stakeholders

Your conduct appears to better serve the interests of other stakeholders, for example in the Submission, it better serves the interests of Authorised Representatives, rather than fulfilling your obligation to pursue the best interests of the FPA as a whole.

4. Personal interests

Your personal interests must not prevail over the FPA and its members' interests to the extent of carrying out your duties as a Director. Should you have a material personal interest in a matter, you are required to notify the other Directors or the Board to enable consideration of the matter at a Board meeting.

You have not communicated to any other Director or the Board any personal interests. Your conduct suggests you may have personal interests in a matter or matters where you have acted to serve those personal interests. In addition you make disparaging comments about FPA members.

5. Real or perceived conflict

You must not place yourself in a position where there is a real or perceived conflict between your personal interest and your duties as Director. Potential conflicts must be notified to the Board and in certain circumstances you may be required to resign.

You have not communicated any potential conflict to the Board, whether real or perceived for its consideration.

6. Dissenting opinion

The FPA Board read the FPA's submission to the PJC Inquiry and was given the opportunity to comment. You made comments which were addressed and you were invited to make further comments (email dated 17 July 2009) but none were received.

You are not required to agree on all matters with other Directors or the Board. The Board provides opportunities to Directors to put their views on issues before it. However, a Director who dissents on certain decisions will not in itself be sufficient to remove all liability to the extent of allowing the making of conflicting submissions or statements that are likely to prejudice the FPA's business, harm, defame or otherwise bring discredit or denigrate the FPA, its members, and/or fellow Directors and other staff.

Board members have expressed concern over your conduct because it is not aligned with the FPA's business and affairs, its members' interests, or your duties as a Director. It is your duty, as a Director to represent and serve the interests of the FPA and its members. If you are unable to fulfil this obligation, you are required to notify the Board. The Board needs to consider your breaches of the Charter, Director's Code of Conduct and possibly breaches under the *Corporations Act 2001* (Cth).

The Board is entitled to impose a number of measures on Directors where there are instances of a breach. It is my intention that this will be discussed at the next Board meeting in September 2009. You have indicated that you are not going to attend the September Board meeting so please let me know if you wish to table any response to this letter for the Board's information at the September Board meeting.

Yours faithfully

JBerry

Julie Berry CFP®
Chair
Financial Planning Association of Australia Limited

From: Julie Matheson [ ]

Sent: Monday, 7 September 2009 5:50 PM

To: 'Julie Berry'

Cc: 'Ian Read'

Subject: RE: Directors Duties

Dear Julie

I received your letter with surprise and disappointment.

I considered the allegations in your letter, and consulted my solicitor, but unfortunately the allegations are very broad, and it is not possible for me to effectively respond to such broad allegations. If you would outline the precise behaviour upon which each allegation is based, I can then address the allegations. However, at the moment, I am not able to do so because the allegations are so broadly drafted.

It does appear that some of your concern relates to my personal submission to the PJC Inquiry. Following receipt of your letter, I immediately contacted the PJC to ensure that they were aware that it was my personal submission, and to be sure that they did not somehow mistakenly believe it was a submission from the FPA. They kindly responded, making it clear that they are aware of that my submission was a personal submission. For your convenience, their email confirmation is copied below.

It is possible that your concerns have now been addressed, since you now know that my submission to the PJC is a personal submission, and has now been acknowledged by the PJC as such. However, if this is not the case, please provide me with detailed grounds for the allegations which you have made.

Yours sincerely

Julie Matheson
Director

The Trading Board (formerly Sovereign Bridge Pty Ltd)
AFSL No. 234 705
PO Box 1898
WEST PERTH WA 6872

Phone: (08) 9381 7310
Fax: (08) 9381 7374
Email:

From: Batge, Shona (SEN) [mailto:] **On Behalf Of** Committee, Corporations (SEN)
Sent: Monday, 24 August 2009 9:22 AM
To: Julie Matheson

Subject: RE: Inquiry into financial products and services - acknowledgement of submission

Dear Ms Matheson

Thank you for your email.

I can confirm that your submission, submission 262, has been listed and published in your name as a personal submission (http://www.aph.gov.au/senate/committee/corporations_ctte/fps/submissions/sub262.pdf) and that committee members understand that the submission has been made in this capacity.

Kind regards,

Shona

Dr Shona Batge

Secretary

Parliamentary Joint Committee on Corporations and Financial Services

Department of the Senate

Ph 02 6277 3543

Fax 02 6277 5719

Email Shona.Batge@aph.gov.au

From: Julie Matheson [mailto]
Sent: Monday, 24 August 2009 10:27 AM
To: Committee, Corporations (SEN)
Subject: RE: Inquiry into financial products and services - acknowledgement of submission

Dear Sophie,

Could you please confirm by return email that my Submission (No.262) will be treated as a **personal submission** and that the views expressed in the Submission are not the views of the Financial Planning Association (FPA), nor its membership, nor any category of membership that exists at the FPA, nor any other membership association that currently exists in financial services.

I look forward to your earliest reply.

Yours sincerely

Julie Matheson

From: Julie Berry [mailto: :]
Sent: Thursday, 20 August 2009 9:05 AM
To: 'Julie Matheson'
Cc: 'Ian Read'
Subject: Directors Duties

Good Morning Julie,

I refer you to the attached, please note that I have also forwarded a hardcopy for your reference.

Thanks

Julie Berry CFP®
Chair
Financial Planning Association of Australia Limited

From: Julie Berry [ ]
Sent: Thursday, 10 September 2009 1:32 PM
To: 'Julie Matheson'
Cc: 'Ian Read'
Subject: RE: Directors Duties

Good afternoon,

In answer to your question yes that is correct.

Julie Berry

From: Julie Matheson [mai']
Sent: Thursday, 10 September 2009 11:57 AM
To: 'Julie Berry'
Subject: RE: Directors Duties

Dear Julie

Thank you for your email of 8 September 2009. I understand from that email that the allegations ("Your Allegations") contained in your letter of 18 August 2009 are entirely related to my personal submission to the PJC Inquiry. Could you please confirm that my understanding is correct?

If my understanding is not correct, and Your Allegations relate to matters other than my personal submission, please provide me with details of precisely what behaviour you believe relates to each allegation. Please provide the actual incidents and dates of those incidents, specifically detailed in relation to each allegation, so that I may respond to each of Your Allegations.

Yours sincerely

Julie Matheson
Director

The Trading Board formerly Sovereign Bridge Pty Ltd
AFSL No. 234 705
PO Box 1898
WEST PERTH WA 6872

Phone: (08) 9381 7310
Fax: (08) 9381 7374
Email:

From: Julie Berry [mailto.]
Sent: Tuesday, 8 September 2009 2:17 PM
To: 'Julie Matheson'
Cc: 'Ian Read'

Subject: RE: Directors Duties

Good afternoon Julie,

In response to your comments as to lack of clarity as to the behaviour being addressed, I refer you to my letter dated 18th of August, which expressly refers to the submission made by you to the PJC.

There were six individual issues raised relating back to the Submission made by yourself which I believe make it very clear as to what your obligations are and where the concerns lie.

Thank you for having now notified the Secretary, Parliamentary Joint Committee on Corporations and Financial Services, Department of the Senate, of your intent to ensure this is a personal submission. This serves to clarify point one of my letter even though this is post the event.

I do not believe that any further clarification is required, your response as received today will be tabled at the Board as advised by Ian in his original email dated 21st August 2009.

Should you wish to provide any further information which addresses the additional points raised in my letter of the 18th August, please be assured that this will also be provided to the Board.

The matter will be tabled with the Board in accordance with our Deed and Charter process

Thank you

Julie Berry
Chair
Financial Planning Association of Australia Limited

From: Julie Matheson [mailto:[illegible]]
Sent: Tuesday, 8 September 2009 3:35 PM
To: 'Ian Read'
Cc: 'Julie Berry'
Subject: RE: Directors Duties

Dear Ian,

Your reply and actions may be a little premature as I have not received a reply from Julie Berry regarding the details of the allegations in her letter as requested so that they may be addressed.

I suggest that it would be improper to circulate and discuss allegations with other Directors which I have no knowledge of, and imply that other Directors would consent to discussing the details of such allegations at a meeting in my absence.

I look forward to a reply from Julie Berry to my request for the details of the allegations so that I can respond accordingly.

Regards

Julie Matheson
Director

The Trading Board
AFSL No. 234 705
PO Box 1898

WEST PERTH WA 6872

Phone: (08) 9381 7310
Fax: (08) 9381 7374
Email·

From: Ian Read [mailto
Sent: Tuesday, 8 September 2009 12:30 PM
To: 'Julie Matheson'
Cc: 'Julie Berry'
Subject: Re: Directors Duties

Hi Julie

Many thanks for copying me on your written response to the letter sent to you by the Chair.

In accordance with the Deed of Agreement & Board Charter, I now have to provide the Directors with a copy of the letter and your response for the Board meeting to (i) review the matter, (ii) consider any submissions put by you, and (iii) determine the appropriate sanctions (if any) which should be applied.

Regards

Ian Read
Company Secretary & Head of Operations
Financial Planning Association of Australia Limited
p 02 9220 4513 **f** 02 9220 4580 **m** 0447 447 157
e **w** www.fpa.asn.au

THE SENATE

PARLIAMENTARY JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

14 September 2009

Ms Julie Berry

Chair

Financial Planning Association of Australia Ltd

GPO Box 4285

Sydney NSW 2000

Dear Ms Berry

The Parliamentary Joint Committee on Corporations and Financial Services has received a copy of a letter sent by you to Ms Julie Matheson on 18 August 2009. In the letter you indicate that, as a Director of the Financial Planning Association of Australia Limited (FPA), Ms Matheson has not fulfilled her obligations to comply with the FPA's Board Charter, the Director's Code of Conduct, and the Deed of Access and Indemnity. You state that Ms Matheson has breached the Charter, the Director's Code of Conduct and possibly the *Corporations Act 2001*, and you link these conduct breaches to Ms Matheson's submission to the committee's inquiry into financial products and services. You further indicate that, at its September meeting, the FPA Board will discuss measures to be imposed on Ms Matheson as a result of these breaches.

The committee also has a copy of an email in which you confirm as correct Ms Matheson's understanding that the complaints levelled against her relate solely to her submission to the parliamentary inquiry.

PO Box 6100, Parliament House, Canberra ACT 2600 Tel: +61 2 6277 3583 Fax: +61 2 6277 5719
Email: corporations.joint@aph.gov.au Internet: http://www.aph.gov.au/senate/committee/corporations_ctte

The committee has considered your letter to Ms Matheson, and your subsequent email, and I am writing on behalf of all committee members to advise you that your correspondence may constitute a contempt of Parliament and a criminal offence on your part (as the person who signed the letter), as well as on the part of other senior FPA personnel who were party to the decision to write to Ms Matheson in these terms (including Mr Ian Read).

Relevant Parliamentary resolutions provide:

> ***Interference with witnesses***
>
> *(10) A person shall not, by fraud, intimidation, force or threat of any kind, by the offer or promise of any inducement or benefit of any kind, or by other improper means, influence another person in respect of any evidence given or to be given before the Senate or a committee, or induce another person to refrain from giving such evidence.*
>
> ***Molestation of witnesses***
>
> *(11) A person shall not inflict any penalty or injury upon, or deprive of any benefit, another person on account of any evidence given or to be given before the Senate or a committee.*

Such action may also constitute a criminal offence under Section 12 of the *Parliamentary Privileges Act 1987*. Penalties may include fines or imprisonment not exceeding six months.

I am writing to inform you, and through you all persons who were party to the decision to write to Ms Matheson in such terms, of the potential implications of threatening, disciplining or otherwise disadvantaging Ms Matheson in any way that may be linked to her submission to, or any of her dealings with, the committee. The committee asks that you withdraw the letter unreservedly and refrain from conducting the proposed review of Ms Matheson's conduct at the September board meeting. Any further action on your part, or that of anyone else, against Ms Matheson as a consequence of her submission to the committee's inquiry will be subject to further action by the committee and possibly by the Senate.

You should also be aware that the Senate's resolutions require the committee to report publicly the facts and its conclusions on this matter to the Senate, which will then decide whether the matter should be referred to the Standing Committee on Privileges. As such, further investigation and action by that committee against you and all senior FPA personnel who were party to this decision is possible.

The committee seeks a written assurance from you and from the FPA that Ms Matheson will suffer no further disadvantage as a consequence of her having made a submission to the inquiry.

Any further communication on this matter should be marked for the attention of the Committee Chair and directed through:

Committee Secretary

Parliamentary Joint Committee on Corporations and Financial Services

Department of the Senate

PO Box 6100

Parliament House

Canberra ACT 2600

Phone: +61 2 6277 3543

Fax: +61 2 6277 5719

Email: corporations.joint@aph.gov.au

Yours sincerely

Mr Bernie Ripoll MP
Chairman

Cc: Ms Julie Matheson

Financial Planning Association
of Australia Limited
ABN 62 054 174 453

Level 4, 75 Castlereagh Street
Sydney NSW 2000

GPO Box 4285
Sydney NSW 2001

Tel: 02 9220 4500
Fax: 02 9220 4580

Member Freecall: 1800 337 301
Consumer Freecall: 1800 626 393
Fax: 03 9627 5280

fpa@fpa.asn.au
www.fpa.asn.au

15 September 2009

Mr Bernie Ripoll MP
Chairman
Parliamentary Joint Committee on
Corporations and Financial Services
Parliament House
CANBERRA ACT 2600

Dear Mr Ripoll

Thank you for your letter of 14 September 2009.

I can confirm that the FPA:

1. Unreservedly withdraws the letter dated 18 August 2009 to Ms Julie Matheson;

2. Will not review Ms Matheson's conduct (as referred to in the 18 August letter) at its September Board Meeting (or any subsequent Board Meeting); and

3. Will ensure Ms Matheson suffers no disadvantage as a consequence of her having made a submission to the Inquiry.

I should also let you know that I have today written to Ms Matheson offering an apology, and confirming the above points, and have attached a copy of that letter for your information.

Yours sincerely

J Berry

Julie Berry CFP®
Chair
Financial Planning Association of Australia Limited

FPA

Financial Planning Association
of Australia Limited
ABN 62 054 174 453

Level 4, 75 Castlereagh Street
Sydney NSW 2000

GPO Box 4285
Sydney NSW 2001

Tel: 02 9220 4500
Fax: 02 9220 4580

Member Freecall: 1800 337 301
Consumer Freecall: 1800 626 393
Fax: 03 9627 5280

fpa@fpa.asn.au
www.fpa.asn.au

15 September 2009

Ms J Matheson

Dear Julie

No doubt you have seen the letter of 14 September 2009 addressed to me, from the Chairman of the Parliamentary Joint Committee on Corporations and Financial Services.

I attach my letter of response to the Chairman, for your information.

I withdraw my initial letter to you dated 18 August 2009 and extend an apology to you. In addition, I confirm that the Board will not discuss this matter, the Board will not review your conduct nor will you suffer any disadvantage as a consequence of your submission to the Inquiry.

It was never the intention of the FPA to hinder you giving a personal submission to the Committee.

Nevertheless the apology is proffered and I hope you will accept it. If you have any further concerns that you may wish to raise please do not hesitate to contact me.

Yours sincerely,

Julie Berry CFP®
Chair
Financial Planning Association of Australia Limited

New South Wales / ACT
GPO Box 4285
Sydney
NSW 2001
Ph: 02 9220 4500
Fax: 02 9220 4580
nsw@fpa.asn.au

Queensland
433 Logan Rd
Stones Corner
Qld 4120
Ph: 07 3394 8288
Fax: 07 3394 8289
qld@fpa.asn.au

NT / SA / Tas / WA
Suite 20, Carrington House
61-63 Carrington St
Adelaide SA 5000
Ph: 08 8237 0520
Fax: 08 8237 0582
sa@fpa.asn.au

Victoria
PO Box 109, Collins St West
Melbourne
Vic 8007
Ph: 03 9627 5200
Fax: 03 9627 5280
vic@fpa.asn.au