SENATE STANDING COMMITTEE ON ECONOMICS
ADDITIONAL ESTIMATES 2008-09
25-26 FEBRUARY 2009

TABLED DOCUMENT NO. 1
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TIME/DATE: 10.50PM, 25 FEBRUARY 2009

STATEMENT BY THE AUSTRALIAN SECURITIES & INVESTMENTS COMMISSION ON STORM FINANCIAL PTY LTD - SENATE STANDING COMMITTEE ON ECONOMICS ADDITIONAL ESTIMATES HEARING 25 FEBRUARY 2009

Preliminary

In the ordinary course, once a matter is under formal investigation under the ASIC Act, ASIC does not make public comment. However, the level of interest in Storm is such that it is in the public interest to depart from this policy in this case in a limited way. What I will now say represents ASIC's views at this time and ASIC reserves the right to change or alter the views expressed as its investigations continue.

What is Storm about?

Let me outline some facts:

- Storm Financial was a financial planning business which had approximately 14,500 clients, largely concentrated in North Queensland, but extended to Brisbane and beyond Queensland;
- The essence of its business was to provide personal advice to clients and to develop plans to invest on their behalf; and
- Storm also invested funds for clients in products that a related company helped to develop. Most notable in this product range were a series of managed funds, which were managed and operated for Storm clients by Colonial (CBA) and Challenger.

The Storm business as described so far is not unlike other financial planning models. Typically, financial planners, including those operated by large

financial institutions, provide advice on financial products and place clients in investments such as managed funds. In many cases, they develop 'tailor made' or bespoke funds for their clients.

The fees payable under this advisory model can be upfront fees or trail commissions based on a percentage of funds under management.

The Corporations Act (which ASIC administers) does not prohibit these advisory models. Financial planners can charge upfront commissions, trail commissions or fees for service. They can develop and place their clients in funds which they manage or have managed for them.

The Act does, however, provide protection to retail investors through:

- setting a minimum standard of advice – personal advice must be (a) based on reasonable inquiries and (b) appropriate for the client, having regard to the client's circumstances;

- placing an obligation on the adviser, before giving any advice, to determine the relevant personal circumstances of the client, and make reasonable inquiries about those circumstances;

- rules for managing conflict of interests inherent in the advisory model (e.g. fee incentives skewed towards recommending investment into funds being managed for the planner).

The law is based on the premise that licensees will comply with the Act. ASIC's role is essentially oversight and supervision and, where it considers there has been a breach of the law, to take action.

ASIC's oversight work in this market (i.e. the market for some 18,000 planners with funds under management in excess of $500 billion) has been extensive and has focused on a number of areas:

- 'shadow shopping' exercises to improve quality of advice in relation to super switching;
- advice and guidance on managing conflicts of interest;
- guidance on the provision of statements of advice as well as collaboration with the Financial Planning Association (FPA) on the sample statement of advice released in 2008;
- ASIC guidance on the compensation arrangements regarding PI Insurance; and
- extensive investor education through such things as ASIC's FIDO website. Examples are: seven key tips for investing; how to spot what is too good to be true and how past performance is not an indication of future investment; stay in control of your investments; margin lending and understanding risks.

ASIC, following its strategic review in 2008, has put in place dedicated teams covering financial planners, funds management and retail and consumer investors. These teams carry the responsibility for surveillance and oversight.

ASIC believes:

- it has adequate resources to monitor and supervise this industry; and
- overall, retail investors should continue to have confidence in the financial planning industry.

<u>What went wrong with Storm?</u>

The advisory model described so far was used by Storm. However, there were two other aspects or additions to the advisory model that created a circumstance of significant vulnerability to a collapse in the share market.

First, Storm added client leverage through margin loans for a number of its clients. This form of leverage for client investments has been a common factor of our markets. Essentially, through leverage, clients can increase the size of their investment by combining borrowed funds (margin loans) with their own funds (equity). To take a simple case: if a client had $100 of equity, rather than buying $100 worth of shares, the client could buy $400 worth of shares by borrowing $300 through a margin loan facility and using all of the shares as security.

The use of margin loans is a feature employed by other advisers and planners. It is not limited to Storm. The attraction of margin loans in a rising or bull market is that they enable clients to increase their profits – so that in the example I have just given a 25% increase in the share price would give the shares a value of $500, or a profit of $100. Thus, the client would double its original equity from $100 to $200. Compare this to a non-geared investment of only $100 – the profit would only be $25.

However, in a falling market, the losses are potentially multiplied. As share prices fall, lenders will seek to protect themselves by making margin calls. In the wake of the fall in the stock market, margin calls have been common. A margin call requires the client to provide additional equity to maintain a safety margin for repayment of the loan (known as the loan to value ratio). In many cases, to meet margin loan calls, clients have needed to liquidate other assets or to liquidate the shares or investments subject to the margin loan.

As indicated, this is a feature of many investment models including Storm's.

Secondly, Storm also recommended leverage, not only against the investments purchased (i.e. the shares or managed funds) but also against other assets (for example existing shares, the family home and any investment properties). Storm therefore pursued a more aggressive leveraging model for its clients, which also included refinancing of existing home loans and other property loans in a number of cases to increase a client's equity. Refinancing took place with a number of lenders, including

Commonwealth Bank and Bank of Queensland. This more aggressive leverage had three distinguishing features compared to 'normal' margin lending:

- a 'whole of balance sheet' approach (i.e. a wider range of the client's assets, including in some cases, the family home were considered when determining the loan to value ratio);
- an ongoing borrowing program against the additional equity created as the market increased the value of investments (Storm called this 'Step Investing'); and
- a more aggressive loan to value ratio for borrowing.

One of the problems associated with this type of model is that the clients can be placed in a very difficult situation if margin calls are made and they might have no 'spare' equity to meet a margin call. They will therefore be forced to sell their investment. In addition, the timing of the market fall might also mean that clients can move very quickly from a position where they have some residual equity in their investment to a situation where they suffer so-called 'negative equity' – meaning that the total value of the investments that secure the margin loan (i.e. the shares or units in the managed fund) is less than the liability under the margin loan.

In addition, margin calls might also have the consequence of crystallising an investor's losses and trigger loan repayments, as well as lead to the need to sell other assets.

Some 3,000 of Storm's 14,500 clients were leveraged into managed funds. Of these 3,000, about 450 were in negative equity towards the end of last year. That is, their margin loan was greater than the value of their interest in the funds or shares. Prior to Christmas this figure had reduced to 300 investors. ASIC understands that there has been a further significant reduction in this figure as former Storm clients have been able to sell other

investments to reduce their margin loan accounts. In all, we think the total negative equity will be less than $20m. This is an estimate at this point as our investigations are continuing.

The important point, however, is that the negative equity for the margin loan needs to be met by the investor from other assets (e.g. value of the family home). So, in the simple case where an investor has $100,000 negative equity in the margin loan (i.e. the loan amount minus the value of the investment), it would need to find $100,000 from other assets (such as the residual equity in that person's home) to restore the required loan to value ratio.

We do not, at this point, know how much 'equity' has been lost by investors or how many have been required to sell other assets (e.g. home and investment properties) to meet margin calls. Given the scale of the market fall and the extent of gearing, the loss of equity is likely to be very substantial.

ASIC has so far commenced examinations of certain Storm officers, attended public meetings of Storm clients, and conducted detailed interviews with a group of 39 investors who had lodged complaints with ASIC. ASIC has also been in direct communication with the main providers of margin loan facilities, Commonwealth Bank and Macquarie Bank, to obtain further details to assist with these investigations. In addition, ASIC is accessing Storms' computer records to undertake a further assessment of the advice given to its clients.

As we know, the stock market has fallen significantly and this has, in turn, led to margin loan calls and losses. At this point it appears that Storm client losses are attributed to falls in the stock market and not, for example, to misappropriation of money.

Our inquiries and present assessment is that Storm's approach to leverage is not the norm in the market. That is, it is on the more aggressive side of leverage. Leverage, aggressive or otherwise, is not prohibited by the

Corporations Act. Indeed leverage has been a feature of the broader and global financial crisis which is still unfolding.

So, in short, the risk/reward for the advisory model was higher reward in the 'bull market' upturn with potential greater losses in a downturn, particularly if the downturn was significant. This downturn has put at risk substantial equity in the investments and the other assets for investors.

<u>What then is ASIC's interest in Storm?</u>

Given the high risk/high reward nature of the scheme, what is ASIC's interest? The Corporations Act does not prohibit aggressive leverage or the taking of high reward/high risk strategies in appropriate cases.

However, the question under the Act is whether Storm's advice to a retail client was appropriate for that client. ASIC's interest in the case and its investigations is to examine if there has been compliance with the law.

Now that Storm has collapsed – (i.e. external administrators and receivers have been appointed) – ASIC is also concerned to ensure that the administration of Storm is conducted appropriately by the external administrators, having regard to the interests of relevant stakeholders. These interests include employees, other priority creditors, unsecured creditors and the secured creditor (Commonwealth Bank).

To explain further, the collapse of Storm as a company does not directly impact the investments owned by Storm's clients. Those clients and their investments can be managed by other planners. On 18 December 2008, the FPA announced the establishment of a planner referral service for Storm clients, which was provided by FPA members at no cost to the client.

In relation to the question of Storm's dealings with its clients, ASIC's areas of inquiry and investigation are:

- Advice: whether the standard of advice was based on reasonable inquiries and was appropriate for retail investors:

    - at the time of the original investment;
    - at later times, including at the time of any increase in investment levels or when margin calls were made;

- Disclosure of risks to investors/clients;

- Management of conflicts of interest;

- Loan and refinancing arrangements with lenders and compliance with relevant laws; and

- Any other matters that might give rise to breaches of duty/obligations in the provision of advice and management of client affairs.

ASIC's interest in assessing whether there have been breaches is broader than just for Storm and its clients.

The information obtained from these investigations might lead to litigation for the purpose of compensating investors. I will make some further observations about such proceedings shortly. However, any such proceedings would also be likely to provide guidance for the future of the industry about the operation of the Corporations Act and the nature of financial advice that should be provided to retail clients. To date, there have been no reported cases about these provisions in the Act.

In relation to the external administration of Storm, ASIC has taken two separate court proceedings in the interests of creditors (including potential future claims by investors) and the due administration of the affairs of Storm:

- Action in the Queensland Supreme Court to freeze the sum of $2m paid by Storm to a company controlled by the directors of Storm one month prior to Storm being placed in voluntary administration;

- Intervention in proceedings in the Federal Court to ensure that the voluntary administration proceeds in a timely manner, and that if any viable reorganisation proposal is to be put forward for Storm that it be presented for consideration as quickly as possible.

Can ASIC recover compensation?

Storm is in voluntary administration (and receivership) and it is not clear just what funds will be available for investors who have a claim against the company. The availability of funds will depend upon the success of the receiver in realising the assets of Storm, which include Storm's existing book of business and trail commissions, and real property assets owned by Storm.

As the holder of a financial services licence, Storm is required to have PI insurance. ASIC expects that any PI proceeds that become available would be paid to the investors affected. In principle, actions in relation to the PI insurance may be taken privately by investors or their representatives, or possibly by an external administrator (e.g. a liquidator). ASIC could also take actions on behalf of investors if it is in the public interest for ASIC to do so (under s50 ASIC Act).

In short, ASIC will, as part of its work, assess compensation actions as it has, for example, in the Westpoint cases. However, it is too early to make any comments about whether any proceedings might be brought and by whom, and with what prospects of success.

Can ASIC prevent foreclosure?

A number of investors may have loans secured against their homes, and hence they will be concerned with potential actions by lenders to take

possession of those properties and sell them. At this stage, ASIC is inquiring into this issue and understands that the Commonwealth Bank, for example, has not undertaken any such enforcement action in relation to any of these investors.

Margin loans are not regulated under the Corporations Act. ASIC's ability to deal with mortgage and loan issues (i.e. to affect rights of lenders to Storm's clients) is limited, because these matters are ordinarily determined by the general law of property and contracts. Nevertheless, as part of its investigation, ASIC will continue to monitor the position and ASIC will assess if there are other possible actions under the Corporations Act or ASIC Act (e.g. misleading or deceptive conduct).

Should ASIC have prohibited the Storm aggressive leverage model?

Or to put it another way, is ASIC now acting after the "horse has bolted"?

ASIC's powers are framed around a presumption of compliance by licensees with a law that requires advice to be provided to retail clients that is based on reasonable inquiries and appropriate to their circumstances.

ASIC would need to have been able to establish systemic (not isolated) breaches of the law or regulatory failures before it could have altered, suspended or cancelled Storm's AFSL. As outlined, the Storm advisory model, on its face, operated as other models did, other than for the greater use of leverage.

While ASIC has been concerned with aggressive leverage and issued warnings to retail investors generally (see above), it does not have the power simply to act to prevent these models.

One of the consequences of a 'bull run' in the market is that it masked any potential shortcomings in an aggressively leveraged advisory model. Consider the difficulty of ASIC trying to close down an advisory model during

2006 or 2007 which was producing high returns for its investors. ASIC would have needed to convince these investors that any future downturn could be more severe, for example, than the stock market crash of 1987 and hence they could lose their equity in the investments and possibly their other assets.

Should ASIC, however, have done more to warn Storm's clients?

Nevertheless, we have asked ourselves the question: could we have done more?

We are in the process of reviewing our contacts with Storm and complaints to ASIC about Storm. What we can say at this stage is that, prior to 2006, there were a number of communications between ASIC, Storm and its officers based on routine ASIC surveillance in Queensland on financial planners. However, any issues, generally about disclosure matters, raised during these surveillance activities, were resolved at the time.

During 2006/07 ASIC received four complaints about Storm in relation to its statements of advice and fee levels. However, no complaints were received from Storm clients. These issues, which concerned disclosure and fees, were addressed at the time by Storm. They did not involve any examination of Storm's advisory model or use of aggressive leverage.

In November/December 2007, ASIC examined a prospectus lodged by Storm for the purpose of a public offering that Storm proposed, to become a listed company. That listing did not proceed. ASIC's examination in relation to this prospectus was centred around protecting investors who may have subscribed for shares, rather than examining the nature of Storm's advisory model.

In early 2008, ASIC received a call to our Call Centre complaining about fee levels charged by an unidentified financial advisory firm (now identified as Storm). On 31 October 2008, ASIC received a number of complaints from investors which ASIC reviewed and followed up with various inquiries. As a

result of that work, ASIC commenced a formal investigation on 12 December 2008.

Neither the earlier surveillance, nor more recent complaints, provided any 'smoking gun' for ASIC. Whether, with the benefit of hindsight, they should have is clearly a matter we are examining. Once investors complained in October 2008, we acted quickly.

Do the problems extend beyond Storm?

ASIC is assessing whether the Storm aggressive leverage model is more widely used in the industry. ASIC believes that it has not been widely used, but it is directing resources to assessing other planners and advisers to confirm this.

Is ASIC adequately protecting retail investors?

ASIC is focused on retail investor and consumer protection. The Committee will recall that, in May 2007, we outlined ASIC's 6 priorities and made clear that this was a clear priority for ASIC. What we do and are doing should reassure investors that we are working for them and our staff want to make a difference for them.

Overall, given the magnitude of the financial and market crisis, retail investors should continue to have confidence in the financial planning industry. Having said that, we see need for improvement in the quality of advice and are working to achieve that. In addition, we see benefit in clarifying the law and setting clear guidance on the inherent conflict in the legislative framework of enabling advice to be given and at the same time charging fees for investment products. Whether that inherent conflict, however, needs to be reviewed is a policy matter for Government. As a regulator, ASIC's role (to put it colloquially) is to play the hand it has been dealt with.

Conclusion

Let me conclude:

- ASIC is deeply concerned with the losses suffered by Storm investors and will closely follow the progress of the external administration of Storm to ensure that action is taken to recover any available compensation for investors.

- It will pursue investigations to identify whether there have been any breaches of the Act or the law generally that might assist in:

    - compensating investors in relation Storm's past conduct;
    - providing guidance to financial planners in relation to the operation of the Act for the future;

- ASIC will also be assessing the market more broadly to maintain confidence in the financial planning industry by seeking to reduce the risk of other similar situations occurring.