## 1. The role of financial advisers

The role of financial advisers and/or planners, to my mind, is to provide competent advice (to a reasonable standard) in their client's best interest.

### (i) Commissions

On providing their services, financial advisers may have arrangements by which they may be able to gain commissions, by directing certain clients of theirs to purchase specific products. For example, a Cyclone financial planner may have an agreement with the Widget Growth Fund, by which Widget will pay the Cyclone financial planner $50 for every customer that the financial planner directs towards Widget. Whether the client knows of this, or does not know of this arrangement, is immaterial - see below:

#### (a) Client not Having Knowledge of the Commission

Let us suppose the client does not know of this arrangement. In this case, the financial planner may be prone to directing his client towards the Widget Growth Fund, not because it is in the client's absolute best interest, but merely to reap the $50 commission into the adviser's pocket. This to my mind is inimical with the adviser's proper role and duty towards their clients (as I have succinctly stated above). The client, unbeknownst to him, thinks he is maximising his returns, or has received the best possible advice, when in reality, he may have been able to purchase Widgets from a more appropriate supplier. In this instance, the client has been well deceived and ill used.

#### (b) Client does have knowledge of the Commission

##### (i) Difficult in Proving Financial Advisers were not acting in client’s best interests

First it must be remembered that is difficult to prove a financial planner’s dishonesty. But let us consider the alternative scenario: the customer is told of the commission that his financial adviser will receive. Regardless of whether the customer is told or not told this information, the financial adviser still has a monetary incentive to direct clients towards the Widget Growth Fund, when it may not be in their client's best interests. The adviser could still point the customer down the road so that the financial planner will be able to reap his or her commission fees notwithstanding the financial planner having disclosed that he will receive the commission. For example, there may be an equally good substitute, e.g. the Spuds Growth Fund, which would more than adequately fulfill the client's needs, but the financial planner may ignore the Spuds fund and may opt for the Widget Fund solely in order to obtain the commission. But of course, the dishonest financial planner is not going to wear his heart on his crown and trumpet to the world he or she is doing this solely because of the commission he will be obtaining - no! There are always significant grey areas by which one decision could be justified over another decision. Proving that a decision was made solely on the basis of commissions would be very difficult to prove in a court of law, especially when all funds are different. For example, the financial planner may justify his decision regarding the Widget purchase because he may feel (dishonestly, I might add) that the managers of the Widget Fund are more talented than the managers of the Spuds Fund, and so on.

Hence, the only way to encourage 'dishonest' financial planners to provide advice that is absolutely in their clients' best interest is to rid the world of this practice of them being offered and accepting commissions. It is a practice that should be wholly stamped out of the industry, and would do a world of good for consumers of financial products.

Furthermore, even if the client discovers this dishonesty, what is he to do? Will he go to the considerable expense, and time and hassle of pursuing his adviser in a court oflaw? It is only when the client loses considerable amounts of money does the thought of suing enter his mind, in the hope that he can recover some sums from his adviser.

**(ii) Client Relationships with Advisers**
Clients choose their advisers. They choose advisers, on their assessment of their competence, and perhaps their ability to get on well with their advisers. Most clients have a good rapport with their advisers. Most clients trust their advisers. And most clients have a very limited knowledge of financial products; they come to people, purporting to be experts, in order to obtain advice. Given that the average client knows very little about financial products etc., he or she is almost always going to rely on the advice received from their professional adviser and act on it. For example, who is the patient that devises his treatment as against his own doctor's advice - the very person he goes to because he is lacking in the expertise with respect to the treatment he should undergo? Hence, given these circumstances, the financial planner may be able to convince their clients (given that the client most probably already trusts the adviser, and given their good rapport) to purchase products more so in the adviser's interests rather than the client's. Again, it must be remembered that such decisions can almost always be justified, though they were made dishonestly, with motives ulterior to the foremost benefit of the client.

It would not be too difficult, I believe, for a dishonest financial planner to convince a client to do the adviser's own will, and to line his own pockets as a result. This is a point that I believe is inadequately addressed. An adviser obtaining his or her client permission does not vitiate the real danger to the client, that he may be receiving suboptimal advice. The only real protection, from the charismatic and trustworthy nature of the financial adviser, would be to ban the practice of them receiving commissions outright.

**(c) Incentives**

It is human nature, that people will do things when they are incentivised to do so. If an adviser has an incentive to advice a course of action (call it X) then he will be more likely to advise that course of action. The only way one can be sure that the advisor will not act in such a fashion is to take away that incentive. It's as simple as that. The financial adviser will be remunerated for providing advice, not for directing a client down a certain road by which the advisor will reap a reward.

Banning this practice of allowing commissions would do the financial planner little harm, given that he has other options of being remunerated for his or her work before him.

**2. Speculating with Client Funds**
Let me state this as axiomatic: the prices of stocks are unpredictable. Nobody has been able to tame stock markets. Nobody is able to predict them, because nobody can predict the future. If any body tells you otherwise it is highly likely that he is seeking to take away your money.

This to my mind is where Storm collapsed. It was not because the price of stock prices fell, but rather because of the supreme incompetence of the advisers in Storm. By taking out margin loans, the advisers were in reality speculating that the stock prices were going to soar indefinitely into the future. The only time (if one is really "investing") that it is advisable to do this is when one has definite insider knowledge that a particular company - whom the market thinks is healthy - is going to collapse the very next day!

But what if the stock prices fall? Then due to the leveraged nature of these "investments", the clients holding those "investments" would suffer great losses. The the layman wanting to learn would do well to read "The Intelligent Investor" by Benjamin Graham, if he/she is indeed serious about learning something about investing. Is this not tantamount to placing a bet on a horse? As Franklin states:

> "In our conservative view, every nonprofessional who operates on margin should recognise that he is ipso facto speculating, and it is his broker's duty so to advice him" (Benjamin Graham, The Intelligent Investor, First Collins Business Essentials 2006, pg 21).

But of course, in this case (and I am referring to Storm specifically) it was the advisers who were encouraging their clients to engage in this speculative practice! And more than that, those advisers within Storm, thought that they were providing some great, noble and competent service to their clients! But Graham in his wisdom noted the folly of their actions:

> "There is intelligent speculation as there is intelligent investing. But there are many ways in which speculation may be unintelligent. Of these the foremost are: (1) speculating when you think you are investing; (2) speculating seriously instead of as a pastime, when you lack the proper knowledge and skill for it; and (3) risking more money in speculation than you can afford to lose."

Firstly, placing large amounts of client funds in margin lending accounts, especially given the poor ability of clients to bear those losses (e.g. pensioners as in Storm's case), would to my mind be risking more money than one can possibly afford to bear. Secondly, what were these grand reasons for Storm using a margin lending facility? An expectation that prices will rise in the future is not a reasonable expectation, especially given my axiomatic statement above, that the future prices of securities are inherently unpredictable. Financial planners cannot know for sure which way stock prices are going to go, and this is superbly demonstrated by the collapse of the Storm financial group and the loss of their client's incomes! One should not use them when "investing" unless one has a very good reason for it, or at least when one properly understands that he is speculating when doing so.

Furthermore, when Storm's clients were starting to lose their initial capital, the margin lending facility should have stopped right there. Continuing to engage in speculation at that point would perhaps be even more stupid than entering upon that course of action in the first place (but both actions are in actuality, equally stupid, especially given the people who were putting the money up: 'poor' pensioners, and given their ignorance in thinking that they were not speculating in doing so.)

It is to my mind that the only people who should be engaged in margin lending facilities are those who: (i) can afford huge losses and (ii) who know that they are speculating (much like betting big money on a horserace).

**Recommendations:**

Hence my recommendations are that:

(1) the practice of margin lending be not permitted by financial advisers and
(2) that they only be permitted to those who know what they are doing (make sure these provisions are watertight so we don't have pensioners who don't know what they are doing getting around this via some loophole).
(3) Financial Commissions should be outright prohibited, notwithstanding their disclosure to clients.
(4) Lastly, I might recommend that the consummate professionals at ASIC who let this situation pass by under their very noses be sacked, or be removed, or be questioned, or be held accountable for this oversight. And let the person questioning them be well placed to know whether their oversight was due to incompetence or a valid reason exists for it – if at all it can be called an 'oversight' and if at all there is a valid reason.

**Summary:**
Let me summarise what I have stated above:

(1) No one can predict future security prices.
(2) Margin lending is ipso facto speculation.
(3) Margin lending should be prohibited to retail clients who don't know what they are doing.
(4) Margin lending should be allowed only to high net wealth individuals who know what they are doing (i.e. who know they are speculating).
(5) Commissions should be outright prohibited, because of the bad incentives they *might and do* create, and secondly, because it is very difficult to prove that an adviser was not acting in a client's best interest in directing a client into a commission based financial product. Lastly, disclosure of the commission does not vitiate its inherent dangers. Commissions should be banned.

I hope that the parliamentary inquiry (and ASIC) will be able to do something to prevent idiots, like the people who ran Storm, from ever again speculating with other peoples' money.