

STORM CASE STUDY PUT TO THE FOFA TEST

Independent Financial Advisor

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Peter Townsend of **TOWNSENDS BUSINESS & CORPORATE LAWYERS**

Much has and will be written about the exposure draft legislation that races under the name of the Corporations Amendment (Future of Financial Advice) Bill 2011, but which is known around the stables as simply FOFA (Future of Financial Advice), FOFA states that the provider of personal advice "must act in the best interests of the client when giving the advice". Section 961C(2) sets out "the steps that the provider must take in acting in the best interests of the client". The list is mandatory but not exhaustive. In other words, there may be other things the provider must do as well that are not listed in the section.

To assist in an assessment of this part of the new law, let's apply a real case study.

On 27 January 2009 a letter appeared in The Age from a former financial planner turned forensic accountant, detailing the advice given to his friends (not clients) in relation to a product issued by Storm Financial. The letter detailed the miserable story of a retired 70-year-old husband and 65-year-old wife who were persuaded to cash out two allocated pensions and a cash account and invest in shares through a bank margin loan. They were given a \$500,000 borrowing limit and drew down \$270,000 with a corresponding 7 per cent commission to Storm. They lost all their retirement savings. The letter detailed a number of issues with the advice provided and it is instructive to compare how they would be dealt with under the existing law, particularly applying the principles set out in the Basis Capital determination by the Financial Ombudsman Service, and how they might be judged under FOFA.

Issue: Despite the clients' ages, the advice was based on a 17-year projection model.

Currently: Section 945A requires the advice to be appropriate for the client. The Basis Capital determination required the adviser to properly assess the clients' risk profile and to follow that profile. Would a 17-year model pass the test of appropriateness?

FOFA: Under FOFA the provider is required to assess the financial situation of the client, to assess and advise the client whether the client's objectives could be achieved through means other than the acquisition of the particular product, to investigate other products that might achieve the objectives, and to base all judgments on the client's objectives, financial situation and needs. In the circumstances of this case could the provider satisfy these requirements? Would it be easier or harder for the client to prove the provider's failure to comply with the new legislation as opposed to the current legislation? Would the investment pass the appropriate requirement under the new section 961H?

Issue: At no time was the risk profile of the client evaluated.

Currently: The Basis Capital determination found the obligation to assess and fully explain to the client their risk profile was part of the planner's obligation under section 945A.

FOFA: If the Basis Capital determination can be applied to FOFA, then the obligation to assess and explain risk profile is part of the establishment of the client's objectives and is therefore caught by the first of the required steps under section 961C(2). In addition, the failure to assess risk profile may in and of itself be a failure to act in the best interests of the client and effectively constitute an additional obligation on the provider.

Issue: The client had no resources to meet any margin call.

Currently: Based on the Basis Capital determination, the failure to consider and advise on the ramifications to the client of a margin call was not only a breach of section 945A, but also clearly negligent and in breach of FPA professional guidelines.

FOFA: Under the draft legislation the actions of the provider would seem to breach their obligation to identify the clients' financial situation, to identify and advise on other products that could achieve the clients' goals and to base the provider's judgment on the clients' financial situation (along with their objectives and needs).

Issue: The client accepted the advice by signing each page of the 150-page statement of advice immediately after a group sales/ information presentation.

Currently: The Basis Capital determination stated that a planner cannot avoid responsibility by saying that the product disclosure statement or other formal documents contain all the relevant information. Rather, the planner is obliged to explain the risks and issues and to ensure the client provides informed consent and approval.

FOFA: Nothing in section 961C(2) deals with this issue. Draft section 961H states the provider must only provide the advice to the client if it would be reasonable to conclude that the advice is appropriate to the client.

Accordingly, the Basis Capital determination remains as instructive as ever on the issue of client consent.

The elephant in the room in relation to Storm Financial clients is the issue of the size of the adviser's commission; in the real life case study apparently 7 per cent. Draft sections 961K and 961L of FOFA require the provider to give priority to clients' interests over those of the provider. It remains to be seen whether in accepting a 7 per cent commission (seemingly considerably higher than the then current norm) the adviser could be said to have breached these draft provisions.

In the situation of the case study, these conflict of interest provisions seem redundant. If the investment is appropriate for the client, then there is no conflict of interest. If the investment is not appropriate, then that is the basis of the adviser's liability, not the conflict of interest.

The case study is perhaps somewhat extreme. It is hard to imagine anyone arguing that the advice given in the circumstances of that case was anything but appalling. Perhaps that is why the effect of FOFA seems so underwhelming when applied to those facts.

There does not appear to be much greater client protection than exists currently, simply more process, more paperwork. The prescribed process may make it easier for clients to take action against advisers, but there clearly remain variables that will still need to be proven, with the accompanying cost and uncertainty.