

The Future of Financial Advice & Liability of Financial Advisors

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Overview of presentation

- Introduction
- Brief overview of common law actions
 - Tort (misrepresentation, breach of duty of care)
 - Contract (breach of implied contractual duty of care and skill)
 - Equity (breach of fiduciary duty)
- Statutory regime
 - Corporations Act 2001 & FOFA reforms
 - ASIC Act 2001

Introduction: Problem Advisors

- Put their interests ahead of clients (*how was the adviser to be compensated and was it linked to the financial strategy or product recommended?*)
- Forget who is (are) the client(s) (*husband + wife, SMSF trustee - whose risk profile was assessed? whose instructions were sought?*)
- Talk down to the client (*did they adequately explain the reasons for and risks associated with an advocated financial strategy or product?*)

Part I: Common Law

Tort

- If incorrect advice provided by financial advisor, client can claim in tort for pure economic loss
 - If advisor gave incorrect advice given with knowledge it was untrue, claim = fraudulent misrepresentation. Client to prove:
 - misrepresentation of fact which adviser knew was false;
 - economic loss suffered as a result of relying on misrepresentation; and
 - advisor intended that reliance
- (*Derry v Peek* (1889) 14 App Cas 337)

Tort cont

- For negligent misrepresentation, client to prove:
 - the advisor owed the client a **duty** of **care**;
 - the advisor breached the **standard** of **care** owed to the client (“an ordinary skilled person exercising and professing to have that special skill”: *Rogers v Whitaker* (1992)); and
 - the client suffered **material** loss as a consequence (here, pure economic loss), and loss is **not too remote**.
- Note statutory causes of action for misleading conduct e.g. ASIC Act s 12DA, Corps Act s 1041H

Contract

- Absent an express clause, there will be an **implied** contractual duty of due care and skill:
ASIC Act s 12ED
- Choice of action: whether the client sues in negligence or contract influenced by assessment of damages & limitation periods
 - Contract: limitation period runs from breach of contract
 - Tort: limitation period runs from when damage discovered – ie– GFC claims now ending

Contract cont

- For both negligence and contract, important factor is the client's **risk tolerance** determined by advisor from outset – this will determine nature of advisor's duty & whether breached
- E.g. *Wingecarribee Shire Council v Lehman Brothers* (2012)
 - Class action by 3 local councils against Lehman Brothers for recommending investment in high risk financial products and losses post GFC
 - Court found recommended financial products did not match councils' **conservative** risk outlook, breaching contractual duty & duty of care

Equity – fiduciary duty

- Fiduciary duty:
 - client **vulnerable** (e.g. unsophisticated in ability to understand the financial product and risks), and
 - client reposes **trust** and **confidence** in financial advisor to act in client's interests
 - *Wingecarribee Shire Council*
 - *Simpson v Donnybrook Properties Pty Ltd* [2010] NSWCA 229 (investment advisor not fiduciary) but see *Commonwealth Financial Planning Ltd v Couper* [2013] NSWCA 444 at [109]

- 2 duties:
 - duty not to receive unauthorised profits; and
 - duty not to be in a position of conflict (or possibility of conflict) without client's fully informed consent.
- nb: Australian financial services licensees also subject to statutory duty to manage conflicts of interest: s 912(1)(aa).

Part II: Statutory Regime

- Corporations Act 2001 (Cth)
- ASIC Act 2001 (Cth)

Background - FOFA

- FOFA reforms part of Labor Government's response to 2009 report by Parliamentary inquiry into Financial Products and Services.
- PJC Inquiry undertaken in response to numerous corporate collapses during GFC, which lead retail clients to suffer significant losses
- New amendments introduced into Corporations Act to address these concerns

Background cont

- FOFA reforms implemented by 2 key legislative measures
- *Corporations Amendment (Future of Financial Advice) Act 2012* (“FOFA 1”):
 - Required financial advice providers to obtain client agreement in relation to ongoing advice fees
 - Increased requirements for disclosure of fees and services associated with ongoing fees; and
 - Enhanced ASIC’s licensing and banning powers in relation to financial advisers

Background cont

- *Corporations Amendment (Further Future of Financial Advice Measures) Act 2012* (“FOFA 2”):
 - **Introduced** “best interests” duty
 - **Banned** conflicted remuneration
 - **Applied** existing regulatory mechanisms under Corporations Act more directly to licensees as well as individual advisors.

FOFA reforms – implementation dates

- Commencement date: 1 July 2012
- Amendments were voluntary from 1 July 2012 to 1 July 2013
- Mandatory compliance after 1 July 2013
- The regulatory regime of Corps Act Part 7.7A cannot be contracted out of: s 960A

Key statutory concepts

- **“Financial product advice”** s 766B
 - “Personal advice”
 - “General advice”
 - “Scaled advice”
- **“Client”** – s 761G
 - “Retail client”
 - “Wholesale client” – s 761G(7) & regs

- **Financial product advice** means: s 766B(1)
 - 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.

“Authorised representative” of a financial services licensee means a person authorised in accordance with section 916A to provide financial services on behalf of the licensee.

“Representative” of a person means:

(a) If the person is a financial services licensee:

- (i) An authorised representative of the licensee; or
- (ii) An employee or director of the licensee; or
- (iii) An employee or director of a related body corporate of the licensee; or
- (iv) Any other person active on behalf of the licensee; or

(b) In any other case:

- (i) an employee or director of the person; or
- (ii) an employee or director of a related body corporate of the person; or
- (iii) any other person acting on behalf of the person.

Requirement for Statement of Advice

- Adviser must give client a SOA: s 946A
- SOA can be:
 - (a) the means by which advice is provided; or
 - (b) a separate record of the advice
(s 946A(2))
- Statement of advice not required if small investment (s 946AA) or if a situation covered by s 946B

Pre-FOFA duties

- Section 945A:
 - “know the client”
 - “know the product”
- Obligated to only provide advice if advisor has:
 - Determined client’s relevant **personal circumstances** in relation to giving advice;
 - Made **reasonable enquiries** in relation to those personal circs;
 - **Considered & investigated subject matter** of advice as is reasonable in all the circs; and
 - Advice is **appropriate** to client

Risk tolerance

- **risk capacity** (client's ability to sustain a market decline without suffering an unacceptable loss of lifestyle or quality of life now or in the future; quantitatively-driven assessment)
- **risk perception** (how much client knows about eg shares and bonds and their historical tendency to follow a roller-coaster path that is not always comfortable; clients who have a high degree of knowledge about markets tend to see them as less risky)
- **risk attitude** (part of client's personality, psychological propensity to take (or refuse to take) risk in return for potential reward)

Risk profiling

Finametrica example questions:

Compared to others, how do you rate your willingness to take financial risks?

- *Extremely low risk taker*
- *Very low risk taker*
- *Low risk taker*
- *Average risk taker*
- *High risk taker*
- *Very high risk taker*
- *Extremely high risk taker*

When you think of the word “risk” in a financial context, which of the following words comes to mind first?

- *Danger*
- *Uncertainty*
- *Opportunity*
- *Thrill*

Investments can go up or down in value, and experts often say you should be prepared to weather a downturn. By how much could the total value of all your investments go down before you would begin to feel uncomfortable?

- *Any fall would make me feel uncomfortable*
- *10%*
- *20%*
- *33%*
- *50%*
- *More than 50%*

You are considering placing one-quarter of your investment funds into a single investment. This investment is expected to earn about twice the term deposit rate. However, unlike a term deposit, this investment is not protected against loss of the money invested. How low would the chance of a loss have to be for you to make the investment?

- *Zero, ie no chance of any loss*
- *Very low chance of loss*
- *Moderately low chance of loss*
- *50% chance of loss.*

When making an investment, return and risk usually go hand-in-hand. Investments which produce above-average returns are usually of above-average risk. With this in mind, how much of the funds you have available to invest would you be willing to place in investments where both returns and risks are expected to be above average?

- None
- 10%
- 20%
- 30%
- 40%
- 50%
- 60%
- 70%
- 80%
- 90%
- 100%

Think of the average rate of return you would expect to earn on an investment portfolio over the next ten years. How does this compare with what you think you would earn if you invested the money in term deposits?

- About the same rate as from term deposits*
- About one and a half times the rate from term deposits*
- About twice the rate from term deposits*
- About two and a half times the rate from term deposits*
- About three times the rate from term deposits*
- More than three times the rate from term deposits*

FOFA reforms - overview

- New duties of financial advisors:
 - “best interests” duty if providing personal advice to retail clients
 - prescriptive disclosure obligations & opt-in obligations
- Prohibition on “conflicted remuneration”
- Best interests duty and disclosure obligations under “opt-in” only apply where personal advice is given to retail clients: ss 961, 962A

	General advice	Personal advice
Description	<ul style="list-style-type: none"> - A recommendation or opinion that does not consider personal circumstances - s 677B(4): “General advice” is advice that is not personal advice 	<ul style="list-style-type: none"> - A recommendation that takes into account personal circumstances - Has considered one or more of the consumer’s objectives, financial situation or needs: s 766B(3) - Can be comprehensive or scaled advice
Licensing	<ul style="list-style-type: none"> - Requires AFSL or to be a representative or an AFSL holder - External dispute resolution scheme membership 	<ul style="list-style-type: none"> - Requires AFSL or to be a representative of an AFSL holder - External dispute resolution scheme membership
Disclosure	<ul style="list-style-type: none"> - Financial Services Guide (FSG) - General advice warning - PDS (if person acquires a product after receiving general advice) 	<ul style="list-style-type: none"> - FSG - Statement of Advice - PDS (if person acquires a product after receiving advice) - Warn if advice is based on incomplete information - Annual fee disclosure statements
Conduct	<ul style="list-style-type: none"> - General AFS licensee conduct obligations - Ban on conflicted remuneration (with some exceptions) 	<ul style="list-style-type: none"> - General AFS licensee conduct obligations - Best interests duty - Provide appropriate advice - Prioritise client’s needs ahead of adviser - Ban on conflicted remuneration (with some exceptions)

‘Best interests’ of client

- S 961B(1) of Corps Act is new operative provision which requires a provider of personal advice to a retail client to act in the client's best interests.
- S 961B(1):
 - “The provider must act in the best interests of the [retail] client in relation to the [personal] advice.”

‘Best interests’ duty cont

- ‘Best interests’ **not** defined in Corporations Act
- However, 961E elaborates as to what would reasonably be regarded as in the best interests of the client
 - “It would reasonably be regarded as in the best interests of the client to take a step, if a person with a reasonable level of expertise in the subject matter of the advice that has been sought by the client, exercising care and objectively assessing the client's relevant circumstances, would regard it as in the best interests of the client, given the client's relevant circumstances, to take that step.”

ASIC's approach to 'best interests'

- ASIC's approach to the best interests duty originates from regulatory concerns that many retail clients received poor quality financial advice leading up to GFC
- ASIC Regulatory Guide 175:
 - “When assessing whether an advice provider has complied with the best interests duty, we will consider whether a **reasonable** advice provider **would believe** that the **client is likely to be in a better position if the client follows the advice**”.

- ASIC will consider “the **position** the client **would** have been in if they **did not follow** the advice, which is to be assessed at the time the advice is provided”
- However, ASIC will “**not** examine investment performance **retrospectively**, with the benefit of **hindsight**”
- Best interests duty is concerned with what occurred at the time the advice was provided

Best interests duty cont

- Statutory 'best interests' duty not strictly a fiduciary duty because it is a **prescriptive** (positive), rather than **proscriptive** (negative) duty
- **Remedies** are also **different**
 - Breach of fiduciary duties result in equitable remedies e.g. account for profits, equitable compensation.
 - Breach of best interests duty carry statutorily prescribed penalties, compensation & remedial

‘Safe harbour’ provision

- S 961B(2) prescribes a series of steps which if satisfied, will satisfy the best interests duty.
- **Prescribed steps** aren’t the only way to satisfy best interests duty, but it’s the clearest way.
- **7-point checklist**
 - 961B(2): “The provider satisfies the duty in subsection (1), if the provider proves that the provider has done each of the following”

7 point checklist: s 961B(2)

- (a) identified the **objectives, financial situation and needs** of the client that were **disclosed** to the provider by the client through **instructions**;
- (b) identified:
 - (i) the **subject matter** of the advice that has been sought by the client (whether explicitly or implicitly); and
 - (ii) the objectives, financial situation and needs of the client that would reasonably be considered as relevant to advice sought on that subject matter (the **client's relevant circumstances**);

7 point checklist cont

- (c) where it was **reasonably apparent** that **information** relating to the client's relevant circumstances was **incomplete** or **inaccurate**, made **reasonable inquiries** to obtain complete and accurate information
- Objective test for “**reasonably apparent**”: s 961C
 - “Something is reasonably apparent if it would be apparent to a person with a reasonable level of expertise in the subject matter of the advice that has been sought by the client, were that person exercising care and objectively assessing the information given to the provider by the client.”

7 point checklist cont

(d) assessed whether the provider has the **expertise** required to provide the client advice on the subject matter sought and, **if not, declined** to provide the advice;

7 point checklist cont

(e) if, in considering the **subject matter** of the advice sought, it would be **reasonable** to consider **recommending** a financial product:

(i) conducted a **reasonable investigation** into the **financial products** that **might achieve** those of the **objectives** and **meet** those of the **needs** of the client that would reasonably be considered as relevant to advice on that subject matter; and

(ii) **assessed** the **information** gathered in the investigation;

- **“Reasonable investigation”**: s 961D
 - (1) A reasonable investigation into the financial products that might achieve those of the objectives and meet those of the needs of the client that would reasonably be considered relevant to advice on the subject matter sought by the client **does not require an investigation into every financial product available.**
 - (2) However, **if** the client requests the provider to consider a **specified financial product**, a reasonable investigation into the financial products that might achieve those of the objectives and meet those of the needs of the client that would reasonably be considered relevant to advice on the subject matter sought by the client includes an investigation into that financial product.

7 point checklist cont

- (f) **based** all **judgments** in advising the client on the client's **relevant circumstances**; and
- (g) taken **any other step** that, at the time the advice is provided, would **reasonably be regarded as being in the best interests of the client**, given the client's relevant circumstances. (“catch-all” provision)

- What would reasonably be regarded as in the **best interests** of the client in s 961B(2)(g)?
- S 961E:
 - “It would **reasonably** be regarded as in the best interests of the client to take a step, if a person with a reasonable level of expertise in the subject matter of the advice that has been sought by the client, exercising care and objectively assessing the client's relevant circumstances, would regard it as in the best interests of the client, given the client's relevant circumstances, to take that step.”

Note to s961B(2)

“The **matters** that **must** be **proved** under subsection (2) relate to the **subject matter** of the advice sought by the client and the **circumstances** of the client relevant to that subject matter (the client’s relevant circumstances). That subject matter and the client’s relevant circumstances may be **broad** or **narrow**, and so the subsection anticipates that a client may seek **scaled advice** and that the **inquiries** made by the provider will be **tailored** by the advice sought.”

7 point checklist cont

- Finally, note operation of s 961B(5):
 - “ The **regulations** may prescribe
 - (a) a step, in **addition** to or **substitution** for the **steps** mentioned in subsection (2), that the provider must, in prescribed circumstances, **prove** that the provider **has taken**, to satisfy the [best interests] duty in subsection (1); or
 - (b) that the provider is **not required**, in prescribed circumstances, **to prove** that the provider has **taken a step** mentioned in subsection (2), to satisfy the duty in subsection (1); or
 - (c) **circumstances** in which the duty in subsection (1) **does not apply**.

Appropriate advice

- Advice providers must only provide **appropriate** advice: s 961G
 - “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, had the provider **satisfied** the duty under section 961B to act in the best interests of the client.
 - Note: A responsible licensee or an authorised representative may contravene a civil penalty provision if a provider fails to comply with this section (see sections 961K and 961Q). The provider may be subject to a banning order (see section 920A).”

Best interests duty cont

- Advice providers must **prioritise** interests of client where there is conflict with own interests or those of their related parties: s 961J
- Licensees must take reasonable steps to ensure that that their representatives **comply** with the best interests duty (s 961L) and may be liable to civil penalties if their representatives breach the requirements (s 961K)

Civil action for loss or damage: s 961M

- S 961M(1): applies if client suffers loss or damage because of a contravention
- S 961M(2): Court may order one or more compensate client for amount of loss or damage
 - If contravenor is financial services licensee – the licensee
 - If contravenor is representative of financial services licensee – the responsible licensee

- S 961M(3) – Court may make order:
 - Of own initiative
 - On application of ASIC
 - On application of the client
- S 961M(4) – in determining damage suffered by client, Court may include **profits** resulting from the contravention that are made by the licensee
- S 961M(6) – action to recover may be begun at any time **within 6 years** after the contravention

Additional powers – s 961N

- s961N(1) – the Court dealing with an action under s961M(2) may, in addition to awarding loss or damage under that subsection and if it thinks it **necessary** in order to do **justice** between the parties
 - (a) Make an order to **void** contract entered into by client for or relating to a financial product or financial service
 - (b) If makes order under (a), make such other order(s) as thinks **necessary** or **desirable** because of
- s961N(2) – without limiting (1)(b), order may include
 - (a) an order for return of **money** paid by a person
 - (b) An order for payment of an amount of **interest** specified in or calculated in accordance with the order

No contracting out – s 951N

Section 951A - Part **cannot** be contracted out of
A condition of a contract for the acquisition of a financial product or for the provision of a financial service, is void if it provides that a party to the contract is:

- (a) Required or bound to waive compliance with any requirement of this Part; or
- (b) Taken to have notice of any contract, document or matter not specifically referred to in a Financial Services Guide, Statement of Advice or other document given to the party.

Disclosure obligations & 'opt-in'

- If a financial advisor gives personal advice to a retail client and fees are to be paid for more than 12 months, this is known as an 'ongoing fee arrangement': s 962A
- Notice and disclosure requirements apply in relation to 'ongoing fee arrangements': s 962K
- These obligations are imposed on the financial adviser, who is referred to as the 'fee recipient'.

Disclosure obligations & 'opt-in'

- The fee recipient must give the client a fee disclosure statement (s 962G) and a renewal notice requiring the client to 'opt-in' to renew the fee arrangement every 2 years (ss 962K, 962L)
- The opt-in requirements only apply to ongoing fee arrangements entered into on or after 1 July 2013, where the client has not been provided with personal advice as a retail client previously by the financial adviser: s 962D
- Requirements for the renewal period and the contents that must be contained in a renewal notice are contained in s 962K.

Prohibition on conflicted remuneration

- FOFA changes are attempt to curb conflicts of interest between advisers and clients
- Arise when advisers receive remuneration from financial product manufacturers when clients act on recommendations/advice

Prohibited payments

- “Conflicted remunerations” are prohibited under the new FOFA regime: ss 963E-963K.
- Conflicted remuneration is any benefit, whether monetary or non-monetary, given to a financial services licensee/representative who provides financial product advice to retail clients, that could reasonably be expected to influence the choice of financial product recommended or the advice given to retail clients by the licensee/representative.
- Volume-based benefits are presumed to be conflicted remuneration unless the contrary is proved: s 963L
- Prohibition primarily targets adviser trail commissions and rebates.

Exceptions to prohibition

- S 963B – Monetary benefits given in circumstances where they will not be considered to be conflicted remuneration.
 - Section 963C – Non-monetary benefits given and the circumstances in which they will not be considered conflicted remuneration.
- E.g. Monetary or non-monetary benefit is not conflicted remuneration if given by a retail client in relation to financial product advice given by the AFS licensee or representative to the client.

Further reforms?

- *Corporations Amendment (Streamlining of Future of Financial Advice) Bill 2014*
- Proposed amendments:
 - remove requirement to renew ongoing fee arrangement every two years (the “opt-in” requirement)
 - Amend requirement for advisers to provide fee disclosure statements to only apply to clients who entered into their arrangement after 1 July 2013
 - Remove the “catch-all” provision in s 691B(2)(g) as a step an adviser may take to satisfy the best interests duty
 - Allow clients and providers to agree on the scope of advice to be provided e.g. limit advice to a particular product (scaled advice); and
 - Allow exception to the prohibition on conflicted remuneration for general advice, but not personal advice, in certain circumstances.

- Bill was intended to commence 1 July 2014 but was not passed by Parliament in time
- Liberal/National Government passed *Corporations Amendment (Streamlining Future of Financial Advice) Regulation 2014* which largely gave effect to the amendments proposed by the bill - commenced 1 July 2014
- Regulation repealed and disallowed in full by Senate (Labor + cross benchers) 19 Nov 2014

Other Rules About Conduct

- Pt 7.8 Div 4A – special provisions relating to margin lending facilities
- s991A – financial services licensee not to engage in unconscionable conduct
- S 991B – financial services licensee to give priority to clients' orders
- S 992A – prohibition on hawking of certain financial products
- s992AA – prohibition on hawking of managed investment products

ASIC is circling

- ASIC Enforcement Report (July-Dec 2014)
 - Important for AFS licensees to have procedures to monitor and ensure compliance
 - Focus on the importance of consumer protection
- ASIC's Complex Financial Products investigation (just released Feb 2015)
 - substantial fines and penalties