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LEGAL BRIEF

Common sense rules

The real revolution in financial planning will not come from FSR — it lies in a recent Supreme Court decision and the evidence given by Wes McMaster

A QUIET REVOLUTION CONTINUES IN the financial services industry. As compliance officers are reporting with feverish focus on the Financial Services Reform (FSR) uptake of the Statement of Advice, and despite them, the industry is slowly being moulded into a profession.

Compliance is the new buzz. Everyone is into it — so much so that they miss the point. But the point is not lost on one man. A Victorian Supreme Court Judge has delivered another tome to reveal the true compliance standards for the financial-services industry in its recent decision in the *Newman v Financial Wisdom Limited* negligence case, in which Wes McMaster was an expert witness.

FSR-induced compliance systems are not the answer — Wes McMaster and the McMaster method are the Holy Grail for Australian financial services licensees and their authorised representatives. Through the Court's judgment of professional standards, the industry will finally be recognised as a profession.

Many are grateful to the Commonwealth Bank for having the fortitude to defend the negligence claim liability against Financial Wisdom Limited and other licensed dealers. Some of these can finally see their names displaced from the media. For the plaintiffs, former clients of the adviser involved, it is vindication of a long legal journey that started with promise, slid into financial disaster and ultimately provided restoration even for the stresses, pain and suffering. But it is a mistake to talk of the June 2004 Victorian Supreme Court decision in *Newman v Financial Wisdom Limited* as just another negligence case. It is much more than that.

What FSR could not possibly have ever achieved the Courts are now enforcing. Newman's case should be seen as part of an overnight revolution. When its values can be embraced, only then can a true compliance system be developed that will have any chance of success of shielding the industry by protecting the consumer.

The Court agreed that some clients were advised by financial planners of dealers unconnected with Financial Wisdom, and were not aware of the existence of Financial Wisdom. But when the Court came to conclude who was to pay, Financial Wisdom was the first in line. The reason? Under section 819 of the old law (which applied to the facts of the case) an unconnected, non-involved and independent multiple authorising dealer is liable for a client's losses, even if not involved in the client planning process.

At all relevant times the adviser held a proper authority from Financial Wisdom, but did not seem to use it much, if at all. The client believed the adviser was engaged in relevant conduct on

behalf of a dealer in connection with a securities and investment advice business carried on by that dealer, and the client knew it was not Financial Wisdom. But the Court still found liability against Financial Wisdom because of the proper authority.

Section 819 gave the Court the basis for finding a deep (Financial Wisdom) pocket from which to restore the finances of the poor unfortunates who followed the adviser from one tax-incentive scheme to another. The judgment is estimated to cost the Commonwealth Bank, Financial Wisdom's owner, \$30 million.

The Court expressed its view that the purpose of Section 819 is to render liable any person who was an indemnifying principal, at the time of the representative's conduct complained of, provided the client believed the representative was acting (whether or not he was in fact so acting) on behalf of someone conducting a securities or investment advice business and the client relevantly acted because of that belief. The financial planning process described in the court's decision included a risk analysis, and each client was asked to rank themselves from one to five. Most put themselves at around three, a few made it clear that they did not wish to put their capital at risk. And yet the majority were put into tax-advantaged investment schemes. The taxation advantage was explained, but in most cases so was the strong financial security of the investment.

This was against a background where the adviser and the dealer (remember, the clients were not aware of Financial Wisdom) advertised a fully integrated financial services facility of uncompromised levels of technical skill, knowledge and creative application and that they would respond rapidly and effectively to the highest standard of work at all times, providing professional advice from a total financial management perspective. They claimed to build clients' net worth with informed investment advice and solid financial planning, using the best information and software applications and their active experience in the field. They would protect clients' assets and lifestyles and would reduce clients' tax with effective planning, taking account of legislative and economic changes, all based on quality income producing investments that would compensate for a slow rate of capital growth. The investments recommended would be secure and carry a low financial risk and would be guaranteed to produce a sound return. Sounds good, doesn't it?

The section of the judgment that relates to the conduct of the representatives should be compulsory reading for marketing and business development managers. The message is simple: do not overstate what you can do, as you will be liable to do it. Say what you mean, and mean what you say.

Wes McMaster's method of financial planning, described in the evidence he gave in Newman's case, is the answer to all your ques-

tions. The opinion of the Court was summed up in one short sentence: "I accept Mr McMaster's evidence." The Court found his evidence of what was required of a professional financial planner was "to be sensible and inherently credible. Indeed, there would be little point in the client who required financial advice having recourse to a financial adviser if the kind of precautions that Mr McMaster said were appropriate were not undertaken before giving such advice."

McMaster's world of financial planning is simple. It is client-focused but it is not just a know-your-client approach — it is a think-about-what-you-are-doing-and-consider-the-needs-of-the-client-personally approach. Advisers should either carry out research and analyse investment products or use research and analysis generated from external sources. If the latter, they should evaluate the overall quality and effectiveness of the analysis. In advising clients, they should take into account general economic and other information in relation to markets, industries and securities, in order to be in a position to make reasonable judgments about future income and growth expectations and risk factors associated with particular securities. They should provide written reports on recommended securities so the client can understand why those securities are recommended.

Financial advisers should conduct a detailed interview to understand the client's present financial position and identify their objectives. Both risk factors and return expectations should be addressed, including risks associated with the issuer and the specific product, market and economic risks, capital and income prospects etc.

A reasonable and prudent financial adviser would note the degree



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of risk involved in a particular investment, irrespective of the client's risk profile or the client's wish to obtain an immediate tax deduction, adds McMaster. If the financial adviser was not prepared to recommend a particular investment but the client insisted on going ahead, the adviser would have the client sign a written indemnity.

McMaster also said that there was room for a prudent investment adviser to recommend speculative investments if the client so requested, provided any loss of capital involved would have no material effect on the client's achieving their goals and objectives.

Of some importance to the financial services industry is the Wes McMaster credo: use common sense. Now there's a thought!

So where is the industry's revolution? It is all around you, it is core to financial planning and it is client-focused. It is certainly not an FSR-induced compliance system. You may satisfy the procedural requirements of FSR, but you may lose reputation, goodwill and your business unless you have a client-focused compliance model, one that also keeps the regulators happy with the right boxes ticked.

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