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LEGAL BRIEF

Fraud, stupidity and trust

Beware the unholy trinity of financial planning.

Sitting on the edge of the financial planning industry, I get insights into our industry that many others cannot see. I even get to see into the future, and can tell you the next major growth opportunity. Today it is in its infancy, but it is growing and will become an important component of financial services in Australia.

It is fraud. Fraud is the next major growth opportunity, and will be closely followed by fraud investigation, fraud litigation and fraud-induced bankruptcy of representatives and licensees.

The professional indemnity insurance companies are most afraid of it. They can cope with negligence within financial services: mistakes in any profession, while not welcomed, are inevitable. Mistakes and negligence can be priced into professional indemnity insurance premiums but insurers can't cope well with fraud and theft.

STAY OUT OF JAIL

You must act now to counter fraud and theft in your organisation. Of course, it already occurs – boxes of pens, a ream of paper for the kids or some coffee supplies; all of these are fair game, aren't they?

Before I talk about professionalism, ethics and honesty, let's get personal. If you know or believe fraud may be happening in your organisation and you do nothing about it, you can go to jail.

This go-straight-to-jail-rule exists across Australia in various forms, but section 316 of the NSW Crimes Act will do as our example. This section imposes the duty to do in certain forms of criminal conduct. A person commits an offence if he or she fails, without reasonable excuse, to bring information to the attention of the police or other appropriate authority if they know or believe that a serious indictable offence has been committed, or has information that might be of material assistance in securing an offender's apprehension, prosecution or conviction.

A "serious indictable offence" means "an indictable offence that is punishable by imprisonment for life or for a term of five years or more". Fraud is one area that falls into this category.

What is your reward for ignoring fraud? Up to two years free food and accommodation in a small room with bars!

Compliance and responsible officers should pay particular attention – after all, they are the ones who should be first aware of the existence of fraud.

Every fraud is made up of simple components. Stupidity of the client plays an important role, but trust and the betrayal of it is the key ingredient. Warning No. 1: clients do stupid things because they trust their advisers. Take the facts in the case of Mr Maher as an example.

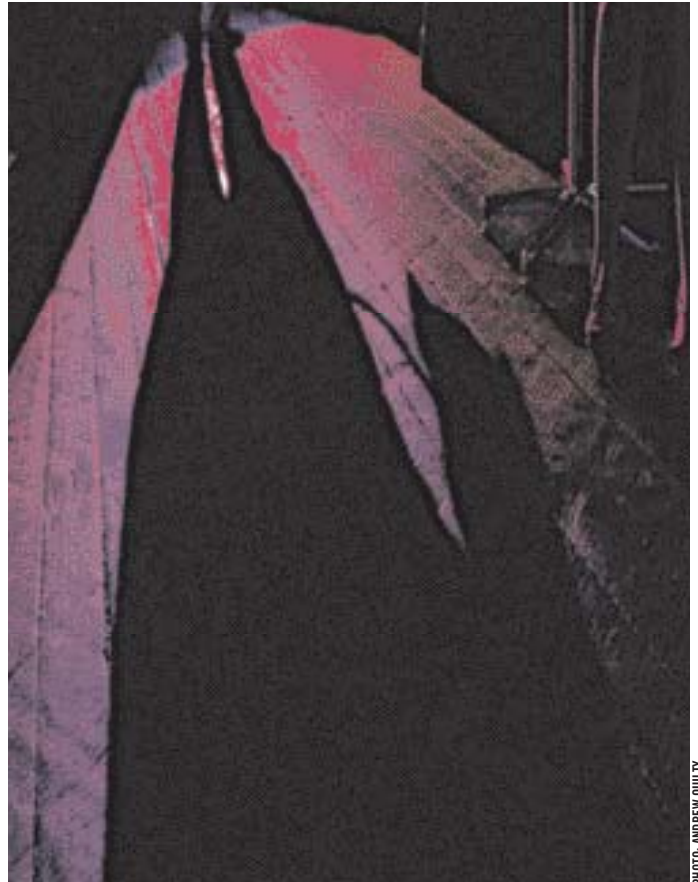


PHOTO: ANDREW GUILTY

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Maher wanted some of his superannuation money and instructed his financial adviser to apply a part of his existing superannuation for three purposes. Two purposes required cash to be withdrawn from his fund by the superannuation fund manager; the third and major purpose required an internal fund transfer to a new account to be conducted by the existing fund manager and therefore no withdrawal of cash.

Maher did a stupid thing: he signed the superannuation fund manager authority form in blank and handed it back to his financial adviser. The adviser thereafter filled in the blanks in the authority wholly in favour of his business bank account and wholly misappropriated the funds.

What enabled this to happen? Was it stupid of Maher to fill out a blank form? Perhaps, but it was trust that enabled the fraud to foster. Warning No.2: you cannot limit trust in the financial planning context.

Is trust unreasonable? No, in fact it is a critical part of financial planning. In the *Newman & Ors v Financial Wisdom Ltd* decision, Justice Manie said of one of the clients in that case: “With all due respect to Mr Duncan, his willingness to engage an organisation which was prepared to put forward these preposterous propositions is indicative of Mr Duncan’s gullibility and naivete (in addition to his desperation) and demonstrates the need which he must have had at all times for professional financial and investment advice.”

JUST TRUST ME

Trust is a simple factor of the financial services profession – clients come to advisers because they trust that they will be given financial direction that will make them better off.

KPMG’s 2004 study into fraud in corporate Australia is compelling and depressing reading. The survey found 27,657 incidents of fraud were reported by 221 businesses – 45 per cent of the 491 survey respondents. More than three-quarters of the major fraud cases involved people within the business. In 75 per cent of cases, the perpetrator acted alone. According to KPMG, the typical white-collar thief is motivated by greed (38 per cent of cases) followed by gambling (21 per cent).

So how do you combat fraud?

Ethics is always the best starting point. What sort of ethics does your financial services organisation have?

I know, you are an ethical organisation with a strong devotion to ethical conduct; you even have the word “ethics” in your mission statement. Don’t fool yourself: unless ethics is on the agenda of your professional development days, unless it is argued and debated regularly, you only pay lip service to ethics.

GROUP THINK

Ethics is in how a person judges an event. It is an integral part of the process of making a decision and is both individual and shared. A group of people with a common sense of ethics make up the ethical culture of an organisation. Good ethics often attract people with good ethics, likewise, bad ethics attract people with bad ethics. The disastrous corporate collapses in Australia and internationally over many decades all share a common failure of corporate ethics.

Of course, it starts at the top: directors and chief executive officers with good ethics tend to infect the whole organisation.

How do you start introducing ethics into professional development? Start with fraud. Examine the issue: what is the role of the financial planner managing a million-dollar portfolio for a client who is receiving the full aged pension? Ask the management team independently of the representatives – the results will give you an insight into your organisation’s ethics.

Don’t tell them about section 316 of the NSW Crimes Act, or your state’s equivalent – otherwise you will miss the opportunity to learn how your organisation approaches ethical issues.

If the emphasis that your management or financial planning team gives to the issue is how to maintain the funds under administration (“what the client does is the client’s business”) you have an organisation where fraud can flourish.

However, if the response is to applaud the client and to examine how the strategy can be rolled out to other clients, a culture of fraud already exists in your business. A compliance officer faced with this should consider moving to another organisation. Such an organisation is usually dead from the head up and will undoubtedly be a career graveyard.

Use a stopwatch to time how long it takes for the word “ethics” to come up in conversation. The earlier it emerges, the more certain you can be that your organisation is a breeding ground for a culture of good corporate and social ethics. Fraud finds it difficult to survive in such an environment.

BAD APPLES

Watch with interest the potential change of attitude when you introduce the idea that knowing or believing a fraud has occurred and doing nothing about it can lead to jail of up to two years. Self-interest has a way of making people think a little more deeply about the consequences of their actions (or inactions). Interestingly, ethics is a factor of self-interest.

Often, the greater the insistence of self-interest taking a priority, the lower the ethical standards that a person will employ in their decision-making process.

Increasingly, compliance officers within licensees are playing a pivotal role in the recruitment of financial planners. They would do well to look at ways of assessing the ethics of each new financial planner before they are appointed to the group. You know the story: one bad apple can eventually make all of them rotten.

How do you protect other people’s money, especially from fraud? Systems are useful for minimising the incidence of fraud and for discouraging the opportunity of pursuing it, but these do not deal with the core reason for the existence of fraud. Ethics is the key to fraud management.

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