

History repeating itself? Lessons from the Storm Financial and Westpoint Group collapses

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Key points

- There are significant patterns in how financial advice was given to consumers in both the Storm Financial and Westpoint cases.
- The same breaches of the Corporations Act can be identified from both cases.
- Despite six years of financial services reform, it appears that even basic adviser obligations are still not followed in the provision of advice to retail clients.
- There are some new risks associated with financial advice that are now also on the radar.
- A different focus may be required within financial advisory groups to break the cycles and patterns identified in this article in relation to adviser conduct and financial advisory processes, to reduce the likelihood of history repeating again.

There has been much speculation over recent months about what went wrong with Storm Financial; who or what is responsible for the client losses which will run into the millions of dollars; and what steps, if any, could have been taken by the Australian Securities and Investments Commission (ASIC) and others to prevent the collapse.

On the face of it, there seems little in common between the collapse of Storm Financial and the Westpoint Group of companies, and the dust is yet to settle on client and regulator action against both groups. However, what these two events appear to share is the failure of financial advisory models which were used to facilitate consumer investment into financial markets.

This article examines what is known about the conduct of financial advisers and their investment advice to consumers in both cases. It argues that there may be many similar patterns in adviser conduct and advice in each case that have increased the risks to consumers in investing. It seems that despite financial services reform, it could all be a little bit of history repeating itself.

Storm Financial — the case so far

When Storm Financial went into voluntary administration in January 2009, it was argued that it was not a

typical financial planning dealer group and that all the evidence suggested that Storm had ticked all the boxes with respect to fulfilling its regulatory obligations.¹

However, what is now known is that not everything was what it appeared to be, and Slater and Gordon, among others, are said to be preparing legal action on behalf of more than 800 former Storm Financial clients in relation to negligent financial advice.²

For the majority of these clients, the financial advisory model followed appears to have been the same. The Storm model was to recommend that clients leverage existing assets and gear into Storm-branded indexed products, developed in conjunction with Colonial First State and Challenger. This was usually facilitated through a margin loan and was usually associated with the establishment of a variable loan account and a cash account facility. ASIC has estimated that of 14,000 Storm clients, 3000 had margin loans.³

By mid-2008 some of these clients began facing margin calls, and in the latter half of the year Storm began contacting geared clients, advising that it may be necessary to switch up to 100% of their investments to cash. In October 2008, Challenger began selling down stocks of Storm clients facing margin calls.⁴

The Financial Planning Association of Australia has made a preliminary assessment of adviser conduct and process in relation to the advisory process adopted by Storm Financial and the recommendations made by its advisers. It has advised that at this stage the following failures are likely to be alleged by clients:⁵

- failure of the adviser to understand margin lending/gearing strategies and their application to the client's objectives and circumstances;
- failure to advise the client of the risks associated with such a strategy;
- some clients were unaware of their debt levels or that margin calls had been received;
- there was a lack of diversification of portfolios outside the geared strategy;
- the advice was unsuitable to most clients' needs and objectives;

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- the client's capacity to repay margin calls or debt from loans was not considered when developing the strategy;
- there was a failure to devise an appropriate exit strategy for the client in the event of a market fall or other factors;
- loan to value ratios were well above industry averages at up to 85%;
- fee structures associated with financial advice (upfront and ongoing) were also well above typical industry charge rates; and

- there was a failure to ensure that clients understood documents they were signing.

Similarities between Storm Financial and Westpoint Group

The following list of allegations can be compared to a summary of the failures in adviser conduct related to investments in Westpoint promissory notes.

Theme	Summary of types of adviser conduct likely to be alleged in the Storm case	Summary of types of adviser conduct identified from Westpoint decisions 2006/07
Adviser integrity	Not known at this stage.	Misleading statements as to performance, product features or security, and business reputations.
Appropriateness of advice	No reasonable basis for the advice to use the gearing strategy with loan to value ratios well above industry average at up to 85%.	No reasonable basis for the advice to invest and, in some instances, reinvest in the promissory notes.
Suitability of advice	The advice to undertake a gearing strategy was unsuitable to most clients' needs and objectives.	Advice to invest high risk, speculative and unsecured promissory notes did not meet client objectives or circumstances.
Appropriateness of advice	Lack of diversification of portfolios outside the geared strategy.	Inadequate diversification of portfolio and investments.
Appropriateness of advice	Failure to advise the client of the risks associated with the gearing strategy. Some clients unaware of their debt levels or that margin calls had been received	Inadequate explanation and examination of risks associated with the investments. Some clients and self managed superannuation funds geared to invest without advice on the risks of this strategy.
Research	Failure of adviser to understand margin lending/gearing strategies and their application to the client's situation.	Lack of independent financial product research conducted into the promissory notes, the guarantees associated with loans to the Westpoint companies, and the capacity of companies to repay interest.
Investigation of client's personal circumstances	The client's capacity to repay margin calls or debt from loans was not considered when developing the gearing strategy.	Inadequate assessment of client's tolerance to risk and capacity to withstand loss of capital and repay debt from gearing strategies.
Disclosure obligations	Failure to ensure clients understood documents they were signing and the nature of the strategy and investments made.	Failure to ensure clients understood the nature of the investment and its speculative nature.
Disclosure obligations	Not known at this stage.	Inappropriate reliance by adviser on general advice warnings.
Disclosure obligations	Fee structure associated with financial advice (upfront and ongoing) well above typical industry charge rates.	Failure to disclose remuneration/commissions benefits.
Suitability of advice	Failure to tailor advice to client and devise an appropriate exit strategy for the client in the event of a market fall or other factors.	Failure to tailor advice to client/use of template documents.

The Westpoint data in the above table is derived from an analysis of relevant decisions against financial advisers and financial advisory groups in 2006/07 by Australian courts, ASIC and the Financial Ombudsman Service (FOS). This research was undertaken in the course of a PhD thesis on ethical decision making in financial services organisations.⁶ The analysis includes two common law decisions finding negligence against financial advisers in their advice to consumers to invest in the Westpoint promissory notes; 25 decisions of the FOS in determining consumer complaints against financial advisory groups; and eight banning orders by ASIC against financial advisers who recommended investments in the Westpoint promissory notes.

There appear to be some areas of adviser conduct known to have occurred in the Westpoint case study, where there is no commensurate evidence at this stage of a similar pattern occurring in the Storm case. These areas include “misleading and deceptive conduct”, and an “inappropriate reliance by the adviser on general advice warnings”. However, similar patterns in the financial advice models can be discerned even at this preliminary stage. Obligations that appear in the Corporations Act 2001 (Cth), such as “know the client”, “know the product”, “have a reasonable basis for the advice”, “explain risk”, “disclose conflicts of interest”, and “ensure clients understand the advice given to them”, were breached by advisers in the provision of advice to consumers to invest in Westpoint and will be alleged again by consumers against Storm Financial.

It is also clear from both cases that the current spotlight on gearing as a strategy to assist investment into the market by retail clients is well deserved.⁷ The current round of government activity to regulate margin lending and ensure there is transparency around commissions and other remuneration arrangements relating to them may assist in preventing consumer losses in the future.⁸ However, the evidence suggests that even current legislative obligations associated with the provision of financial advice are not being met by advisers, so it will be interesting to see what a new round of legislation will achieve in this area.

Practical implications

There are a number of practical implications arising from the analysis presented in this article for heads of advice and compliance managers within financial advisory firms.

1. If gearing strategies are adopted within your advice model, immediately review your compliance systems and procedures in relation to the same, and check the client’s capacity to repay debt has been considered and loan to value ratios are reasonable.
2. Template statements of advice must still be tailored to ensure the client’s circumstances and objectives and the recommendations made to invest are linked.
3. There is no such thing as a “one size fits all” recommendation to invest in a financial product or strategy.
4. Review instructions given to your auditors to ensure that the quality and appropriateness of the financial advice given to clients is reviewed, in addition to the other legal obligations associated with statements of advice.
5. Check whether your advisers are meeting their duty to undertake an independent assessment of the financial products they recommend to ensure they match the client’s objectives and circumstances.



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Footnotes

1. Taylor, M, “Attention shifts to the margins” *Money Management Magazine*, 12 February, 2009, p 13.
2. “Storm clients in compensation no man’s land” *Money Management Magazine*, 12 February 2009, p 4.
3. Beaman, L, “In the eye of the Storm” *Money Management Magazine*, 22 January 2009, p 10.
4. Above note.
5. Financial Planning Association of Australia Ltd, “FPA CEO e-news”, 10 February 2009, p 1.
6. Smith, J, “Through the looking glass: a study on professionalism and ethical decision making in financial planning”, paper presented to the ANZAM conference, Auckland, 3 December 2008.
7. McCormick, D, “The overselling of gearing” *Money Management Magazine*, 26 March 2009, p 20.
8. “Sherry flags tougher margin lending regime” *Money Management Magazine*, 12 February 2009, p 6.