

Financial Advice: Lessons from Litigation

By Adj. Prof. Wes McMaster, July 2006

Over the last four years I have spent a great deal of time preparing expert opinions and appearing as a witness in court cases involving financial advice. Some common weaknesses keep recurring in the way financial advisers give their advice and I have prepared a half-day training course to address these issues. In simple terms, my observation is that financial advisers who end up in court are generally in that position because they lack some competency and they have not been properly trained. You can argue that this is an issue for the Licensee because if proper supervision was in place, the unfortunate financial adviser would not have slipped through the cracks. While this is true and it reflects the Licensee's obligation, it is equally the responsibility of a competent professional to deliver compliant advice.

The good news is that this is not difficult to fix. Assuming that a financial advice business has appropriate processes and systems in place, it is a training issue. Litigation of financial advice is growing and Licensees should consider including a focus on compliant advice and defensive strategies in their regular professional development training for their representatives. This might even impress your professional indemnity underwriter because it is aimed at reducing potential liability. Here are some of the common mistakes that I see.

Client Objectives

In nearly all of the cases that I have examined, client objectives have not been clearly defined. How can you advise someone how to efficiently employ their financial resources to achieve their objectives when you don't know what they are? An objective must be able to be measured, then you can measure whether a client is on target or not to achieving it and whether any corrective action needs to be taken. It is not enough to record, "Client wants to retire in 10 years". Better to record, "Client needs an income of \$60,000pa after tax (present value) to retire in 10 years". This provides an objective target and the adviser needs to demonstrate how the advice will achieve it.

Adviser Bias

I have worked on some cases that clearly indicate adviser bias in the recommendations. I have seen advisers who favour putting all of their clients into particular investments or into margin lending positions with little regard to the very different positions of the clients as well as the different objectives. These advisers seem to have a "fad" view of their favoured positions and a naive` expectation that as long as the client makes money, then all will be well. However, the reason they are in court is that their clients lost money and then questioned the appropriateness of the advice. I have typically found that this style of adviser does not include any analysis, modelling or reconciliation of the advice with the objectives in their documentation. An example of this is recommending margin lending with no cash flow or sensitivity analysis.

Risk Profiling

Here is a vexed question because there is no standard. In this short article, I am not going to discuss the different methods. My observation is that about half of the cases that I have seen are unable to reconcile the advice with the risk profile. In some cases the client has disputed the risk profile and this may indicate that the adviser never agreed on a risk profile or even discussed the implications with the client.

Basis for Recommendations

We all know that an adviser must have a reasonable basis for making any recommendation. ASIC policy statements are explicit about what this means. Of the written financial advice that I have seen in the courts, I cannot remember one of those documents that reconciles why the advice was appropriate.

Research

I have done a lot of work in this area and I have recently given Slater & Gordon an opinion on the Westpoint Information Memoranda. Advisers are required to conduct research into the subject matter of any recommendation. Some advisers do their own research, some rely on in-house professional researchers and others outsource the research to external groups. The adviser should evaluate the overall quality and effectiveness of analyses provided by any research organisation to ensure that the reliance placed on any information from that organisation is "reasonable in all the circumstances."

I am surprised by the lack of commonsense that some advisers have demonstrated in selecting and evaluating particular investments. Westpoint is a classic example of this. My conclusion from looking at about 70 cases where this was an issue is that the advisers lacked the competency to understand the risks associated with the investment(s) in question. Again, I see this as a training issue.

An adviser should at any time be able to provide sufficient written information about the securities recommended so that the basis on which those securities were considered appropriate for the particular client can be understood. Many of the cases I have reviewed have not satisfied this requirement.

It is my opinion that investment research, portfolio construction and investment management are weaknesses in financial adviser training but, ironically, investment is the core of most of their businesses.

Record-Keeping

Poor record-keeping brings a lot of advisers undone when they are challenged about their advice. If you have not kept good records then you will find it difficult to defend your advice.

Summary

This list is not exhaustive and you can see from my comments that all of these issues should be part of the basic training of financial advisers. I suspect that what is happening is that advisers start as properly trained and then over time they lapse into what they see as an expedient pattern of behaviour to increase sales. However, a true professional understands that the attention to detail and the maintenance of advice principals produces better advice and strategy and that is in turn reflected in higher quality clients and client satisfaction. You will thus build a more sustainable business and therefore a more valuable business.

Most of the advisers who find themselves in a legal dispute with clients are decent people who simply lack good training. I am giving a lot of training courses to financial advisers in South East Asia and I am dealing with the same issues of basic financial advice principles. I think that Licensees in Australia would do well to take their representatives through professional development sessions re-visiting the fundamentals of financial advice and compliant behaviour. Compliant behaviour does not come from compliance officers, it is a professional state of mind.

Wes McMaster consults to the industry on all matters relating to financial advice and the management of financial advice businesses. He runs training courses aimed at improving the quality of advice and provides expert opinions for the major law firms in Australia.

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