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JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

Reference: Financial products and services in Australia

FRIDAY, 4 SEPTEMBER 2009

SYDNEY

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JOINT STATUTORY COMMITTEE

ON CORPORATIONS AND FINANCIAL SERVICES

Friday, 4 September 2009

Members: Mr Ripoll *(Chair)*, Senator Mason *(Deputy Chair),* Senators Boyce, Farrell, McLucas and Williams and Ms Grierson, Ms Owens, Mr Pearce and Mr Robert

Members in attendance: Senators Farrell, McLucas, Mason and Williams and Ms Owens, Mr Pearce and Mr Ripoll

Terms of reference for the inquiry:

To inquire into and report on:

Issues associated with recent financial product and services provider collapses, such as Storm Financial, Opes Prime and other similar collapses, with particular reference to:

1. the role of financial advisers;
2. the general regulatory environment for these products and services;
3. the role played by commission arrangements relating to product sales and advice, including the potential for conflicts of interest, the need for appropriate disclosure, and remuneration models for financial advisers;
4. the role played by marketing and advertising campaigns;
5. the adequacy of licensing arrangements for those who sold the products and services;
6. the appropriateness of information and advice provided to consumers considering investing in those products and services, and how the interests of consumers can best be served;
7. consumer education and understanding of these financial products and services;
8. the adequacy of professional indemnity insurance arrangements for those who sold the products and services, and the impact on consumers; and
9. the need for any legislative or regulatory change.

WITNESSES

ATKIN, Mr John, Managing Director, Trust Company Ltd; and Executive Committee Member, Trustee Corporations Association of Australia 18

BATEMAN, Mr Dennis, National Treasurer, Association of Financial Advisers Ltd 26

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MACKAY, Ms Claire, Director and Certified Financial Planner, Quantum Financial Services Australia 44

McEWAN, Mr Ross Maxwell, Group Executive, Retail Banking Services, Commonwealth Bank of Australia 56

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NOWAK, Mr Michael, Queensland Chair, GenXt Committee, and Adviser, Association of Financial Advisers Ltd 26

PETRIK, Miss Bianca, Corporate Development Manager, Professional Investment Services 111

TAGGART, Mr James, National President, Association of Financial Advisers Ltd 26

WHITE, Mr Lee, General Manager, Leadership and Quality, Institute of Chartered Accountants in Australia 2

Committee met at 8.46 am

CHAIRMAN (Mr Ripoll)—I declare open this public hearing of the Parliamentary Joint Committee on Corporations and Financial Services. This is part of a series of public hearings the committee will hold to inform its inquiry into financial products and services. The committee is inquiring into issues associated with recent financial products and services provider collapses, such as Storm Financial, Opes Prime and other similar collapses. In conducting its inquiry the committee has made a decision to focus specifically on non-superannuation products and services. Witnesses giving evidence to the committee are protected by parliamentary privilege. Any act which may disadvantage a witness on account of their evidence is a breach of privilege and may be treated by the parliament as a contempt. It is also a contempt to give false and misleading evidence to a committee.

The committee prefers to hear evidence in public, but we may agree to take evidence confidentially. The committee may still publish confidential evidence at a later date but will consult with the witnesses before doing this.

[8.47 am]

ELVY, Mr Hugh, Head, Financial Planning, Institute of Chartered Accountants in Australia

WHITE, Mr Lee, General Manager, Leadership and Quality, Institute of Chartered Accountants in Australia

CHAIRMAN—Welcome and thank you for your submission and for appearing today. If you would like to make some opening remarks, that would be welcome.

Mr White—The Institute of Chartered Accountants thanks the committee for the opportunity to appear before it today. The Institute of Chartered Accountants in Australia is the professional body representing chartered accountants. The institute represents over 50,000 chartered accountants and 12,000 accounting graduates who are currently enrolled in our chartered accountants postgraduate program. Our members work in diverse roles across commerce and industry, academia, government and public practice throughout Australia, including rural and regional Australia and in over 140 countries around the world.

The institute's aim is to lead the profession by delivering visionary leadership projects, setting the benchmark for the highest ethical, professional and educational standards. The institute represents a wide range of professionals who operate within the financial services sector and has a strong interest and involvement in this industry. The institute believes that the role of the accountant within the financial advisory industry has substantially diminished as a result of the regulatory changes to the financial services industry. An opportunity exists to rebalance this and increase consumer accessibility to quality financial advice. At the outset, the institute would like to clearly state that it is very supportive of the objectives of this inquiry and understands the importance of a robust financial services regulatory framework and the services provided to the public.

In preparing our submission and today's opening remarks, we have approached the challenges facing this committee by endeavouring to analyse the various issues and to prioritise them with what we see as the drivers for the delivery of quality financial advisory services.

We have also drawn on our knowledge and experience that arose with the delivery of professional services in other regulated industries and, in particular, where governments decided to alter policy settings in those industries. For example, the changes that occurred with the audit profession with CLERP 9 and, more recently, with the new tax agent services regime.

I will return to the drivers. The institute has identified what it believes are the key drivers for the delivery of quality financial advisory services—and there are five. The first is a professional education and qualifications framework. This incorporates a recognised, consistent, high quality education that includes robust ethical and practical components. The second is the culture of the industry. The overarching commitment to delivery of quality services is a must. It is a culture that operates in the public interest, with appropriate remuneration models that remove conflicts of interest. The third is appropriate regulatory settings. The fourth is the effectiveness of the

processes and procedures that are used to deliver the quality services. The fifth and final one is about consumer understanding.

Remuneration. The importance of remuneration and conflicts of interest within the financial advice industry is a debate that the accounting profession led with the release of its Financial Advisory Service Standard, APS 12, in 2005. Furthermore, I would like to bring to the attention of the committee that the institute released a paper Reinventing Financial Planning in 2007 that stated that remuneration and conflicts of interest were the primary issues the industry needed to address. At the time of its release, it was not widely accepted by many within the industry, including some of our own members. However, in recent times, we can see that industry moves have validated the issues that we raised at that time. In particular, the institute welcomes ASIC's submission to this committee where it stated:

> ... the Government should still assess changing the policy settings of the FSR regime so that advisers cannot be remunerated in a way that has the potential to distort the quality of advice given.

ASIC clearly stated that, for this to occur, a number of forms of remuneration would not be permitted, including commissions, soft-dollar incentives, volume bonuses and fees based on percentage of funds under advice. Many have stated that the core issue in regard to remuneration and conflicts of interest revolves around disclosure, transparency and availability of choice. The institute believes this is not adequate and that there should only be removal of conflicts of interest—actual and perceived. That is the appropriate solution. Remuneration models must be based on the advice provided, not the sale of product or funds under management.

Measures of success: accompanying the drivers to the delivery of quality financial services. It is important to clarify what we see as the measures of success for the delivery of quality advice. Defining success and measuring is subjective, but the institute believes that it is a very important initiative. For some it could be argued that the measure of success would be the elimination of any future collapses such as Storm and consumers losing money who have received financial advice. Others would suggest that the measure of success would be informed decision making by consumers. The institute would encourage further work on clarifying appropriate measures of success and would be pleased to participate in their development.

The role of the regulator. There is much debate about the role of the legislation and the regulator. A significant issue appears to be the regulatory expectation gap between the expectations of what the consumer believes the role of the regulator to be and the actual role of the regulator. There are indications that the consumer believes, for example, that licensing within the industry provides a form of guarantee by the regulator. This is not a realistic expectation and it indicates that significant education and communication are required for consumers and others to enable them to clearly understand the role of the regulator. The institute also believes that greater cooperation between the regulator and the leaders in the financial services community could lead to the development of an early warning system of adverse signs and trends in the industry. The institute would support the development of this initiative through its resources and wide membership.

In summary, the critical issue is identifying the drivers for the delivery of a quality financial advisory service that encompasses professionalism through education, experience, culture,

appropriate remuneration models in combination with consumer understanding and appropriate regulatory settings. Thank you for the opportunity to make this opening statement.

CHAIRMAN—Thanks very much, Mr White, and again I thank you for your submission and for your presence here today. I might begin by focusing on chartered accountants and the difficulty of defining who is exactly what in the sector. Specifically, accountants are not allowed to provide financial advice, yet there is no definition of what is an accountant is. Anyone, really, can label themselves an accountant. Within your own organisation and profession, how is that made distinct?

Mr White—I might start with a couple of higher level remarks and then pass to Mr Elvy. You are right that anyone can hang out their shingle and call themselves an accountant. I think that is something for another day, and we as leaders in the profession have debated how we could change that. In our membership we do have a range of practitioners that provide different services, one of which is financial services advice. With the changes that came not that many years ago, there was certainly a feeling and a sense within our membership that the role of the 'trusted adviser' had been somewhat diminished. Hugh?

Mr Elvy—One of the key issues for chartered accountants, as Mr White mentioned, were the changes that basically removed what was called incidental advice. Many accountants were looking at whether they should become licensed in the current financial services regime and, as a result, many of them have not actually become licensed. So one of the quandaries and the grey areas that we still address with our members is what they can and cannot do under the financial services regime.

CHAIRMAN—Is it as clear cut as that? Obviously, in practical terms, it all revolves around a relationship of trust, whether you call yourself a planner, an adviser, an accountant or whatever term you use—that your client, the person who comes to see you, has an enormous amount of trust. What we are trying to understand here is how we make sure that trust is not misplaced. How do we know people are following the law? How does your organisation give instruction or comply with those mechanisms?

Mr White—Sure. In our profession, chartered accountants, not only have they come through the educational requirements but their postgraduate work is focused particularly on ethical behaviour. Now, how do you approach the culture of our profession to ensure that it is always driving and delivering quality services? It is partly through training that occurs through the education and partly ongoing training and reminding of the key messages. But we also have quite a strong quality assurance program, where all practitioners over a period of time would be examined to ensure that they are complying not only with the legislative requirements but also with the requirements of our own association—so, our professional requirements as well.

CHAIRMAN—So your backstop measure is really membership of the institute, as it were, and what your group does to ensure that your members do the right thing?

Mr White—A key component of ensuring the delivery of quality services is our quality assurance framework. It is not the only element; as I said, there is education, training, ongoing interaction and peer support. All of these assist in trying to drive the culture of our profession to make sure that it is delivering what you started out with, Chairman—trust and advisory services.

CHAIRMAN—As we have heard in this and another inquiry—into agribusiness MISs—accountants certainly do play a role in providing advice, and it can be financial or planning advice, but sometimes they are authorised under a dealer group or somebody else's AFSL to provide single-product advice. I am concerned about how that operates, because the person of trust, the accountant or anyone else, then has this single-product sales role but it is seen in the light of advice. Do you have much experience or knowledge of how that works within your sector?

Mr Elvy—Yes. It is actually one of the issues we raised in our MIS submission and also in our most recent PJC submission—that one of the areas that really need review is the licensing of an organisation and an individual to advise on only one particular product. We believe that that really is a deficiency, because again it raises the issue of conflicts of interest. It is not possible to provide holistic advice if your only product solution is one particular product. We believe that is a significant driver, particularly in the MIS area and generally. If you are limited to one product, you really cannot provide holistic advice, and we do not support that.

CHAIRMAN—That leads me to my next question. If that is the case—and I think you are right; there is concern about the single product problem—how do we detach the manufacturers of products from the distributors of those products, to remove that conflict? How do we remove that conflict so that, for example, somebody like an accountant cannot simply be ticked off as an authorised rep and begin giving advice but only on one product? How do we detach that?

Mr Elvy—One of the issues with regard to the legislation and regulation is the focus on product. When it comes to the training and qualification side of things, you actually become compliant under Regulatory Guide 146 on a particular product or product area. One of the comments that we made in our submission was that the focus should be on demonstrating compliance and competence in providing advice. The areas would be, for example, wealth creation and investment, not just managed funds or any superannuation insurance, because, again, that is a focus on product. One of the key issues that we raised in our submission and also in our opening remarks is the importance of a culture that really is delivering professional services and providing professional advice. That is where we think a lot of the focus should be. It should be no longer on the product but on the advice side. At the moment the product manufacturers are developing the products and, as a result of that, you have business models which are focused on products as opposed to advice.

Senator MASON—Gentlemen, you have made a couple of novel suggestions. You say that we should 'consider expanding the compliance audit of AFS licence holders to include the advice given by authorised representatives'. How would that work?

Mr Elvy—There are two components to that. Our basis for that recommendation is that—

Senator MASON—It is an interesting recommendation.

Mr Elvy—Yes. In a number of submissions and at a number of the hearings, comments keep coming up that Storm met their compliance requirements. There have been a lot of discussions about the tick-a-box component. Whilst there are some drivers with regard to providing quality advice, one of the really key issues is: who is actually checking the advice? Storm must have had a compliance team and would have been doing reviews, but obviously something came out of

that which was not appropriate and there appear to have been deficiencies. One of the solutions that we said could be considered is an inspection—that is, checking of the actual advice that the authorised representatives have provided from an Australian financial services licensee.

Senator MASON—Who would conduct that? You could give it to chartered accountants.

Mr Elvy—Absolutely! From a regulatory perspective, you would think ASIC, but it also comes down to resources, manpower, and it is probably not possible. Consideration would be given to, potentially, a third party. It might be part of the compliance audit—that is, every three years an independent compliance audit is required to sample some of the advice that is being provided.

Senator MASON—It is an interesting idea. Thank you. You mentioned that remuneration should not affect the nature of the financial advice, because there can be a conflict of interest. I think 'actual or perceived' is what you said, Mr White. I will leave that to my colleagues to address. It has been addressed many times, as you know, but it is a good point. Mr Brogden mentioned, in our Canberra hearing, tax deductibility for financial advice. Is that to counter the argument that the provision of financial advice where people have to pay a fee for service will take it outside the ability of many people to pay for that advice? Is it part of the argument that tax deductibility will make it cheaper?

Mr White—Yes, it is. That is one of the drivers to say that, if we are trying to make sure we are transitioning this profession and trying to get some focus on all being able to access it, then perhaps some form of incentive along those lines of tax deductibility would be wise.

Senator MASON—Just think what a boon it would be to the industry, Mr White. I will have to give that some thought.

Mr Elvy—In addition it will introduce consistency and equity. In some cases the commission and the commission payments are actually deductible. You have a conflict there between deductibility of a commission remuneration versus fee for service. Also, from an administrative perspective, if you have a fee-for-service model then if I am providing advice I need to, currently, put down the advice that I am actually providing and see what is tax advice and what is not tax advice and then I develop my invoice. So you have got some administrative issues there in terms of delivery of the service and, again, that adds to the costs associated with it.

Senator MASON—There would be complexities if we did not change the nature of being a licensed financial adviser because if you are mixing sales of product with financial advice then it becomes complicated. We are going to have to address that issue. Thank you, Gentlemen.

Senator McLUCAS—Thank you for your submission. I would like to get an understanding of what happens when an audit is undertaken. I understand your point that that does not audit the quality of the advice. What does it audit?

Mr Elvy—The annual audit for an Australian financial services licence really has two components. There is a financial audit and also a compliance audit. In simple terms, it is a review of, obviously, their financials and also, from the compliance perspective, it is looking at outlining that they have been reporting their compliance breaches and so forth on an annual

basis, which they have to do to ASIC. In outline, they are meeting their procedural and process requirements. It does not look at the actual advice being provided by their authorised representatives.

Senator McLUCAS—When you say it looks at the financials—

Mr White—it looks at the financial statements of the organisation. An auditor would undertake a range of activities of audited steps in order to determine whether those financial statements as prepared are materially correct and present a true and fair position.

Senator McLUCAS—So it is essentially looking at its viability as an entity?

Mr White—It is a bit broader. You have got an operating statement and a balance sheet comprising assets and liabilities as well as a range of notes. The auditor's opinion sits on top of those financial statements and opines on what the presentation is of those.

Senator McLUCAS—So in no way does it go to the operations or the quality of advice?

Mr White—No.

Senator McLUCAS—It just means that the columns add up, essentially.

Mr White—It means more than that.

Senator McLUCAS—That is what I am trying to get to.

Mr White—That is an important element of it. It means that the accounts are prepared in accordance with the financial reporting framework and the auditors are performing their procedures in accordance with their rules on those financial statements in that framework. It is a quite rigorous exercise.

Senator McLUCAS—But it goes to the question that you raised in your submission about what the community thinks that 'audit' means in terms of being ticked off by ASIC—and Storm passed its audit with flying colours we understand. What does that mean to the community? I think that is a difficult question.

Mr White—There are expectation gaps in a range of areas and I think we have covered a couple of aspects. Leaving aside financial statements for a minute, in my opening remarks I made a reference to the licensing element and called that a regulatory expectation gap. Clearly, you can sense that a lot of people who perhaps are not close to understanding the regulatory frameworks that are used see the term 'licensing' as giving some form of direct approval or imprimatur. Whilst those closest to us would say, 'No, that doesn't do that, and this is clearly what licensing is about,' we have got this expectation gap between what those who are informed know is occurring versus what people are generally receiving it as. That is what we were alluding to in our remarks by saying there needs to be a lot of work done in this space. It is not easy to do, but you have got to keep working at it, otherwise the communication gap will always be a problem.

Senator McLUCAS—I will share with you something that one of the witnesses before us earlier this week suggested to us. She rang the Financial Planners Association to ask them if Storm was a member prior to her investing a lot of money. They said, 'Yes, Storm is a member of the FPA,' and on that basis she went ahead.

Mr White—So there is a different form of expectation gap.

Senator McLUCAS—That is right. Do you suffer from that sort of problem as well?

Mr White—We are alive to that type of issue as to the responsibilities of our membership and how people brand themselves as chartered accountants. What is really important for us is that once they are admitted they undertake their ongoing training obligations, that our quality assurance program, independent of that group, is examining how they perform their services and that the institute at times deals very strongly with members who do not adhere to their requirements. So we are very alive to the reputation and the brand of chartered accountant and we try and take steps to make sure that it is upheld.

Senator McLUCAS—So it is quasi-registration, so to speak?

Mr White—It is membership of a professional body. If people saw it as a registration as to that, you could argue that.

Senator McLUCAS—Thank you again for your submission.

Mr PEARCE—Thanks very much for your submission and for being here. I want to focus on recommendation 3 in your submission. You recommend that the legislative and regulatory framework be changed from financial products and financial product advice to regulating financial advice. So it would be a move from financial products and financial product advice to regulating financial advice. But the framework does regulate financial advice. It regulates general advice. It regulates personal advice. I am unclear as to what you meant by that.

Mr Elvy—The focus of our recommendation and comments there is also based on feedback we receive from our membership and, in particular, from the training perspective as well. The business models that have been developed are very focused on financial products. Whilst, as you correctly say, there are definitions for personal financial product advice and general advice and so on, there is still, as far as the business models are concerned, a lot of focus actually on the products. As I mentioned in regard to the training side, you actually become competent in products, as opposed to necessarily the advice.

Mr PEARCE—But, as you said, that is more to do with the business models rather than the regulatory framework, isn't it?

Mr Elvy—It is, but we believe that the business models have really come out of how they are read into the regulatory framework and the legislative framework.

Mr White—It goes back to the overall opening remarks about the drivers of quality in this space. One of them is getting the appropriate regulatory settings.

Mr PEARCE—Okay. That is all I had to ask.

Senator FARRELL—Thank you, Gentlemen, for coming along today. One of the things that I think are quite obvious about the evidence that we have received over the last couple of weeks is particularly in respect of Storm, in that they were selling the wrong product to the wrong people. The idea that you convince people who are retired or close to retirement to go into massive debt on what is a relatively speculative investment seems completely inappropriate. You seem to have grasped that issue in your submission by suggesting that there needs to be an audit not just of the financial records of the company but of the advice itself. Would you expand a bit more on how you would see that? Who would conduct that audit? How would you pick up that this was completely the wrong way to go for these people? Who would be the person who would then give the bad news to the person that they are in the wrong investment?

Mr Elvy—There are a couple of issues there. One comment I would make is that the need to review statements of advice and the advice is also more than likely related to the remuneration models that actually exist and are in place. So the need to provide through a third party—or through ASIC's resources—an analysis and review of statements of advice and of the advice being provided by authorised representatives is really a requirement because of what is in the remuneration models that exist. So, from the institute's perspective, we are looking at it and saying, 'Well, at the moment there are obviously some conflicts of interest that exist.' I am assuming Storm had a compliance department, but for whatever reason inappropriate advice was being provided to the consumers who were actually out there. So the idea of having a third party inspection, which may be on a three-yearly basis, as I mentioned previously, to check random samples of—

Senator FARRELL—You could do a lot of damage in three years.

Mr Elvy—We have not gone into whether it is needed on an annual basis or how you would actually do it or whether there would be trends. As we mentioned in our earlier statement, maybe early-warning systems could be put in place which would pick up adverse signs and trends and therefore direct us to go through and audit the advice being provided by an AFSL authorised representative. Or maybe it could be on a more structured basis, be on an annual or two-yearly basis.

Mr PEARCE—There is some of that happening now. The regulator does some of that now through mystery shopping and—

Mr White—Shadow shopping. It does have a level of surveillance as well.

Mr Elvy—That is right.

Mr White—Could I perhaps jump in there for a minute and tease that out a little further. I also make reference to the fact that there are some other professions where there has been a lot of focus and there has been government intervention around how to drive greater quality. The audit one was the example I gave. In that type of regime, there is a combination—a co-regulatory environment. There is ASIC as the audit inspector that conducts work over periods of time and it is based on its risk assessments. That is done in conjunction with the work of the institute in its

quality assurance program. So for different types of regulated industries, there are ways of setting up policy settings to deliver frequency and nature of review.

I think what we are alluding to is that, if we had the Holy Grail as being the delivery of quality financial advice, then you peel down to the drivers of that quality and part of that is the interaction between the regulatory settings and the work with the industry itself. And I think you can explore different settings to hopefully deliver the right effects. If you take it just to a discussion on product and advice, I think you leave aside a range of those other drivers that we spoke about, particularly around the culture of the industry. We heard earlier about the reference to being 'trusted advisers'. So it is really driving on a range of different areas to get to the right settings so that we do not have the types of examples—or we try to minimise the types of examples—as best we can of inappropriate advice.

Ms OWENS—Thank you for your submission. It was really interesting. I am interested in the recommendations that the institute was making prior to the global financial crisis and the collapse of Storm. A lot of people have good hindsight—

Mr White—Yes.

Ms OWENS—But you were actually talking about changes quite early. Can you tell me what you were talking about then and why and what additional things you have added because of the recent collapses?

Mr White—I will have a shot at that first and Mr Elvy, who was directly involved, can then follow up. You are right: in 2007 we came out publicly in a document stating clearly what we thought was appropriate remuneration for this type of service delivery. It was clearly not supporting product or commissions and was based around the delivery of a fee for service. At that time we felt we really had to take a leadership position, and we did. It was not fully supported by all of our members—I have to be honest—but we felt it was the right place in the public interest. Clearly debate around remuneration is a major focus of this committee. But, having said that, where we are trying to take a focus now is around these other drivers. Remuneration is fundamental to this discussion, but there are also other aspects that I would encourage the committee to consider in how to actually go forward in the delivery of quality services.

Mr Elvy—As Mr White mentioned, the 2007 paper was really focusing on what the future is for financial planning. Part of that was remuneration, but it also looked at all the other issues of professionalism, which included education, operating in the public interest and so forth. Part of that was because a number of our members were also moving into that area of financial advisory services. The outcomes in that paper were ones that we based a lot of our views and opinions on in terms of how we believe the industry, which is such a growing industry, should be heading.

I guess from the global financial downturn that we have had, we realise that a lot of the issues that we raised in that particular paper were validated as a result. One of the areas that we were looking at for the future is: what is the next step that we need to take in providing tools and resources to our members to incorporate a lot of the issues that have really come to light as a result of the global financial downturn.

Ms OWENS—You talk about a quality of advice audit, which is quite a tricky concept. How do you measure quality of advice? Advice for one person may be fine and for a different person it could be wrong. How complex is it and what kind of framework would there be?

Mr White—We did touch on this in the opening remarks. It is a tough area in which to tie down exactly the measures of success of quality advice. I think you need to try to strike a sense of whether the individual, the person who is consuming these services, achieving what their goals are and try to make sure that they are being informed of a range of their opportunities. We do not come here today with those measures, but we do come here today saying that it is really essential that work is done in this space, following on from identifying the drivers to looking at the measures of the success. I think if we get that sorted, all of us—whether we are service providers or users of the services—will all have common goals.

Ms OWENS—You referred to measures of success. I was going to go somewhere else, but I will go back to that. Earlier in your opening remarks you talked about the two measures as 'not having collapses' or 'informed consumer choice'.

Mr White—There is a wide range there.

Ms OWENS—I thought it was really interesting that we look now at failure as a collapse but we do not look at failure as not doing as well as it should have done.

Mr White—Those two examples were not meant to be comprehensive; they were meant to just present a couple of different aspects of a range. What the institute is saying here today is that we think some more needs to be done in trying to work through that range of what we would all say are acceptable measures of success for financial advice.

Ms OWENS—Yes, but measures of success rather than protection against failure, which is—

Mr White—Yes.

Ms OWENS—Again, I know it is very early days for a discussion on this, but would you see the audit as general quality control or is it also about identifying the riskier elements?

Mr White—I think they go a bit hand in hand, to be frank. If we use our experience in some other aspects, say, as the audit profession, when we are assessing the delivery of quality audit services, it encompasses both of those components.

Ms OWENS—With the increase in standards, qualifications and all the rest of it, do you see a role for the salesperson—the specific product salesperson?

Mr Elvy—One of the challenges that the industry has had over many years is trying to meet the interests of various groups. As to having, for example, a two-tiered system—which various people have mentioned and discussed previously—the institute's position is that the introduction of a two-tiered model would just add further complexity and confusion for the consumer. As we mentioned in our opening statement, the consumer needs the opportunity to be able to see an adviser who has a recognised, consistent qualification. So you know everyone is the same and the remuneration model is the same. Therefore, they can have that trust with a professional

adviser, as opposed to talking to a salesperson. As we have seen with Storm, you have gone to people who have been well educated and there is that trust there. The institute believes that introducing a two-tiered model will just add further confusion at a time when consumer literacy is still very low. Maybe in years to come, when everyone understands the financial service industry, there may be opportunities. But, currently, there is a lot of naivety and lack of understanding of the industry, so we need to make it as simple as possible.

Mr White—Now is the time to move from selling to provision of quality financial advice.

Ms OWENS—With the increase in standards—and it is a good idea; I am not even questioning it—we have a growing number of people in Australia who find themselves with large amounts of money towards the end of their lives and they have never invested. We also find people in their 20s now, with the beginning of super, needing broad-ranging advice which is not about shares and is actually about property and really quite simple stuff. How do you keep that affordable?

Mr White—I think it is a challenge. There will always be a balance on this because what is affordable to one individual might not necessarily be affordable to another. What I can say is if we get the policy settings right and the drivers of quality services are here then I think the market pricing will be appropriate for the delivery of the quality. What we have got at the moment feels to be a complete imbalance where there is not delivery of quality advice and quite, at times, substantial fees. So what I am saying is let us think about the quality. Yes, we need to be conscious of the affordability, but my sense is that, as with a range of other services, the two will actually come together.

Ms OWENS—The increase in standards to a degree level takes time. What kind of transition arrangements would you foresee?

Mr Elvy—The transition arrangement would have to be maybe a three- to five-year time horizon. A number of the issues that we have raised in our submission are not short-term fixes and, as Mr White mentioned, the opportunity exists now to put in place various regulatory settings and key drivers which are to look at things potentially 10 years down the track until it is actually all in place. Many people, for example, talk about consumer responsibility, saying that consumers should take more responsibility. The reality is that it is not going to happen in the current environment where you have got limited consumer literacy. So you cannot pass it off and say consumers need to take more responsibility. Yes, consumers need to increase their education and understanding themselves, but that is a generational issue. That will happen probably 10 or 20 years down the track when my kids are coming out of high school and so on. Similarly, when we are talking about increasing standards and education, it is not going to happen overnight. There needs to be a transition period and it may well be over a three- to five-year period.

Mr White—That is where we come back to there being a number of drivers of quality. If we can commence and take short-term measures on some of them, whilst we have recognised the transition periods of others, we are moving in the right direction in driving the quality.

Ms OWENS—I think you are suggesting there that we need a 20-year literacy program.

Mr Elvy—I think it will take a long time.

CHAIRMAN—If somebody was providing completely inappropriate, bad-quality advice, but making lots of money, how do you know that it is actually bad quality if they are making money? Or is it just a case that it is bad, inappropriate advice when you lose money? How would you define it?

Mr White—That is really at the nub about the measures of success. In some ways you are asking the question that if I am doing okay but not as well as I should be—

CHAIRMAN—No, it is not that at all. I am saying that you are making outrageous, incredible money—more than anybody else—but you are being provided with the most inappropriate, reckless advice. You are still making lots and lots of money. Is it inappropriate or reckless advice?

Mr White—Yes, I think I am still at the point around how we actually define the measures of quality advice.

CHAIRMAN—Because it is possible that that happens. As we know from history and experience, it did happen.

Mr White—Yes.

CHAIRMAN—So does it become only inappropriate once you start going in the other direction and you start losing money?

Mr Elvy—Inappropriate advice is inappropriate advice whether you are actually making money or you are losing money.

CHAIRMAN—That's fine, but how do you prevent that? If somebody is making lots of money, how do you actually stop them making money? How do you say, 'You have to stop this; it is inappropriate. What you are doing is reckless. Stop making all this money'?

Mr Elvy—The key issue comes down to the grassroots issues of the actual advice being provided. Once people are making money then yes, it is a really difficult situation if you are looking at someone's investment strategy and saying, 'This is not really appropriate for you. I appreciate you are making a lot of money.' There is a challenge there to say that it is inappropriate and that they need to change it.

CHAIRMAN—How can it be inappropriate if somebody is making 10 per cent more than everybody else? I am seriously asking the question to try to understand how that might work.

Mr White—In some ways, being a left brained accountant you often think about risk and reward. I think there needs to be elements of risk blended into measures of successful advice. Whilst today might be sunny, tomorrow very well may not be; therefore, that is an important element to quality advice.

CHAIRMAN—Given that we have that picture in front of us, what are the preventative measures that currently exist to put the brakes on? Regardless of how much money you are

making, whether it be on paper or real, when the advice is inappropriate what are the safety measures that are in place now?

Mr Elvy—One of the key drivers—which we mentioned in our submission and also in our opening remarks—also relates to the issue of remuneration and the grassroots advice that is being provided in the first place. A lot of the issues that we talk about now are about how we prevent it after the fact. Our comments on the delivery of quality advice really come down to who is providing that advice and how appropriate the advice is, which comes out of qualifications, ethical behaviour and those sorts of things upfront. They are the real key drivers.

CHAIRMAN—How far do you think law should go in stopping people from risking their money? What is the risk ceiling? Should we go up to someone and say, 'Stop making money; this is risky'? How do we stop people taking risk? I am not saying I want to. I am just asking the question. You are the guys with the experience. You represent a fairly large chunk of people with lots of collective experience. What are your views?

Mr Elvy—At a forum that we held to obtain members' comments, we asked what the role of a financial adviser is. Interestingly, from the forum we held one of the key issues that was raised was telling consumers—their clients—what not to do. They said that, as an adviser and an accountant for their clients, part of the key issue is not just what the strategy to make money is but is also saying upfront, 'No, don't do this.' One of the roles of that trusted adviser in the first place—and I think this goes along with what you are saying about whether you actually regulate it—is not just appropriate advice but telling the client what not to do.

CHAIRMAN—How much responsibility should each individual adviser have for every word they say—not just what they write? How far should that go?

Mr White—Do you mean in a sense that—

CHAIRMAN—In the simplest of senses. If an adviser is giving advice to someone and says, 'I advise you to take all your superannuation and all your life savings, roll the dice and place them on stock X to see what happens', how much personal responsibility is there? They could make a lot of money—it could be a really great stock. I do not know what would happen. But how much personal responsibility should that adviser have for giving that advice?

Mr White—My response is that they should have a strong level of responsibility for that, that as a professional—

CHAIRMAN—But they are not professionals.

Mr White—I am talking from our membership perspective. As a professional guided by their ethics, their quality and their being inspected, they need to make sure they take that responsibility.

CHAIRMAN—But what is that responsibility—apart from feelgood?

Mr White—It is not about feelgood as much as it is their responsibilities to their professional obligations.

CHAIRMAN—That responsibility obviously does not go to a fiduciary responsibility.

Mr White—No.

CHAIRMAN—So, really, in the end that responsibility is just to—

Mr White—meet their professional obligations to deliver their quality services.

CHAIRMAN—And if they do not they are a bad person. That is pretty much it.

Senator McLUCAS—When we spoke to Mr Cassimatis yesterday, he indicated that people self-selected. Once they had been to so-called 'education events', they self-selected to go down the Storm road. How does that fit with what you have just talked about with Chairman Ripoll?

Mr Elvy—Obviously I was not at the hearing yesterday, in terms of the self-selection. I understand that an education seminar was run and as a result the clients said, 'I want to be a part of the Storm process.'

Senator McLUCAS—That is essentially right.

Mr Elvy—The institute's perspective on that is that the responsibility still goes back to the adviser and the advice being provided. The client may self-select and say, 'I am interested in going forward with this,' but in the current environment it is still the responsibility of the adviser to provide appropriate advice. As I mentioned to the chair a little earlier, part of the role of the adviser is to say, 'This is not appropriate for you.' As it seems to be the case with some of the examples out of Storm, the advice was not appropriate. If a person is retired, is paying off their home and is elderly, gearing is not an appropriate option, and if the client is saying, 'This sounds great; I want to head down that track,' a professional needs to take a position and say: 'No, it is not appropriate for you. There are other solutions.'

CHAIRMAN—On the appropriateness of advice: (1) it is impractical for anyone outside of that particular organisation—say a regulator—to check individual statements of advice. Even if they did, making a judgment call on what is inappropriate might be just a sliver one way or the other—should you have $10,000 in the market or $10,500 in the market? Where do you draw the line on what is appropriate? One product might be very inappropriate if you risk your house on it but if you throw $500 on it it is not going to make much difference to your life. It is pretty complex in terms of the many, many statements of advice that are out there. They are 60 to 120 pages long. Practically, who could ever take on the challenge of looking at all of them, making a decision and saying: 'That's in; that's out. That's no good; you can't do that bit. That bit's good advice; that bit's not good advice. You shouldn't have $10,000 in; you should have only $5,000 in'? Where do you draw a line? It is just too detailed, too complex. How do we know, in a regulatory sense, that compliance is being done?

Mr White—You are right, Chairman, practically you would not be able to look at all that, and even if you did look at some you would be seeing some marginal differences in your judgments compared to what might have been documented. I come back to the drivers, in a sense. If we can get all of the components working in the right way, I think it will take you a lot further along.

In terms of regulation, the regulator will be as focused around the quality systems, policies, processes and methodologies—how the service is being delivered—because if you have confidence that those elements are in place then hopefully you are going to get to the appropriate advice. That will not sort out the $500 to $1,000 or whatever but hopefully it will eliminate what you would call the ‘outlands’ of inappropriate.

CHAIRMAN—My concern is that organisations such as Storm, I am led to believe, were very compliant. They ticked all the boxes, had an audit. I am led to believe that that is the case. It was a question of their core values, systems and structures, which I am sure the Storm organisation still believe today are completely fine? How do we measure that—when it is not really the individual adviser?

Mr White—You really have a form and substance issue there to some degree. Whilst I do not want to sound like a broken record, without other elements of these drivers in place, no matter how strong one might be, you are still not going to get to the end result of having quality advice. Some of the elements we touched on, which really are at the heart of the substance, are about ethical behaviour and a focus on making sure that we are not just doing something in form, that we are actually delivering substantial quality.

Mr PEARCE—So you are now talking about something outside of the regulatory framework? You are now emphasising the ethical framework more than the regulatory framework?

Mr White—I am saying all of these elements, not just one element, are important in the delivery of the services and could assist.

Mr PEARCE—To take Mr Ripoll’s example: how do you objectively evaluate the advice—whether it should have been this or whether it should have been that? And, if you do that, where does it stop? Would you support the same review of advice being given to auditors, tax agents, accountants who provide advice for self-managed super funds? Would you support all of that advice being audited as well?

Mr White—From the institute’s perspective, when we conduct our quality assurance program we actually do look at the different elements of the practice.

Mr PEARCE—From the institute’s perspective, but would you support a regulator doing that sort of surveillance across all areas, because advice is not just financial planning advice? Your members give advice.

Mr White—The regulator now looks closely at audit services.

Mr PEARCE—But I am talking right down to tax returns—advice, as I said, about self-managed super funds, and all the other sorts of things that an everyday suburban accountant gets.

Mr White—I think you have got to strike the policy settings perhaps in different ways depending on the impact and risks involved.

Mr PEARCE—I agree.

Mr White—It was decided to look at the quality of audit services in the past because there was a sense of the impact and the ripple effect that poor audit could have in the capital markets and elsewhere. Therefore, we are looking at this element today around financial advice, because of the significance of the impact. Perhaps the tax commissioner would be much more focused on the quality in the tax returns, but it does not necessarily have those strong ripple effects.

CHAIRMAN—Gentlemen, thank you very much. I appreciate your submission, and your evidence and time today.

[9.42 am]

ATKIN, Mr John, Managing Director, Trust Company Ltd; and Executive Committee Member, Trustee Corporations Association of Australia

FITZGERALD, Mr Anthony George, Managing Director, State Trustees Ltd; and National President, Trustee Corporations Association of Australia

CHAIRMAN—Welcome. I invite you to make some opening remarks.

Mr Fitzgerald—There will be a couple of opening statements: one from me and one from John. Thank you for the opportunity to appear before the committee today. By way of background, the TCA was formed in 1947. It represents 17 organisations, the eight public trustees around Australia, and nine of the 10 private trustee companies licensed under state and territory law.

Services we provide include traditional wealth management services, covering the writing of wills, the administration of deceased estates, powers of attorney and trustee services. That has now been expanded to include funds management, superannuation, financial planning and acting as corporate trustees for debenture issues and securitisation programs. In total, the industry administers or has under management about $500 billion in funds.

Most recently, COAG has undertaken to federally license trustee companies and take the licensing off the individual states, and that is in progress. Despite the fact that we will become federally licensed, trustee companies still will have a requirement to act as a prudent person and those prudent person principles are enshrined in the state law and the state trustee acts. Trustee companies can be held liable for the mismanagement of assets entrusted to their care. I will ask John to add to that in terms of some of the specifics we want to get into.

Mr Atkin—I am the managing director of Trust Company Limited. Trust Company is one of Australia's leading independent listed trust companies, having been established in 1885. I am a member of the TCA Executive Committee. The other piece of activity that we do that is relevant to the submissions that I am going to make is to act as an independent responsible entity for a number of investment schemes.

As you know, under the twin peaks policy adopted by the Wallis report in 1997, ASIC supervision of securities and investment markets has been based on what is known as the efficient market theory, which is the belief that regulatory intervention in financial markets should be kept to a minimum. The global financial crisis and the resultant turmoil in investment markets has exposed a number of inherent weaknesses in the efficient market theory. In particular, we would say there has been a failure to provide appropriate safeguards to ensure the proper conduct of two critical agents in the market: financial advisers and promoters and managers of investment schemes. We appreciate a large part of the committee's work has focused on the role of financial advisers, but this morning I would like to focus on the failure of the single responsible entity regime to protect investors in managed investment schemes. Numerous examples can be identified where the responsible entities for these schemes have

compromised the interests of investors by acting in the interests of the promoter. In other words, investor protection has been compromised by the lack of independence implicit in the single responsible entity regime which was introduced by the Managed Investments Act back in the 1990s.

The committee will be familiar with the plight of investors in the Great Southern and Timbercorp schemes. Quite apart from the flaws in the basic business models, which I appreciate some of you are looking at in another context, the interests of investors in those schemes were compromised because the single responsible entities were subsidiaries of the ultimate promoter and actually acted in the interests of the promoter and not the investors. The most notorious example is the so-called project transform, where the investors in the underlying schemes were encouraged to give up interests in what may have been viable schemes to take shares in the head stock of Great Southern. Those shares, as you know, are worthless today. Similar examples can be found in the schemes promoted by Alco, Centro and MFS.

The so-called safeguards built into the Managed Investments Act have failed on their first serious test. In particular, the independent decision-making requirements in a single responsible entity system have been shown to be inadequate. The independent directors of a responsible entity are pitted against the resources and interests of the company who appoints them, pays them and can remove them. If a properly formed compliance committee with external members is in place, a majority of independent directors is not even needed. However, a compliance committee does not provide any real time monitoring or checking on the responsible entity's actions and is similarly lacking in independence in that the external members are paid by, appointed by and can be removed by the effective promoter of the scheme. Similarly, the present regime does not require an independent custodian and the financial underpinning of the schemes is often inadequate.

We would say the flaws that have been exposed are inherent in the design of the single responsible entity regime rather than a result of poor supervision by the regulator. Most, if not all, of the weaknesses were identified at the time of the debates around the introduction of the MIA, and they have now been exposed. At the same time, the supposed benefits in terms of reduced cost to investors have not been realised as there has been no real reduction in the level of fees taken by managers and no check on those investment scheme managers.

Again, as predicted at that time, these weaknesses in the design of the single responsible entity regime have led to a downgrade of our investment markets globally. For example, Morningstar's global investor experience research report issued in May this year scored Australia only a C for investor protection and highlighted the absence of an independent trustee in Australia's regulatory regime for managed investment schemes.

The TCA recommends that the committee reconsider the policy settings of the single responsible entity regime, which is out of step with the protections afforded investors in most other major investment markets in the world. In particular, we believe that the MIA model needs to be amended so that there is timely independent monitoring of the promoters and managers of investment schemes. Thank you.

CHAIRMAN—Thank you for that. I might begin by asking you your view or interpretation of trust companies, the public trustees and so forth—the collective corporations that you

represent. You say they have a very high level of ethics and standards. They minimise losses for clients, look after them and always give appropriate advice. How would you describe what they look like?

Mr Fitzgerald—I will speak on behalf of the public trustees, which is where I am most closely connected. They are established under their various state pieces of legislation. They have quite prescriptive duties that they need to undertake in terms of looking after a wide range of particular types of clients. But I think the 'prudent person' principle which must apply to all of the trustees is one where you always have to act in the best interests of the client, irrespective of what that would mean for you as an entity. The primary activity needs to be focused on acting in the best interests of the client, and that needs to be assessed on an individual basis, depending on the client that you have in front of you. That can vary from a person who has no assets at all, if you are looking after a represented person, to the wealthiest person in Australia. You have to assess them individually.

CHAIRMAN—How does that compare with the rest of the financial services sector?

Mr Atkin—If I can respond to that and give the background on the private trustee companies, and there are probably only 10 of us, did you say, Tony?

Mr Fitzgerald—Yes, in total.

Mr Atkin—There are only 10 in total, nine of whom are members. They vary a little bit in character. There are probably only two listed trustee companies where the trust business is the primary core of the business, and that would be us and Equity Trustees. Perpetual has a trust business, but it also has a very sizeable funds management business. Most of the other private trust companies are subsidiaries of banks or other organisations—for example, Elders has a trustee company. I would agree with Tony in terms of characterising us, and what lies at the heart of a trustee's business is that they must prefer the interests of their client over their own and they must act in the best interests of their client.

CHAIRMAN—And there is a good track record of that? History demonstrates that?

Mr Atkin—We have been around since 1885, and there would be others of that vintage. Even on that point, the two failures that led to the introduction of the Managed Investments Act was Estate Mortgage collapse in the early nineties and Aust-Wide. I think the records will show that in Estate Mortgage investors ended up with a payout of 60c to 70c in the dollar, and in Aust-Wide they got 100c in the dollar. You are never going to protect against flaws in business models entirely, but having an independent party in there playing a role in the interests of investors as their primary function is important.

CHAIRMAN—So, if there is this big gap between the standards, operation and track record of your corporations and what happens in the rest of the financial services world, what is the difference? What are the key drivers that distinguish between what you do in terms of consumer protection and appropriate advice compared to what happens in the rest of the industry?

Mr Atkin—I think Tony put his finger on it in saying that we are obliged to act in the interests of our clients and we cannot take commissions that we do not disclose to clients. Personally, I

support entirely ASIC's advice that financial advisers should be subject to fiduciary obligations. I come to this partly from a lawyer's background, but it is just unthinkable to me that you can give advice to a client without giving it in the client's best interest and preferring your own interest over theirs. It is implicit in an advisory role. It is unthinkable to do otherwise. It is an example of where, if you are relying on agents, you must make sure the agent is acting in the interests of the principal.

Senator MASON—To link them into the fiduciary duty?

Mr Fitzgerald—Exactly, yes.

Mr Atkin—Yes. Otherwise, if they do not have that constraint of acting in the interests of their principal—their client—they will act in accordance with their economic incentives and they will push products to maximise their revenue, and that is what has happened.

CHAIRMAN—Does a problem arise where they have to act as an employee in the best interests of their employer as well as the best interests of their client? Who wins?

Mr Atkin—It depends then on the obligation of the employer. If the employer's obligation is to act in the best interests of the client, you will get alignment of interest and obligations.

CHAIRMAN—Thanks.

Senator MASON—Gentlemen, thank you for your submission. It is interesting. It touched on some different areas from those we have encountered over the last couple of weeks. What about ratings agencies? I think we heard about this about 10 days ago, didn't we, Chairman?

CHAIRMAN—Yes.

Senator MASON—We did have a look at ratings agencies very briefly. How critical are they in determining investment decisions?

Mr Atkin—That is a good question. They play a role. To be honest, in our role as an independent trustee—I am probably thinking more of the work we do as, say, an independent responsible entity, because there are some managed investment schemes that engage an independent responsible entity—we do not necessarily second-guess the manager on their investment decisions if they are within the mandate and there are no related party interests. It is where the related party interests come up so that there can be a conflict that we will be extremely vigilant, and we will be extremely vigilant about proper disclosure to investors. But, to be honest, we do not make that many investment decisions ourselves. We would have professionals making those decisions. We are just the safeguard to make sure there is no conflict on it. I think the problem with ratings agencies, as I understand their role internationally, is that they have effectively been paid by the promoters and their economic incentive has been to act in the interests of their promoters.

Senator MASON—How do we make them accountable? You are a lawyer, Mr Atkin. It is an easy question for a Friday morning.

CHAIRMAN—So are you, Senator.

Senator MASON—Yes, but I am not a good one now! Mr Atkin is.

Mr Atkin—I do not know that lawyers are necessarily that good about accountability. They often obfuscate and find excuses.

Mr PEARCE—Really?

Senator MASON—Mr Pearce is very cynical.

Mr PEARCE—They have their clients' interests at heart, I am sure.

Mr Atkin—That is another discussion.

Senator MASON—It is difficult, isn't it?

Mr Atkin—I think it comes back to how they are retained and paid. Again, if you are relying on the so-called efficient markets theory, look at the role of the agents, because a ratings agency would be another agent in that market. If they are being paid by the promoters and that is where their incentives lie and there is no check on that then that will dictate and influence their behaviours, and that is what has happened. Whether you have some registration or licensing system for them—I have not looked at it in detail, to be honest—

Senator MASON—It is an interesting issue. You did touch on it 10 days ago. It is very difficult, I think. I am not saying you are wrong in terms of the conceptual difficulty, but it would often be hard to decide, generally.

CHAIRMAN—It is not limited just to credit rating agencies and other rating agencies. It is land valuers, house valuers and, in terms of MIS schemes, those who do the soil testing. They are all paid by the promoter of whatever scheme or investment it is.

Mr Atkin—That is true. I am thinking of a case we are involved with at the moment where the valuer was appointed and given instructions by the manager. We were asked to sign off on the accounts. We are challenging them directly with the valuer, basically. Again, looking at valuers in that specific example, we have actually spoken to the valuer and he said, 'We were instructed by the manager to do the valuation that way.' We said: 'What if we instructed you to do the valuation?' When we asked the valuer, 'Is that the way you'd have chosen to do the valuation?' the answer of the valuer was no. So we said, 'We'd like the valuation done as you'd have preferred to do it.' That is a live example where the independent responsible entity, by intervening, has actually changed the dynamic with that valuer.

Mr PEARCE—Gentlemen, thank you very much for being here. Mr Atkin, in your opening remarks, you made some broad statements and comments. I am always very interested when someone makes sweeping statements. I think you said that the Twin Peaks model was proven to have failed in the global financial crisis and that it was based on the market's efficiency model and that that was premised on the idea of having—I think you used the term—'not much intervention in this space'.

Mr Atkin—Just to clarify, I do not think the Twin Peaks model has failed. Although it is not subject to your inquiry, I think APRA and the prudentially regulated part of the market has performed exceptionally well by world standards.

Mr PEARCE—That is right. So you are not saying that the Twin Peaks model has failed?

Mr Atkin—No. And I am not necessarily saying that the security and investments area has failed in a major way. There are clearly examples where it has failed for investors. We are not advocating more market supervision by ASIC. That is not where I am personally coming from. We think the flaw is in the design of some of the incentive structures and obligations of participants in the market. Does that make sense?

Mr PEARCE—Yes. Thank you for clearing that up. I think you also made a comment along the lines that you find it amazing that people in the financial advice area act in their own economic interests.

Mr Atkin—Yes.

Mr PEARCE—Who pays you?

Mr Atkin—I am obviously paid by my employer. The trust company receives a professional fee by its clients.

Mr PEARCE—Do you act in your clients' interests?

Mr Atkin—Absolutely.

Mr PEARCE—So you act in your economic interests, just like everybody else.

Mr Atkin—I see a trust role very akin to a professional obligation. I think any professional has three orders of duty. Their first duty is to the society, and we as a trust company and the public and private trustees have that obligation. Our second duty is to our clients. After we discharge our duty to our clients, we are entitled to make a living out of the discharge of that professional service. But our fees are a third order priority for us.

Mr PEARCE—Mr Atkin, I got the impression that you were separating groups, if you like. You were saying that there is a group over here that clearly acts in its own economic interests and there is another group over there, which includes us, who do not act in our own economic interests.

Mr Atkin—No. The point I was making was that financial advisers are not obliged to act in the interests of their clients, which I find an extraordinary proposition. As I understand it, that is the point ASIC has made in its submission. They are only obliged to give advice with a reasonable basis. They are not obliged to give advice in the client's best interest. That is the basic point I am making. The danger is when that is coupled with fee arrangements where advisers are entitled to a commission from the promoter of the scheme.

Mr PEARCE—I noticed that you used the words 'failure' and 'failed' quite a lot in your opening comments. Your initial comments were directed across the regulatory framework but then you brought your focus very much to MIS.

Mr Atkin—I am not saying that Twin Peaks has failed and I am not even necessarily saying that the investment markets have failed, but there are probably a dozen spectacular examples of failure in the MIS system.

Mr PEARCE—As I mentioned yesterday, this is our challenge: we are legislators; we can look at the context of everything but, at the end of the day, our job is to make laws and to try and make the best laws possible in order to protect Australians. So we have to always come back to the question of: what do we actually need to do in the law to strengthen disclosure, transparency and consumer protection? You can make all the sweeping statements you like but, at the end of the day, they are not going to change the law. What amendments do we need to make to the law to protect Australians? What do you suggest that we do as legislators?

Mr Atkin—I should emphasise that this is a personal view of mine and trust company; it is not a position that the TCA is putting. Personally, I think you should reintroduce the requirement for an independent trustee on managed investment schemes. We are one of the few countries in the world that does not have it. I do not know if any of you were involved in the debates during the 1990s which raged for some years—

Mr PEARCE—We are all too young!

Mr Atkin—before the managed investment scheme came in. All of the predictions made by the industry at the time have come to pass. Because Australia has had 15 years of very favourable economic conditions and rising investment markets, this is the first time those schemes have been tested. All the flaws have been exposed. There is nothing that was not said then.

Senator MASON—You mentioned fiduciary duty too.

Mr Atkin—Absolutely, that is at the core of what a trustee does.

Senator McLUCAS—On the question of disclosure of fees, you made the point earlier that you disclose all the fees associated with advice giving and putting people into a regime of investments. However, we have heard that many of the people who were Storm investors only found out about what fees they had paid subsequent to the collapse. Storm was obviously compliant with the disclosure laws. What is wrong with the disclosure laws? Many people who talked to us really did not understand what the fees were that they were paying.

Mr Atkin—I have come at this a slightly different way, and I am not familiar with Storm in the detail that you are—

Senator McLUCAS—No, I am asking in a more general sense.

Mr Atkin—I noted the chairman's comment earlier that it would seem Storm has complied and has very good compliance systems—

Senator McLUCAS—Would appear too, I suppose.

Mr Atkin—I would suggest you make inquiries at a different level. Where were the commissions being paid? Who was paying them? What were the incentives for the sale of the products? That is where the problem was.

Senator McLUCAS—Yes, I understand that. These investors were not aware that they were paying not only a seven per cent upfront fee but a 1.14 per cent annualised fee over the total amount. Many people did not know that. It was obviously somewhere in the documentation but that was not evident to many investors.

Mr Fitzgerald—I cannot offer an explanation for that. I do not understand how that could happen, to be honest. It is the right question, but I cannot understand how you could be compliant and yet that could happen.

CHAIRMAN—Yesterday, we heard evidence that Storm made annualised profits 10 to 12 per cent every year. That was their model: 10 to 12 per cent every year.

Mr Atkin—As a company or for their clients?

CHAIRMAN—I am not sure, but that was purported to be the return rate, that if you were with Storm you would make 10 to 12 per cent every year.

Mr PEARCE—That was in relation to the Australian stock market's annualised growth over 100 years.

CHAIRMAN—The Australian stock market had grown 10 to 12 per cent every year over 100 years.

Senator MASON—On average.

CHAIRMAN—I am not sure, we will look at it. To me, that figure did not sound right.

Mr Atkin—I can only go to another context. I am a client of another trust company and I think seven or eight per cent was their number.

CHAIRMAN—I just thought you might have further light to shed on that.

Mr Atkin—No.

CHAIRMAN—Gentlemen, you have been very helpful. Thank you very much.

Proceedings suspended from 10.09 am to 10.31 am

BATEMAN, Mr Dennis, National Treasurer, Association of Financial Advisers Ltd

KALANTZIS, Ms Christina, Co-chair, Government and Policy Committee, Association of Financial Advisers; and Principal, Alexis Compliance and Risk Solutions Pty Ltd

KLIPIN, Mr Richard, Chief Executive Officer, Association of Financial Advisers

NOWAK, Mr Michael, Queensland Chair, GenXt Committee, and Adviser, Association of Financial Advisers Ltd

TAGGART, Mr James, National President, Association of Financial Advisers Ltd

CHAIRMAN—Welcome. Would you like to make an opening statement?

Mr Klipin—Thank you for the opportunity to appear at this hearing today. I would like to introduce my four colleagues. Jim Taggart is the AFA's national president and is managing director of the Taggart Group, a small licensee. Jim has a focus on adviser education and chairs the AFA education committee. Jim is also finishing off his DBA at the University of Western Sydney. Dennis Bateman is the AFA's National Treasurer; he is also managing director of Toowoomba Financial Centre and is licensed via the AXA Group. Dennis has a broad client focus and advises within rural Australia and has a unique perspective in a regional sense. Michael Nowak is the GenXt chair in Queensland and is a part owner of Joe Nowak Financial Services. In a sense Michael is the future of financial advice and financial advisers. He is degree qualified and uniquely qualified to talk about the issues facing the incoming generation of financial advisers. Christine Kalantzis is the principal of Alexis Compliance and Risk. She is the co-chair of AFA's Government and Policy Committee. She is a lawyer by background and worked through the FSR changes and as a general broker sees the FOS and EDR issues up close every day.

By way of a brief introduction, AFA is Australia's oldest professional adviser association. We are celebrating 64 years this year. We are an association of, by and for advisers, with around 1,350 members spread right across the country. Our members are both advisers and licensees. In essence, they are mostly small business owners who serve their clients and their communities with distinction. Our view is that the role of financial adviser is to build, manage and protect the wealth of Australians. Our members today provide holistic advice to all Australians. They have had a strong heritage in insurance but now provide a broad focus on advice.

We are here today to provide input into the failures surrounding Storm and their corporate collapses and the possible solutions to improve the market for advice. Before we start, on behalf of AFA members, we would like to acknowledge the shocking circumstances which led to the financial ruin of many of Storm's former clients. The pain of loss and grief that pours through their submissions should be mandatory reading for all financial advisers. It is a responsibility that all involved in the financial services sector must share so that in years to come we can say that this generation of leadership ensured that it does not happen again. We understand also that this inquiry has been in Far North Queensland this week hearing testimony from former clients and that the reality of their loss will stay with you for a long time.

The AFA has welcomed this inquiry from the start, because the failure of Storm, and others, opened the floodgates to a flurry of views and abuse and the maligning of an entire profession. In essence, the past 12 months has been open season on financial advisers, who have been blamed for almost every ill of the global crisis. This inquiry is keen to debate and address the issues to ensure that consumers are well served by advisers; to get clarity around the role of an adviser; to get clarity on the components of good advice outcomes; and to address the role of remuneration models, the role of the regulator, the role of the government and, obviously, the role of the professional association.

So what have we learnt? What is the AFA's view? Clearly, risk has been the backbone of financial advice—that is, the nature of risk, market risk, investment risk, product risk, company risk, investment risk, transferring risk, risk management and risk tolerance. These terms are stock-in-trade for all competent advisers and are the key to addressing the issue of 'knowing your client' as part of the advice process. It is also our view that FSR has worked well. The AFA's view is that FSR, which stemmed from the Wallis report in the nineties, paved the way for a revolution in the financial services marketplace. In essence, FSR broke the nexus between advice and product. The statement advice became the value of exchange between advisers and their clients. It became strategy first and then implementation into the appropriate products or platforms.

The twin peaks of regulation have cushioned Australia from the worst excesses seen in Europe and the US. Our view is that the system is not broken—far from it—but, clearly, there are improvements required to ensure better outcomes in parts of the process.

So, briefly, what are our suggestions? We need to ensure that consumers are well served by advisers. We need to ensure there is a robust and competitive marketplace. This is the best insurance for good consumer outcomes. The AFA has addressed many issues in its submission but we would like to note three key issues. They are: the need to restrict the use of the term 'financial adviser', the need to see education as a critical pathway to lifting standards, and the need to see the fee-commission debate as one of consumer and adviser choice as well as the operating of a market mechanism to ensure competition.

We also note for the record the submissions of both ASIC and Treasury and commend both to the committee. One of the key philosophical issues raised by the Treasury submission—and one that resonates across the profession—is the notion of careful and deliberate consideration before making major changes. There is, of course, much at stake and many competing agendas. The issues for AFA members and their clients is dealing with wholesale changes, which may create unintended and unforeseen circumstances. Often, the issue solved creates its own set of issues.

Finally, financial advice is about addressing three key areas. In a sense, it is about people who live too long, or dying too young or becoming sick or ill. In essence, the AFA's view is that advisers need to build, manage and protect the wealth of their clients. If you look at the Storm scenario through this prism, there was a clear error in the lack of protection and the lack of risk management through the process. Our members work with their clients and their families, with businesses—small and large—across Australia. Advice needs to be needs focused and client focused because it is based on a long-term relationship. The role of advice is clearly critical along the way because people change and circumstances change, needs change and markets and products change. The key lessons we have learnt over recent years are: (1) serving the consumer

well, honestly and diligently is always the most important outcome; (2) consumers need to make informed decisions, so education is vital; and (3) advice is key but we need to make sure that we understand it and make it easy to understand and implement.

There are tens of thousands of clients of financial advisers in the Australian community whose lives have been touched by getting good advice. It is these stories that we need to tell to rebuild the trust and confidence of the community. Finally, the AFA would like to put on record and thank the PJC for their interest, their willingness to engage and their understanding of the issues. We are optimistic and confident that together, the committee, with the input it has sought, will provide wise counsel and direction for the industry and the profession.

CHAIRMAN—Thank you. We appreciate your submission and your opening remarks. We also appreciate and understand that many people—in fact the majority of people—working in the sector are good, honest people who work very hard to improve their clients' position. I want to turn to the issue of advisers broadly. Across the spectrum, how well do they understand the thousands of products? How well do they really understand risk? How well qualified are they?

Mr Klipin—Across the roughly 16,000 advisers you obviously have people who have experience. The two gents on my left and right would have a really good understanding of all the issues that they raise, partly because of formal education and partly because of their experience. On my extreme left, Michael has been in the business for less than three years advising and obviously his pathway is a journey in evolution. He has formal qualifications but the time in the saddle is less so, so this is probably the first major downturn that he has experienced. If good outcomes are a combination of experience and education then everyone is somewhere on that journey.

CHAIRMAN—I appreciate individual cases but I am talking about the broad spectrum. You cover a lot of different people and are a broad based organisation. How well qualified and experienced are the advisers generally?

Mr Klipin—AFA members are pretty well experienced but, as we said in our submission, the bar needs to be raised and we need to get better outcomes. We do not think an RG146 qualification as a baseline is high enough.

CHAIRMAN—So you think there needs to be more education, better standards and more understanding of individual products, risk and all those things.

Mr Klipin—Absolutely. RG146 has produced a lot of technically competent advisers in the marketplace, but the standard is not high enough. A big part of financial advice is the bedside manner, the engagement skills and the fact that we are running a relationship over a generation. It might be a 20-30 year relationship, so people have to connect with each other, understand the issues, tease out the objectives and tease out the focus.

Mr Taggart—We, particularly I, see education as being lifelong. That is a vision that we hold really closely, and that is my role as chairman of education. I lecture part time and tutor at the University of Western Sydney. I am a CFP and also our highest post nominal FChFB, so I feel reasonably experienced academically and from a practical point of view to make a couple of comments. First and foremost, we value excellence. The course that we have just designed,

particularly for our advisers, embraces that concept. We are very much on board with becoming better educated as advisers, which in turn resonates with and flows through to our consumers. So I have taken a position at the board level to really put education at the forefront.

CHAIRMAN—I understand people can have qualifications and 30 years experience. The people who ran Storm were very experienced and probably cleverer than a lot of other people in terms of product manufacture and so forth. But how does education link or relate to appropriateness of advice and the way advisers deal with clients? You can have all the qualifications in the world but that does not mean you are going to do a good job; all it means is that you are qualified. How does education link to the actual giving of advice?

Mr Taggart—If you get time to have a look at how we have structured the four courses, you will see how they attempt to overcome the issues that you raise. Our first course is ethics and compliance, which is non-negotiable. Then we embrace that and envelope that around the technical skills. Part of the technical skills is another course dealing with client engagement. We acknowledge what you are saying, and we have taken on board to try and overcome those issues and raise the bar in terms of making our advisers better educated in the client-adviser relationship.

CHAIRMAN—How would you define appropriateness of advice? What does that mean to you or to your members?

Mr Bateman—According to our traffic rules we must not speed and we must not drink and drive, and we have regulations through FSR and that type of thing. One of the rules of the Corporations Law is 947, the know your client rule: understand your client, their financial position, where they want to go, the lifestyle they want to create now and in the future and how to protect it. That is my understanding from dealing with clients over all the years I have been practising.

CHAIRMAN—But you could interpret that anyway you like, couldn’t you?

Mr Bateman—I could.

CHAIRMAN—Tell me what it means to you.

Mr Bateman—What it means to me is to understand, if I am talking to you, what your current financial position is, what your lifestyle objectives are and what the best way is for you to achieve those over a period of time within the risk profile of the types of investments and types of risk that you are prepared to take to achieve your goals. It is to get an understanding between you and I so that you will understand the risks that you are taking to achieve the goals you want to achieve. There is a trade-off between risk and return, and you have to understand as a client what you want to achieve and what risks you are prepared to take.

CHAIRMAN—Do you think clients generally understand that?

Mr Bateman—It is a difficult thing to get across to clients. I cannot say that all of my clients understand it 100 per cent, but if we have a mismatch then whenever the market goes down I will lose clients.

Mr Klipin—I think that question goes to the heart of the whole consumer literacy piece. There is a need, obviously, for consumers to take responsibility for the financial decisions that they make but equally there is for advisers, who are in a sense the client's first educator when they get into that relationship.

CHAIRMAN—Can you explain to me how consumers or clients can take responsibility for decisions they make when they actually do not make any decisions but rely trust? They say, 'If you say that's good I take your word'? You can ask anybody; that is generally what happens.

Mr Klipin—I think, if we look at the system we have at the moment, that is the piece that we have to change. We need to ensure that kids come out of school with an understanding of the way the system works and the issues around—

CHAIRMAN—I appreciate that but, for example, some people who invested in Storm and lost their life savings were actually qualified financial planners with 30 years experience. Are we ever going to get to the point where we can educate the community to be at that level as well? Why would you need a financial adviser? If you understood it all, why would you need to go see anyone else?

Mr Klipin—Sure. To go back to your earlier point, which was on the issue of morality and ethics: we can have a whole bunch of very intelligent and highly educated people, but if there is not a moral and ethical overlay to treat their clients fairly and to do the right thing by their clients then you are going to get exceptions to the rule. The question for all of us as regulators and so on is to ask, 'Can you create a system that prevents that happening?' That no doubt is the question this committee has grappled with and will grapple with.

CHAIRMAN—The issue of appropriate advice is a central question for us. One person may say a bit of advice is appropriate, another person may say it is slightly inappropriate, another may say it is completely inappropriate and yet another may say something different again. It is very much up to the individual. How would you find appropriate advice? Is it that if you are in the market and making money it must be appropriate because you are going forward but if you start to lose money then the advice is no longer appropriate? How does it work? Is advice only ever appropriate in rising markets? Does it come into question when markets fall?

Mr Klipin—Because it is a legal term I might ask Christina to address a couple of those points.

Ms Kalantzis—Thank you for the question. When we are talking about the appropriateness of advice, you are exactly right in asking whether it is an indefinable term. What one person would deem appropriate advice would be somewhat different to what someone else would deem appropriate advice. That is one of the issues for the financial ombudsman service when they review the complaints that are currently on foot there. What the law has done is to define certain parameters for what advisers need to advise upon. One of them is 'know your client' and the other is 'know your product'. If we use those two premises we will come to what is appropriate advice, which is 945A.

To expand what giving appropriate advice is, the regulator has also provided guidance in its regulatory policies—that is, Regulatory Guide 175. It asks that advisers undertake certain things

to give appropriate advice. One of those things is exactly what Dennis gave a summary of, which is to do an analysis of who the client is, understand what their financials are, understand what their liabilities are, understand where they want to go, what their retirement income is and what the objectives they want to achieve in the next five or 10 years are.

CHAIRMAN—Could I ask you about that point about their objectives. What if your client says, 'I want to take the maximum possible risk you could ever take, put it all on the line and spin the wheel'? Is it appropriate advice to still say: 'Okay, if that's what you want and you're clear about it—not a problem. We'll give you a statement of advice to that effect and you sign it'? Does the adviser waive their responsibility in the sense that the statement of advice clearly sets out what they are going to do and the customer signs it? Does that negate all the other bits about 'know your client'? 'Knowing your client' does not tell me much, either.

Ms Kalantzis—We all know that you cannot outsource the basic premise that you are giving advice, so as a financial adviser you cannot outsource that and say that the client made the decision and it is all the client's onus to fulfil that obligation. In terms of what happens if the client comes in and wants to do something extremely risky and it is contrary to what the adviser's advice would be, the adviser then has a role to educate the client as to what the risks involved with those investment decisions are.

CHAIRMAN—What if it is not contrary to what the adviser thinks? What if they both agree?

Ms Kalantzis—If they both agree, then we are talking about the risk tolerance of that client. When the adviser did the analysis of that advice, the adviser then would have asked questions about the client's tolerance to risk and also what their past experience has been in investing. They will also gather information saying: 'These are the circumstances and these are the reasons why you want to invest in these types of products. I have explained to you the risks associated with investing in these types of products and the outcomes of investing in those types of products as well.' So either we come to a conclusion together or, if you are of the opinion that this is what you want to achieve—

CHAIRMAN—Then you sign the statement of advice.

Ms Kalantzis—That is right.

CHAIRMAN—Does that mean you are then responsible, or not?

Ms Kalantzis—No, there is client informed consent. What we have done there is that the client has engaged with the adviser and the client has given some informed consent to the adviser that that is a strategy that they want to embark on. Then the adviser's role, depending on what the terms of engagement are—if they do have terms of engagement and an ongoing relationship—would be to have ongoing reviews with that client to confirm—

CHAIRMAN—What happens when it all goes wrong and the client says, 'Hang on, that's not what I understood'?

Ms Kalantzis—When it goes wrong—and that is what we are seeing at the moment, perhaps in terms of the products that were chosen for some clients—clients sometimes come to the

recollection that perhaps it was out of their risk tolerance or out of their profile as such. This is an interesting question because, when we talk about risk tolerance assessment, risk is an intangible. A person may have viewed a product as something they would have been able to tolerate two years ago when the markets were going up, when they did not want any reviews and they were happy to continue putting more money into gearing type strategies, but when the market goes down, as it did in 2007 or 2008, you see that there is a change of mind. It is the adviser's role to continually manage expectations, and it is also the adviser's role, when they do their regular reviews, to bring the client back in and say: 'You know what? We're overweight in this area and we're underweight in this area, so let's balance it.'

CHAIRMAN—What if the advice is just to continually gear up higher and higher, no matter what?

Ms Kalantzis—Then we are looking at inappropriate advice, aren't we?

Mr Bateman—We have limits in our practice where we would see that as inappropriate, insofar as you have to have your own standards for the way you want to deliver advice if it is beyond what you consider a reasonable risk to take. We have had an instance where a person wanted to borrow to invest in a self-managed fund and we clearly, according to our guidelines, did not believe that was appropriate. The client went away, invested a little bit of money and then came back and wanted to take umbrage at the fact that he got advice somewhere else that he could do that. But it was outside the parameters of what we felt was reasonable in dealing with our client.

CHAIRMAN—So it is what you feel is reasonable? How does that work? Is it just a value judgment you make?

Mr Bateman—I think you have to have a certain ethic and a moral view of the way you want your business to run. You do not want to incur an additional risk in the way you operate your business. If certain people or clients would increase the risk of operating a practice, you have to consider that.

Senator MASON—Thank you for your evidence. It is good to get some evidence from the coalface, so thank you. You just spoke about an ethical and moral overlay to your profession. In many professions that ethical or moral overlay is given legal form by the imposition of a fiduciary duty. That gives it legal form. That is right, isn't it?

Ms Kalantzis—Yes, that is right.

Senator MASON—Why shouldn't we have that in your industry?

Ms Kalantzis—When we are talking about fiduciary duties, they are common-law principles as well and it depends on what the profession is. Our association has the view that an adviser's role is that of a fiduciary nature.

Senator MASON—It is?

Ms Kalantzis—That's right, where it is, whereby there is a profession and then you have a duty of care obligation to your client. So we acknowledge that there is a fiduciary duty. And it actually meets the requirements of fiduciaries, which is trust. There is a position of trust and also reliance as well. And that goes back to my comment which was that you cannot outsource the basic premise of you being an adviser and giving advice to the client even if the client wants to undertake a different road. So that's fine. So we agree with that statement in terms of an adviser's role being of a fiduciary nature and that it does actually encompass the duties of what fiduciaries are with the trust provisions.

Senator MASON—So if this committee was to recommend to parliament to impose specifically a fiduciary duty on the industry there would be no objection?

Ms Kalantzis—That is a different question.

Senator MASON—But it is a fair question, Ms Kalantzis.

Ms Kalantzis—One is that common law comes up with the duties as to what fiduciaries are and we actually acknowledge those duties that the judges and the magistrates come up with. So there are no problems there. In terms of embedding that into the current legislation, I think we should go to the core issue which is that we have to ask whether we actually know what a financial adviser is. Because there is no restriction of that term 'financial adviser'. If you ask our members in terms of their understanding of what a financial adviser is, they will link it up to Corporations Law requirements and they will say, 'I am a financial adviser because I am duly authorised to give advice, I can give personal advice, I have supervision and monitoring requirements, I have education requirements and I also have ongoing training obligations.' So I think before we even jump ahead and try and even consider the idea of legislating fiduciary duties into Corps law, perhaps we should look at the basic premise of what a financial adviser is.

Senator MASON—That begs the question. I think we can assume we know what a financial adviser is for the purposes of this committee. The question is whether we would legislatively impose that on the industry. You seem to be hedging against that, Ms Kalantzis. We have heard a lot about morality and ethics and everyone is very concerned, but how are we going to make sure that parliament can be assured that the industry is actually doing the moral and ethical thing? Recent practice would suggest that it is not going to happen just by itself. That is true, isn't it?

Ms Kalantzis—I would not agree with that.

Senator MASON—Oh, really?

Ms Kalantzis—No, because what I would say is that, at the end of the day, the discussion at the beginning was that there are only a few advisers, and my understanding is that the committee actually acknowledges that most advisers actually do things in the interests of their clients—

Senator MASON—I don't think anyone would doubt that, but so do most trustees, lawyers and accountants. It does not mean that you do not impose a severe duty on them. That evidence we have had, even from the previous witnesses the Trustee Corporations Association of Australia, was that the taking of a commission is in fact an inherent conflict of interest and inherently would not be an aspect of fiduciary duty.

Ms Kalantzis—That is a very strong—

Senator MASON—This has very profound implications for the industry though, doesn't it.

Ms Kalantzis—Yes.

Senator MASON—This is where you get to the core of the industry and the committee is going to have to look at it. What do you say to that? And this evidence is not just from the Trustee Corporations Association. We have had this evidence right throughout the last two weeks—that there is an inherent conflict of interest when you receive commissions and that that would not pass a fiduciary duty test. So what are we going to do?

Mr Bateman—Is that relative to the controls we have under FSR and disclosure and everything et cetera?

Senator MASON—Yes.

Mr Klipin—I suppose the question we all need to end up with—and clearly we are a representative body of financial advisers—is that if you look across all the financial services in a vertically integrated value chain, there are ownership and transparency issues around people understanding who it is that they are dealing with and what product it is that they will end up with and so on. We have the view that that is the right question to ask. But let us unbundle and let us look at all parts of the value chain so that people understand that they get the linkages. The focus over the last 12 to 18 months has only been on the financial adviser—and we acknowledge, as we have already said, the issues surrounding Storm. But we see that as one where if they operated outside the law and did not overlay their ethical and moral position, do we then want the other roughly 16,000 advisers who are doing the right thing to take a far more onerous path—those who have not had parliamentary inquiries created because of their conduct? I think there is a need to separate that out.

The issue of conflict is rife. In all walks of life we have conflict. In financial services, the way that the Wallis inquiry interpreted conflict is that we had should disclose it. We manage it by disclosing it so that people will have transparency around where the conflicts are and what the revenue amount is. Clearly, we think that system is working. There are obviously moves within the industry to take that next step, whether it be around the peak commission issue or the education issue.

Senator MASON—Mr Klipin, the evidence, though, is that, even if you disclose that you receive a commission, that will skew the nature of your advice. That is the evidence we have heard over the last two weeks. I am not having a go at anyone, but that is the evidence that we have heard. This committee somehow has to come to terms with that and how we will address it.

Mr Bateman—I understand where you are coming from. In our practice we have freedom of choice for how clients can pay for their advice—that is, whatever is the most tax-effective way for them financially. So, if they choose to have the funds required for the advice or the cost of the advice taken out of the investment they want to place or the product or platform they want to place, as their advisers we believe that is their choice. If they want to write out a cheque, we are

quite happy to receive a cheque for the advice. As far as our position in our practice is concerned, all we want is to get paid for the advice.

Senator MASON—As long as your advice is not skewed by the nature of your payment. That is the point.

Mr Klipin—That is what you are referring to but, as far as the client is concerned, they are paying X dollars for advice whether that be paid in the form of a commission or in the form of a cheque. My concern is that, if one form of remuneration were deleted from the system, we would exclude a lot of clients in Australia who need advice but who cannot afford to write out a cheque.

Senator MASON—Mr Chairman, I think we had evidence last week and this week about making it tax deductible. Is that right?

CHAIRMAN—We have had all sorts of things. I want to challenge you on this issue of remuneration. Isn't the problem with commissions that they are embedded? You cannot—

Mr Bateman—Yes, you can. In the products I am dealing with you can remove the commissions.

CHAIRMAN—Is that not just a personal decision that you make? For the majority of people it is just easier. That is the whole point of commissions, isn't it? It is the ease of interaction. You walk in the door, you get some advice and you get a product. It is just simple. You get paid. The problem is that you are working for the people who are manufacturing the product; you are not necessarily working for the client.

Mr Bateman—I disagree with that. In my practice, I disagree with that.

CHAIRMAN—In your practice, yes.

Senator MASON—Mr Bateman, you may well be right. But the chairman is simply echoing so much of the evidence that we have heard over the last two weeks that, by the very nature of the mode of payment, the advice will necessarily be skewed. That is not particularly uncontroversial. That is what the evidence is saying.

Mr Bateman—I know where you are coming from. But where I am coming from is that I would not like my clients to not have the choice to do it in the most tax-effective way. You might say, 'We can go back to the tax department and the tax department will automatically allow all financial advice to be tax deductible.' I do not think that is possible. If it were, it might be great. But, from a client's point of view, I think they need to be able to make a choice on the best way to remunerate for their advice.

Senator MASON—Mr Bateman, you would be paid in the same way that an accountant or a lawyer is. That is the argument.

Mr Bateman—Yes, but an accountant's or a lawyer's fees are related to generation of personal exertion, income or whatever. That is tax deductible.

Senator MASON—It might be; it depends on the context of the advice. But the advice you give is at least as important as legal advice. This is life savings.

Mr Bateman—That is right. I do not disagree with that.

Senator MASON—That is why we are concerned about getting it right.

Mr Klipin—I think your concerns are absolutely justified. In this whole debate that for the last 18 months has been raging in the public domain there are a couple of issues. One is what we actually mean by a fee for service. Are we talking about the hourly rate; are we talking about the six-minute clock that turns on and off? Clearly, where the financial services have an advice position, the origins have come from the tied life insurance companies where advisers did act as agents for the company not for the consumer. So, in a historical sense, we have to see where we have come from to know where we are today.

Let us cut the nexus at this point. The issues surrounding Storm were so severe—and I think it is still debatable whether they were a fee-for-service model or a commission driven model, but let us leave that on the side—that we now want to get to a situation where we operate in the same way that the legal and accounting profession operates. There is a whole piece around the access and affordability of advice. I think that Treasury has spoken to that point, and we have certainly made that point again and again. We would like to see that the commission system is easy to operate while also allowing access and, clearly, that the disclosure issue, which is the conflict of interest piece, is addressed within a statement of advice. It is addressed because advisers have to sit down with their clients and sign off to say, and it was Dennis's earlier point: 'Here is where you are at. Here is where you want to go. Here is the way we can help you to get there. Here is what it is going to cost you.' There are lots of advisers who offer the options—

Senator MASON—But again, we have heard advice that disclosure 'has failed'—and I am quoting here—to protect the consumer. I just make the point from evidence over the last two weeks—it is not unusual.

Ms OWENS—You have just taken me where I want to go. I want to go back before the last 18 months, because you represent financial advisers. We had had 15 years of boom and a whole range of new people entering the investment market because of their super funds and their shares that came in the mail from demutualisation. So we had inexperienced investors and 15 years of boom and you could actually be sloppy and still not fail. What was the association looking at? What were your concerns prior to that 18 months? Had you seen changes in the industry? Had you seen changes in behaviour? Was the industry running fat? Was there something about it that you were concerned about, or was everything okay?

Mr Klipin—Are you talking about the past—

Ms OWENS—I am talking about prior to the 18 months. Having had so many years of boom and so many new investors—

Mr Klipin—If you go over the last 18 years, we had the marketplace deregulated and we had lots of international competitors. The marketplace for advice and the marketplace for products became pretty competitive and some of the products that came out, as we have seen with various

CDO products and so on, became way too sophisticated and were arbitraging all parts of the system. From an association point of view, the mandate that we have always been on is about representing and supporting our members, and that is around professional development issues, education issues and so on. The industry has been on this pathway to professionalisation. We saw the code of practice piece come out. We have seen the convergence of the insurer side with the investment side. The advisers of today are, in a sense, unrecognisable from what they were 15 years ago except that they are still dealing with clients and helping them on their journey. So hopefully that gives you a sense of what we have been doing prior to the last 18 months.

Ms OWENS—So they weren't warning bells ringing?

Mr Bateman—The same as they were for everyone else. But we do not drop our premise that you still have to know your client really. You still have to understand their risk tolerance—where they are now and where they want to be and how they want to get there. You have to manage that and, because it is booming, it does not mean to say that you take away that risk tolerance. It still has to be there. That is my concern, and in some cases and with things coming up on the radar, maybe this risk tolerance thing was not required anymore for some people.

Ms OWENS—No matter what your regulation is, there will always be companies that obey the letter of the law at the very least but not the spirit. There were clear issues, I guess, as we approached the last 18 months with some companies that some people were aware of, yet there did not seem to be any early warning bells ringing through the regulation at least. Can you see any way in which an early warning system can be introduced that actually starts to flag when these excessive risks—

Mr Bateman—If we could we would be worth a lot more money than we are today. I know that it is a very pertinent thing, but I still go back to the way we conduct our business and where we analyse people's risk tolerance and ensure that they maintain their risk within those parameters. If you throw those away, then their risk is excessive. We have managed a lot of our clients' risk tolerance within this terrible downturn and that type of thing and the clients, fortunately, are starting to see a little bit of light at the end of the tunnel now. I went through the 1987 stock market crash. I have been in the business for 36 years. There are a lot of people out there a lot smarter than I am in the investment world that did not see it coming. So it is a very hard question to answer.

Mr Klipin—I have just two points to add to that. One concern is the product manufacturer and whether the process to get a prospectus authorised—in a sense, a tick-a-box process—meets the legal requirements. It is quite clear that there is some evidence of operators who have created products—called something when they are not—and advertised terrific rates as debenture style products, and we know the failures of Westpoint and so on.

Our view has been that there is a need for ASIC to have a more onerous requirement to look at not only whether the prospectus meets the requirements but who is the operator behind it and will they be able to deliver to their client set. That is on the product manufacture end. On the advice end, I have read the transcripts with interest over the last few nights, because this is a consistent theme. Within the profession, within the industry, people know what is going on. If you get half-a-dozen people who have been around the traps and who have a network, you can quickly ask a few questions under the radar and get a sense of it. That goes into the whole world

of whistleblowing and the questions of how do you pre-empt these issues, and do you have to wait until the whole thing falls over before you strike? I know you have received evidence on those issues.

The short answer is that there is, at this point, not a mechanism for that to happen, where it can be taken seriously and things can be done prior to things getting way out of control, and I guess this committee will need to address that. But I think on both the product side and the advice side, yes, there are steps that collectively we can take so that products do not come to market that are not in the best interests of the clients and that advisers who operate at the fringes, who operate outside the framework, are not able to continue. You would note in our submission that we have said: let us define the role of financial adviser but let us also ensure that advisers have to be members of an association. I understand that there are a few issues with that. But the main issue is that, if you can catch all, you can then ensure and apply the standards, the ethical standards and so on, and you have a far greater opportunity to do that. At the moment people can operate at the fringes and it is not until you read it in the newspapers that you know things have gone wrong.

Mr Bateman—I would like to make a comment as an adviser about something that is very difficult for clients to understand sometimes. If you say a balanced fund has got 70 per cent in equity and 30 per cent in secure investments, the clients ask, 'How can it be balanced?' I think if the committee could make a recommendation to government and ASIC it should be along the lines that any investment product should be true to label and reasonably understandable by the community. That is, if it is a balanced fund you would have about fifty-fifty in each section of the portfolio. If it is a high-growth fund you would expect it to have about 100 per cent. And there are probably a couple of other portfolios in between. If that could be a recommendation, that would go a little way towards educating clients on what to expect from an investment product or platform.

Mr Taggart—I would just like to go on the record and say that the vast majority of our members are extremely ethical, are compliant and do the right thing—uberrimae fidei. I can only say that from the perspective—and I say that to the group here—that I go around Australia for about a month and I talk, live and breathe what I love: dealing with people and their problems. And that is not motherhood statements—let me make that really clear to all of you.

CHAIRMAN—Thank you, Mr Taggart. We appreciate what you are saying. We are not attacking your members, but we just have not got that sort of time.

Mr PEARCE—Thank you all for being here. I found your introductory remarks very illuminating. What you have said in your remarks is very pertinent to us as a committee, and I mentioned this earlier. At the end of the day, we are nothing more than simple legislators. We have to walk away from a lot of the contextual discussions and we have to come back to what our job is. Our job is to look at the law and to work out the best way to strengthen the law so that Australians can be protected—that is our core job. What you have highlighted this morning is that for those who know the current law there is quite an extensive array of requirements in the existing law.

Ms Kalantzis—That is right; I agree with you.

Mr PEARCE—Ms Kalantzis has particularly highlighted that, within the existing structure, the regulatory regime has a whole series of steps. Mr Bateman, you in particular know that because you do it every day. So, when we look at what has taken place in these desperately unfortunate situations, we have to identify whether what failed was the regulatory system—the law—or the implementation. Quite often you hear about the baby getting thrown out with the bathwater, for example. Do you believe that the regulatory system holds well for protecting consumers? Mr Bateman, in your practical experience, what is your view?

Mr Bateman—As an advisor, if I breach any of my licence requirements to deal with clients, knowing the client and all that sort of thing, I am out of business.

CHAIRMAN—How are you out of business, sorry?

Mr Bateman—If it does not meet the compliance regulations and I get marked down to an exit strategy, I am gone.

CHAIRMAN—How many people has that happened to?

Mr Bateman—Quite a few, not in our business, but I do know of cases where people's licence has not been renewed because of a bad audit. I do not believe that the legislation needs to be changed. It may need to be finetuned because we have had it running for five years and there has been a little bit of tinkering around the edges and that type of thing, but in my view it affords a lot of protection to consumers and puts a lot of responsibility on advisors to ensure they do the right thing and meet the obligations and the spirit of FSR.

Mr PEARCE—In the chair's questioning when he first started he spoke a lot about how you measure what is appropriate. What is appropriate to you, Mr Klipin, might be inappropriate to other people. I am always fascinated by how this debate comes up about the appropriateness of financial advice. For example, how do you measure when you go to a lawyer whether or not the advice is appropriate? How do you measure when you go to an accountant whether or not the advice is appropriate? How do you measure when you go to a doctor whether or not the advice is appropriate? Why do you think this sort of questioning always comes back to the financial planning industry? What do you think has happened there?

Mr Klipin—That is the key question, and we were talking outside about it. In a sense it is as though financial advisors are held in a special place. The perception is that they need to meet standards that are beyond those of other professions, and clearly that is not the case. What we, as a community of financial services, have failed to do and need to do is to communicate the value and the benefits of working with advisors. Sadly, from time to time, issues like Storm arise which allow people to say: 'No, there hasn't been any change. They're all bad; they're all ratbags. Consumers, tread at your peril.'

CHAIRMAN—No-one here is saying that.

Mr Klipin—I know that is not the case, but I think the legislative response, as you say, needs to cut through and ask the question: 'What do we need to change to get a better outcome next time around and what will be the consequences if we end up changing?' We are on record, with our submission and verbally today, saying that the system has been pretty robust, that there are

very strong components to it and that in the main most advisors do the right thing by their clients. But there are things that we can improve, such as the terminology around licensing and other things we have already covered.

Mr PEARCE—I am always fascinated by it. If I walked into a lawyer down here on Pitt Street this afternoon and said, ‘Look, I’ve got a particular situation, what’s your advice?’ and that lawyer gave me a range of advice which proved to be totally inappropriate and cost me an absolutely fortune to litigate, what could I do about that?

CHAIRMAN—You could sue that lawyer.

Mr PEARCE—That is right, through common law. You can sue anybody through common law. My question is: why is it differentiated? There is this absolute differentiation that Mr Klipin has noted. It is an interesting point, as you say. Maybe they are seen as being above other professionals in some ways; I am not sure. Finally, coming back to the recommendation you have about defining advice and what an advisor is, what are you actually proposing? Are you saying that we should recommend that the Corporations Act be amended to contain the definition of an advisor?

Ms Kalantzis—With that recommendation, we are saying that there is a definition embodied within Corporations Law.

Mr PEARCE—There is not one within the act.

Ms Kalantzis—There is. Chapter 7 of Corporations Law tells you what the activities of an adviser are.

Mr PEARCE—Yes, what the activities are, but not a definition of—

Ms Kalantzis—Of what an adviser is; that is right.

Mr PEARCE—It tells you the activities, but it does not tell you a definition.

Ms Kalantzis—We are suggesting linking them.

Mr PEARCE—And putting a definition in?

Ms Kalantzis—That is right. So, if someone is engaged in the activities, having been duly authorised, and held up as a representative, whether a corporate authorised rep, a representative employed or an authorised rep, in giving personal advice, which is understanding the needs and analysis of the actual client, let us actually call them something and restrict the term to ‘financial adviser’, because at the moment we are seeing mortgage brokers purporting to be financial advisers. We are seeing those in the real estate industry purporting to be financial advisers.

CHAIRMAN—You wouldn’t say that a mortgage broker is a financial adviser?

Ms Kalantzis—Not in the definition that we are proposing. The definition that we are proposing is that they actually give advice within the financial products of Corporations Law.

My understanding is that the activities that mortgage brokers are involved in are not within the financial products class of Corporations Law.

Mr PEARCE—So you would like to see an amendment that says, 'the financial adviser is all of this'?

Ms Kalantzis—That is right.

Senator McLUCAS—That leads to my question. Your recommendation is that one of the requirements of a financial adviser is that they be a member of an association, which is, in my mind, quasi-registration, not a board of registration. It was put to us earlier—and I raised this earlier—that a couple of days ago a woman rang the Financial Planners Association to ascertain whether Storm were a member of FPA. They were. On that basis, she thought she was protected. I am interested in your advice on this. FPA do not do any assessment of someone's practice; they take their membership. FPA were very embarrassed and struck them off et cetera. But does simply being a member of an organisation give a consumer any protection?

Mr Klipin—It is towards consumer protection. If you are a member of a professional association and you sign onto the code of ethics—and I will be happy to leave you a copy—which talks about the obligations of a member, then it ought to follow that consumers who deal with members of that association are in a better and stronger position.

Senator McLUCAS—It ought to follow?

Mr Klipin—Yes, it ought to. What ought to then happen is a whole range of activities that associations need to do in order to ensure that people meet particular standards. Clearly, if they are not meeting those standards, the associations need to exit them, as Mr Bateman said.

Senator McLUCAS—Do you do that?

Mr Klipin—We have a disciplinary process, yes.

Senator McLUCAS—That is different from FPA, as I understand it. I may be wrong. I want to tackle a problem—that is, protecting consumers—from a different tack. My assessment was that this company was a member of FPA and had met all of the requirements of the Corporations Act, in that audit that happened early last year—so that did not identify a problem—and the 'know your client' rule was covered, because they had filled in a statement of advice. All those things happened and yet we have thousands of people who have lost everything. Can I ask the question this way: the one thing many of those people who have been so badly hurt had in common is that their understanding of the product that they bought into was not strong. Many people have told us that they had said to their adviser they wanted a low-risk product; they did not want their house to be at risk. Even after all of that, they borrowed millions of dollars, had double gearing, all that sort of stuff. Can we devise a tool, a checklist to be put on a computer that ASIC would run, that would not tell you that you would get a certain sum of money if you did these things, but it would simply say that, if this is the approach you are taking, it is either a low-risk, a medium-risk or a high-risk investment strategy? Is it possible, given your knowledge of the industry, to give the consumer a system that would assess the advice that they are being given?

Mr Taggart—With respect, those tools essentially apply now. We use them.

Senator McLUCAS—But are they publicly available and can they be used by less educated consumers?

Mr Taggart—I think your question is excellent. I originally said that education is at the forefront of my life and within my fiduciary relationship with my clients, and also at the organisational level. It is really important that that takes place in that relationship and trust becomes part of it. There are tools available that help clients and advisers to become better educated. We use those in our practice; that is what I am trying to say. I cannot comment on everybody. There are tools available in the public domain that give them something with regard to it. One of the issues I have seen teaching at the university is that in the last couple of years they have only put up courses with financial services and so on as part of this journey. It is interesting to note that they now have embraced the importance of those within financial services, at both undergraduate and postgraduate level.

Senator McLUCAS—I am trying to empower a consumer in a relationship that does not mirror your practices, Mr Bateman and Mr Taggart.

Mr Taggart—Yes. It is a very good question.

Senator McLUCAS—In my view, these people were intentionally poorly educated. They were given the option of one product and one product alone. They self-selected. Do you let your clients make an assessment of whether they want to do something or do you give them an array of products? I think you give them an array of products. How do we give a consumer some power in a relationship that is not mirroring ethical practice?

Mr Klipin—On the issue of risk there are two things, one on the product side. There has been a lot of evidence around truth in labelling, ensuring that within the product disclosure statement a well understood and broadly accepted low risk, mid risk and high risk.

Senator McLUCAS—They were not shown that.

Mr Klipin—No. I am saying, at the moment, as Mr Bateman said, you can have different interpretations of what a balanced fund is. If you had a standardised process that defined the terminology around low risk, high risk and so forth, people could happily match themselves to it. Equally, reading Mr Resnik's evidence online the other night, the whole area around ensuring that risk profiling is strong, robust and consistent both at a consumer level and also through the process that advisers work through I think becomes important. I will not comment on Storm specifically, but if you asked most financial advisers for their view of margin lending as a product set, they would say: 'Handle with care.' If you asked for their view of a double-geared margin lending product, they would say, 'Handle with serious care.'

Senator McLUCAS—I understand that. We are not dealing with a situation where people were provided with accurate advice, according to the evidence we have been given. They were told they were in a very low-risk product. How do we empower to withstand what, in my view, is inaccurate advice?

Mr Klipin—I think it gets back to the appropriate definition.

Senator McLUCAS—I do not want to wait until another company goes bust and thousands of people lose everything. That is the legal channel. I want to give the consumer some power in this relationship.

Mr Bateman—You are referring to having something on ASIC's website and different variations of risk profile on the website. Within those risk profiles there is a characteristic of the type of investment spread that they might have which may be helpful for people. My concern is—although I think it should be done—how many clients would refer to that?

Senator McLUCAS—You could make them.

Mr Bateman—You could. The other thing is: a lot of clients felt that debentures were secure but a lot of client lost a lot of money on Westpoint, Bridgecorp and so forth.

Senator McLUCAS—That is why I phrased the question: is it possible to construct a tool?

Mr Bateman—They bought those businesses direct. They would assume that they were secure, guaranteed investments, when in fact they were not.

CHAIRMAN—Thank you to all representatives of the AFA. We appreciate your submission and the time you have given us today as witnesses.

[11.33 am]

MACKAY, Ms Claire, Director and Certified Financial Planner, Quantum Financial Services Australia

MACKAY, Mr Tim, Director and Certified Financial Planner, Quantum Financial Services Australia

CHAIRMAN—Welcome. I invite you to make some opening remarks.

Mr Mackay—Thank you for the opportunity to appear before your committee. Quantum is an independently owned, successful and growing financial planning firm and training organisation. We are both certified financial planners and chartered accountants and between us we hold bachelor's and master's degrees in commerce, economics, law and business administration. Claire is also admitted to the New South Wales Supreme Court.

Australians today are concerned about the financial planning industry, and rightly so. They have seen recurring examples of rampant abuse of consumers and a lack of professionalism shown by the advisers they trusted. From Townsville to Geelong to Perth, if you have not been personally impacted then you will know someone who has been. The focus of our submission is recommending practical reforms. With your help, we can boldly reform the financial planning industry so that consumer confidence and our profession will emerge stronger than ever.

It is time for financial planners to be honest with themselves. As financial planners, we regret the actions of those financial planners who have abused their clients' trust. As financial planners, we take charge of our own destiny today by proudly and loudly pleading with you to give us an explicit statutory fiduciary duty to our clients. We know that many in our industry are sceptical of how and whether an explicit fiduciary duty will work. There are many complicated issues to resolve but as professional financial planners we can make it work.

It is time to empower consumers and increase competition by turning off the 'rivers of gold'. It is a sad fact that, in financial planning, he who pays me is my boss. No-one would consider allowing lobby groups to pay fees to politicians, yet we allow product manufacturers to pay financial planners and dealer groups. By 'rivers of gold', we mean commissions and any other type of financial arrangement between product providers, platform and dealer groups and advisers. The only parties who resist this reform are those who financially benefit from the rivers of gold.

We recognise that it will be hard, unpopular and costly for many in our industry to undertake this reform. We do not accept that voluntary industry codes are sufficient. This reform is not about helping financial planners. It is about helping consumers. I would now like to hand over to Claire, who, if you were wondering, is my sister.

CHAIRMAN—We weren't!

Ms Mackay—Quantum's financial planning business specialises in investment, retirement planning, and superannuation advice. We advise our clients. We do not sell them products. It is time to call the salespeople what they are: salespeople. In the interests of consumer transparency and protection, there should be a clear distinction between independent advisers and financial product salespeople. Furthermore, there should be no distinction in the standard to which either is held. They should both have a fiduciary duty to their client. The aim of this is to provide clarity to consumers—not to make it easier for people to sell their products.

It is time for the real financial planners to stand up. We propose the establishment of a professional standards board which is independent, self-funding, with compulsory membership, which sets high and uniform professional and ethical standards. Only members of such a board could call themselves financial planners or financial advisers. Consumers will then have professional titles they can recognise and they can trust. We estimate the cost of this to clients at 1c a day, and we are happy to discuss this further.

It is time to raise the bar. We call on you to raise the financial planning education and experience entry standards. We are proud that our submission is one of the few to recommend how you can practically implement this. We are happy to discuss this further.

As financial planners with a long future before us in the industry, we are passionate and proud of the value we add to our clients. We are honoured to be our clients' trusted adviser. We are the second generation to advise Quantum's clients and we want the next generation to be proud of the profession that today we, together with your leadership, helped reform.

CHAIRMAN—Thank you very much. We really appreciate your submission and the detailed work you have gone to, and your presentation today. Do you think FSR is sufficient, in the way it currently stands, to deal with all of the complexities that are involved in the giving of advice? Do you think there is just enough in there, enough application in FSR, to be able to deal with all of those complexities?

Ms Mackay—From the comments made earlier to the committee, we think the FSR does actually have a fiduciary duty to clients that is imposed on advisers. We think that the regime was a watershed five to seven years ago and it does have the ability to work. It does work.

Mr Mackay—Where it could possibly be beefed up is in the addition of the fiduciary duty. We believe there is an existing implicit Commonwealth fiduciary duty, and we are a bit concerned by other organisations who state that there could be a cost in adding an explicit one if there already is an implicit Commonwealth fiduciary duty. It does concern us somewhat.

Senator MASON—You heard the evidence of the previous witnesses, didn't you?

Mr Mackay—Yes.

CHAIRMAN—Can you just clarify for me: does 'know your client' mean 'act in the best interests of your client'?

Mr Mackay—That is how we interpret it.

CHAIRMAN—That is how you interpret it. But is that what it means?

Ms Mackay—We are not lawyers, but in practical terms if you know your client and you are giving them advice that is appropriate to who they are then it does mean acting in their best interests. I cannot understand how advisers could give advice that is not in the best interests of their client.

CHAIRMAN—But what do you think about the fact that it is absent from FRS? FSR talks about knowing your client. It is one thing to know someone; it is something else to act in their best interest.

Mr Mackay—Correct.

CHAIRMAN—Is that a deficiency?

Mr Mackay—Yes, that is why we are recommending the addition of the explicit fiduciary duty.

CHAIRMAN—You do not take commissions—is that right?

Mr Mackay—We do, on insurance products.

CHAIRMAN—On insurance products only?

Mr Mackay—Yes. It is problematic in that area. We are transitioning to a fee-for-service model. As Claire said, we have a long future in this industry and the recommendations we are making are based on the future.

CHAIRMAN—Why do you not like commissions? What is it about commissions that you do not like?

Mr Mackay—First of all, my belief is that commissions reduce competition. One of the key aims should be that we reduce fees to clients. Undoubtedly the financial services industry is competitive. However, the competition is at the wrong points in the value chain. For instance, typically a client will come in and will be given advice to put their funds into a platform. To do that they will have to pay the adviser fees, the platform fees and the underlying fund manager fees. They will pay between 250 and 300 basis points. That is paid over and then there is a fight between the platform, the dealer group and the adviser on how to divide that pie. It is in no-one's interest to make that pie smaller. It is in everyone's interests to try and get a bigger slice of that pie. Now, if we turn it on its head and get rid of the commissions—and not just the commissions, also the other transfer payments between these bodies—then all of a sudden the adviser now has to negotiate with the client that level of fee. And they are in competition, effectively, with the product provider and the platform for a certain slice of the client's wallet. Do you understand my reasoning?

CHAIRMAN—Yes, I do. In your view would that mean that you could grow the broad market—that more people would get advice—or would it restrict the ability of people to gain advice?

Mr Mackay—I have heard two arguments put forward often. One is regarding choice and the other is regarding reducing access to consumers. I think both are fatally flawed arguments. The first is that consumers want choice. We actually advocated this view until about six months ago. You have CHOICE coming in this afternoon. I would ask you to ask them whether consumers want choice. I am guessing that they would say no.

Mr PEARCE—Did you advocate choice?

Mr Mackay—We did.

Mr PEARCE—What changed your mind?

Mr Mackay—Listening to the arguments that were put forward to us. We came to the conclusion that when clients come in they typically ask their financial planner which ones to choose. They do not come into a financial planner seeking choice on fees; they come in seeking good advice at low cost. Financial planners understand those fees much better. There is an information asymmetry and they have a financial interest in one being selected. So we argue that giving choice to consumers means that you are giving them an uninformed choice—and an uninformed choice is no choice at all.

Secondly, there is an argument put forward that removing commissions reduces consumer access to advice. Firstly, we do advocate that advice fees paid by the client should be tax deductible.

Senator MASON—Should be?

Mr Mackay—Should be, yes. I assume that when some people use this argument what they mean is that consumers would stop paying for advice if they knew how much it was really costing them. They seem to suggest that instead we should continue to hide the cost from consumers via commissions hidden in these products. To us, this seems like an appalling argument for allowing commissions to exist. According to Ric Battellino, the Deputy Governor of the Reserve Bank:

> This reluctance to pay for advice upfront appears to be a form of money illusion, whereby investors may feel that they are somehow paying less for financial advice if the cost is buried in reduced earnings in the future.

CHAIRMAN—How does that work differently for the Storm case, where was the complete opposite. In fact, it was very up front—7½ per cent, in your face, a big fee, straight up front, right now. How does that work?

Mr Mackay—I do not know. I am not completely au fait with how they structured their fees. You are saying that they—

CHAIRMAN—Basically, they had a seven or 7½ per cent up-front fee. You paid it all up front in one hit, straight out of the investment product.

Mr Mackay—Yes. Obviously, there are many issues involved in Storm. We are talking about reforms at the general industry level as opposed to trying to fix the Storm situation.

CHAIRMAN—That is fine.

Mr PEARCE—The chair asked you about commissions. I think the question he asked you was: why don't you like commissions?

Ms Mackay—I think the thing is—

Mr PEARCE—No—you answered it. So, you do not like commissions?

Ms Mackay—We do not.

Mr PEARCE—But if I come to your business today to buy insurance, you would sell me a product with a commission. Have you knocked commissions back?

Ms Mackay—In certain circumstances—we have spoken to our clients about this—if the commission is taken away, it is not necessarily credited back to the consumer's account.

Mr PEARCE—No—but if I come to your business today and I say, 'I'd like an insurance product,' you would tell me that you still insurance products with commissions.

Mr Mackay—For legacy. We accept commissions on legacy products. Typically, for new clients who come in today we charge a fixed fee per year, regardless of insurance or other products we put them into.

Mr PEARCE—Let's say I come in and I have a legacy product, but I am happy to move to you from some previous person, and I have an insurance product with Asteron, let's say, or Tower. You do not like commissions, but you operate in a market where you accept commissions.

Mr Mackay—Correct.

Ms Mackay—We talk about it with the client. For new clients, we do not want to accept commissions. That is the line. For clients who have legacy issues, we work through them. We are transitioning clients across and some clients are saying, 'Look, I don't want to have to write the cheque every month,' or whatever, so I am happy to do that.

Mr PEARCE—So, if I come to your business today and say, 'I'd like to get some insurance. What would you recommend?' you will only recommend to me an insurance product that does not have a commission?

Ms Mackay—No, we would recommend the best product for you in your circumstances that is available in the market.

Mr PEARCE—What happens if it has a commission? Would you recommend it to me?

Ms Mackay—We would obviously—

Mr Mackay—We can set commissions back to zero in some circumstances.

Mr PEARCE—That is my point: will you recommend a product to me that does not have a commission to you?

Mr Mackay—It depends on the circumstances of the client.

Ms Mackay—If you come in and say you want insurance without commission, we would do everything we can to get you the product that is appropriate for you.

Mr PEARCE—Let’s take a practical example. You are in North Sydney, aren’t you?

Mr Mackay—Chatswood.

Mr PEARCE—Same place! Let’s say I walk in this afternoon and I share with you my particular circumstances. You will go about ‘know your client’ and all of that. I share with you and you find out I have an income, expenditure, and a nine-year-old son and older children who cost me a fortune et cetera, and you will say, ‘Chris, I think the best product for you would be X, Y or Z.’ Will you recommend that to me if it has a commission?

Mr Mackay—For new clients we do not charge commissions, so, no, we would not charge you any commission on an insurance product.

Mr PEARCE—You won’t?

Mr Mackay—No, not for a new client.

Mr PEARCE—Regardless of the product?

Mr Mackay—Regardless of the product.

Mr PEARCE—But if I am a former client of someone else and I have an existing policy—

Ms Mackay—But you are a new client to us.

Mr Mackay—If we can switch it off, we will.

Mr PEARCE—If you can?

Mr Mackay—Yes. If it is repaid to the client.

CHAIRMAN—I think we are clear. They are doing their very best.

Ms OWENS—You are transitioning. You did not say, ‘We don’t like commissions. We are stopping today.’ You are actually transitioning. How difficult was the transition? Are their barriers to that transition? We hear stories that it would be very difficult for the industry to stop doing this. Can you tell us what the experience was like?

Mr Mackay—For the entire industry, yes, we agree that it probably will be very difficult, but that is not a reason to not undertake the reform.

Ms OWENS—Why would it be difficult, from your experience?

Mr Mackay—We use the expression ‘rivers of gold’. It is very descriptive. Earlier, you discussed the fact that it is easy to collect this money, with regard to commissions. Accountants have to chase up their clients. With financial planners it is all played by the product manufacturer. All of a sudden we now, as financial planners, have to chase up money from clients. Also, it means you have to have an ongoing a relationship with that client. You have to offer them a good service, otherwise they will not be prepared to pay it. If there is no service and no relationship ongoing, even though a commission has been paid, it will be hard to transfer that commission into a revenue.

Ms OWENS—So there is an additional cost to your business of chasing the fee?

Mr Mackay—Potentially there is, and there is the lost revenue from clients whom you no longer talk to but for whom you are still getting commissions.

Ms Mackay—The hardest element in the transition across is having that conversation with the client because, for many in the industry, if they have not had a conversation for a while, it is difficult to prove that they are providing value. All of a sudden they are turning around and saying we are now not receiving money from someone you were not aware of or have forgotten, but now we are actually asking for money out of your bank account. That conversation is the difficult thing. I think many in the industry are afraid of having that conversation with their clients because they are going to have to stand up and say, like a lawyer or like an accountant, ‘My time and my professional expertise is valuable and I should be paid for it.’ It is that conversation that professionals have with their clients to justify their value and to justify their payment.

Ms OWENS—But you are able to turn those commissions off in every case if you wish. Are there some products where you cannot?

Mr Mackay—There is an issue with some products in that you can turn the commission off, but it is not then rebated to the client. Then we have to charge them on top of that.

Ms OWENS—Thank you.

Senator MASON—I thank you very much for your submission. I suspect there would be many in your industry that do not enjoy it; nonetheless, I thank you. You believe there should be a statutory fiduciary duty. Is that right?

Mr Mackay—Yes, we do.

Senator MASON—That will certainly clarify the law. Do you think that commissions constitute an inherent conflict of interest?

Mr Mackay—Yes, we do.

Senator MASON—Because it skews the nature of the advice?

Mr Mackay—It can.

Senator MASON—You say on page 5 of your submission:

For example, where an organisation accepts commissions or hidden payments on any financial product it is reasonable to assume (unless otherwise stated) that their submission will support the continued allowance of commissions or propose delaying tactics to protect commissions on those financial products for as long a period as possible.

Is that right?

Mr Mackay—Yes.

Senator MASON—The argument we are hearing consistently is this: if commissions go, disadvantaged people in particular will have less access to financial advice. You have proposed that advice might be tax deductible, which would increase accessibility. But you also said that this would make the cost of that advice apparent rather than hidden. Is that what you are also arguing?

Mr Mackay—Yes.

Senator MASON—Do you think that is a good thing?

Mr Mackay—Yes. I think all fees for advice should be agreed between the financial planner and the client themselves, and the transfer of money should be from the client to the financial planner.

Senator MASON—This would lead to the further professionalisation of the industry?

Mr Mackay—Yes.

Senator MASON—Thank you.

Mr PEARCE—I was impressed by the comments you made about your academic qualifications. You would obviously like to see the bar lifted in terms of qualifications. Can you share with us how you think that would be best structured and what sort of qualifications are involved? Do you think there needs to be a minimum and what would that minimum be?

Ms Mackay—As you are probably aware from other submissions, the current standard for the RG146 qualification is the equivalent of a diploma level. We are currently involved in discussions with IBSA, Innovation and Business Skills Australia, the body that looks after the content of those diplomas, about raising the content and standard. We would recommend that we immediately raise it to an advanced diploma level for new entrants. We will not go into the grandfathering issue. We also recommend immediately imposing an experience component to it.

Mr PEARCE—So that there is some practical experience to it?

Mr Mackay—Yes, so there is an 18-month or a two-year supervised work experience.

Mr Mackay—Just to qualify, we view an advanced diploma at first-year university level.

CHAIRMAN—First year?

Mr Mackay—Yes. It is currently at diploma level.

Mr PEARCE—So you are saying an advanced diploma. Okay. The other question I had was: you made a suggestion, which I think is a very interesting suggestion, about having an independent oversight regulatory body. I presume that you mean something like the AASB—the Australian Accounting Standards Board. Do you mean the same sort of model as that, where it is an independent board with its own ethics, its own benchmarks and its own governance process? Is that the sort of model you are talking about?

Ms Mackay—Slightly. In that one, the individual accountants are not members of that board, so the Institute of Chartered Accountants and the CPAs support that board and adhere to it and impose those obligations.

Mr PEARCE—You want the planners to be individual members.

Ms Mackay—We would like that as well, yes. Similar to what has occurred in the UK.

Mr Mackay—It is what is going on in the UK at the moment and it is also what the financial planning association in America is advocating—a professional standards board over there as well.

Ms OWENS—Is there any role at all for a pure salesperson—a person who sells one product and that is it?

Mr Mackay—Yes. We use the analogy: if you walk into a Ford dealership you should expect to buy a Ford. There are some financial advisers out there who are in a similar situation. There is always a role for them, but it should be made perfectly clear to the consumer that that is the role that they are fulfilling.

Ms Mackay—I think at the moment the concern is that consumers cannot identify who independent advisers are and who are salespeople employed by product manufacturers to sell their product.

CHAIRMAN—Just on the compliance issue, and there are two parts to my question: how do you see compliance and how do you think the industry sees compliance? Is compliance about ticking a box and protecting yourself, or is it about providing protection for your client? How do you see that and how does the industry see it?

Ms Mackay—We actually talk about a compliance culture within our organisation. We see it as embedded in everything we do, because ticking a box is not the essence of what compliance is about. It is not about making sure that the boxes are ticked. We see it as protecting us as licensee, our advisers as authorised reps, and our clients. We see it as uniform.

CHAIRMAN—How do you think the industry works? Is compliance just about ticking the box and protecting yourself rather than focusing on the protection of your clients?

Mr Mackay—I do not feel we are qualified to comment on behalf of the rest of the industry.

CHAIRMAN—That is fine.

Mr PEARCE—You have got an interesting business, it seems to me, in the sense that you hold an AFSL but you are an RTO in your own right as well. Why are you an RTO?

Mr Mackay—We see great synergies between finance and education. As a registered training organisation we do not just educate our clients; we also educate our financial planning clients—

Mr PEARCE—You do. That was going to be my next question.

Mr Mackay—Yes, we do, for those who want to learn more. Some are too busy, some are not interested, but that is a big part of our service: we educate our clients, because educated clients are happier clients, in our experience.

Mr PEARCE—In my own experience, I think that there would be very few AFSL holders who are also RTOs. So I think it is quite an interesting model that you have developed there. I think it is good for your own people as well as for your clients. On that score, how do you attract clients to your business?

Ms Mackay—The majority of them are through word of mouth. Our clients are happy clients and they want to refer us to their friends and family.

Mr PEARCE—You have never had an unhappy client?

Ms Mackay—We have had clients who have been unhappy at times, and we work through the issues with them.

CHAIRMAN—Could I bring you back to education just briefly? You obviously do not try to educate your clients in terms of understanding all the intricacies. You are not trying to give them a diploma-level understanding. It would be impossible. What are you trying to educate them to understand?

Mr Mackay—Risk and return are the two biggest concepts.

CHAIRMAN—How quickly, normally, could you impart that sort of education?

Mr Mackay—It is a process.

CHAIRMAN—Could you, in a reasonably short period of time in a meeting, explain the basic concept if somebody said they really did understand the basic risk.

Ms Mackay—You can begin that discussion, but it is also re-emphasising that with your client. Clients come in with fixed views, and if you are trying to educate them about something you need several discussions.

CHAIRMAN—Can it be done in reverse? You are trying to do the right thing; you are trying to educate your clients to understand risk so they do not take too much risk. Can it be done in reverse, where you can educate someone into taking more risk than they ever dreamed possible?

Mr Mackay—Yes, I do believe that is the case. For instance, if you look at the term 'high yield bonds', they were originally called junk bonds. They are exactly the same product, but it is how you market that product. In that case, the old name 'junk bonds' was focused on the risk. When they changed the name to high yield bonds, all of a sudden the focus was on the return.

CHAIRMAN—So education seminars can be just as much aimed at so-called 'educating' people into taking more and more risk, rather than educating people about what risk is.

Mr Mackay—They could be used in that way.

Mr PEARCE—That is interesting, isn't it? Some evidence earlier from a financial adviser planner was interesting. I would like to contrast this. Again, it is a practical example. Chris walks in again to Quantum Financial Services and we go through the whole process, and I say to you: 'No, but hold on a minute. I've been told by my friend'—you must have this a bit—'that they've invested in A, B, C, and that's where I want to go.' If you deemed that investment to be not in my interests given my profile and all the rest of it, you would tell me that presumably. But what would you do if I said to you: 'No, I want to put some money into A, B, C. I want to put some money into this fund or that fund because Mary or Jimmy my cousin's done that and they've done really well out of it and I reckon it's great.' What would you do?

Mr Mackay—We would go through a process of trying to educate you if we honestly thought that that was the wrong thing—

Mr PEARCE—Against it?

Mr Mackay—Yes, against it. Having said that, at the end of the day, if you are adamant that that is what you want to do, we are your adviser. We do not have any discretionary power over what you can and cannot do, and so if your direction is to do that, then we have to follow that direction. If we feel uncomfortable with that, if it is a massively disproportionate percentage of your portfolio, we would probably say, 'Thank you, but we really can't serve you as your adviser.'

CHAIRMAN—So you give them advice that if they wanted to do this, you would advise against it. But if they really wanted to, you would advise strongly in the direction of just a small portion of their portfolio?

Ms Mackay—Ultimately it is their money. We do not say, 'You can't go spending your money or you can't go put it in a bad investment that we advise you against.'

Mr PEARCE—So you would help me?

Ms Mackay—We would not want to help you, and so, as Tim said, we would either try to help minimise the risk that you would be exposed to or if we cannot do that and you are adamant then that signals a relationship that maybe we do not want to continue.

CHAIRMAN—But you would make it clear though, I think that is the point.

Ms Mackay—Absolutely.

Mr PEARCE—You would knock me back then?

CHAIRMAN—Chris, I am sure you have been knocked back before.

Senator MASON—And it is the second time you have been through the door today!

CHAIRMAN—And on that very good note, thank you very much. We really do appreciate your submission. It was very detailed, of very good quality, as was your evidence.

Proceedings suspended from 12.02 pm to 1.00 pm

COHEN, Mr David Antony Keith, Group General Counsel, Commonwealth Bank of Australia

COMYN, Mr Matthew Peter, Executive General Manager, Equities and Margin Lending, Commonwealth Bank of Australia

FRENCH, Dr Brendan James, General Manager, Customer Relations, Commonwealth Bank of Australia

GUNNING, Mr Timothy James, General Manager, Commonwealth Financial Planning, Commonwealth Bank of Australia

McEWAN, Mr Ross Maxwell, Group Executive, Retail Banking Services, Commonwealth Bank of Australia

NAREV, Mr Ian Mark, Group Executive Manager, Business and Private Banking, Commonwealth Bank of Australia

CHAIRMAN—I reopen this public hearing of the Joint Parliamentary Committee on Corporations and Financial Services, part of a series of public hearings the committee will hold to inform its inquiry into financial products and services. The committee is inquiring into issues associated with recent financial services provider collapses such as Storm Financial Group, Opes Prime Group and other, similar collapses. In conducting its inquiry the committee has made a decision to focus specifically on non-superannuation products and services. Witnesses giving evidence to the committee are protected by parliamentary privilege. Any act which may disadvantage a witness on account of their evidence is a breach of privilege and may be treated by the parliament as a contempt. It is also a contempt to give false and misleading evidence to a committee. The committee prefers to hear evidence in public, but we may agree to take evidence confidentially. The committee may still publish confidential evidence at a later date, but we would consult the witnesses concerned before doing this.

I welcome all the representatives from the Commonwealth Bank of Australia. I note for the public record that we have also invited the CEO, Mr Ralph Norris. Mr Norris cannot be present today but has made a commitment to appear at a later date. We have accepted that, so we will be talking to Mr Norris at a later date. Is there anything any of you wish to add about the capacity in which you appear today?

Mr Narev—I am the group executive of Business and Private Banking, which is the division through which Colonial Geared Investments reports.

CHAIRMAN—Thank you. Do any of you wish to make opening remarks?

Mr Cohen—My colleagues and I welcome the opportunity to assist the committee in its deliberations today. I am the general counsel and I am responsible for legal affairs within the Commonwealth Bank Group. Most relevantly today, I have been closely involved in the review of the bank's involvement with Storm Financial and in designing the resolutions scheme

involving Storm Financial clients who borrowed money from the bank. I would like to reiterate a number of key points from the submission that we lodged with the committee. As one of Australia's largest financial service institutions with one of the largest financial planning groups, we welcome the opportunity to participate in this inquiry into the provision of financial services and financial products, in particular issues associated with the recent collapse of high-profile financial service providers. Whether the regulatory framework is appropriate to ensure Australian investors can have confidence in financial products and services is very important to CBA.

CBA has a strong interest in a regulatory environment that ensures Australian investors have access to affordable, quality financial advice and have confidence in the financial products and services being recommended to them. As we have said in our submission, in our view the regulatory framework for financial advice does not require wholesale change. We consider that with appropriate application of the existing framework and effective enforcement poor outcomes for clients will be rare. We have recommended in our submission 11 areas where additional information provided by industry participants to ASIC should enable the development of a risk weighted strategic view of an advice business. This will assist ASIC to identify either a failing business or a business with a high potential for failure. We recognise that ASIC's role in this respect is not easy, and it can be assisted by the financial planning industry providing relevant and useful information to ASIC to enable it to monitor licensed financial advisers in a more strategic way. Further, CBA supports the proposed legislative changes in relation to margin lending, advice and the disclosure work being done by the Financial Services Working Group.

I would like to address briefly the bank's association with Storm Financial. As you know, CBA, amongst others, provided financial products via Storm to their clients in order to realise Storm's financial advice. As the bank's CEO, Ralph Norris, has stated publicly, 'The position in which some Storm clients find themselves, though not caused directly by the bank, does involve the bank to some degree.' Today my colleagues and I echo Mr Norris's statement that we are not proud of the bank's involvement in some of the issues faced by those customers. Our CEO has also publicly announced that customers can be assured that, where we have done wrong, we will put it right. Both before and since that announcement we have been taking action to put wrongs right. First, our customer assistance program established with customers on the ground in Townsville and, second, our innovative resolution scheme.

We recognise the very real financial hardship suffered by some of our customers and we are genuinely concerned to assist them reach fair solutions and outcomes. As a first step we did put in place a customer assistance, or hardship team, in Townsville in February this year. That team continues to work with affected clients. The team has met with over 1,000 customers to learn more about their circumstances and, wherever possible, to help form a longer term plan to address their hardship. Our offers of assistance have been tailored specifically to each individual client's circumstances, and those offers have included loan reductions and loan write-offs, loan restructures, reduced interest or zero interest for the life of the loan, and permanent tenancies.

To further help our customers who face hardship and recognising that in some cases we have contributed to that hardship we have established an innovative resolution scheme with the aim of providing swift, fair and transparent outcomes for affected customers. Not only will the scheme produce quick outcomes but, as a result of early claims being determined by former High Court Justice Ian Callinan, it will give the banks sound guidance on the offers that we make to

customers who face similar circumstances. As an example of one of the issues that will be determined early—and it is an issue that we are aware the committee is interested in and wants to learn more about—is the question of who was responsible for margin calls being made to customers who had margin loans and will be considered early in the resolution scheme. We would like to address that issue during the session today because we do believe we have valuable information that will be of interest to the committee.

The resolution scheme is underway, and we have sent letters to all eligible customers explaining the scheme and how it will operate. In addition, Matt Comyn and Brendan French, who are here today, have attended information evenings organised by Slater & Gordon and the Storm Investors Consumer Action Group. So far approximately 430 customers have registered to participate in the scheme, and we are in the process of establishing an electronic document platform that will facilitate the delivery of important documents to customers and their lawyers. We hope to be making offers to customers in the coming weeks with a view to an efficient and quick process. To ensure customers are fully advised throughout the process, the bank is funding the cost of independent legal and financial advice up to agreed levels. To further assist customers, the bank has frozen interest payments on loans to those customers who register for the scheme by the end of this month.

In terms of our learnings, the bank has learned from mistakes that we have made in relation to some of our lending to Storm customers. Amongst the steps we have taken to remedy the situation, we have improved our valuation decisioning tool, known as VAS, which I am sure the committee has heard about, we have tightened our loan approval processes, and we have augmented our compliance and audit checking processes. We will be doing everything possible, and I can assure the committee of this, to ensure that the mistakes we have made in the past do not occur again.

Finally, while CBA acknowledges and is willing to put right the wrongs that we may have committed, it needs to be recognised that there are other parties significantly involved in the hardship suffered by Storm clients. CBA is not responsible for either those parties or their contribution to the hardship being experienced. Chairman, thank you for the opportunity to address the committee and our team is available to answer the committee's questions.

CHAIRMAN—Thank you, Mr Cohen. I would like to get a couple of things straight first so that we are all on the same platform and we understand what we are talking about. Colonial Geared Investments is a subsidiary of CBA. Can you describe that to me?

Mr Cohen—Certainly. Colonial Geared Investments is a business within the Commonwealth Bank. It sits within our business bank and is an operating business which specifically focuses on marginal lending.

CHAIRMAN—So it is wholly owned; it is a subsidiary; it is the Commonwealth Bank?

Mr Cohen—It is wholly owned; yes.

CHAIRMAN—We are not talking about some other third party?

Mr Cohen—No. That is correct; it is the Commonwealth Bank.

CHAIRMAN—You also talked briefly about, and you mentioned throughout your submission, Storm clients.

Mr Cohen—Yes.

CHAIRMAN—Do you make a distinction between Storm clients and your clients?

Mr Cohen—In essence Storm clients became CBA customers in some circumstances. So there is a commonality. Some Storm clients also became CBA customers.

CHAIRMAN—I understand that, but the Storm clients were also your clients.

Mr Cohen—Our customers.

CHAIRMAN—Yes; your customers. So they were your customers.

Mr Cohen—Yes.

CHAIRMAN—So there is no distinction. You are not just calling them Storm's clients for convenience or anything like that?

Mr Cohen—No.

CHAIRMAN—It is clear that they were your customers; they were not somebody else's customers even though they might have been Storm customers as well.

Mr Cohen—Exactly. Perhaps I can assist you to understand why that terminology was used in our submission. We usually use that terminology in circumstances where we are relating to the financial advice that may have been given by Storm. In that context we refer to them as Storm clients. Where we are talking about loans, for example, made to a person—and it is a loan made by CBA—then they are a CBA customer.

CHAIRMAN—That is fine. In your submission you say 'What we are doing to help Storm clients,' but really it should be, 'What we are doing to help Commonwealth Bank of Australia clients.'

Mr Cohen—Customers; yes.

CHAIRMAN—Yes; customers or clients. I will use the word 'clients'. You talked briefly about the Commonwealth Bank's relationship with Storm, and you have mentioned that in your submission. Obviously it is of great interest to us to understand how that relationship operated. You have not really gone into any detail. You talked about there being some sort of a relationship, but my understanding is that the Commonwealth Bank set up a specific BSB number just for Storm Financial, that you had also set up a specific team to work just with Storm clients and that there was quite a bit of effort over a long period of time put into Storm as an organisation. Firstly, tell me why that is and then how that operated.

Mr Cohen—I might give you a general overview and then Ross McEwan can talk specifically to some of the issues that you have raised. The association with Storm commenced in 1994. It was an association that commenced with a business that was known as Legal and General, which was then acquired by Colonial. The Commonwealth Bank Group acquired Colonial in 2000-01, so the association originally began before the Commonwealth Bank owned Colonial. It might be useful for the committee to understand the context of the Storm business in reference to our overall business. Perhaps both Ross McEwan and Ian Narev can talk a little about where the Storm association and the volume of business fit in within the Commonwealth Bank Group and how it relates.

Mr McEwan—I will address the home loan side of the business. Many of the comments that you made relate to the home loan part of the business. It was a unique relationship as we look through the Storm business association with our business. It had been running since about 1999. There was a small unit of about three to four people who were located in our area office and who serviced the Storm clients in the last five years of operation, dating back to 2004-05. It was quite unique for the Commonwealth Bank to have a cell that looked after a group that was not a broker and was not a referral agent, so therefore no commissions were actually paid to Storm for the business that they tendered to us.

It was also the uniqueness of that—that is, that there were no commission flows—that made it quite difficult for us to identify true Storm clients as we looked at it at the beginning of this year. The reason a BSB number was set up—it was set up in 2008; very late in the piece—was actually to start identifying those clients, because you need a BSB number to process, and the BSB number, which is a branch number, was actually allocated out to a branch within the Townsville area for which we have a number of branches. So can you imagine, whilst the unit is serviced, the actual clients got allocated out because of the BSB number and it therefore made it quite difficult to assess how much business was actually running through the proper cell itself. So it was quite unique in the sense that it had no broker relationship or referral relationship, and it had its own unit there, which is not something that we run throughout the country.

CHAIRMAN—Was that very generous of you to set all that up and not receive anything back? There were no brokerage fees, no commissions?

Mr Comyn—No.

Mr Cohen—No, not paid to Storm. The business was actually tendered from Storm. We would get a tender document saying they had a client who was looking for a home loan, here were the basic details and then we would send—

CHAIRMAN—But, on the home line side of that, it was very small though, wasn’t it? I think in your submission you said 0.2 per cent of something.

Mr Cohen—It was 0.2 per cent. And actually it is 0.2 of our overall book and was pushed—

CHAIRMAN—But home loans are pretty well run-of-the-mill in terms of bank business. I mean that is what banks mostly do. I am more interested in the setup in terms of the margin loans or what was set up in terms of the team. I do not know how many people it must have

involved. You would not have set up a whole specialist team, a BSB number, to identify Storm customers, go to all that trouble just for some home loans.

Mr Cohen—Sorry, just for clarity: the BSB number was for home loans only.

CHAIRMAN—Okay.

Mr Cohen—Okay. So it was solely for the home loan business and put up in 2008 to start identifying that business coming through.

Mr Comyn—It was set up relatively late, in August 2008—

CHAIRMAN—Can I just clarify. The home loans invariably all ended up—at some point, those same customers ended up getting margin loans. Storm was not a mortgage broker just trying to get home loans for people, were they?

Mr Cohen—No, they weren't.

CHAIRMAN—Because in fact their business model was the opposite of that.

Mr Cohen—That is right. They were not set up as a broker. They actually tendered out their business to ourselves and to other banks. So, I think the area you are looking at is—then moving on—that is the home loan piece and how it was structured up. The next piece is around how the margin lending was set up.

Mr Comyn—Ian can talk about the margin lending arrangements.

Mr Narev—Mr Chairman, I will talk about the margin lending arrangements with Storm. In doing so, I might just set one extra note of context in addition to what Mr Cohen said about the organisational housing of Colonial Geared Investments. The Commonwealth Bank basically has two margin lending businesses. One is our CommSec margin lending business, and one is our Colonial Geared Investments margin lending business. The distinction between them is quite important for current purposes, because the CommSec margin lending business lends directly to end customers. The Colonial Geared Investments margin lending business deals through financial advisers through dealers with end customers. So all customers of Colonial Geared Investments or margin loan customers of Colonial Geared Investments have come through a financial adviser, whereas on the CommSec side they have not. So that is a quite important context.

CHAIRMAN—But the contract for the margin loan—

Mr Cohen—The contract is between the Commonwealth Bank and the customer.

CHAIRMAN—In both cases—in the CGI case and in the CommSec case?

Mr Cohen—Correct.

CHAIRMAN—They have just come through a different mechanism.

Mr Cohen—Correct. Through different channels and through different organisational teams. In terms of the relationship between Storm and the Colonial Geared Investments business, Storm was one of approximately 7,000 dealer groups who were being dealt with through Colonial Geared Investments at that time. It was the largest by revenue. It was roughly 10 per cent of the revenue of Colonial Geared Investments at the time. And just to give you an idea, I think the financial year of 2008 was the peak year of the relationship, from the Commonwealth Bank's point of view. The overall revenue from Storm margin loans that year was $7.8 million out of a total revenue for the division of just over $4 billion. So, while it was a significant 10 per cent of the dealer group part of Colonial Geared Investments as part of the overall business, it was actually a relatively small number. There is a high-value team of relationship managers, who deal with all the main dealer groups, and Storm was dealt with through particularly a couple of individuals in that team primarily.

CHAIRMAN—Still on the relationship—I am just trying to establish that we get the framework and the context right. Obviously there was a relationship with Storm; the CBA had a relationship with Storm. Your submission tends to read as though there was not much of a relationship, that it was almost casual, that it was just a few staff—obviously because they had to deal with Storm. Is that what you contend is the case? Or was it deeper than that?

Mr Comyn—Chairman, if I could say that we are well aware of some of the suggestions, made both to the committee by other witnesses and in the media, that the relationship ran deep, ran to the highest levels et cetera.

CHAIRMAN—Yes. I know what is in the paper. What I am asking you is what you think or what you are telling us it is. I am aware of what is in the paper.

Mr Comyn—We would like to establish for you exactly the level of the relationship.

CHAIRMAN—Sure.

Mr Comyn—It was not a relationship that ran to the highest levels of CBA. It was an association whereby Storm did refer customers to the CBA, and we have been quite open about that. And we dealt with those customers. We also dealt extensively with Storm through CGI on the margin loans, and that is something that we acknowledge. The relationship was no more than a referral of business to us, and we in turn serviced the business. In some cases—that is, through CGI—that went via Storm. In other cases—that is, the home loans—it was directly with the customer.

CHAIRMAN—So you contend, if I interpret this rightly, that there really was not much of a relationship. You were just doing business and there was not a higher level relationship.

Mr Cohen—No.

Mr Narev—There is one other point of context which I might offer in terms of your question about the BSB in relation to the margin loan business. Storm helped its customers get home loans through a variety of different banks and then helped its customers get margin loans through us and other providers.

CHAIRMAN—Yes, I am aware of that.

Mr Narev—The staff, because of the structure of the Colonial Geared Investments business, were actually not aware which of the margin loans coming through to them were home loan customers of the Commonwealth Bank and which were not.

CHAIRMAN—Were these just ordinary home loans—somebody purchasing a home—or were these people refinancing?

Mr McEwan—A number of these were refinanced. As I said earlier on, they came to us via a tender. So that tender may have been existing customers through other relationships with the bank or they may have been coming from somebody else or they may have had no home loan at all—it was actually a new home loan. So each of those was a tender document and process that was set up, it came to us and we then made a decision as to whether we wanted that home loan and put in our pricing.

CHAIRMAN—Can you tell us whether there were any formal agreements, in writing or contractual, between the Commonwealth Bank and Storm Financial?

Mr Cohen—There was a formal agreement established in 2002 in relation to a particular product known as CALIA. That was an agreement whereby we and Storm agreed how Storm would monitor the affairs of customers who took up the CALIA product. That was in 2002. There was, in 2007, a letter between us and Storm which dealt with some aspects of how the two of us would conduct our affairs in relation to CGI margin loans.

CHAIRMAN—And what was the detail of that?

Mr Cohen—Of that particular letter?

CHAIRMAN—What is the nature of how that worked?

Mr Cohen—If I can perhaps go back to the 2002 agreement first. I should say that this is in relation to a product that was not extensively used by Storm clients.

CHAIRMAN—If you could be brief on that one and then move quickly to the other, that would be great.

Mr Cohen—Okay. That was a typical dealer agreement that CGI established with dealers who had an arrangement with CGI. It was an arrangement that set out whose responsibilities were what, and in that document it was clearly set out that it was Storm's responsibility to monitor customers' margin situations and their affairs and to pass on and make margin calls. As I said, however, that was not a product that was used extensively.

CHAIRMAN—To pass on margin calls from who?

Mr Cohen—From CGI.

CHAIRMAN—So CGI would need to make the margin call with Storm and then Storm would need to pass it on?

Mr Cohen—That is correct.

CHAIRMAN—And there was no variation upon that process? That was just the process. Was it adhered to?

Mr Cohen—That was the process between us and Storm at that point. I think it is important to understand also that from about 2003 onwards there was a change in process. Up until 2003—and I think the committee has heard witnesses give evidence to this effect—there were margin calls made directly by CGI to the customers, so not necessarily via the financial adviser.

Mr Narev—I should just provide one extra detail about that point. In 2002 and 2003, the process for margin calls was that the dealer—the adviser—would actually notify the client and that would be followed up by letter from Colonial Geared Investments, which would typically arrive four or five days later. As a part of ongoing business model reviews in the ensuing—

CHAIRMAN—That was 2002 and 2003?

Mr Narev—That was 2002-03.

CHAIRMAN—Fast forward to 2007-08. What is happening there? What agreements have got in place and how do they operate?

Mr Narev—The letter to which I think you are referring is the May 2007 letter between the Commonwealth Bank and Colonial Geared Investments. The primary reason for that letter was to clarify a loan-to-value ratio of 80 per cent for customers of Storm who were invested in a specified range of funds from Colonial First State, Challenger, MLC and Barclays. It said that customers who were invested in those specific funds would be entitled to a global loan-to-value ratio of 80 per cent. There were some details relating to the weighting of different funds and how that might go into the loan-to-value ratio. That was the primary reason for the letter.

CHAIRMAN—Who was that initiated by?

Mr Narev—That was the subject of discussions between Storm and the Commonwealth Bank.

Senator WILLIAMS—In relation to the situation back in 2003, did you say that you would contact Storm about a margin call and they would contact the client back then?

Mr Narev—That is my understanding, yes.

Senator WILLIAMS—I question that because I have a document here, dated back then:

Emmanuel Cassimatis, Ozdaq Securities Pty Ltd

The following letter has been sent to the above named borrower—

a marginal investor—

and also their guarantors if applicable. It is for your information only.

Mr Narev—My understanding of that is that, in addition, once Colonial Geared Investments had written to the customer, the definitely provided a cut copy of the letter they had given back to the customer.

Senator WILLIAMS—So you wrote directly to the customer in a margin call in those days?

Mr Narev—Yes, and a copy of that was provided to the dealer. At the same time, prior to the customer even having received the letter which was copied to the dealer, the customer would have heard directly from the dealer.

CHAIRMAN—What was the arrangement and agreement between Storm and CBA for the 2007-08 period—covering after 2003?

Mr Narev—The key parts that are addressed in the letter—and then I will come back to what is not in the letter, which might be equally important—is the 80 per cent loan-to-value ratio and then, as I think the committee has heard, at the end of that there is the comment: 'In the unlikely event of a margin call, Colonial Geared Investments and Storm Financial will work in partnership to clear the margin call.' I am aware that this is a topic of a lot of interest to the committee, and I wonder whether I might offer a couple of thoughts on that now.

CHAIRMAN—Please do.

Mr Narev—Our practise undoubtedly in the business at the time, with 7,000 dealers, was to make margin calls through the dealers. I can say that, in the October 2008 to December 2008 period, 15,000 margin calls were made to customers outside Storm from the Colonial Geared Investments business. To the best of my knowledge, having made inquiries of my team, every one of those was made through a dealer. So our understanding was certainly that the margin calls for Storm customers would be made through Storm, as the financial adviser, and three files a day of information were provided to Storm to this end. We are also aware that in 2004, 2006 and 2007, although market conditions were a lot better, some margin calls were made. I think around 40 in 2004—

CHAIRMAN—I would just like to take you back a bit. You said 'three files a day'; three files of what?

Mr Narev—This is information relating to Storm clients and their positions, largely, at the end of the day, given the prices of the funds.

CHAIRMAN—Why were there three files? What is the three?

Mr Narev—They all contained different information. One is called a loan file, one is called the customer file, and one is called the transaction file.

CHAIRMAN—And they were sent every day?

Mr Narev—Yes, they were sent every day.

CHAIRMAN—And you have got documentary evidence that they were sent every day?

Mr Narev—As you can imagine, we have looked into this quite carefully. In January and February, we undertook significant internal reviews to establish what we could. You can imagine that, over the period, it is very difficult to check whether every document was sent every day. What we know at a minimum—and I am not saying this is all—is that, substantially, all of the information was sent by the Commonwealth Bank during that period.

Mr PEARCE—What was the purpose of sending three files a day to Storm?

Mr Narev—From the Colonial Geared Investment's point of view, bearing in mind that the primary relationship in this part of the business is between the financial adviser and the client, it was to make sure that Storm was up to date on the positions of the unit prices of the clients' positions and their loan-to-value ratios.

Mr PEARCE—So that they were then in a position to be able to contact their clients?

Mr Narev—Correct.

Mr Comyn—In fact, the data that was actually sent—the three files that Ian is talking about—is an automated process and was sent to a Storm Financial email address. My understanding is that it was then uploaded into Storm's systems. On top of that, the Colonial Geared Investments website was updated daily, which Storm financial advisers would have access to.

Mr PEARCE—So I was a Storm client and I went above my LVR, Storm would have known that within a day?

Senator WILLIAMS—As long as your files were up to date. Were they kept up to date during that critical period?

Mr Narev—That is another question that we have looked at. Again, we are unable to verify, given the nature of the information, that every unit price for every customer over the period was up to date. We know that substantially all of them were. As part of the remediation process that we are talking about, one of the things that will clearly be critical here is if, in relation to any given client on any given day, information was wrong and that led or contributed to a client's loss. That is something that we would expect to come out in the remediation scheme. So we do know that substantially all the information was provided and it was substantially correct, at a minimum. But that does not mean that in isolated cases there may have been problems.

Senator MASON—Mr Cohen, I think you said that the relationship between Storm and the CBA was no more than a referral of business? Is that right, or did I misunderstand that?

Mr Cohen—I did say that.

Senator MASON—You say in your submission under 'Executive Summary':

Although the intent was genuinely to assist customers, the local relationship with Storm was sometimes too close, and on occasion we lost objectivity.

Is that right?

Mr Cohen—Yes.

Senator MASON—Are you aware that yesterday the committee discussed Mr Jelich's submission, where he details all sorts of examples of that relationship? Have you read Mr Jelich's submission?

Mr Cohen—No, we have not. We have not heard his evidence from yesterday. We have summaries of it from our people who were attending.

Senator MASON—Is the submission up on the web?

Mr Cohen—We have read Mr Jelich's submission.

Senator MASON—In one of his examples he describes what is 'a cosy relationship' between Storm and the CBA. Is there any aspect of that that you would question? There are seven different indicia there of 'a cosy relationship'.

Mr Cohen—We might not look at the home lending side.

Senator MASON—Forget the home lending. What else?

Mr Cohen—Yes, we are aware of the indicia there that Mr Jelich refers to. I do not want the committee to think that it suggests that, therefore, it was a pure mail-only, email-only type business. Of course, we did have meetings with them and we did discuss business with them as part of what I would regard as a normal business referral arrangement. In relation to home loans specifically, Mr McEwan can comment on the extent of that relationship. As you have noted, in our submission we do say that in the context of home loans we did allow the relationship with Storm to cloud our view of who the ultimate customer really was. We acknowledge that. We do acknowledge that that is something that needs to be looked at. It will be looked at in the course of the resolution scheme.

Senator MASON—Did it make any difference in relation to margin lending? Did that close relationship change your behaviour in relation to margin lending?

Mr Cohen—In what sense?

Senator MASON—Because it was such an intimate relationship with Mr Cassimatis and Storm. Did you retain your objectivity in terms of lending money to clients?

Mr Cohen—We believe that in the context of margin lending, and the same with home loans—

Senator MASON—I am not interested in home loans; I am interested in the margin lending.

Mr Cohen—Okay. In the context of margin lending, the answer is: we do not believe that the arrangements between us and Storm clouded our view as to the making of margin loans. However, I would say—because I do not think that it the full story—

Senator MASON—No, I do not think it is either.

Mr Cohen—I would say that we acknowledge that there may have been deficiencies. If there were deficiencies, then that is something that we would definitely be picking up in the resolution scheme.

Senator MASON—Let me go to the process of margin calls. There is evidence—in a sense as a summation of Mr Paul Johnston's evidence—that Storm Investors Consumer Action Group gave. They summarised some evidence from Mr Paul Johnston, who apparently was the head of Colonial Marginal Lending from early 1996 until his departure from the company in 2003. He says:

The loan agreement is and always has been between the client and the borrower, not the agent – in this case, Storm.

Is that right?

Mr Cohen—That is correct, absolutely correct.

Mr Narev—Yes, a contractual relationship.

Senator MASON—So you bear the risk? Is that right?

Mr Cohen—Correct.

Senator MASON—Also, Mr Johnston says that he:

…was instrumental in the writing of clause 4.2 of the terms and conditions which talks about 'you' receiving a margin call. My knowledge and practical application of that clause is that the bank contact the client in writing, then the client (in consultation with the adviser) rectifies the position. Again, I should stress that if the margin call wasn't fixed in the five-day period, I immediately sold the client down to protect BOTH parties (unless evidence was supplied that positive action was being taken to get the call fixed).

Is that right?

Mr Narev—The margin call process, we believe, was done, as I said, through the financial adviser and then onto the customer. I say, in reference to your question, that our sense on looking back at the business and the conduct of business over that time in terms of the buffers, the margin calls et cetera was much more driven by the amount of confusion that can be caused through an unprecedented drop in equity values, rather than special treatment for Storm as a result of any particular relationship between Colonial Geared Investments and Storm—in other words, as assessments were being made. In essence, here, the interests of the margin lender and the interests of the customer should be aligned.

Senator MASON—I agree. Indeed. I accept that. Because in a sense you are protecting the borrower.

Mr Narev—If the customer loses, the bank loses and there is no hedging or anything the bank can do that means that somehow it might come out ahead if a customer loses, so the interests there are fairly well aligned.

Senator MASON—Okay, I accept that. You referred to the letter—and this has come up in evidence—of 18 May 2007 from CGI, under the pen of Craig Keary. It relates to two issues, and you have raised both here this afternoon, in relation to CGI allocating a global LVR of 80 per cent for about 10 different indexed funds; is that right?

Mr Narev—That is correct.

Senator MASON—Would that have been made known to the clients?

Mr Narev—I am not sure but I doubt it would have, because the other important part of the letter, if you look at the bottom of the next page of the letter, is that it says Storm Financial will not gear a client above 65 per cent. The way these two numbers should be reconciled is: generally, a client would have been geared into the fund at the time of investment at 50 per cent. In fact, even at the end of August 2008 when the markets were starting to come down, the average loan to valuation ratio on the book was 67 per cent. So, to the extent that there was an 80 per cent buffer agreed in this letter, the thinking behind it—and obviously I was not here at the time, so I am going from hearsay—was that in essence it was a buffer against a falling market. It was not expected that Storm would communicate to clients that they should come in at 80 per cent. It was assumed that they would communicate to clients that they should continue to come in at 50 per cent, maybe up to 65 per cent, in the knowledge that there was then effectively an extra 15 per cent buffer and on top of that there was another 10 per cent buffer in case markets fell.

Senator MASON—Why would Mr Cassimatis have sought that and you granted if it were irrelevant?

Mr Narev—I cannot speak for what was in his head at the time, but obviously to the extent of being able to withstand some market downturns et cetera it just gives a greater level of comfort. That is certainly our view on how he might have sought it. It is also possible that you could seek this kind of LVR so you could gear up clients more than you had in the past.

Senator MASON—This is a relationship between you and those clients. Given that the LVR has changed to 80 per cent, and that is both good and bad but it changes the risk to the client—

Mr Narev—Correct, and to the lender.

Senator MASON—And to the lender, to you; indeed, I accept that. Yet you are not communicating that to the borrower. Why is that? I do not understand that.

Mr Narev—It is a very understandable question. This really goes both to the heart of how this relationship was conducted and to the proposed changes to the Corporations Law about how

margin lenders who work through dealers should deal with end customers. The discussion about the suitability of the product for a particular customer's needs, what might happen, was a discussion that was had between a licensed financial adviser and the end customer, not between the margin lender and the end customer. The margin lender received only an application form—

Senator MASON—Do you think that is prudent?

Mr Narev—We support the changes to the Corporations Law that are going to require some changes to that. So in that sense, in terms of understanding the market risk of the product and the volatility of the product, this is something that we do not feel customers probably understood well enough. If you look at the differences, as we have, in the past few weeks, for example, in some of Storm's literature, which I have seen over the last couple of weeks, the likelihood of a margin call is raised as very small. In some of the literature customers are told, 'Actually a bigger risk, rather than taking on a margin loan, is to do nothing.' If you look at the CommSec side of our business, which deals directly with—

Senator MASON—That is fine; I understand that. But the bottom line here is that the risk has changed and the clients—your clients, who have a contractual liability to you—have not been informed. That is a fact, isn't it?

Mr Narev—I am not sure that the risk has actually changed.

Senator MASON—It has. The LVR has changed.

Mr Narev—There is a question here—and I expect this will be discussed extensively in the remediation process, because this is a bit of a vexed question—about whether or not in fact a margin call is intended as a stop loss for a customer.

Senator MASON—Mr Narev, come on; you can do better than that. Let's be serious. Quite clearly the risk has changed. It is for and against both the lender and the client, the customer, but it has certainly changed and the client has not been advised. I am not sure that is responsible, Mr Narev.

Mr Cohen—Could I maybe make one point there. We do acknowledge that some of the issues around margin lending are not clear. It would be fair to say that that is exactly the reason why we are taking—

Senator MASON—Mr Cohen, the question is not whether they are clear; the question is whether you acted appropriately and prudently. You may have acted in accordance with the law. I am not making any suggestions there. The question is whether you acted ethically, appropriately, morally and prudently.

Mr Cohen—I think that is an issue that should be and will be dealt with in the resolution scheme.

Senator MASON—I am just touching the tip of the iceberg here. What we now know is that the risk of the investment has changed, both for you and for the client, and the client has not

been informed. I am not sure that is prudent. Can I draw your attention to the second page of the letter, where you say:

Despite our allocation of a global LVR of 80% to your clients on the basis of our expectations being met, as set out above, nothing in this letter modifies or varies the obligation of any client borrower under clause 3.2 of the margin loan to pay us the amount owing under the margin loan if that client borrower is either in default or we send the client borrower a five day notice requiring payment of the amount owing.

So quite clearly you had premised the idea that you could well send a client borrower a five-day notice requiring payment of the amount owing, hadn't you?

Mr Narev—Under the terms and conditions of the margin loans for the vast majority of customers it was provided that a margin call could come either from the advisor or directly from the margin lender. That is a right that is protected.

Senator MASON—On the next page you say:

In the unlikely event of a margin call, CGI and Storm Financial will work in partnership to clear the margin call. Note, however, that CGI reserves its rights under its margin lending terms and conditions.

I will get to the nature of the partnership we have just mentioned in a minute; I think this is part of this relationship that we have discussed. You do not think it is very much, Mr Cohen, but I am not convinced that there is not some sort of relationship—we will get to that. The margin lending terms and conditions include, as previously discussed, the possibility that the bank will make contact directly—that is right, isn't it?

Mr Narev—The possibility, yes.

Mr Cohen—Senator, I might add that that is also for the benefit of the customer, as it turns out.

Senator MASON—I accept that. In the past, we have heard evidence that Colonial Margin Lending made calls directly, and Mr Jelich gave the following evidence:

- 1997 – The South-East Asia Economic Crisis;
- 2000 – The Tech Wreck;
- 2001 – September 11; and
- 2003 – The Iraq War.

All of the margin calls referred to above were handled in an efficient and timely manner. Colonial were efficient and provided timely notices both in writing and by phone during these difficult periods.

Not one of my clients ended in a position where they had negative equity in their investments, or even close to negative equity.

Would you accept that that was his evidence?

Mr Cohen—I am sure that is the case.

Senator MASON—So what changed?

Mr Narev—I should note the submission from another adviser, Mr Fuller, where he said

… no client would ever receive a margin call direct from their margin lender.

Senator MASON—So you have read Mr Fuller's submission but you have not read Mr Jelich's?

Mr Narev—I think Mr Cohen said he had read both submissions.

Senator MASON—Have you read Mr Jelich's?

Mr Narev—I have not read Mr Jelich's.

Senator MASON—But you have read Mr Fuller's?

Mr Narev—I know that Mr Fuller said this.

Senator MASON—I see—you have read some submissions but not all.

Mr Narev—As explained before, during 2002-03 and, I suspect, prior to that, based on inquiries that I have made, a follow-up letter was sent from Colonial Geared Investments but a call was also made by the financial advisor. What changed was the decision on that. I might also note that in December—

Senator MASON—Sorry, just to go back, did you say a letter was sent?

Mr Narev—Yes. And I think I explained in response to the chairman's question why that changed.

Senator MASON—You did, as well as in answer to Mr Pearce. Let's go very slowly through what changed. Also, the committee would like to have any evidence you have that there has been a change—a letter, an email or even a note of a phone call. Start again slowly.

Mr Narev—I hope I explained why that change occurred in 2002-03.

Senator MASON—No, explain it again.

Mr Narev—The change occurred because in 2002-2003 and, I am assuming, prior to that, the practice as I understand it—again, I am relying on discussions I have had with the team—was that a notification was made from a financial advisor to the end customer and that was followed up by a letter four or five days later directly from the margin lender. As it happened—

Senator MASON—That is what you say. That is not necessarily the evidence that Mr Johnston gave. Mr Johnston gave different evidence. He says there were calls directly from

Colonial, as then constituted, to investors. He does not say there was any waiting for a call from a financial adviser, does he? There is bit of conflict of evidence there.

Mr Narev—I agree. This is clearly in conflict with—

Senator MASON—Do you accept that?

Mr Narev—Yes, I do.

Senator MASON—All right. Carry on.

Mr Cohen—I would like to add to that. The calls that are referred to could well be the physical letter that was sent from CGI to the customer. That amounts to a call.

Senator MASON—You mean the letter was a call?

Mr Cohen—Correct.

Senator MASON—I accept that.

Mr Cohen—I just wanted to clarify that.

Mr Narev—The other thing that I know from the team anecdotally, from December last year, is that at that point—and you are aware that there was a time from December when some communications were handled directly from Colonial Geared Investments to the end customer—there were a large number of discussions between Storm and Colonial Geared Investments during October and November 2008 as the market downturn worsened. Certainly from the Colonial Geared Investments side, it was increasingly realised that the instructions to Storm were not being acted on. From early December—

Senator MASON—Just say that again slowly. This is critical.

Mr Narev—I have mentioned that from the point of view of how the business model worked—the understanding clearly in the margin—

Senator MASON—Why did it change? Why did the process for margin calls change?

Mr Cohen—Could I try and answer the question, Senator?

Senator MASON—Please, yes.

Mr Cohen—The process, prior to that, as you heard, involved the dealer being notified, but also the customer received a letter.

Senator MASON—That is contested. Mr Johnston's evidence is different. But, all right, there was certainly a change. I accept that; we agree on that.

Mr Cohen—The logistical reason for the change was this: we found in the business that notifying the dealer would occur by email or by telephone. Notifying the customer would occur by mail—a letter, physically in the mail.

Senator MASON—From?

Mr Cohen—From CGI directly to the customer. What changed is that we stopped sending the letter directly to the customer.

Senator MASON—Why?

Mr Cohen—The reason was that, due to the mail delays, quite often that letter proved to be useless, because the dealer had already notified the customer. Having received a phone call from CGI—

Senator MASON—Why wouldn't you spend 50c sending a letter in any case?

Mr Cohen—Because we found that the effectiveness of the dealer contacting the customer was high. Sending a letter did not add anything to the process. What we did then—

Senator MASON—I am sure the phone call to the dealer was a good idea. It is great if the phone call from the dealer goes to the client—I accept that; that is terrific—but you could send a letter, it costs 50c, or you could phone the customer. Why didn't you?

Mr Cohen—Because we relied on the dealers to have that personal contact, given that the—

Senator MASON—So you subcontracted a critical commercial decision that affects the money of thousands of people. You subcontracted that responsibility to a third party.

Mr Cohen—No, we would disagree with that.

Senator MASON—You would might disagree with that, but that is what has happened, hasn't it?

Mr Cohen—No—

Senator MASON—It is not your responsibility; it is Storm's. You did not contact the clients. Why not?

Mr Cohen—We did.

Senator MASON—Later. I will get to the timing in a second.

Senator McLUCAS—So you are saying that, in October or November 2008, the response to margin call changed in that you notified the dealer by email or phone, but you decided at that point, or at some time—and I want to know when the decision was made to change—that the

option of sending a letter to the customer directly from CGI was not, in your view, a sensible thing to do. So my question is: when did that policy change occur?

Mr Narev—We are unable to point to the specific time when the policy change occurred.

Senator McLUCAS—Why not?

Mr Narev—What we do know is that it was significantly in advance of 2008—years in advance of 2008 is the best hypothesis. The reason is that, given the people and the business had changed over that long period of time, we are unable to point to the specific time and place that decision was made.

Senator McLUCAS—So you do not have a policy handbook that tracks changes like that?

Mr Narev—Not that change. We would also note—

Senator McLUCAS—It is a fairly substantive change. I think you would agree with me.

Mr Narev—I understand the point but we would also note that the other 7,000 dealer relationships that were run through Colonial Geared Investments were run exactly the same way, and 15,000 margin calls were made through those 7,000 dealer groups in the October through December period by financial advisers.

Mr Cohen—If I could perhaps supplement that answer it may assist Senator Mason's line of questioning as well. Rightly or wrongly I say this: the industry practice in this type of business was for the conduct of margin calls to be made firstly to the dealer group and then the dealer group or the financial adviser would in turn contact the customer. That was a process that was industry wide. It was a process that operated throughout the 7,000 dealers that CGI had a business with. As we have said, we cannot pinpoint the exact date when that change occurred but it was subsequent to 2003 and well before 2008. It was years before 2008.

If I could just add the last fact for you: in the lead-up to the big market falls occurring in October and November of 2008, margin calls were made through all of the dealer groups that were associated with CGI, including Storm. All of the dealer groups, including Storm, up through to September, and even through to early November in Storm's case, were responding to those margin calls—were passing the margin calls on to their customers. In fact, Storm wrote a letter to its customers on 8 October 2008, pointing out that certain actions needed to be taken in order to avoid those customers' falling into difficult positions. It was clear to us that not only were the other 7,000 dealer groups handling margin calls in exactly the way that conduct over the last several years had occurred, but that so were Storm. Things did start to go awry, and we have pointed that out, but certainly in September Storm was passing on margin calls. Certainly in October Storm was passing on margin calls.

In its 8 October letter Storm said to its customers, 'We are monitoring the market and we are monitoring your situation.' During October we received over $600 million worth, effectively, of action in response to margin calls from Storm. It was very, very clear that Storm was acting on margin calls. Storm was passing on margin calls to customers because that was the way the industry was operating and that was the way Storm had operated with us.

Later on when we raised the issue that there did not seem to be enough action occurring in response to margin calls, Storm, in emails to us—we are happy to show them to the committee if that would help—told us not to contact customers directly because customers were their property.

Mr Narev—That was as late as December 2008.

Mr Cohen—That was an email in early December from Mrs Cassimatis.

Senator McLUCAS—In early December you had been advised by Storm not to contact customers?

Mr Cohen—They were telling us not to contact those customers.

Senator McLUCAS—Do you think Mr or Mrs Cassimatis has a right to tell you, the lender, not to contact your customer?

Mr Narev—We do not believe they have a right. In that time, in these market conditions, regular contact was being made about the best way to strike the right balance between the needs of the customers and the needs of the financial institutions involved.

Senator McLUCAS—I have just one more question and then I will leave it for others. You would have heard of Mr Cassimatis's evidence to the committee, where he said that he thought the policy was that it would be like 2003, where it was the banks' responsibility to contact the customer. What do you make of that?

Mr Cohen—Senator, I am afraid to say that we simply cannot agree with that characterisation. We have documents from Storm that make it very clear that Storm was acting on margin calls by passing on the margin calls that CGI was making to Storm. For example, there were emails in September 2008 from a Storm employee saying that Storm had a proven track record of managing margin calls throughout the relationship with CGI.

Storm was highly active in responding to margin calls. There was $575 million worth of response to margin calls directly from Storm by way of redemptions in October. We have already mentioned Mr Fuller saying that no client would ever receive a margin call directly from a lender. We have the instruction from Storm on 16 October 2008, from Mrs Cassimatis, instructing that funds from clients' holdings be put into cash deposit accounts.

We have the fact that in an email of 16 October there are seven staff from Storm claiming to be working full time on the processing of margin calls. It was very clear to us that Storm was active processing margin calls. There was no silence from Storm; there was action on Storm's part. However, what concerned us was that the speed of response and the action taken in response to margin calls declined significantly through November. It was at that point that we decided that we had to take direct action.

Senator McLUCAS—You covered this area earlier, but I would like to hear more about it. It has been said by many witnesses that the information you were providing to Storm was wrong. It was full of errors. How can you convince me that that is not accurate?

Mr Narev—There are a couple of aspects of this that I think are important. First of all, in the immediate aftermath of the end of last year, one of the first things that was done in the Colonial Geared Investments business was to, as best as it could, retrace all the processes that were undertaken at that time. I think I mentioned this before, possibly in response to the Chairman's question. That has suggested to us that we did provide substantially all information and it was substantially correct.

Senator McLUCAS—What does 'substantially' mean?

Mr Narev—Substantially means that—

Senator McLUCAS—Sixty per cent of it was right, or what?

Mr Narev—It is a fair question. The review was unable to say—because of the large number of files that were sent through it over a period of time, it was unable to recreate all of them all the time. The conclusion that was reached is that, at a minimum, it could say that substantially all of the information was provided.

Senator McLUCAS—That does not tell me much.

Mr Narev—What we are committed to is that to the extent that any misinformation may have caused loss to an individual customer, that is something that we would absolutely be committed to putting right as part of the remediation scheme. We know that our systems were substantially reliable. Substantially, as you have identified, does not equal completely, because we cannot at this point say they were completely reliable—although we do not know that they were not—but if that did contribute to any loss that an individual had, then that is something that will be dealt with in the remediation scheme.

Senator McLUCAS—But it is a broader question than that. Mr Cassimatis's assertion is that because your files were so wrong, there were so many errors in them, he could not use them to act. It is not simply about you dealing one-on-one with customers who have been hurt, although that is important. His assertion is that he could not use the information.

Mr Narev—There was also an email as late as 15 October from his son that we received saying that Storm's own systems were giving them the most accurate picture for the client, and in fact they could calculate unit prices as accurately as the fund manager could, to three decimal places, for all of their customers. So based on the feedback we had from Storm during that period as we have gone through it, we have not seen any signs of lack of information. There are two dates that we are aware of where Storm has said in some of the discussions that they did not receive files. I do not have them in front of me. I think there was one in October and one in November. They are two dates that we can verify in our own review that the information was indeed sent.

Mr Cohen—I should add that those are the only two dates that we know of where Storm has told us that they did not receive information. And as Ian has said, our own review has shown that in fact there was information on those dates.

Mr PEARCE—But they also said their own systems were giving them the same information.

Mr Narev—They also said that their systems were given the information.

Senator WILLIAMS—Mr Cohen, Mr Norris has signed the front of your submission. Who prepared your submission? Did Mr Norris prepare your submission?

Mr Cohen—No, there was a team of us involved in the submission, including people on this table.

Senator WILLIAMS—On page 15 of your submission you said:

In 2006-2007, several of our staff with inside knowledge of our operating processes, policies and procedures were recruited by Storm. Moreover, these individuals used their pre-existing relationships with staff in our Townsville area office to encourage loan approvals.

How do you define 'several' of your staff? How many is several?

Mr Cohen—We are aware that you have received evidence to the committee that in fact only one person joined in that particular period, and that is correct. Only one person did join in the 2006-07 period. We said several people had joined in that period. In fact it was both before and after 2006-07 that several people joined.

Senator WILLIAMS—But your statement says in 2006-07 'several of our staff left the bank and joined Storm'. Was there in fact only one?

Mr Cohen—There was one in that period who joined Storm.

Senator WILLIAMS—So what you have in your statement is incorrect?

Mr Cohen—That is not correct that particular statement.

Senator WILLIAMS—Why?

Mr Cohen—Why is it not correct? Because when we looked at the dates of those who had transferred—and I should say, Senator, there were about six to seven people; and I have the exact numbers here if you would like me to be absolutely precise—and joined Storm between 1999 and 2007.

Senator WILLIAMS—So between 2006 and 2007, when you say several, there was in fact just one?

Mr Cohen—There was one person who joined in that particular year.

Senator WILLIAMS—At the bottom of that same page 15 of your submission it says:

… while many Storm clients had relationships with many financial services organisations, when Storm advised its clients to enter into one of our margin loans, this involved staff from other divisions who had no knowledge of the source of investment funds (i.e. via home loans).

But former CBA staff in Townsville who was working for Storm, Kristy Devney says:

This is not true.

She goes on:

The CBA has stated that when Storm advised its clients to enter into one of the CBA's margin loans, this involved staff from other divisions—

as I have just quoted. And she says this is not true. She says that the Commonwealth Bank and Colonial:

… were well aware of the Storm process.

She then quotes a product called CALIA from the CGI website. Who is correct, you or Ms Devney?

Mr Cohen—Senator, I think the reference to CALIA there is also a reference to that document that I said was signed in July 2002 between CGI and the Cassimatises or Storm. There is no dispute, I think, between us and that witness as to whether there was knowledge about that product. That product did involve people taking out loans and investing in securities. To go to your precise point—was there knowledge across the organisation about the way the Storm model operated? The way the CGI business takes applications—and Ian Narev can give you a bit more detail if you would like it—is that an application form is completed by the adviser and the customer. It arrives at CGI with a cheque attached that represents the equity. That equity can come from any source at all, and Ian might be able to give you a bit more detail about that.

Senator WILLIAMS—When people approached Storm, the evidence that the committee has heard this week is that Storm would get a broad outline of the potential client's position, whether they owned their home, whether they had a job, et cetera, and then would forward it to someone like the CBA, and the CBA would proceed with an approval of the application of the loan, if I can put it that way, without even the signature of the client. Did that happen in your lending process?

Mr Cohen—Ross McEwan can give you the exact detail of how that happened, for example, on the home loan side. I think that is what this is referring to.

Mr McEwan—As I said earlier, we would receive a tender document from Storm saying that they had a client that had a certain position and was looking to borrow X dollars—would we please tender in for that business? That tender would go to us and other banks. We would then send back and say, yes, this is the pricing because it was mainly a pricing position they were after. They were trying to get the cheapest home loan rate in the marketplace. We would put in an offer for that and then we would receive a full application from the client via Storm. That would come to us and we would put it through our normal home loan application process.

Senator WILLIAMS—When you went through that process surely the people in the CBA were aware that this borrowing against their home loan was for a Storm investment?

Mr McEwan—Certainly people that were close to it, yes, I would say that in most cases that would be the case because it had come from Storm.

Senator WILLIAMS—When you look at the Townsville branches, you had up to 600 audits of those applications done, I believe, which is what your former area manager of the CBA up there, Andrew Jackson, told us just two days ago.

Mr McEwan—Yes.

Senator WILLIAMS—He was informed down the line from state manager, John Hoey I think his name was, that: 'Congratulations, everything has been done by the book and we have audited a lot of those applications for home loans and there was no discrepancy whatsoever.'

Mr McEwan—When we had a look early in the year around the Storm situation we asked the question: 'We have the margin loan—what has happened on the home loan situation?' So we did request what we call a desktop audit where you actually pull up the file, have a look and see if it complies with policy. That was, I think, the situation in February of this year when looked at, on desktop, 600 files approximately, so you are correct.

Senator WILLIAMS—Obviously, you are happy with the way that those CBA staff had lodged those loan applications?

Mr McEwan—When we looked at those on the first run through they looked as though they were within policy. We look at a number of features within it. Remember, too, that we were looking at it from a desktop position as opposed to pulling all of the files and going through every piece of the detail.

That was in February. As the Storm situation evolved, and we started to see a lot more clients coming in and wanting to talk to us about this situation, it became quite obvious that there were some irregularities in individual cases so we dug a lot deeper than that. That is why we say in our submission there are some areas that were irregular and we are going to have to put those right. That came after we went into a far more detailed review of files. It was a sampling of files that came out of those clients coming in and talking to our people and us setting up that unit.

Senator WILLIAMS—Obviously, that is when you saw something wrong with regard to Mr Jackson, hence he was speared from his position.

Mr McEwan—We have not at any stage said who has gone or what is happening with our staff; we have left that very confidential. We do have a very thorough process of review that has been going now for a couple of months. It is looking not just at the Townsville staff but all staff who had association with the situation. We are going through a major process on that.

Senator WILLIAMS—We heard from a witness yesterday: Sean Mcardle. I do not know if you are familiar with Mr Mcardle, but he was quite surprised to find his $2½ million loan with CGI all of a sudden went to $3 million of debt to his name. He had never put an application in for it and he had never signed anything but found his borrowings from the Commonwealth Bank had blown out an extra ½ million dollars. Are you familiar with the situation, Mr Cohen?

Mr Cohen—I am not familiar with the absolute facts of that situation. In fairness, we have not gone through every single customer yet. That is exactly what the hardship team is doing, and now the resolution scheme as well. Mr Mcardle's case will go before the resolution scheme if he wishes to participate. The actual facts will be dealt with and, as we have said, if we have done wrong in that respect it will be addressed.

Senator WILLIAMS—We have heard a lot of evidence of people's debts going up and up and up, and they were not aware of it. They said that they were not even signing forms for extra money. We have had numerous witnesses say, 'Our debts just went up and up and we were not aware of it.' They obviously put their trust in Storm and in you. As Mr Mcardle pointed out, $500,000 was slammed onto his debt and he did not know a thing about it.

Mr McEwan—Just picking up from the home loan perspective, for us to have lent—

Senator WILLIAMS—No, sorry, I am referring to CGI in that case.

Mr McEwan—Yes. I am just clarifying with the home loan, where they would have to go through an application or a top up process. It would be fair to say that when we received applications, and I think that the committee has heard that our staff said they had made contact with those people, for about 12 per cent of the ones we sampled that had actually not heard from Storm about the additional borrowings we went back to Storm and said, 'This application will not go ahead until we actually have the customer understanding what is going on.' That is my understanding of that situation.

Senator WILLIAMS—Fair enough. I think that is why it is important the committee actually speaks to people like Mr Clothier as well during our investigation.

Ms OWENS—You said before that the responses to the calls by Storm clients slowed in November and at that point you started dealing directly. That is right?

Mr Narev—Yes.

Ms OWENS—You had 7,000 other advisers at that time, and they were very difficult times. Were there other advisers where those responses also slowed? What was your monitoring process for that? What is your process that rings the alarm bells?

Mr Narev—There is a system that we rely on, the Empire System, which helps us with daily unit pricing of the underlying securities and loan devaluations et cetera which trigger margin loan reports. Obviously, the volatility in these markets was unprecedented. In relation to the margin calls made through the other dealers, they were almost without exception executed as intended by the adviser directly to the customer.

Ms OWENS—I know that, but you noticed in November—and initially Storm was responding, as you said—there was a slowing with Storm. Did you notice slowing with other dealers as well?

Mr Narev—Not to the best of my knowledge, but I might ask Mr Comyn to comment on that.

Mr Comyn—To no significant degree at all.

Ms OWENS—But you have a monitoring system that picked that up?

Mr Comyn—That is right.

Ms OWENS—Within how many weeks or days of the slowing starting did it pick it up?

Mr Narev—Pretty much instantly. We are keeping track, with the clients, on the number of their clients and margin calls and on the status of those margin calls on a client-by-client basis. So it is generally a matter of hours and possibly days but certainly not weeks.

Ms OWENS—So you started dealing directly with them in November?

Mr Narev—Storm clients from the beginning of December.

Ms OWENS—Was it when you were meeting with them one-on-one because of the slowing that you started to identify some of the anomalies in the loan processes?

Mr Cohen—Not so much then, Ms Owens, no. What we did understand from Storm clients—our customers—from the time we made contact in early December was that they would not really want to talk about the margin loans or the margin calls with us until they had had an opportunity to consult with the Storm advisers. So there was a period when it was difficult, even with direct contact with the customer, to get action started, because, naturally—and I think it was understandable on their part—they wanted to get advice from their adviser.

Ms OWENS—When you started dealing with people and started noticing the anomalies in the loans, what caused you to start dealing directly with those people?

Mr McEwan—That was probably well into the February-March period, when a number of the customers were having major financial difficulties and starting to look for help from us. It was at that stage, when we started doing detailed analysis of what position those customers were in and pulling their files, that we started to find some irregularities that set off warning bells with us.

Ms OWENS—Do you have systems in place that monitor and flag irregularities on an ongoing basis?

Mr McEwan—Yes, we do. We have a very detailed process through which we put, for example, home loans, and an audit process that shows up certain things as well.

Ms OWENS—Would the irregularities that you found in the case of the Storm clients normally have shown up earlier?

Mr McEwan—It is quite hard to say in this situation. They came about because we delved into these in a lot of detail. As we have said, one of the issues that showed up there was around the valuation system. Those were not things that show up with regularity anywhere else around

the country; we have actually got the data that shows the percentage, and it is a minor percentage. So we were looking for quite specific areas here.

Ms OWENS—Okay. Thank you.

Mr PEARCE—Thank you all for being here this afternoon. I want to ask you a number of questions, but can I start by thanking you for your willingness to acknowledge that, in some areas, you believe there has potentially been wrongdoing and for your willingness to make that right. I am sure that I speak on behalf of all the committee when I say that we really do want to see any wrongs made right. So I thank you for your willingness and your commitment to doing that. I am particularly interested in the relationship between the bank and Storm. Mr Cohen, you have made some comments this afternoon, and I want to get them on the record once again. Essentially, was your relationship with Storm any different to the relationship you had with any other agency or advisory firm that you dealt with?

Mr Cohen—I think it is fair to say that the association we had with Storm spanned a number of areas of our business. As you have heard, there was clearly strong involvement in our CGI business and our home loan business, and thirdly in our wealth management arm, which managed the index funds—these were specific, Storm-badged index funds. So the association with Storm spanned several areas of the organisation. I would say that that is not an absolutely standard arrangement. It is quite common for large organisations to have relationships with us in more than one area, but, in this particular case, Storm did have relationships across three areas. Fourthly—and, again, this is probably a little bit unusual—Storm was also a corporate borrower from the organisation.

Mr PEARCE—Focusing on how margin lending worked, I think you mentioned 7,000-odd people that dealt with you on margin lending. There was no difference between the way that process was being managed with Storm compared to any other advisory firm?

Mr Narev—No; that is correct.

Mr PEARCE—Why is it that the committee has not heard evidence from many other people that had margin loans with other entities? In your view, why is it that we have been inundated with evidence relating to Storm?

Mr Cohen—I will give you our view. We understand that the people who have most experienced difficulty are the Storm clients. That has been our experience as well. Our experience is that it has not been the clients of other dealer groups who have suffered the same hardship and misfortune. It has largely been confined to the clients of Storm. It is probably not appropriate for us to comment on why that is the case. We do not know why Storm may have done what it did, but it is very clear that the extent of problems faced by Storm clients was not a problem shared with clients of other financial advisory firms.

Senator WILLIAMS—Were Storm clients levered up into further debt than other clients?

Mr Narev—The loan-to-value ratio of 80 per cent was the highest among the dealer groups within Colonial Geared Investments, but based on the assessment we have done across the

industry there are other margin lending facilities, at the Commonwealth Bank and at other banks, that were around about the same level.

Mr PEARCE—But, again, there was no difference in the way you did your business in relation to Storm compared to any other area?

Mr Cohen—In the margin lending business, that is exactly correct.

Mr PEARCE—On a couple of occasions in your submission you touch on the area of 'Storm insisted that we contact it, not its customers'.

Mr Cohen—Yes.

Mr PEARCE—But I think you also made the point later in your submission that a request like that is not uncommon. But you seemed to be quite strong on the insistence. Was it a stronger insistence than normal, Mr Narev? I am trying to understand the way that the relationship worked.

Mr Narev—I think again it is endemic to the whole structure of the industry in margin lenders dealing through dealers. You will probably note that in the suggested amendments to the Corporations Law, an affirmative obligation is now mooted to be placed on margin lenders to look behind the margin lending form that they get through dealers into the individual circumstances of the client. That did not exist at the time, and that is endemic to the industry for that part of margin lending which is done through dealers, in contrast—as I said before—with what we do directly with CommSec.

Mr PEARCE—I understand.

Mr Narev—The nature of the relationship is very much one between a licensed financial adviser and his or her client, with the margin lender as a product provider. It is a little bit difficult to comment about whether it is greater or lesser, but for the dealer groups through which Colonial Geared Investments deals, to a greater or lesser extent all of them see themselves as the guardian of the customer.

Mr PEARCE—In summary what you have told us this afternoon—and correct me if this is not right—is that you had a relationship going back quite some years with Storm. Business continued as usual. It happened every day. You sent three lots of data files every day. They were doing what they did; you were doing what you did. That essentially went on for years, through the early 2000s—2002, 2003, 2004, 2005, 2006. But something changed somewhere along the line, and you cannot share with the committee what, in your view, changed with Storm?

Mr Narev—What changed in terms of our relationship with Storm or in terms of Storm itself?

Mr PEARCE—In terms of Storm itself, if there was a change.

Mr Narev—It is difficult from where we stand to affirmatively state what changed with Storm. What we would say—and this is known to the committee—is that the period from September to December that year was a time of unprecedented decline in the equity markets, and

the whole margin lending industry, in addition to other industries, was facing changes that it simply had not seen occur in the history of the people working there. I can only assume that Storm found the same thing and that may have resulted in changes in how it dealt with its customers.

Mr PEARCE—But you are telling us that you did not change your behaviour?

Mr Narev—We did not change our behaviour.

Mr Cohen—That is correct. We cannot know for certain what happened within Storm, but on its face it would appear that Storm struggled to deal with the exceedingly volatile times the market was experiencing.

Mr PEARCE—Importantly, again, you are telling us that nothing changed from your perspective. You continued as you had been doing, is that correct?

Mr Cohen—That is correct.

CHAIRMAN—I would like to take you back to the loans approval process. The contract is obviously between yourselves, as the lender—be it a home loan or a margin loan—and the customer directly, as well as having the intermediary. In your submission you talk about the staff having authority and approving loans. Is an individual member of staff, at an area office or a regional office, the person who approves these loans or do loans go to a central body or a central team in Sydney for their approval?

Mr Cohen—Can we split that between home loans and margin loans, because the practices vary, and we can talk about the delegations, if you like? Mr Narev will talk about the home loan delegations.

CHAIRMAN—Sure.

Mr Narev—Firstly a loan comes in. Our staff have various levels of delegation of authority at the front line and, once they go beyond that, they have to send the loans into a centralised area. For example, the Queensland area goes to our Sydney office.

CHAIRMAN—Where is the final tick on a loan?

Mr Narev—The final tick for a stock standard loan that meets all the policy requirements and has all the information and everything there can be signed off—as long as it is within policy—either with a mortgage lender or, as in this case, at the area office where they have the authority to do so.

CHAIRMAN—That is for home loans?

Mr Narev—Yes, but the next stage is, if for some reason there is something that does not fit within policy, it can go to a different area where people have higher levels of authority to deal with it outside of policy.

CHAIRMAN—Have you found anything extraordinarily different or wrong historically with anything that happened in the northern area, or were they standard and straightforward?

Mr Narev—No; they went to Sydney.

CHAIRMAN—On the margin lending side?

Mr Narev—The margin lending side is different, given the nature of margin loans is that they are a market risk product where the focus is on the underlying security versus the capacity to repay. So, for the Colonial Geared Investments business, an application comes from the dealer—and, as I think has been said before, the dealer completes with the client—and, as long as that loan is for underlying stock which is on our approved list and at loan-to-value ratios which are within our approved list, that is approved.

CHAIRMAN—But that is done in Sydney or somewhere else, not at a local level.

Mr Narev—The Colonial Geared Investments business is all based in Sydney anyway, I think.

Mr Cohen—Again, there is a level up to which loans can be approved and above certain levels they go to another level for approval.

CHAIRMAN—We have heard evidence and had submissions to the effect that clients of Storm did not fill out any forms. They may have signed a whole range of papers, but they did not specifically fill out any information. The information was filled out by ‘someone else’. Would you have an idea as to who that someone else who filled out those forms would have been? Did the bank fill out the forms?

Mr Cohen—Again, this differs between the home lending and the margin lending—so we might get into the specifics a little bit with Ross and Ian—but, in general terms, on the home loans side, when applications were received they were often received completed, and we received them from Storm. Ross can go into a little more detail there. On the margin lending side, applications were also received completed. There were various documents that were signed by the actual borrowers. Ross might give you a bit more of a sense of the home loans.

Mr Narev—To kick off a home loan, you need an application, so that is what we would receive. Then we would make the contact with the client to make sure that what we had was—

CHAIRMAN—Did you always make contact with the client in terms of a home loan, in all cases?

Mr Narev—That is a standard policy and is also what we heard from our staff was the case.

CHAIRMAN—And for margin loans?

Mr Cohen—Not through the dealer channel, no.

CHAIRMAN—So you would not make contact. In the end you took it on faith; whatever was presented to you was it.

Mr Narev—Yes, the focus was on the underlying securities and the loan-to-value ratio.

Senator WILLIAMS—What about repayments?

Mr Narev—This is an important differential between the home loan and the margin loan. Typically for the margin loan, in 80-plus per cent of the Storm cases, the interest was prepaid and effectively capitalised into the loan. Again, the focus is on: what is the underlying security and what is the loan-to-value ratio on the security, because there is not the same regular monthly principal-plus-interest payments in the manner in which a home loan is serviced. That is standard throughout the industry.

CHAIRMAN—The Storm model obviously involved gearing and double gearing, step investment, recapitalising initiatives, and all of that is now known and well documented. The CBA and CGI provided finance and had a relationship, and I understand you also did some due diligence in terms of an agreement or an arrangement you had between yourselves and Storm. What was that due diligence? What did you do?

Mr Cohen—I believe you might be referring to evidence the committee received around some due diligence, in early 2002 I believe.

CHAIRMAN—There may have been another time also, I think, when there was some due diligence done in terms of an arrangement or an agreement. It is my understanding that Storm were making an attempt to have a deeper relationship—a formal agreement put in place—and the Commonwealth Bank was looking at this and did some due diligence in terms of how that arrangement might work.

Mr Cohen—I will tell you what we do know, and it may or may not align with what you have heard. We are aware that at some stage Storm did propose that the Commonwealth Bank get involved in some form or other in relation to its proposed float on the stock market. There was some due diligence done at that point. I believe there was an information memorandum that was provided by Storm to the Commonwealth Bank and I understand that the discussion was around the question of whether or not the Commonwealth Bank would play a role in some form or other in the float of Storm.

CHAIRMAN—And what did due diligence find?

Mr Cohen—We did not proceed. In the end, that discussion and due diligence was at quite a low level within the organisation. It did not proceed through the organisation and, as you know, the Storm float did not proceed either. Is that the due diligence that you are—

CHAIRMAN—That is fine. I just wanted to put on the record what you claimed to be the case.

Senator MASON—The chair has reminded me that we were to have the pleasure of him coming before us in Canberra shortly, so I will not start another round of questions that I was

going to ask. I will leave that for next time. I just want to finish off where I was. I just want to make sure this is correct. Mr Cohen, I think you said in relation to margin calls that there was no letter from the Commonwealth Bank to your customer, and also there was no phone call. Is that correct?

Mr Cohen—Which period are we talking about?

Senator MASON—Post 2003.

Mr Cohen—Post 2003, when the process changed, we changed to a process whereby margin calls were made directly to the dealer. That is correct.

Senator MASON—So you did not contact the customer directly.

Mr Cohen—That is correct.

Senator MASON—No phone call and no letter. All right. I just want to get this right. This was the normal process with other financial dealers. It was quite the regular practice, in fact, the normal practice. Is that right?

Mr Cohen—In the period after 2003, 2004, yes, that was our practice with dealers.

Senator MASON—And it worked satisfactorily?

Mr Cohen—Yes.

Senator MASON—Mr Narev, after 2003 it worked quite satisfactorily?

Mr Narev—Yes.

Senator MASON—Assuming that is all right and the process is working well, you are telling financial advisers and they are telling your clients, it is slightly unusual. What this amounts to is this: by leaving the transmission of the margin calls to Storm—the financial planner—that is allowing Storm, which is a third party, to dictate the timing of the margin call—a critical call that might, and did, prejudice your customers. That is right, isn't it?

Mr Narev—Well, that is correct. What I would say, though, is that I would not categorise lightly the relationship between a financial adviser and his or her client. That is the person to whom they are looking to for financial advice on a whole array of things to do with the specific investment that they have.

Senator MASON—Sure, Mr Narev, but they are your customers.

Mr Narev—They are our customers.

Senator MASON—And you are bearing the risk, and their contractual liability is to you. And you are allowing a third party—you are subcontracting that responsibility to them, by allowing

them to do the transmission of the call. The timing in fact is not from you. The timing is from Storm. I think it is extraordinary.

Mr Narev—I would not describe the relationship as a subcontract. There is a tripartite relationship here between a financial adviser, a margin lender and a client. It is not the case that there was only a contractual obligation going between two of those parties and that it was subcontracted out. The core relationship here through the dealer channel is the critical relationship between a licensed financial adviser and the customer who turns to that financial adviser for advice on a whole array of their financial needs. We have said in our submission that we relied upon Storm to do the right thing and they did not do the right thing. But there is a—

Senator MASON—No-one is actually quibbling with that. The bottom line is, though, the contractual relationship is between you and the customer. As we now know after two weeks of hearings, the late transmission of the advice cost people their homes and their livelihoods. So I assume, Mr Narev—and I think your submission says this—that you agree with the new legislation coming through that demands that from now on you, the bank, tell your customer directly. Why do you think that is a good change?

Mr Narev—My reading of the new bill is that it actually preserves the option as the client's option for that call to come.

Senator MASON—Fine.

Mr Narev—It does not impose an affirmative obligation only on the margin lender. It merely says that the client will have the option of having the call exercised by the dealer or through the margin lender. So it is perfectly conceivable that, even under the new regime, people will receive margin calls not from the margin lender but from their financial adviser.

Senator MASON—If they choose to. Why do you think that is a good change?

Mr Narev—The interesting experience we had is that in December, at the time at which some of the calls were being made directly from Colonial Geared Investments to customers, customers were asking our people: 'Why are you calling us? We want to talk to our financial adviser.' If this has resulted in loss to any individual, I have absolute faith that that will come out in the remediation process. But in the large number of cases the individual sees the primary relationship as being with the person who has said, 'What are your goals? What are your financial needs? This is the product that you should have. Give us a seven per cent fee and we'll look after that for you.'

Senator MASON—Sure, they may. I do not dispute that. Firstly, Storm clients did not have that choice. That is the evidence. Secondly, the contractual relationship is between you, the Commonwealth Bank, and your customer. I still find it extraordinary that you can leave the transmission of that advice—that is, the satisfaction of the debt to you—to someone else.

Mr Narev—The contractual relationship, in its terms and conditions, expressly provides that the margin call may come either from the margin lender or from the financial adviser.

Senator MASON—I understand that, but still the debt is to you and someone else is transmitting that advice. When it is late—as I think is the evidence that we have had—what happens? People lose their homes and their livelihoods because no-one knew that the margin calls had been made. Some may have known, but many did not. We certainly know that.

Mr Cohen—I think it is clear from what we have heard from customers ourselves that some customers did not know that margin calls had been made. What you are alluding to is that that was because Storm, as their financial adviser, had failed to pass on that information. But you are also suggesting, I think, that that was also because the bank itself did not directly go to those customers until we realised that Storm was not doing so. It is the fact that we contacted those clients when we realised that Storm was not doing that.

Senator MASON—I think you explained that this process happens automatically, but when did you first realise that a Storm client would become subject to a margin call? When did that happen? Was it October?

Mr Cohen—No, before then. There were a number of early calls in September.

Mr Comyn—To give you an idea, on 3 October there were 48 outstanding margin calls. So there were very few until late September and early October. Then, obviously, as the market fell substantially in October and November that number rose.

Senator MASON—So that was in late September. The evidence is that you did not contact those people directly until December. Is that right?

Mr Cohen—Early December.

Senator MASON—That is over two months.

Mr Cohen—Actually, it is not that long because the extent of noncompliance with margin calls only became apparent to any significant extent as we travelled through the early part of November.

Senator MASON—Let us go to that. In the past, pre-2003, margin calls had to be satisfied within five days. That is right, isn’t it?

Mr Cohen—That is correct.

Senator MASON—This took over two months. Were you convinced that the clients were taking appropriate action to meet those margin calls?

Mr Narev—When you refer again to the correspondence between Storm and its customers on, I think, 8 October, one of the primary mechanisms that was used was a significant redemption of funds—over half a billion dollars. But between the time margin calls were made and December, nothing happened. There was a high degree of activity and there was a large frequency of discussions between Colonial Geared Investments and Storm about how to get the best outcomes.

Senator MASON—But Mr Clothier says in the letter of 9 February that it was only in December 2008 that CGI became aware that Storm was not notifying clients. Colonial then contacted clients directly. So there was some action, but it was over two months after you first notified Storm. Nothing was happening. Storm did not in fact tell people. I am not blaming the Commonwealth Bank for this, but what concerns me is why there was not greater prudence on your behalf to assure that had been done—over 2½ months.

Mr Cohen—Over half a billion dollars of margin calls were satisfied in the very period you are talking about. That was not inaction.

Mr Narev—Through the redemption of the funds.

Senator MASON—Yes, I accept that—some were. But, as we have heard over the last two weeks, in many cases people did not receive margin calls at all and went into negative equity of 143 per cent, in some cases.

Mr Cohen—Yes.

Senator MASON—So are you convinced that you took sufficient action over the two months? There was some action, of course, from Storm. Are you convinced you did all you could to inform your clients of margin calls that they were liable for?

Mr Cohen—It is a fair issue and it is one that we addressed in my opening address, and it is an issue that needs to be determined—and it will be determined—in a resolution scheme.

CHAIRMAN—Are there automated triggers in terms of margin calls? People do not do this manually. There are not thousands of people individually flicking switches.

Mr Narev—Clients show up on the system as being in margin call—that is correct.

CHAIRMAN—It is automated. So when the trigger point is hit, what happens in a margin call?

Mr Narev—In the Colonial Geared Investments business, as opposed to the CommSec business, a notification is sent to the dealer that these clients of yours are in margin call.

CHAIRMAN—So you are certain that that took place?

Mr Narev—I have mentioned before that, as best as we can guess it—

CHAIRMAN—But that is what you are saying?

Mr Narev—We can estimate it happened most of the time. I cannot stand here and say to you that in absolutely every case it did. If it proved not to have been done and that caused a loss, that is something that will come out in the remediation scheme.

CHAIRMAN—Is it possible to manually override or change the margin call trigger?

Mr Narev—Technically, it would be possible to manually override it, yes.

CHAIRMAN—What I am getting at is: is it possible that there was an agreement in place between Colonial Geared Investments and Storm which meant the trigger point had shifted? Is that possible? I suppose it is just a matter of plugging in the data and saying, 'The trigger point was x; now it is 2x.' Is that possible?

Mr Cohen—We know nothing of any such arrangement. It is a hypothetical and we are not aware of—

CHAIRMAN—So you are saying that is not the case?

Mr Cohen—We are not aware of that at all.

CHAIRMAN—So, for the record, there is an automatic trigger point. It is computer generated. That sends out an email or some sort of notification to the dealer, who is then meant to follow through—

Mr Narev—By making the margin calls.

Mr Comyn—Can I add to that? Generally, what we will receive back is a list by client and the instructions that have been taken from Storm. I have an example here. There are 200 clients on the list and for each client they mention what action has been taken. We had assumed that, as part of that action, they were discussing those actions with the individual clients.

CHAIRMAN—I just want to draw your attention to the Sydney meeting. I think it was on 4 December—is that right? Yes. There was a Sydney meeting with Mr Cassimatis and also—

Mr Narev—Mr Tait.

CHAIRMAN—It was organised by Storm, I believe, to specifically meet with the CEO, Mr Ralph Norris, to discuss some very important matters, obviously, on 4 December. Those matters were the failing business and investments and a way to trade, borrow or cover the calls out of trouble. Are you aware of that meeting and what took place?

Mr Cohen—Mr Comyn can probably comment. But yes, we are aware of that meeting and we are aware that a high-level proposal was put by Storm for the bank to advance more funds to Storm.

CHAIRMAN—Was Storm, or the founders of Storm, trying to cover for every margin call of its clients?

Mr Narev—As best we understand it, the intention was that money would be borrowed by Storm from the Commonwealth Bank to meet the margin calls of its clients.

CHAIRMAN—Of the Commonwealth Bank?

Mr Narev—Of the Commonwealth Bank.

Mr PEARCE—How could Storm borrow money in its own right to meet the margin calls of individual clients?

Mr Cohen—We do not know what arrangements Storm had proposed between it and its customers. Storm, as I think I mentioned a little earlier, was a corporate borrower from the bank in its own right. We lent money to Storm in its own right for its own corporate purposes, not for its client purposes. The arrangement that was being proposed, as we understand, was that the bank lend further money to Storm and Storm in some fashion—frankly, this proposal did not go far, for fairly obvious reasons—would fund customers to meet their margin calls. I know some importance has been attached to this by various witnesses, but it was actually against the interests of the Commonwealth Bank and it was against the interests of our shareholders. In fact, the liquidator of Storm has reported that Storm was insolvent in early December; making a further loan to Storm in those circumstances had all sorts of legal and insolvency implications.

Senator WILLIAMS—Did you lend Storm $10 million in October just prior to that?

Mr Cohen—There was a drawdown of an existing facility in, I believe, September or October.

Senator WILLIAMS—To pay out a facility they had with Macquarie Bank?

Mr Cohen—I am not aware of the reason.

Senator WILLIAMS—Macquarie says in their submission that in October a facility was paid out to Macquarie. I believe it was a $10 million facility that you lent Storm in October 2008. You might be able to check on that for us.

Mr Cohen—We can certainly take that on notice.

Senator McLUCAS—I will go back in time a little bit. I want to know who makes the decision to sell down stocks and where that fits in terms of the advice of margin call. You are saying there was no action on the margin call. What is the next step and when did that all start happening?

Mr Cohen—If I understand the question correctly you are asking how the sale of the underlying fund investments occurred?

Senator McLUCAS—Yes.

Mr Cohen—In essence, once a margin call had been made, Storm, particularly in the October period, actioned that call. It would action the call by directly contacting the fund manager and ordering redemptions of the units held by individual customers in that fund. The fund manager, on receipt of a redemption request, would then seek to sell the underlying securities held by that fund and, in effect, redeem that customer out of the fund by liquidating the underlying securities.

Senator McLUCAS—So who makes the decision on the time to do it and who is advised of that decision?

Mr Cohen—That is a decision that is up to the relationship of the financial adviser and the client. As we saw from the letter of 8 October that Storm wrote to its customers, it was advising its customers to liquidate their holdings in the funds into cash. What we saw occur during October was the implementation of that advice by Storm by ordering redemptions of their clients' units in those funds.

CHAIRMAN—So they ordered the redemptions?

Mr Cohen—Yes.

CHAIRMAN—In all cases?

Mr Cohen—Are you asking whether it was sometimes CGI and sometimes Storm?

CHAIRMAN—Yes.

Mr Cohen—The situation was that it was up to Storm to take the particular action in consultation with their customer. A margin call can be satisfied in several ways, of course. It can be satisfied by, for example, paying more cash in. It can be satisfied by selling down some securities. In this case, Storm's advice on 8 October was to liquidate up to 100 per cent of the fund units in order to preserve against further losses as a result of a deteriorating market.

Mr PEARCE—They wrote to their client saying that and got their customers to sign a form?

Mr Cohen—Correct.

Mr PEARCE—They then presented those forms to you?

Mr Narev—As I understand it, there was authorisation to present them directly to the holders of the funds, Colonial First State and Challenger.

Mr PEARCE—So Storm provided those signed form and then the action took place.

Mr Cohen—That is correct. The purpose of allowing direct interaction between Storm and the fund manager was to facilitate those transactions. Because the market was moving rapidly, delays in implementation could result in swings in market value of a considerable amount.

CHAIRMAN—What was so wrong with the Storm badged fund that led to its complete closure, rather than just a selling down of position and allowing it to continue to exist?

Mr Cohen—There were a number of Storm badged funds that were administered by our wealth management arm. Those funds in turn invested in underlying securities. Most of these funds were indexed funds; they tracked the ASX index.

CHAIRMAN—Does that mean the fund was geared?

Mr Cohen—Was the fund itself geared? I would have to take that on notice.

Mr Narev—No, it was not geared. They were unleveraged index funds.

Mr Cohen—These were indexed funds, so they just tracked the ASX index. The process was that once redemptions started to be received, the underlying securities needed to be sold in order to fund the redemptions. These funds went from approximately $700 million down to $46 million in a matter of six weeks. The four indexed funds that I am talking about therefore ended up with roughly $11 million in each fund. The result of that was that those investors who still had their investments in that fund were effectively bearing all of the administrative, management and running costs of those funds amongst what was now a relatively small number of investors, as opposed to when a much larger number of investors were involved. The running costs are not insubstantial because those funds have derivatives and hedges in place.

The trustee of those funds, which is a member of the Commonwealth Bank Group, needed to look at the interests of investors who were remaining in those funds, not the investors who had got out of those funds. It was therefore essential that we take a view as to what was in the best interests of those remaining members. Also, it is probably relevant to know that because these funds were indexed funds—they were tracking the ASX index—with such a small amount left in each fund there was a serious risk that those funds would fail to comply with their mandate, which was to invest in the index in proportion to shares in the index. From a trustees perspective, it is obviously a major risk to fail to meet the mandate in accordance with the constitution of the fund. Taking into account the interests of the investors, the costs of the funds, the fact that those costs were now going to be met by an increasingly small number of investors, the trustee made a decision to close the fund in order to ensure that those investors did not suffer unduly. It was very much a case of intergenerational inequity potentially arriving as a result of leaving those funds open for too long.

Mr PEARCE—It was negative arbitrage because those customers that were left were having to pay the full cost of the funds. Because there were fewer customers, the per customer cost was significantly higher than when there was a lot of customers. Is that right?

Mr Cohen—That is correct.

Senator McLUCAS—When did that occur, Mr Cohen?

Mr Cohen—The closure of the funds occurred in early December.

CHAIRMAN—Mr Cohen, we have heard lots of evidence from really decent people who thought they were safe by investing with the Commonwealth Bank of Australia and its related entity, Colonial. They firmly believed that the bank would ride out the market fall with them and then come back out of it as the market recovered. Why did that not take place?

Mr Cohen—Are you asking why the bank proceeded with selling down and why the funds proceed with selling down, and why we did not just wait until the market corrected itself?

CHAIRMAN—Yes. The view of a lot of people was that, if there was sufficient agreement, relationship and business between Storm, Storm's clients, and the Commonwealth Bank, there was an arrangement in place that meant you would possibly ride it out with them or the bank would stick with them. Why did that not happen?

Mr Cohen—With the benefit of hindsight it is relatively easy for people to say that if we had all just hung in there for a few months more we would have been fine. Nobody had the benefit of that hindsight in November and December. Markets were going through unprecedented volatility. We had not experienced volatility like that since the early 1930s. It was not a sensible decision to take a bet on the markets continuing to rise. In fact, with the benefit of hindsight, we all know that the markets fell substantially again between December 2008 and March 2009.

Many of those customers—and we do understand the reason people say this; I think it is an understandable human reaction—now say: 'Look at the markets now. If we'd simply hung in there, we wouldn't be in this position.' It is a perfectly understandable human reaction. I am afraid, however, that there is a good likelihood that, if people had stayed in their positions through December 2008 and January and February 2009, as the markets continued to fall, they would be in a substantially worse position. I know that does not appeal to customers who face hardship at the moment, and that is why we are trying to deal with that hardship.

Senator WILLIAMS—I can see where you are coming from there, but have a look at the customers' position. Let's have a summary of what we have heard this week and here today. No doubt Storm Financial was a river of gold for the Commonwealth Bank and CGI to invest in. You would have invested hundreds of millions, perhaps even billions, of dollars in that program. We have heard from Andrew Jackson, a former area manager in North Queensland. The target levels of his branch were raised from $530 million or $540 million one year to $760 million the next year. His targets are set by your head office or hierarchy and your people in lending have to try and meet them—in other words, they have pressure on them to sell, sell, sell. You obviously had a lot of confidence in huge growth up in North Queensland.

We have had the situation where people, many of them elderly and on pensions, have mortgaged their houses because they trusted their Storm adviser and trusted your organisation. When 90 per cent LVR came, to save them from losing everything in their life the gate did not drop because of your relationship with Storm, or Storm did not carry the duties out properly, or you had a system where you trusted Storm to notify those very customers and they did not, where perhaps you should have been notifying them yourselves earlier. The one safety net they had did not capture them and they lost everything in their lives. Where do we go from here? Surely in future you will set up a situation in your organisation where you will contact the customer to let them know if they are in marginal calls so they can take action and do not rely on a third party to do that. Have we learnt that lesson in the whole episode?

Mr Narev—I have a couple of responses, certainly in relation to the Colonial Geared Investments side. First of all, in terms of our internal discussions about this reaction, the thing that weighs most heavily on us personally and as an organisation is the plight of the people.

Senator WILLIAMS—I can understand that because I have literally spent months trying to keep people alive.

Mr Narev—I understand that, and that has been the front and centre focus, which is why our first priority is to get our resolution scheme up and running and put significant organisational resources behind it. At no time since this has happened has the plight of people done anything else than weighed heavily on the organisation, and our primary responsibility at the moment is to put right where we did wrong, as our chief executive has said. In terms of the margin lending

business specifically, we obviously are looking very carefully at the proposals in the corporations bill. We have said in our submission that we support those and we are already putting plans in place to implement those fully. What it is important to recognise, however, is that they do represent a fundamental change to how this part of the margin lending business was conducted inside the Commonwealth Bank and outside the Commonwealth Bank at the time. That helps these people very little, I understand, but those obligations are being taken very seriously.

Senator MASON—But in future, will you be contacting people in how take out a margin loan directly? That is the question: will you be contacting them directly after this shocking experience?

Mr Narev—We will first see where the law gets to, but I would say with a fairly high degree of certainty that that is something we will look at very carefully.

Senator MASON—Thank God for that. At least we have got that far.

CHAIRMAN—Gentlemen, thank you very much. Thanks to everybody in the room as well. Thank you for your submission.

Mr Cohen—Chairman, if I could just finish by reiterating a couple of key points. We acknowledge that people have suffered hardship, and we have said we are not proud of that. We want people and the committee in particular to understand that we are genuine about doing something for these customers. We do not enjoy seeing our customers in hardship. We see the need and we hope that our resolution scheme, once it goes through, will show the community, our shareholders, our customers and you that the scheme is worthwhile, that it is providing a swift and fair outcome and that the Commonwealth Bank actually does care about its customers. We care a lot about our customers. We certainly do not appreciate the fact that they are suffering hardship. We do want to do something about it.

CHAIRMAN—Thank you.

[3.00 pm]

FREEMAN, Ms Elissa, Senior Policy Officer, CHOICE

CHAIRMAN—Welcome. I invite you to make some opening comments.

Ms Freeman—Thank you for the opportunity to appear before the committee. There is a broad expectation amongst consumers that financial advisers will act in clients' best interests and provide unbiased and impartial financial advice. Consumers pay for financial advice services with the expectation that they have someone on their side to help them navigate the decisions they make. We suggest that the conflicts of interest, particularly in the remuneration arrangements received by advisers, and failings in the legal duties mean that very few consumers are in fact getting what they expect from their financial adviser. People are genuinely surprised to learn that financial advisers have no explicit obligation to act in their clients' best interests. There is a mismatch between clients' expectations of the service provided and the obligation of advisers under the Corporations Act.

The requirement to disclose conflicts is often more of a hindrance than a help. People are poorly equipped to identify, accept and account for the impact of conflicts on advice, mainly because consumers simply do not expect conflicts in the first instance. Disclosures are not sufficient to counteract a client's own understanding of the role of an adviser. There is also evidence to suggest that disclosing conflicts can perversely increase consumer confidence in the advice rather than act as a stark warning on the quality of advice. We clearly need new laws to improve the obligations financial advisers have to their clients. A fiduciary duty on financial advisers would establish a legal obligation to act in good faith in the best interests of clients. This new legislative requirement would lead to a higher quality of advice and the emergence of a professional advice industry that is in line with consumer expectations of advisers.

Along with this reform must be a concerted effort to remove structural conflicts of interest in the remuneration arrangements. These conflicts can arise in a number of ways. Conflicts can mean that advisers are effectively salespeople of product providers. Conflicts can encourage advisers to sell products instead of providing strategic advice. Conflicts may provide incentives to recommend products that are inappropriate. They can encourage advisers to churn clients through products. Worse yet, they can encourage clients to borrow inappropriately to invest. Upfront and trail commissions, asset based fees, soft dollar commissions and volume bonuses all exhibit one or more of these conflicts. This is not a marginal problem. Around 85 per cent of adviser revenue is generated through these payments.

The primary focus of the fee versus commission debate has been one of disclosure and consumer control, both of which are very important but which divert focus from the nature of the fees being charged. Many in the advice industry are promoting asset based fees with the suggestion that they are somehow conflict free when they are not. The problem with any asset based charge is that it carries the same taint of conflict as commissions. There are incentives on advisers to favour strategies that involve debt in gearing to build assets that generate fees for advisers. If the industry transitions from asset based commissions to asset based fees, the

disclosure may be better and consumers should have the ability to turn off those fees, but the market distortions arising from asset based charges will remain.

The CHOICE submission proposes that ASIC be given the power to exclude remuneration arrangements that are inconsistent with fiduciary duties an adviser owes a client. This would have the effect of excluding financial remunerations that entail any conflict of interest. It would require that upfront and trail commissions, asset based fees, soft dollar commissions and volume bonuses be banned from the advice industry. Improving the quality of advice requires that we systematically remove remuneration arrangements that create conflicts of interest. That will mean structural changes to the industry and, specifically, changes to the way advisers are paid for the advice they provide.

But, even once the distorting influence of current remuneration models is removed, there will remain circumstances where consumers are given poor advice as a result of negligence or dishonesty. That is why it is essential that consumers have access to compensation mechanisms, including a financial service compensation scheme of last resort. The recent collapses have highlighted a significant gap in consumer protection mechanisms afforded by financial services regulation. Even if a retail client of a licensee is awarded a sum in compensation by an external dispute resolution scheme or a court, they may never receive that sum. Of the 81 Westpoint cases in which binding determinations were made by the then Financial Industry Complaints Service, 36 cases with a total value of $2.2 million have no prospect of payment due to the liquidation of the licensee. Unfortunately we are likely to see a similar outcome in the case of Storm Financial.

A last resort compensation scheme is an essential element of the compensation regime. It would provide compensation where licensees have breached their licence conditions and are otherwise unable to compensate consumers—for example, due to liquidation. The scheme would bring Australia’s financial services compensation arrangements into line with those of other international financial services hubs such as the United Kingdom and with other sectors of the Australian economy that already have schemes in place—for example, the Australian Stock Exchange.

CHOICE is here today because we have spent more than 20 years warning about the structural conflicts of interest in the advice industry. The conflicts are real, they undermine the quality of advice and they contribute to investor losses. Disclosure has not worked. It is time to start dismantling conflicts and build an advice industry that consumers can trust. Thank you. I am pleased to take questions.

CHAIRMAN—Thank you very much. We really appreciate both your submission and your additional information today. I will just take you straight to 2.1 in your submission, ‘Commissions and conflicts’. I particularly want you to explain a bit further the issue of churning of clients. You refer particularly to life insurance products, funds and other investments that were particularly related to an adviser. Could you just give us a bit more detail about what you see as churning of clients.

Ms Freeman—Churning relates to the specific example where a client, perhaps, already has an investment product and, on the advice of a financial adviser, they move from a similar financial product into a new one. The conflict that arises is because, in making that switch between very similar financial products, the adviser generates an income stream for themselves.

It really relates to up-front commissions and trail commissions. So when an adviser receives a new client it is certainly in the adviser's interest, if the client does have financial assets, to transfer them all over to new financial assets that generate a commission for them.

CHAIRMAN—What is the most practical way to prevent something like that happening? Is it just to get rid of commissions?

Ms Freeman—Yes, removing commissions would entirely prevent that from taking place.

CHAIRMAN—So how would people be paid? For life insurance, for example, it may be quite difficult or expensive to organise and plan for someone. How would you otherwise pay for life insurance if not through a commission?

Ms Freeman—The simple answer is a flat fee, but clearly that is not going to be something that would be appropriate in all situations. I think that within superannuation funds insurance is a very viable option and does not necessarily come with the same trail commission arrangements, so it would really depend on the particular circumstances of the individual insurance option that is being looked at.

CHAIRMAN—We have not heard a lot about churning, so that is why I am interested in it. We have had lots of submissions and evidence on a range of things, but churning, although I have heard of it, is new in terms of the evidence we have. How deep is it in the sector? How common is it?

Ms Freeman—I think it is fairly common. We have included a case study in our submission which is, I think, a situation that would arise quite often. When a new client seeks out a new financial adviser, often the first thing that we hear reported to us is to look at the superannuation fund arrangements. Superannuation is a very important financial asset for just about every Australian, but the trail commissions that can be generated from superannuation arrangements are also very significant. So superannuation is a particular target of churning in the advice industry.

Mr PEARCE—Just on that point, when you say 'often', what are we talking about? Can you give us a sense of what 'often' means?

Ms Freeman—Often that we hear from them or often that the—

Mr PEARCE—Yes. You just said then, and you also say elsewhere, 'Consumers often reported to us.' So what is 'often'?

Ms Freeman—Earlier this year, in line with this inquiry, we put out a call to our members to ask them to communicate with us about their experiences with financial advisers.

Mr PEARCE—So these consumers are your members.

Ms Freeman—We communicate directly with our members, but we also make our website information and services available to the broader public. Certainly all the work we have done

around conflicts of interest in the advice industry has been available to the general public. But the direct communication most often is with our membership.

Mr PEARCE—What is often? What was the frequency?

Ms Freeman—Over the last four months we have had hundreds of consumers communicating with us about their experiences of financial advisers. That is in relation to a direct call that we have made to them. It is often in the context of asking them about a particular problem that they are experiencing that we will have hundreds of people getting in touch with us.

Mr PEARCE—Do they contact you via email?

Ms Freeman—Yes.

Mr PEARCE—Are you in a position to provide the committee with some of that feedback? Would you be able to give us a report on it? I am really interested to know about this churning aspect, to take your point, Mr Chairman. Were they from a particular state? Were they from a particular demographic? Were they older people? Were they younger people? Were they from Tasmania? Were they even from the far north coast of Queensland, for example?

Ms Freeman—I think the short answer would have to be no.

Mr PEARCE—You are not in a position to give us that information?

Ms Freeman—The short answer will be in no—let me explain why. It is for two reasons. Firstly, when I say that hundreds of people have gotten in touch with us, not every consumer will raise the specific issue of churning. Secondly, we do ask people when they get in touch with us whether they are willing to go on the record with their comments and the vast majority simply are not.

Mr PEARCE—I am asking if you can give us a report of the number and where they are from. We are not interested in Mrs Jones who lives at 2 Brown Street.

Ms Freeman—Again, unfortunately no because we do not ask them for specific information.

CHAIRMAN—That is fine. Focusing on churning, in your opinion or experience across the sector, would you say this is so common that it invariably happens with almost all advisers? Is there this irresistible temptation where, if somebody comes to you, you would automatically try to bring all of their assets and whatever investments they have in line with your product list?

Ms Freeman—I think that any consumer who is seeking financial advice would reasonably expect a financial adviser to look at the full gamut of financial products that they hold. You would certainly expect a financial adviser to be looking at your current superannuation arrangements and your current insurance arrangements. The concern that we raise is largely based on the way in which the adviser is remunerated. You have to disclose upfront, I would suggest, those who are being paid by upfront fees. Our specific concern is where the adviser is being remunerated through commission arrangements. I would suggest that you are more likely

to see churning happening where there are commission arrangements in place than where there are fee-for-service arrangements in place.

CHAIRMAN—I am also concerned, but I am thinking it might be difficult to distinguish between those that are churned and those that would be just a case of bringing them across to your platforms. Would that be difficult to distinguish?

Ms Freeman—Yes, it would be very difficult to distinguish. Part of the reason that we have advocated for a new fiduciary duty is so that, where there are a number of options available—particularly, for example, in superannuation—the adviser is required to recommend the best option for the client. Because that does not happen at the moment, it is very difficult to say whether we have instances of churning simply to generate commission or whether there is in fact a recommendation that is in the best interests of the client.

Mr PEARCE—In relation to this churning, on page 8 of your submission, you say:

In fact pretty much whenever a client changes planners they will get switched into products on the new planners approved product list and that is what pays the best commissions, soft dollars, loans etc for the new advisers practice as a whole

Can you tell us what evidence you have of that?

Ms Freeman—First of all, let me be clear that I am talking about the specific situation where there are conflicts in the remuneration arrangements being charged. This is a generalisation within that particular situation. In terms of making recommendations from an approved product list, that would be standard practice across the industry.

Mr PEARCE—But that is not what I am asking, Ms Freeman. I am very interested in this area, as the chairman said. I will ask the question another way. You have made this statement; what did you base it on? What evidence do you have for that?

Ms Freeman—I suppose I am not going to answer that the way you would like it answered. I am going to answer it this way: if the laws were such that we could be assured that every time advice was given to recommend a particular product that was being recommended in the best interests of clients then we would have no basis to make this sort of claim. But without that being the case, we look broadly at what is happening in the industry and we cannot be sure that the recommendations that are being made are in fact in the best interests of clients.

Mr PEARCE—I understand that, but that is not what you have said. I understand what you have just said there, but that is not what you said in your submission. What you have just articulated is very logical and very sensible, but in your submission you are saying that it is in fact pretty much whenever. When we receive a submission like this, the question always arises about what that is based on. When I read your submission, that is the one thing that crept out at me. I thought that was a very important statement and I would like to see the evidence for that. Are you saying you cannot provide any evidence for that?

Ms Freeman—I do understand what you are saying. It was a very broad generalisation, but it does characterise our broad concerns with the industry.

CHAIRMAN—Would it be fair to say in relation to that that this happens invariably all the time and it is just difficult to distinguish whether it happens specifically because there is a commission or because it is in the best interests of the client? Since you cannot tell the difference, you therefore end up in a position where you say, 'Everybody does this, but we can't—

Ms Freeman—That is precisely the case.

CHAIRMAN—That is how I understood it.

Senator McLUCAS—Ms Freeman, I know you have not had a lot of experience with the detail of Storm Financial but that is one area that we are meant to be following up. I do not know if you have been here for some of the day. You have?

Ms Freeman—Yes.

Senator McLUCAS—One of the things that concerns me is that, because of the nature of the product that they were selling, the way they encouraged—and I think that is a generous word—people to participate and the whole model they were operating under meant that the power relationship between the investor and the product seller was very inequitable. It may be the case but I do not know that if we change disclosure rules, change the Corporations Act and bring in the legislation that is being looked at now whether that would really protect these consumers. I feel that it would not. I asked a previous witness whether we need an independent tool so that a potential consumer, once they have received the package of measures from a financial planner, could plug those elements into a formula that would be able to indicate to the potential consumer whether or not the product or the product mix is low risk, medium risk or high risk. Consistently over the last few days we have been told that when these people went to the planner they said, 'I don't want to lose my house,' or 'I am a very low-risk investor,' as most people in their 60s are. But they still went into what anyone with any financial knowledge would know was a very high-risk strategy. Do you have any comments on whether or not you could devise something like that or on what you would do to assist people to balance out that power relationship a lot more?

Ms Freeman—I think you have characterised it very well. Even if such a tool were to be developed, people still put their trust in their adviser. If the adviser is not doing their job properly then I do not think any sort of tool, no matter how good it is, is going to change the quality of advice that the adviser provides to the client. I know that ASIC is looking at the sorts of risk warnings that should apply to various products—and I am involved in some work that is being done, particularly within superannuation—but that is not going to be a solution. The evidence we have heard in this inquiry and the submissions to this inquiry are a very good characterisation of how people perceive financial advisers. The reality is that the legal protections that are afforded to them are not in line with people's perceptions of their financial advisers. Very large wholesale changes to this industry are being mooted. There are very large structural changes that CHOICE is supporting. They are changes that will fundamentally shift the financial advice industry away from its roots as essentially insurance salespeople to independent, impartial providers of financial advice. And it is a shift that needs to take place.

Having said that, I do agree with you that that is not going to solve the problem. That is why in my opening statement I raised the issue of compensation arrangements. The very important

reason why a person would seek licensed financial advice is that they do have access to compensation if they receive bad financial advice. So we need to make sure that the structure of the financial advice industry is right and that it is in line with consumer expectations. But also, when something goes wrong, people must have access to adequate compensation because things will go wrong.

Senator McLUCAS—In the case of these clients of Storm, adequate compensation would be an enormous amount.

Ms Freeman—Yes. I am certainly not in a position to say what sort of compensation would be required. But if people do not have confidence that bad advice will be punished and some form of compensation will be received then I do not see how consumers can have confidence in the financial advice industry.

Senator McLUCAS—The compensation fund that we have at the moment is professional indemnity insurance. We heard from Mr Cassimatis that he had $40 million of PI.

Ms Freeman—Yes. Our submission outlines a series of problems that we have seen with professional indemnity insurance. Ultimately that insurance does have limitations. It does not cover investors where there is potentially fraudulent activity or where the adviser has gone into liquidation. These are the areas, unfortunately, where problems happen. When consumers need protection and compensation, it is because these very extreme events have taken place. We outlined in our submission a number of reforms that we would like to see made to the professional indemnity insurance scheme, but we also recognise that that will never be the final solution and a compensation scheme of last resort is in fact needed. I am aware that various models have been drafted. The former financial industry complaints scheme has provided quite a detailed version. We have had a look at that and we think it is quite good.

Senator McLUCAS—Finally, coming back to whether we could devise some sort of tool, does CHOICE think we could make it compulsory for a potential investor to use the tool, to have some sort of external assessment? I am not saying you should have to go to another financial adviser for another piece of advice—that would be very expensive—but could we force a consumer to go and use this tool prior to making an investment? Is that fair?

Ms Freeman—I do not know that you could compel someone to access that sort of information. I think that would be very difficult to achieve.

Senator McLUCAS—There are ethical issues around that as well.

Ms Freeman—Yes. There is a wealth of financial literacy information available. There is ASIC’s fido website and the Understanding Money website, and there are other individual organisations that produce excellent information. There is not an absence of information to help people understand their own risk profiles or understand the risk attached to different sorts of products. I know that ASIC is constantly working to improve those financial literacy resources, and I am aware of the sorts of interactive tools that they want to introduce shortly, but even that will not address the problem that we have seen with Storm Financial.

Senator McLUCAS—I think you are right.

Ms OWENS—On the subject of the fees that people are paying, do you get a sense from your research and your phone-ins that people are aware of what they are paying and how advisers are being paid?

Ms Freeman—The people who tend to talk to us are generally the more astute and savvy consumers, I have to say. So the ones who talk to us do have some understanding of their fees. That does not mean they are necessarily happy with the fees they are paying. In looking at the submissions Storm Financial's clients have made to this inquiry it certainly struck me that there was a very low understanding of the gross effect of the fees. This is a problem that we see with commissions and asset based fees. The percentage figures tend to underestimate the gross impact of fees over a period of time. People tend to work in dollar terms, and percentages do not lend themselves to being easily comprehended. Part of the reason that we favour fixed dollar fees for fixed services is that it is much clearer to the individual consumer precisely what they are paying for the advice. Unless you know how much you are paying it is very difficult to determine the quality and level of service that you are receiving for that advice.

Ms OWENS—We have heard evidence from a number of different bodies that up-front fees would increase the cost to such an extent that it would price the service out of the range of less affluent investors. Do you have any sense of whether that is right or wrong?

Ms Freeman—I reject that outright. ASIC's submission stated that they do not believe there would be an increase in the cost of advice. There has been research done, particularly by Industry Super Network, which has found that commission based payments can be anywhere from two to 12 times the cost of equivalent up-front fee services. So I simply do not accept that the overall cost of advice will go up if we move to a fee-for-service arrangement. That does not mean that there is not this sort of 'money illusion' to overcome—this sense that people do not want to pay big lump sums for advice up-front. Again, I think this is part of the structural change in the industry. Through this process we will be holding the hands of consumers as well as holding the hands of financial advisers. Just because you are charging, for example, a lump sum fee for advice does not mean that a customer is in effect paying that all in one hit. You could easily have an arrangement where the payment is made over a period of time, as happens in other industries quite regularly. So there is the issue of the total cost of the advice, which I simply do not accept would go up, and then there is the issue of how it would be paid. I think there are all sorts of ways to accommodate the needs of both consumers and advisers.

Ms OWENS—There was also a suggestion that having the fees up-front would actually lead to competition on fees and may actually result in a reduction in prices.

Ms Freeman—Yes, I think that is quite likely. Fees at the moment are largely hidden. I still hear from consumers occasionally who think that they are getting free advice, and nobody is getting free personal financial advice. It is this distortion that commissions create. The product provider is essentially setting the fees in many cases so it is sort of understandable why people would not necessarily draw the dots, but it is their money that those payments are being made from.

So, moving it up-front is going to create greater clarity for consumers. It will create a competitive dynamic amongst the adviser community. One of the problems that I have at the moment is that people often ask me how much it should cost for different types of advice. It is

very, very difficult to say that with any degree of certainty. Looking at any other industry I would be able to tell you approximately how much it would cost to see a lawyer for this sort of advice or to see a dentist for this sort of work, but, because the fees that are charged are so hidden, it is very difficult to provide that sort of guidance to consumers. I think that moving to a fee-for-service remuneration structure will bring that much more clarity to the industry that people will have a much better sense of how much it costs to get advice and, therefore, how to understand the quality of service that is being provided.

Ms OWENS—One of the things that was clear about the collapses—and there were several of them in recent years—is that there were no early warning systems. If you dig around you will find people who thought that this was not right and that was not right and advised their clients away. But there was no early warning system whatsoever to catch what was probably increasingly becoming evident over a substantial period of time. Do you have any ideas on what kind of systems could be in place?

Ms Freeman—I have to disagree with you because I think the warning signs were there from the very beginning; it is just that they were so hidden that people could not see them. The warnings that were there were about the conflicts of interest. The conflicts would have been disclosed in statements of advice but they would have been buried deeply, in the worst case, in a footnote on page 50 of a 100-page document. I know that this is generalising very much the so very severe collapses that have taken place, but conflicts of interest are so poorly understood by consumers; they are supposed to be the early warning sign that the advice you are receiving is not as clean, tidy, impartial and unbiased as you would like it to be. But people do not read those conflicts in that way. As I mentioned in my opening statement, there is in fact evidence that suggests that disclosing confidence, perversely, increases consumer confidence in the advice because they see it as very forthright and forthcoming for an adviser to acknowledge that they do have these particular relationships. These are the sorts of perverse arrangements that are in play in disclosing conflicts. That is why our preference is to simply get rid of these conflicts in the first instance.

Ms OWENS—How long has Choice been collecting information, even anecdotally, on the finance services?

Ms Freeman—We published as early as 1987. I have with me today an article from 1990, and it could have been published today!

Ms OWENS—I have asked this question of most witnesses and rarely get an answer: we have had 15 years of unprecedented growth and it was as if all our roads suddenly went downhill—there would never be another hill. So we have had what I would call ‘cars’ made that could not go up a hill; they were made to go down. We have had products that were made for good times and we have had this growth in customers, including people getting large superannuation payouts late in their life—their first investment ever—people getting de-mutualised and people buying shares. So we have had this growing customer base of inexperienced investors and 15 years of boom at the same time, which is a very volatile mix. Up to the global financial crisis we do not see a lot of evidence of the industry identifying that as a potential issue and making recommendations about how the industry would function, even if it continued to grow. If we had had another five years of boom we would have had an even bigger collapse, eventually. Has Choice noticed trends in the industry over the last 10 years that it has sought to address?

Ms Freeman—We have observed all the same trends as the rest of the community and we have certainly published a lot more information, for example, on superannuation. We publish regularly on what we call complex financial products. Just this month we published on options trading. To clarify, Choice is a publisher of consumer information as well as an advocate on behalf of consumers. We identify the sorts of products that we should be publishing in part by identifying the sorts of products that are being mass-marketed to consumers. Also, we have our own warning systems that we use to identify which products we need to be looking at. So that is broadly how we approach it.

As I said, we have been publishing, probably unusually, some of the more complex products, simply because we have noted that they have been pushed so heavily to consumers. I was very pleased to see that one of the terms of reference for this committee is to look at the marketing of financial products, because I can tell you that one of the trends we have clearly observed is that much more complex market products are being marketed direct to consumers. That is an area of concern for us.

Having said that, I will say that Choice has not always been ahead of the game. There have been products that have gone by that have collapsed, and I have regretted that we have not published earlier. We did not see the warning signs for products. We did not publish on Storm and we did not publish on Westpoint. We do not have a crystal ball that others do not have. There has been an explosion in the types of products that are around and the complexity of products. We pick products that we can report on and we do.

CHAIRMAN—Is it the products that fail, or is it the advice on the products that fails?

Ms Freeman—Both fail. I can tell you that, in terms of Choice's position, the only thing that has been consistent is our position on the problems with the advice industry. There has been very little change. We have been warning about conflicts and commissions since 1987.

CHAIRMAN—Good to know people were listening!

Ms Freeman—That is not to say that changes have not been made. It is just that now what we have seen is that the changes that were made, particularly as a result of the Wallace inquiry and financial services regulation, are not working. And that is the disclosure based regime on which financial services regulation is based. Over time, there have been changes put in place but they have shifted the risk from the industry to the consumer. The risks have increased, and consumers are not in a position to manage them.

Ms OWENS—So you have noticed an increase in the aggressive marketing of and growth in the complex category?

Ms Freeman—Yes.

Ms OWENS—I have just one more question. With the compensation fund, there are probably two dangers: the moral hazard danger but also the danger that people start to believe that they will be compensated if they lose money in the share market. Clearly that is not the case. So on what kind of terms would you consider that compensation would be appropriate?

Ms Freeman—Yes, I agree with you. We are very careful when we are talking about this in public to make it clear that we are not talking about bad luck; we are talking about bad advice.

Ms OWENS—Or even bad decisions, for that matter?

Ms Freeman—Yes. This is entirely based around breaches of license obligations. That is the basis on which a consumer can make a complaint. The scheme that we are proposing is not about broadening the basis on which a consumer can seek to make a complaint and seek compensation. It simply provides access to a revenue stream where a complaint is upheld.

Senator McLUCAS—I have one very quick question, going to the question of disclosure. I understand that the statements of advice that were provided by Storm Financial to its clients were compliant with current law. But very few investors who have come before us have said they understood that they were paying this type of fee. It has been put to me that we could make a very neat amendment to the requirements for the SOA by saying that, on one page, as an addendum to the SOA, there would be a statement of all fees over time, and potentially you could add commissions into that too. But it would be one page all by itself, not tucked in anywhere, and it would be just one page. What do you think of that?

Ms Freeman—The problem is not just the fees; it is the conflicts that are attached to the fees and commissions that are payable. I would not want to prioritise one over the other. That is my first point. Choosing the right information to highlight to consumers is a very important process to go through. Unless we are systematically removing those conflicts as they occur, I do not know that consumers are going to have a better understanding as a result of highlighting fees and highlighting the conflicts that are attached to those fees. I am not sure that the problem as it has been identified would actually be solved.

I have seen this tried in a whole range of industries, and I have to say it never works well. People have a poor understanding of something as simple as a percentage based fee, for example—a very poor understanding. You can put it in large font, you can put it in bold and you can underline it, but that will not change the fact that people do not have a good understanding of it. But what concerns me more is that people do not have a good understanding of how that may impact on the quality of advice they are receiving. Unless they understand not only the remunerations that they are paying to the advisor and the impacts of that, we will see more of these events in the future.

Senator MASON—It is a fairly aggressive submission you made from Choice. It was excellent. You said that the financial planning industry is built on a structural conflict of interest. So you would see the payment of any commission as an inherent conflict of interest, because it skews the nature of the advice?

Ms Freeman—Yes.

Senator MASON—Do you think a fiduciary duty would go some way to ameliorating that?

Ms Freeman—The structural conflicts are twofold: (1) because of the payment arrangements, like conflicts, that fundamentally, in our view, undermine the quality of advice; and (2) because

of the ownership arrangements within the industry. I know there has been some talk about separating the advice industry into two separate tiers—the notion of tied advisers—

Senator MASON—Selling products, in effect?

Ms Freeman—Yes—who would have an explicit and obvious relationship with a product manufacturer, and those who would be independent in a more pure sense. I have to say that I do not think that is a solution to this problem of the structural conflict in the industry. What appeals to me more is a small paragraph in ASIC's submission which talks about, of all things, the Israeli approach, whereby an adviser is restricted from making advice on products where the owner owns a 10 per cent share or greater. So, in effect, they cannot recommend products that are manufactured by an owner that has a substantive interest in their firm.

Senator MASON—Indeed, to exclude those products—that is right. Thank you.

CHAIRMAN—To finish, I will ask a very broad question. It appears, from your submission and some other things that we have heard, that it is as if some advisers are transferring their own wealth goals and beliefs to the client. Everywhere I look I see clients saying, 'No, I do not want to take that much risk; I do not want that much; I do not need that much.' But it is the advisers who are actually pushing for that—almost as if they are pushing their own value and belief set onto their clients. That would make some sense: they are advising others on what they believe in.

Also, there seems to be no exit strategy. So somebody might come in and say, 'I want enough to retire on.' Surely that would be a set figure: 'I need $1 million,' let us say, to take an arbitrary figure. But once that target of $1 million is reached, like a lot of people in Storm, they do not exit—they say, 'Now it is $2 million,' 'Now it is $4 million,' 'Now it is $8 million'—there is never an end point where they can actually say, 'This is fine; I now have enough to live on in my retirement.' How do we deal with that? How do we deal with the transfer of belief from the adviser to the client?

Ms Freeman—I think a fiduciary duty is a good start. An obligation to act in the client's best interests is a perfect start to creating a culture shift. Beyond that, our submission makes it quite clear that we do understand the foundations of this industry in a sales based culture and a culture where there is a very close relationship between product providers and advisers, and that advisers are often seen more as a distribution channel of product providers than as an independent, impartial source of advice.

In our submission we suggest that more needs to be done to provide incentives for advisers to take that final leap and be able to declare themselves independent, impartial and unbiased. I do not know whether those same cultural problems are occurring in the very small sector of the adviser community that does meet the legal definition of independent, impartial and unbiased, but it would be very interesting to find out if that were the case. If that adviser community does not display those sorts of cultural concerns that clearly are there in the broader adviser community, then the more we can do to encourage the direct fee for service and the break from the relationship with the product providers the better.

One thing that we have talked about in our submission is the need for equal tax treatment of adviser fees. I know this has been raised by others. It can potentially be seen as a conflict for the

advice industry to be seeking for advice fees to be tax deductible, but, potentially, it is part of this broader movement to an independent, impartial and unbiased advice industry. And if we were to make fixed fees for fixed services tax deductible then that could also contribute to providing the sort of culture that consumers are clearly seeking from the advice industry.

CHAIRMAN—Ms Freeman, that is fantastic. Thank you very much. We really appreciate your time, your efforts and your submission.

Ms Freeman—My pleasure. Thank you.

[3.46 pm]

EVANS, Mr Grahame, Managing Director, Professional Investment Services

PETRIK, Miss Bianca, Corporate Development Manager, Professional Investment Services

CHAIRMAN—Welcome. Would you like to make some opening remarks?

Mr Evans—Yes. Thank you to the committee for the opportunity to appear this afternoon. Having spent about 37 years of my life in the industry—and I hesitate to say this—I am probably one of the longest serving members of the industry that has fronted the committee. Over that time, there have been many, many changes—particularly through 1983 and 1987, through the various crashes in 1989, through the recession 'we had to have' in 1991, through the liquidity crash in 1994, through the Asian crisis in 1997—through a whole range of different issues. It has not been as smooth sailing as some people think it has been.

Professional Investment Services is the largest licensee by a number of advisers, and to me it is a microcosm of the Australian financial advice environment. We do not tell advisers how to charge or where to place their clients' funds. It has one of the largest approved product lists. Some people see this as a problem, but others see this as a significant choice to meet the needs of most clients. In fact, last financial year, the average upfront commission and fee for all funds placed was just 1.2 per cent, excluding GST. This was actually quite a low fee and I think confirms some of the issues we will talk about. I would consider this representative of the market as a whole, because of the size of our business. I think it is an indication of where advisers actually are regarding their fee charges.

Almost every industry has its bad eggs. In my time in the industry, the majority of advisers put their clients' interests first at all times. It is funny that people see their own adviser as being okay so it must be the other ones that are the crooks. That is a very common expression that you hear in the marketplace. Many advisers have come from other industries and other professions, such as lawyers, teachers, the military or defence forces, and many have come as a result of career changes which have been forced upon them for a variety of reasons. The portrayal by some sections of the media of financial advisers as commission-hungry thieves has done much to destabilise the trust that many clients have in their own advisers. Whilst it is important for the committee to focus on the terrible issues at hand, I would encourage them not to use a sledgehammer to crack a pea—to use an old expression.

Has the current regime held up well in the worst financial crisis we have seen in recent times? How many 'Storms' are there out there? How many one-size-fits-all practices exist? In my experience, these practices are the exception, not the rule. The key message is that financial advisers and the financial service industry as a whole strive to operate with integrity, provide quality advice and quality financial products and services. The key issue to me is about quality advice. I believe that, without quality advice to consumers, they would be left to their own accord and make many, many more costly mistakes.

From our analysis of the current problems, the industry needs to take a risk based approach to change. What are the issues likely to have the most impact on consumers, and, therefore, how do we mitigate those risks? Our recommendations for positive reform are included in our submission. I would like to make two comments. Firstly, in relation to product failures, licensees should be given the capacity to act on behalf of their clients and investors to undertake proceedings against financial services product providers for the recovery of damages for corporate misconduct and product failures, similar to ASIC's powers. At the moment, we have to wait for people to come to sue us before we can join a product provider who has actually failed in their duty. We do not have the authority to take them on ourselves.

Secondly, in relation to conflicts of interest and remuneration, the issue is not about conflicts of interest in and of itself, as conflicts are inherent both directly and indirectly across the different remuneration methodologies, including instances like salaried advisers. There are conflicts associated with all the different types of remuneration methods, even to the extent that on an hourly fee base, if you have not dealt with lawyers or accountants over time where you think they have pushed the hours out to get greater fees, then I am sure you have not lived. It has been one of those environments. We are not free from conflicts wherever we go. However, the business model risks must rate up there in the regulator's eyes as the key risk for consumers seeking advice, because that is where a lot of people become disadvantaged. It is not just inappropriate advice for one person.

When dealing with specific misconduct and inappropriate practice, it is important to note that there will always be instances in which fringe participants engage in high-risk or inappropriate practices, both at the advice and corporate levels, which will be difficult to present. I noticed yesterday's comments regarding McDonald's approach—a one-size-fits-all strategy. Practices such as the Storm practice are an exception; they are not the rule. Provision of quality advice should be our goal, but it should be in a framework which manages the elephant in the cupboard, not on issues which have little or no impact to the consumer. We are obviously happy to answer questions with respect to our submission.

CHAIRMAN—Thank you, Mr Evans. We appreciate your submission and your time today. You made a couple very interesting points. I will go to one of them. You said it is only other people's advisers who are no good. Let me assure you, with the evidence we have heard, there are plenty of people saying that about their advisers. I do not want to cast aspersions, but what they are telling us is that their advisers were criminals and they will be telling the whole world. As much as we do understand the problems in terms of the media and the way they have portrayed advisers generally, with a very broad brush, we do understand that problem you face. Part of the role of this committee is to try to, if anything, restore some credibility, which I look at it in a way to give confidence back and make sure that, at the same time, we have a good, sound basis for that and that we have efficient safety mechanisms in place as well as consumer protection. It is a balance of all of that. Perhaps sometimes it is the industry that has done itself the worst disservice by allowing a whole range of its own people, regardless of how small they are in proceedings, to give it a bad image.

Mr Evans—That is right.

CHAIRMAN—You also mentioned how many other Storms exist. Who knows? There could be some now. I doubt that there would not be some other Storms out there. I will just make this

point and then you can give me your view. It is not just about the worst-case scenarios of Storms; it is also about people getting really bad advice, which means it takes them an extra 10 years to pay off the house or they are paying double the amount for life insurance than they should, or they may have the wrong loan and when they have to break the loan it costs them $10,000 to get out. The adviser, broker or whoever gave them the advice should have known and explained to them the detail. So it is not just about worst-case scenarios. People can go through a whole lifetime, get a heap of bad advice and end up quite poor. Perhaps they would not lose their home, but just end up really poor because they never got good advice. Could you give us your view of that?

Mr Evans—I would certainly agree with that. I have seen examples over my many years in the industry where that has actually happened. The industry is relatively young in real terms and we have not got to the stage of turning into a profession. I think that is still a fair few years away from happening. The regulation that was introduced in 2003 was a start process. It is far from an end process. We believe that the education process should be enhanced—

CHAIRMAN—For advisers?

Mr Evans—for advisers—to an undergraduate basis, and also to a situation where they need to have some form of professional year, like we have seen with the chartered accountants' environment, and some lawyers are in the same situation, so that you can have experienced people mentoring them into that environment. They need to have the base knowledge and understanding, because, as we have just heard through the *Choice* submission, there is the complexity of some of the products. They are becoming more and more complex every year. That makes it even more difficult for the adviser to understand. So the adviser needs to step up their education. We are dragging most of our new recruits from universities. We have a number of arrangements with about 20 different tertiary institutions to do so, but we need to step that up and have a base level of education and a process which allows people to be mentored into a situation where they are at the level at which they should be able to provide advice at a competent level.

Senator MASON—You mentioned in your opening statement that, in your view, financial advisers already operate in a sense with a fiduciary duty. What do you mean by that?

Mr Evans—I mean they are acting in the best interests of their clients. Maybe it is a mistaken belief, but my view is that if all advisers are acting in the way that they are being portrayed then the community has a real problem because we are saying that the values and beliefs of advisers, who are a cross-section of the community and have come from all different walks of life, are in effect compromised. I personally cannot believe that is the case. Therefore, I do believe that the majority of advisers act in the interests of their clients.

Senator MASON—I am sure that is right, but would you have any objection to the imposition of a statutory fiduciary duty on financial planners?

Mr Evans—Probably not, because I think that is actually where they are now.

Senator MASON—All right. That is fine. But we have heard some evidence that some people believe that the receipt of commissions by financial advisers is an inherent conflict of interest

that subverts and is contrary to a fiduciary duty. In other words, you cannot have both. What do you say to that?

Mr Evans—I think it would be a conflict if there was a bias that actually existed. I am not quite sure whether the committee has seen any indication of levels of commission on product that is actually out there. Let us take the products which are non-platform products, which you can buy across the counter now. I will deal with platforms separately. If you look at the range of equity trusts you will find that their commission levels are virtually all the same. So if there is no bias in that then where is the conflict of interest?

Senator MASON—There are relationships. The committee has heard evidence that often particular financial advisers are linked to certain banks like Macquarie, the National Australia Bank or the Commonwealth Bank and therefore the financial advisers give advice that you should invest in particular products related to those particular banks. So the advice can be skewed, can't it?

Mr Evans—It can be skewed. If a person were to walk into the Commonwealth Bank and speak to a Commonwealth Bank adviser or walk into the National Australia Bank and speak to a National Australia Bank adviser then generally they would expect they are going to get some product from that provider.

Senator MASON—Sure, but that is the point. We have heard so often over the last two weeks that you walk into see a financial adviser, with the big symbol of financial advisers on the door, and there is no apparent relationship with any bank. Then there is an issue, isn't there?

Mr Evans—There is if there is no disclosure. And it has to be overt disclosure, not hidden at the back of documents. I tended to agree with Senator McLucas earlier with her statement about the one-pager. There should be more overt disclosure of these issues.

Senator MASON—We all agree with Senator McLucas. She is always correct on these issues; I would not be game to disagree! I think you are right that disclosure documents in the past perhaps have not been sufficiently transparent. I have one last question. The previous witness from CHOICE said that ASIC should be granted:

> … the capacity to exclude particular conflicts of interest where it is satisfied that the conflict is inconsistent with the fiduciary duties an adviser owes a client …

That strikes me as an interesting policy perspective. What do you think about that?

Mr Evans—In a perfect world, I would say that is actually a great view. But I think we tend to live in theoretical environments which actually are not reality. We have an environment here, as I am sure has been said and which I have seen mentioned in some other *Hansard* reports, where the industry is subsidised in various ways by the cost of advice.

If you take that situation away—as you have heard from CHOICE, they believe that would give greater confidence from the point of view of quality—it is a situation where the cost of advice will go up. It may come down over many years, but are we talking here about revolution or evolution? From that perspective, if you go and completely change the economics of the

industry overnight it causes upheaval to many trusted relationships with those who are being charged correctly and whose interests are being looked after by their advisers.

Senator McLUCAS—Thank you for your comment about the one-pager; I will not ask you that question. The other issue that I tried to progress today is the power imbalance between the investor or consumer and the adviser. You said it correctly: everyone else's investor is not very good, but mine is. There has to be faith, because you are talking about your future with this individual. How do you give that person the ability to be a critical thinker about the advice that they are being given? What I am trying to find a policy solution to is the circumstance where people are duped. Poor advice might be given here and there, but with the issues that we are talking about people have been duped, in my view. How can we protect them?

Mr Evans—I think there are two issues here. One of the problems that you have in any industry is that you get a range of expertise and quality from very, very good to very, very poor. Therefore, you need to be able to put in levels of safeguards which try to shorten that poor end of town and move it up towards the better end of town. A lot to do with what we have seen and consider—and not only in this financial crisis but also in past financial crises—has been the level of risk that people are prepared to take on. In a bull market, when they are talking across the fence to their friend about how much money they have made it is amazing how people's levels of risk grow. But we have seen more psychometric segmentation of risk undertaken in recent times to determine how people react in a down market. I really think that this risk issue is something that is underdone. We now have to think about things such as liquidity risk, which has been impacted by mortgage trusts, and asset concentration risk, the leverage which has been the root of all evil with respect to our current environment, not only when we are talking about Storm but in all sorts of other environments. We need to be able to look at a lot more of these risks so that the client can see and identify those risks.

I do not know whether you can find a tool, because the tool will be skewed one way or another by the people who have developed it. I think we need to concentrate more on being able to explain to our clients and being able to have a check point for the different types of risks so they can say how they feel about it. Some of my old friends at IPAC, one of the other well-known dealer groups that are in town, use a measure which shows people what number of years in a period of time you are likely to have a negative return.

Senator McLUCAS—That is what Storm did. 'Every seven years it is going to go up 10 per cent.' That was part of their pitch. It is all accurate, but there are lies, damn lies and statistics! We do not want to end up with a series of regulatory changes that do not change an iota for that group of people.

Mr Evans—And I agree with you. When we look at the solutions there at the moment, I am not quite sure how you protect people from themselves. One of my big concerns with advice and the provision of advice is that people will sit in front of an adviser and nod their head but have no idea what the adviser is saying.

Senator McLUCAS—We have heard that all week.

Mr Evans—They make widgets, they sell widgets—whatever they do, they do not want to look stupid or ignorant. In that situation they should not be. They should always be asking questions until they understand. But how do we stop people in that environment?

CHAIRMAN—But it is not practical. From what we have heard and understand, the reality is that most people say: ‘As my adviser, if you are recommending that to me because you think it is good, that is fine. Even if I have the capacity to understand, I do not have the time. That is why I pay you. If you are telling me that that is good for me, then I trust you. You are going to do the right thing by me.’ They actually say those words. ‘I trust you. If you recommend it, no worries—go for it.’ They do not need to look any further, because the relationship, that payment between you and them in whatever form, implies that you will do the right thing by me. People actually do ask the questions, but unfortunately what comes back is not satisfactory sometimes.

Senator McLUCAS—There is that side of it, but then there is the other side which is expressly saying to the adviser: ‘I am a low-risk person. The last thing I would want to do is lose my house. I want a low-risk product,’ and then ending up with a mortgage over their house and double gearing. How do you get from A to B there and how do you stop that happening? That is the question we have in front of us.

Mr Evans—At the moment, part of the process that happens with licensees is field audits from their own home perspective and desk audits. So they will call files in and review those and identify a rating for an adviser in respect to their compliance. Part of that process is to look at the appropriateness of the advice. This is probably a relatively new situation since the introduction of FSR in 2003. I think there is greater sophistication happening in this area but—as you have quite rightly said, Senator McLucas—there may need to be some other tools which do say this is a tick for these people.

Senator McLUCAS—Thank you for your insight.

Ms OWENS—You said before that commissions are not a conflict of interest, because they are the same. Where does the competition come in if all fees are miraculously the same?

Mr Evans—If I could just take one step back, the majority of the industry places investments through platforms. I am sure that over the days you have been bombarded with platforms. They were actually a result of the 1987 crash. In platforms, no commissions are paid in respect to the investment vehicles inside those. So, when somebody actually selects a number of different investments inside those platforms—just put shelf space fees to one side for the moment—there is no inherent conflict inside the platform because of that situation as there is not a commission there. You would expect that the investments chosen inside the platform have no conflict. The only conflict you have got is with respect to the administration platform that you have and what that actually means. Conflict does appear to come in where the list of products is reduced substantially on a platform so that there are only a certain group of products that can be utilised which have some sort of link to the remuneration process.

Putting that aside, from a competitive basis, most advisers that we deal with—as I said, we do not tell our advisers how to charge—will have a charging mechanism of their own. So they will say, ‘I will charge you one per cent on your first $500,000, half a per cent above that, and 0.7 per cent ongoing from that perspective.’ They will not take that into account, because their process is

not about the product; it is actually about the service of financial advice. This might sound altruistic, particularly after the bad stories that you have heard, but that is generally the basis on which they would do it. They say: 'This is my service and I am going to provide you with a diversified portfolio. I am going to monitor this and look after this for you and these are my fees.' That is generally how the industry looks at it. Whether somebody charges at four per cent on an Australian equities fund very rarely comes into the equation, because that adviser will have their own charging basis in respect to the advice that they are providing.

Ms OWENS—Would a volume bonus bring a conflict?

Mr Evans—A volume would definitely bring a conflict, because you are saying, 'If you put more money into my product, I will pay you more.' There has got to be an absolute conflict in that respect. There is no doubt with volume bonuses; they are in that category.

Ms OWENS—The current system has various kinds of commissions, trail fees and other names I cannot remember. Do you think it is possible for an uneducated investor to actually get their head around how much they are paying in fees? Do you think it happens in practice?

Mr Evans—I am not so naive as to suggest that that would be the case in all instances. I think that goes back to how well it is disclosed. It goes back to the chairman's comments about trust—and Senator Sherry was well and truly onto this issue as well, before his change in portfolio. The document that is put in front of you is all jargon and gobbledygook. People would have no idea what the fees are for, other than the actual dollar figure that they see. One of the steps we have taken as an industry is to try and get better disclosure, but I do not think we are there yet.

Ms OWENS—One witness said they did not think it would be possible to put together a list of average fees for the various kinds of services because there is so much complexity in the way those fees are calculated over time. Is that right?

Mr Evans—I think we have the ability to review that through this process that we are going through now. It is one of the areas which, from an industry perspective, is happening too slowly for people like CHOICE and others. A little over 60 per cent of our advisers are on a fee-charging basis and rebate commissions. Some are on asset based fees, which CHOICE does not like. But we need to consider the fact that we are judged on the performance of the advice that we actually give. That judgment by the client is based on how well the investment does.

CHAIRMAN—It is interesting that you should say that. I asked earlier whether the appropriateness of the advice is about the judgment or about the performance. If it performs well, it is good advice. But is it appropriate advice?

Mr Evans—That is right. And it is actually that situation. In the research we did on our own clients for this inquiry, that was second behind 'trusted relationship'.

CHAIRMAN—On that measure, if it is just about performance, Storm were excellent. Their performance was phenomenal—up until it all fell over. So, even if you are making a lot of money, is the advice appropriate? It might seem the opposite—the more money you are making, the more inappropriate it may be.

Mr Evans—In our submission we made a small comment about whether they would be happy to take the benefits as they went forward.

CHAIRMAN—But it is not about whether they are happy; this is a question about appropriateness. The client will never understand how appropriate the advice is for them. If they did, they would be a financial adviser themselves. They pay an adviser because they are seeking appropriate advice. An investment simply performing well is not an indication of appropriate advice, or even good advice. It just means you are a making lots of money. It might actually be very bad for you—as we have seen evidence of.

Mr Evans—I totally agree with you.

CHAIRMAN—How do we deal with that?

Mr Evans—The average person today retires with somewhere between $150,000 and $200,000, besides their own home. So, despite what people may think, it is still fairly low. And then they chase income. There have been failures in recent times around debenture companies. In New Zealand, for instance, some 26 companies have gone broke. People chase income but do not understand the risk. They are put in that position because they need it to live. So what might be appropriate advice and what they want in the way of income start to decouple. The adviser is then put in the position of—and this is an interesting one—deciding whether they will continue with a client who will not take appropriate advice or whether they will adjust their advice to allow the client to be in that situation. And I can tell you that that is quite a regular conundrum.

CHAIRMAN—That is interesting.

Senator McLUCAS—Mr Evans, I will be frank with you. I am not positive of the structure of your organisation. Do you have much to do with margin loans?

Mr Evans—A little. Our assets under management at the moment are approximately $17 billion that we look after. There is about $360 million of that in margin loans.

Senator McLUCAS—In the period that we are talking about did you have any margin calls on any of those loans?

Mr Evans—Many.

Senator McLUCAS—What happened between the lender, yourself as the adviser and the client in terms of advising of the margin call?

Mr Evans—From my understanding, this was a situation where the lender advised both the client and the adviser. The reason the adviser likes to know is if there is a requirement to sell an asset people need to actually understand which asset they should be selling particularly around tax considerations and the type of investment. My understanding—and this may be wrong; I am not working day-to-day next to them—from the advisers I have spoken to is that the provider has actually contacted both the client and the adviser so they could then talk to them about which asset they would have to actually sell to prop up their current loan.

Senator McLUCAS—This is interesting. I wonder if you could do us a favour and confirm with the committee that that is accurate, because that would be very useful information.

Mr Evans—We will.

Senator McLUCAS—When you say the lender contacts the adviser and the borrower, how do they contact them? Is it a telephone call? Is it an email? Is it a letter in the mail?

Mr Evans—I would have to check on that. I remember being in a taxi coming back to an airport and actually having an adviser ring me about a particular issue. The phone call had been made to the client directly from the lender on that issue. But I would like to check to see whether that is actually common practice or whether that is just one instance where it actually happened that way.

Senator McLUCAS—Thank you very much.

Ms OWENS—There have been some suggestions that the definition of 'financial planner' needs to be defined a little more and separated from sales, as in two separate functions. What is your view on that?

Mr Evans—I would agree as to the provision of advice and the product. One of the problems I have with the Corporations Act is that it has a 'know your client, know your product' rule, which is fine except the product, from a financial adviser's perspective, should be the advice and the diversified portfolio that they actually provide. Unfortunately, that is not how the law was written and we need to abide by the law as it stands. But we have diversified portfolios for a reason: if something falls over, then you actually have the other parts of the portfolio to support that investment. Unfortunately, when you lay a gearing over the top of it that changes the complexity completely. But it really is that we should be looking to the advice side. If all products actually had their commissions removed, to me it would not be an issue. I think the industry would survive. I have been anti this issue because I think it is the wrong issue. As I said, most of our advisers are heading in the direction of fees anyhow, but I think it is the wrong issue. We need to actually find the answer to the other problems of how to protect the consumer and how to manage these risks, and the commission issue is probably the easy target. But I do not think it is actually going to solve the problem of that. So when you are talking about sales versus advice I think there is a clear distinction between the two.

Ms OWENS—That is very interesting, thank you. I ask this next question all the time, because I think we need to be very cautious that we do not regulate only because of the bad times; we also actually need to regulate because of ordinary times. So I am always interested to know where people were before the crash, where their attention was and what they thought needed to be better before the crash and then how their view changed over the crash.

Mr Evans—The research issue was a major challenge from my end. We have over 500 products on our approved product list. As I said earlier, some people might say that that is excessive; others would see that there is a substantial amount of choice for clients because of their varying circumstances. We deal with some five or six different research houses. The issues that we see around some of the product failures have come from the inability of the research process to identify financial engineering going on in organisations that increases leverage. There

is no early warning sign to give you that indication. We were a user of Great Southern. In 2004, they were a top 200 ASX listed company. At that stage, they had very little debt. But in a short period of time, all of a sudden a substantial amount of debt went into the business. Where were the identification processes that should have sent a flag up the flagpole and told us that we had a potential problem? My challenge at the moment, post the global financial crisis, is trying to work out the risks associated with research into an organisation like ours. We placed $1.7 billion of new investment last year. The year before, we placed something over $3 billion. Anything that we touch in dollar terms is large. Therefore, the research needs to be very exact. That is one of the issues that has come out of the before and after situations. Events like the GFC uncover all sins. Therefore, you have to be able to start seeing around corners.

Ms OWENS—Were you aware that the transparency was a growing problem or, like everyone, did you discover it later?

Mr Evans—I heard you discussing signals earlier on. The signals that come to mind are when investment managers start topping up their portfolios with their own money. Then you need to start worrying about it. That was probably the first signal.

Ms OWENS—Except that no-one knows.

CHAIRMAN—On that note, thank you both very much for your submission and your evidence today.

Committee adjourned at 4.22 pm