



Product Research How Much is Enough?

December 2009

SIX KEY POINTS

- Advisers are expected to demonstrate care and a detailed understanding of products before they can assume that they are suitable for a particular client.
- Approval of a product by a licensee does not required advisers to use it. The adviser must decide in each case, which products to offer each client, based on their suitability for the client.
- Advisers must evaluate the overall quality of research, including the APL provided by research to ensure that it is reasonable to rely on that information. They should also consider economic and accounting information in relation to markets and industries and securities generally.
- Advisers are not expected to go beyond publicly available documents. However, they are expected to have a detailed understanding of the products they recommend from their own reading and analysis of the available material
- Giving the client the PDS or other product information will not override the adviser's duty to point out the risks of a product to a client. Most clients are capable of a detailed understanding of these documents and are entitled to rely on what the adviser tells them.
- If advisers who call themselves investment advisers act as financial product salesmen, they need to make it quite clear to the client that that is what they are doing. Otherwise they will be held to the duty of care that is appropriate as if they are reasonably relied on as giving objective advice.

A number of recent cases and increase in claims arising out of the global financial crisis have brought the issue of the adviser's duty to understand and research products starkly into the limelight. The questions that they raise are:

- To what extent can advisers rely on their licensee's APL?
- Must advisers' do their own research and if so, how extensive must that research be?

One case involved promissory notes issued by Westpoint and the other involved a so-called fixed interest product offered by Basis Capital.

WESTPOINT

In the case involving Westpoint¹, in 2004 ASIC had issued a press release advising that it was investigating Westpoint's practices in raising money by the issue of unsecured promissory notes (which were in effect unsecured IOUs) – it obviously thought that it should have been registered as a managed investments scheme. A Queensland adviser, Mathew Brannelley was sued by a number of clients who had invested through him in one of the later Westpoint projects, known as Baycorp Mezzanine - in mid 2005.

Adviser's Knowledge of the Investment – The information memorandum contained considerable information about the investment, and it was found that if the adviser had read it as carefully as a reasonably competent investment adviser should, then he should have been aware of the risks of the investment.

¹ Evans & Ors v Brannelley & Ors [2008] QDC 269

Some of the risks that were ascertainable from the IM included:

- That the promissory note was unsecured and was unregulated high risk investment which was not capital guaranteed;
- That the company issuing the promissory notes had no second ranking mortgage over the development property or a second ranking charge over the special purpose development company;
- That the investment was not guaranteed - In fact, in this case, the adviser misleadingly asserted that the investment was guaranteed and there was a guarantee in place but the client did not have the benefit of it; and
- That the client was not lending money directly to the development company, but to a company which did not own the real estate being developed.

The judge said that none of these were particularly sophisticated or complicated issues and most could be ascertained without much difficulty from looking at the documents that Westpoint had provided to the adviser. Because the adviser held himself out as having expertise in relation to investments, which involved having an understanding of those investments and their advantages and disadvantages he should have understood them and pointed them out to the client.

The judge did canvas many other issues that it thought the adviser should have known or been concerned about from his experience and the documents that he had access to:

- It was unusual to mezzanine finance to be raised by issuing promissory notes to the public;
- There was a an unidentified senior debt financier – this should have given rise to suspicion in the mind of a reasonably competent adviser because the inference was that not all the senior debt required for the entire project was in place; either another senior debt financier was being sought for part of the project or the existing senior debt financier had not yet committed to fund all of the senior debt required for the whole project;
- Westpoint had carefully avoided saying how much of its own money was going into the project and it was not possible to determine from the information memorandum what the profit margin for the project was;
- The figures in the information memorandum were unusually bad for a property defendant – which begged the question of why a property development company which was supposed to be as good as Westpoint was putting together a project where the numbers stacked up so badly and was essentially putting it together on the basis of borrowed money;
- There was inconsistent information in the documents about the sate of completion of the development; and
- There was suspiciously little hard factual information in the information memorandum about a number of information such and the age and stage of pre-sales, the actual cost of construction as compared to budget or the progress of the work compared with the construction schedule.

It can be seen that advisers are expected to have an extensive knowledge of investments that they recommend.

Use of APL – This investment had been included in the licensee's APL. The licensee was Deakin which was in liquidation by the time of the court case.

The adviser did not sell all the products on the licensee's APL – he had made a deliberate choice to sell this one. The court found that he had information that ought to have alerted a reasonably careful investment adviser to the fact that there were significant problems with this investment and that considerable personal caution should be exercised in dealing with it. In these circumstances, the Court felt that the adviser should have been thinking for himself and could not be heard to say that he had relied exclusively on the licensee.

He commented that ***just because a product is approved by a licensee, that does not mean that advisers are required or even expected to sell or try to sell it to everybody. It is a matter for the adviser to decide in a particular case, to which individuals, particular products on the APL would be offered. The fact that the adviser does this is sufficient to break the chain of causation to the licensee.***

Despite this, the judge found that the licensee was vicariously liable for the adviser's conduct as they were its agent. On this basis, he apportioned liability 25% to the licensee and 75% to the adviser.

BASIS CAPITAL²

The second case involved an investment in what was said to be a fixed interest investment in the Basis Yield Fund. The adviser had recommended this investment for an SMSF where the client was in the allocated pension phase, drawing the minimum pension amount each year. The investments were made in 2 phases, the first being \$1.2 million in April 2005 and the second a further \$1 million in April 2006

The client's risk profile (which had been undertaken by an outsource provider) had initially identified him as Risk Group 4 investor. Although most such investors chose a portfolio with 30% exposure to high risk investments, as the client had stated that he would feel uncomfortable if the total value of his investments went down, by 10%, the profiler recommended that he be placed in low return/low risk investments (with 0% high risk investments).

The client had told the adviser that he wanted the money value of his investment to retain its purchasing power. Because of this and despite the risk profile, the adviser classified him as a "Balanced Investor" and recommended an allocation of 60% growth/40% defensive assets. Initially he recommended an allocation of 2% to international fixed interest in the defensive asset category, but this was later amended to 5.5%

Suitability of the investment – Van Eyk research reports held by the adviser had identified the Basis Yield Fund as an international fixed interest investment, but did not say for what risk profile it was suitable or provide an in-depth analysis of its financial position. Although it paid a regular interest payment, otherwise the Basis Yield Fund did not accord with the general attributes of fixed income investments for the following reasons:

- While it provided regular payments to investors, the rate of this return was variable;
- Redemptions were governed by liquidity;
- The fund manager was investing in Australian and international equities as well as having exposure to the sub-prime market in the US and invest in below investment grade assets (i.e. <BBB) without any limitation;
- It was neither income nor capital guaranteed;
- The fund had a high gearing ability – as high as 300%;
- The investment cycle had already been running for a considerable time and therefore end of cycle aberrations were more probable; and
- The fund was governed by Cayman Islands regulations which are not as equal or robust as local regulations.

This information was apparent from the PDS and research notes.

The adviser defended his selection of the Basis Yield Fund on the basis that it was highly recommended in his licensees Approved Product List. However FOS said that this was not enough.

² FOS Determination 18959 30 June 2009

Adequacy of Research – According to FOS, an *adviser must go beyond the APL to demonstrate care and a detailed understanding of the product before he can assume that it is suitable for a particular client.*

Further the Basis Yield Fund did not qualify for the portfolio in the first place. The adviser selected it without any real appraisal of its risk or understanding of its possible behavioural outcomes. It was inherently high risk and unsuitable in view of the client's willingness to take only a small amount of risk.

FOS said that the *adviser had to evaluate the overall quality of the analysis provided by research organisations, including the licensee's internal research department to ensure that reliance placed on any information from the licensee is reasonable in the circumstances. The adviser should also consider economic and accounting information in relation to markets and industries and securities generally.*

It found that the licensee and the adviser did not properly research the investment at the time it was recommended and therefore could not explain the true nature of the investment to the client.

The moral of the story

It can be seen from both these cases that it is not enough for an adviser to rely on the APL provided by its licensee. Advisers must have a clear and detailed understanding of the products you recommend so that you can evaluate their suitability for the particular client and explain the products features and risks to the client.

SOME OTHER INTERESTING FINDINGS

Some other useful guidance and comments can be extracted from these cases.

Financial Salesmen – In Westpoint, the judge commented that the adviser was really just selling an investment product regardless of its qualities or suitability for the client. The problem was that they did so in the guise of an investment adviser. He said. That if people who call themselves investment advisers are going to act as financial product salesmen, they need to make it quite clear to the client that that is what they are doing or they will be held to the duty of care that is appropriate as if they are reasonably relied on as giving objective advice.

Additional Documents – In Westpoint, the client alleged that the adviser should have been aware of all sorts of additional information about Westpoint because he had been so closely involved in arranging investments in the Company's projects over an extended period of time. The adviser denied knowing many of these facts and while the court found that many of them were significant and relevant to the decision to invest, with two exceptions, one of which was the information memorandum, it did not go so far as to find that the adviser should have been aware of this additional information.

The other exception was the press release issued by ASIC that it was investigating Westpoint. The judge thought that this was something that a reasonably careful financial planner ought have been aware of and taken into account with advising on the investment. This was because it indicated concern on the part of ASIC and also because it was relevant to the prospects of success of the fundraising and the project.

The good news from this is that it implies that advisers are not expected to go beyond publicly available documents to gain their understanding of products that they are recommending. However, as can be seen above, they are expected to have a detailed understanding of those products from their own reading and analysis of the available material.

Risk Profiling SMSFs – In the Basis Capital case, FOS found that the adviser had erred in assessing the risk profile of the individual member of the fund. He should have looked at the fund itself.

The fund must be independent of its members and its investment strategy needs to take into account its objectives and obligations and also the likely obligations of the fund to pay or roll out member benefits. It is therefore likely that the risk tolerance of a fund will be different from that of its members, even for a single member fund.

Contributory Negligence – In each case, the client had been given product information - information memorandum for Westpoint and the PDS for Basis Yield Fund.

In Westpoint, the information memorandum was unclear and the adviser had sent the client letters providing information about the security for the investment that was contrary to the information in the information memorandum. It was found that the client had not contributed to their loss because it was reasonable for them to rely on the information and assurances that the adviser had given them. The fact that they had not examined the information memorandum closely was not held against them.

Similarly in Basis Capital, the client did not read the PDS or the Van Eyk research reports, but the court accepted that even if he had, he would have been none the wiser as the research reports did not clearly indicate the risks associated with the investment.

Ongoing Review – In the Basis Capital case, the licensee and adviser's service proposition included a promise to "provide regular ongoing monitoring of your managed fund investments with ongoing advice provided when and where required". The adviser asserted that this meant that it would undertake a quarterly review of the SMSF's investments and an annual review of the investment strategy and did not include automatic updates or ongoing warnings as it was impossible to monitor managed funds on an ongoing basis.

FOS found that in view of the Service Proposition, the licensee and adviser had agreed to provide ongoing monitoring and did not accept that it was impossible to monitor funds on an ongoing basis.

TIP

Review your service promises to your clients to ensure that you are not over promising and under delivering on investment monitoring.

CONCLUSION

There are many important lessons for advisers in these cases. We strongly recommend that you think carefully about these and consider how your advice process might benefit from revision to incorporate them.

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