The Following Paper is a description of many of the principles governing financial advice in Australia. It is written by Wesley McMaster and is updated from time to time.

1 Relevant Standards for Financial Advice

(1) Financial advice is designed to instruct a person on the efficient use of their financial resources to achieve their objectives.

(2) It is useful to refer to accepted standards that apply in giving financial advice. To do this we need to first understand the process that a reasonably competent financial adviser will follow in giving financial advice.

(3) Although I cannot give any legal opinion I believe it is necessary to give my understanding of the interpretation of the rules governing financial advice and it is also my understanding that this interpretation reflects the general views of Australian Financial Services Licensees.

1.1 The Advice of a Reasonably Competent Financial Adviser

(4) In my experience, a reasonably competent financial adviser would undertake the following process in formulating and delivering personal financial advice to retail clients.

(a) A reasonably competent financial adviser would first undertake a discovery process with the client so that the adviser understands the client's position. The purpose of this is to ensure that any advice is appropriate to the client's personal circumstances, investment objectives and tolerance to risk (appropriate advice). Where advice applies to financial products, this principle of appropriate advice is mandated by s945A of the *Corporations Act 2001.*

(b) The discovery process will include the following information:

(1) Personal position (family, career and other matters);

(2) Assets and liabilities;

(3) Income and expenses (this will include the income and expenses of a spouse, if relevant);

(4) Ownership of assets (if a trust is involved then the financial adviser needs to know who are the beneficiaries and their relevant individual taxation positions) ;

(5) Identification and agreement on objectives (objectives must be measurable otherwise the financial adviser cannot measure the progress towards achieving them)[1];

(6) Tolerance to risk.[2]

This information will form the basis for formulating a financial strategy for a client. A financial strategy is the sum of the actions designed to achieve the financial objectives of the client.

---

[1] See 1.6 for a detailed view on objectives

[2] See 1.7 for a detailed view on risk tolerance

(c) Common experience suggests that most people use their financial resources inefficiently. Consequently a reasonably competent financial adviser will design a financial strategy to do two things. The first is to re-position the client so that they use their financial resources efficiently. The second is to advise on immediate and future strategies designed to achieve the client's objectives. The financial strategy will be documented in a Statement of Advice (SOA).

(d) The SOA documents the advice given and the reason for that advice. The advice has two components. The key element of the advice is the financial strategy and this typically includes an investment strategy. The investment strategy is generally expressed as an asset allocation model. The second element of advice is in the selection of financial products to implement the strategy, for example choosing individual investments to populate the asset allocation model. The SOA will also contain a written disclosure of the interest of the financial adviser in giving the advice as well as documenting the research undertaken on any product recommended.

(e) Once a financial strategy has been determined, it is prudent to review it regularly and measure the progress towards achieving the objectives. Accordingly, a key aspect of an ongoing relationship between a client and a financial adviser is usually that the financial adviser accepts responsibility to conduct such reviews. These reviews typically occur annually. Investment portfolios are generally reviewed and rebalanced more frequently. The annual review will also include a discussion with the client about the amount of risk in the portfolio and whether this should be adjusted.

1.2 The regulation of financial advice

(5) As described above, when giving financial advice, a reasonably competent financial adviser adopts a two step process. The first step is to design the financial strategy. The second step is to select financial products to implement that strategy.

(6) My understanding is that common law principles of professional responsibility and/or negligence apply to both steps of that process. The basic principle is described in *Lanphier v Phipos* (1838) 8 Car & P 475 at 479 [173 ER 581 at 583], where Tindal CJ said, "Every person who enters into a learned profession undertakes to bring to the exercise of it a reasonable degree of care and skill." I understand this principle has been confirmed by the High Court of Australia in *Rogers v Whitaker* (1992) 175 CLR 479, in which Mason CJ, Brennan, Dawson, Toohey and McHugh JJ stated: "In Australia, it has been accepted that the standard of care to be observed by a person with some special skill or competence is that of the ordinary skilled person exercising and professing to have that special skill." (at 487).

(7) The provisions of the *Corporations Act 2001* apply to the second step, being the selection of products to implement the financial strategy.[3]

(8) In addition to the requirements of the Corporations Act, ASIC issued Regulatory Guides (RG) numbered 167, 168, 175, 181 and 244 to clarify its interpretation of the Corporations Act and the standards ASIC expects

[3] The *Corporations Act 2001* commenced on 15.7.01. Prior to this date, the *Corporations Act 1989* applied.

Australian Financial Services Licensees (Licensees) and their Authorised Representatives (ARs) to follow in giving financial advice.

From approximately 1997 these RGs were called Policy Statements (PS). Before 1997, the then Australian Securities Commission issued Policy Notes (PN). In my opinion, the transitions did not involve any changes to the relevant standards. The following PS and PN applied:

(a) until 3 March 1997, PN 23;

(b) between 3 March 1997 and approximately 2001, PS 121 and 122;

(c) between 28 November 2001 and 13 May 2005, PS 167 and 168 (updated 8 November 2002 and 2 October and 2 November 2003);

(d) between 26 June 2003 and 13 May 2005, PS 175 (updated 23 September 2003); and

(e) from 30 August 2004, PS 181.

(9) The ASIC policies and interpretative guidelines set out in these Regulatory Guides are not a comprehensive statement of the legislation and therefore must be read together with the Act. They should be used only as guidance on key aspects of the relevant legal obligations.

(10) ASIC Regulatory Guides form the basis of ASIC audits of financial advisers and ASIC measures the performance of financial advisers by these rules.[4] The rules therefore are considered as minimum standards of behaviour for financial advisers and are "best practice" guidelines.

(11) The Financial Planning Association of Australia Ltd (FPA) also issued a set of rules that were professional standards for financial advisers. The FPA called their rules, the "Rules of Professional Conduct" and they reflect the standards outlined in the ASIC Regulatory Guides. Australian Financial Services Licensees also use these rules in their training and in their Manuals of Procedures for their Representatives and Authorised Representatives.

(12) Based on my experience as a financial adviser, an academic (training financial advisers and as a consultant in the industry) and former Chairman of the FPA, it is commonly accepted, that the industry standards expressed in these Regulatory Guides reflect the industry standard in respect to giving financial advice as an authorised representative of an Australian Financial Services Licensee.

(13) An examination of the relevant parts of the *Corporations Law* and *Corporations Act 2001* (Cth) as well as the policy guides issued by the (then) Australian Securities Commission (ASC, now ASIC), starting with SPN 23 and SPN 41, reveals that the general principles of:

(a) disclosure of interests;

(b) ascertaining that a recommendation is appropriate to the investment objectives, financial situation and particular needs of the client as known to the financial adviser;

[4] In the Policy Notes, Policy Statements and Regulatory Guides issued by the ASIC (formerly the ASC) they describe how they expect financial advisers to satisfy their obligations under the relevant Acts that apply to financial advice. I refer to these descriptions as “rules”. For example RG175.126 identifies some “rules” that certain information is to be included in a SOA.

(c) basing the recommendation on such consideration and investigation, reasonable in all the circumstances, in relation to the securities which are to be recommended; and

(d) accounting for the client's tolerance to risk

have not changed since the commencement of the *Corporations Act 1989*. Consequently, when I quote recent publications to explain these principles, they were just as relevant in 1989 as they are today.

I summarise key elements of these rules below.

1.3 The additional standards that apply to a Licensee

(14) A Licensee has obligations in addition to the obligations of a financial adviser. A Licensee is responsible for meeting the conditions of its licence. This will include financial conditions. However, the most important issue is that the Licensee is responsible for almost all advice given by its ARs[5]. This causes Licensees to develop strict compliance processes within their businesses and processes for supervising their ARs.

(15) Licensees have obligations under sections912A(1)(c), (ca) and (f) to supervise and train their ARs.

1.4 Standards for the Supervision of Financial Advice

(16) One level of supervision of advice is to mandate that all ARs use the approved templates for Statements of Advice (SOA) or Limited Statements of Advice (LSOA). In my experience, a reasonably competent Licensee will prepare templates covering the various generic strategies that are likely to be included in a SOA. The benefit of having all ARs use these templates is that advice within the area covered by the template will be consistent and the wording and data will be compliant with the rules of the Licensee.

(17) Another level of supervision that is common for Licensees is to mandate that all advice must comply with the published policies of the Licensee. A reasonably competent Licensee will publish a policy statement on each generic financial planning strategy (such as negative gearing or switching products). The purpose of the policy statements is to establish the rules which apply to the Licensee's ARs when giving advice on the subject matter. By mandating that all advice must comply with these policy statements, the Licensee is seeking to ensure that advice is reasonable and appropriate to the client and that advice on a subject matter is not given if the client does not satisfy the conditions described within the particular policy statement.

(18) Where a Licensee operates from a single site, it is common to have advice reviewed by a peer before it is delivered to a client. Single site Licensees are often small businesses and may not have a full time compliance officer.

(19) Most Licensees which operate from multiple sites have larger businesses and more resources than Licensees operating from a single site. These businesses will generally have a full time compliance officer or team. The degree of supervision of advice will depend on the size of the business. With medium sized businesses it may not be commercially possible to examine all written advice. However, with large businesses (with more resources) there is

[5] I refer to an Authorised Representative of an Australian Financial Services Licensee as an AR.

a trend towards examining all advice. In my experience, the following processes are common.

(a) A new AR will generally have to submit all written advice for review until the Licensee is satisfied with the AR's competency and adherence to the rules of the Licensee.

(b) All ARs will submit a quality control checklist (QCC) to the Licensee to indicate that advice has been prepared. The advice may or may not be examined by the Licensee subject to the QCC and the assessed competency of the AR.

(c) The Licensee will have an audit programme to systematically review a sample of written advice given by ARs. If a web based Customer Relationship Management (CRM) system is used (such as Xplan), then advice can be examined centrally without leaving head office. If this is not the case, then advice can only be examined by a visit to the remote office or by requesting that it is sent to head office. An examination of advice includes an examination of file notes and other documentation associated with the advice.

(d) Compliance staff may also examine commission statements to look for unusual transactions and this will cause the examination of the advice associated with those transactions.

(e) Compliance staff may also conduct an audit programme relating to specific issues such as super switching.

(20) A reasonably competent Licensee will conduct an annual audit of each site where ARs operate. The purpose of these visits is to inspect signage; office standards; organisational capacity to provide the required level of service; and client files.

1.5 Approved Product Lists

(21) Australian Financial Services Licensees are responsible for the advice that is given by their representatives and they have a consequent obligation to supervise that advice. One of the tools of supervision that they employ is the Approved Product List (APL).

(22) It is normal practice for a reasonably competent Licensee to restrict their ARs so that they can only advise clients on the investments that are included on the Licensee's APL.

(23) In my experience, a reasonably competent Licensee will undertake the process described at 1.9.2 or a process similar, in examining whether a financial product should be placed on the APL.

(24) By going through the process in paragraph (65) a reasonably competent Licensee will filter investments with a view to excluding those that carry unacceptable risk or those that are unlikely to meet the return or other criteria that the Licensee considers acceptable. By default this process identifies acceptable (to the Licensee) investments that the Licensee may include on their APL.

(25) Reasonably competent Licensees will also review the investments on the APL so that if there is a material change, they may remove the investment from the APL and advise their ARs as to what action should be taken with clients as a result of the removal. If an investment that was included on an APL issued a new offer document or any information that is a material change, then a

reasonably competent Licensee would, as a matter of routine, review that investment to determine whether it should remain on the APL.

(26) This process provides the following benefits to the Licensee.

(a) The Licensee can be confident that the investments included on the APL meet the firm's criteria.
(b) The Licensee has reduced advice liability through a thorough research process and the restriction of ARs to only advising on the investments on the APL.
(c) The Licensee controls distribution of client financial resources through control of the products that will or will not be included on the APL.
(d) The Licensee limits their ongoing research requirement by restricting the APL to a certain number of products and therefore avoiding the need to research the universe of products.

(27) Where an AR wants to give advice on a product that is not on the APL of the Licensee, the rules of a typical Licensee are such that the AR must request permission. A reasonably competent Licensee then assumes responsibility for reviewing available information about the product and forming a judgement as to whether to allow the AR to give such advice or not.

1.6 Objectives

(28) The function of advice is to achieve an outcome (objective). Advice cannot be constructed to achieve an outcome if that outcome is not known.

(29) In my opinion a reasonably competent financial adviser cannot give appropriate financial advice without understanding what the client wants to achieve. In formulating financial advice, a financial adviser will design the strategy to achieve the client's objective. Consequently understanding the objective is critical to the advice.

(30) If the financial adviser is not aware of the objective, then there is no parameter within which the advice should be given. Additionally there would be no basis for the advice.

(31) The risk to the client if the financial adviser is not aware of the objective or the objective is not clearly defined is that the advice may not be appropriate to the client. For example, a financial adviser may advise negative gearing when that risk is not necessary in order to achieve the objective.

(32) With respect to financial product advice the s945A obligation to have a reasonable basis for advice is further explained in RG175.101

"The client's relevant personal circumstances are 'such of the person's objectives, financial situation and needs as would reasonably be considered to be relevant to the advice'"[6]

(33) Although the Corporations Act applies to financial product advice, it is generally accepted in the financial advice community that the same standards apply to all financial advice.

(34) Financial objectives should be quantified so that they can be measured. Measurement should include a timeframe and a quantum.[7] If an objective

---

[6] S761A Corporations Act 2001

[7] Refer to paragraphs 261-273 of the following Judgement. Australian Securities and Investments Commission v Cassimatis (No 8) [2016] FCA 1023

cannot be measured then, during the period of progress towards the objective, a financial adviser cannot determine whether the client is likely to achieve the objective or whether remedial action needs to be taken. Further, by quantifying an objective, a financial adviser can determine what financial resources and how much risk (and therefore what asset allocation) needs to be applied to achieve the objective.

(35) In my experience it is common for clients to be initially unable to quantify their objectives. The role of a reasonably competent financial adviser is to explore with the client what they really want to achieve and then to help them translate that into a quantum and timeframe.

(36) There are times when a client is not able to quantify their objectives. Where this is so, a reasonably competent financial adviser will recommend a benchmark so that the performance of an investment portfolio or strategy can be measured and determined to be efficient[8] or require remedial adjustment. For example, a benchmark for an investment portfolio could be to achieve growth of 3% pa above inflation in any 3 year period. For a share market portfolio it could be to achieve growth of 3% pa above the S&P/ASX 500 Index.

(37) At times a client will have objectives that cannot be achieved given their financial resources and timeframe. In such cases, it is the role of a reasonably competent financial adviser to advise the client that they should either adjust their financial resources; the amount of risk that they take; the time period; or their objective. Adjusting the amount of risk they take will introduce a volatility experience that may not correlate with their risk profile.

1.7 Risk Profile

(38) After identifying a client's objectives, a reasonably competent financial adviser will then determine the client's tolerance to investment risk. This is called the client's risk profile.

(39) There is a significant difference in the type of investments that a reasonably competent financial adviser would recommend to clients with different risk profiles. The risk profile will determine the asset allocation that is appropriate to a client because the asset allocation defines the risk and return character of an investment portfolio. Consequently the identification of a client's risk profile is critical in determining the advice that is appropriate to that client.

(40) Section 945A of the Corporations Act 2001 requires a financial adviser to have a reasonable basis for the advice taking into account the client's "relevant personal circumstances".[9]

"(1) The providing entity must only provide the advice to the client if:
(a) the providing entity:
(i) determines the relevant personal circumstances in relation to giving the advice; and

---

[8] By "efficient", I mean that because risk and return are related, a high risk investment should achieve a high return and a low risk investment should achieve a low return. A high risk investment that achieved a low return is inefficient.

[9] This section was replaced in July 2014 with section 961B that requires an adviser to act in the best interest of clients. The principles of s945A remain.

(ii) makes reasonable inquiries in relation to those personal circumstances; and

(b) having regard to information obtained from the client in relation to those personal circumstances, the providing entity has given such consideration to, and conducted such investigation of, the subject matter of the advice as is reasonable in all of the circumstances; and

(c) the advice is appropriate to the client, having regard to that consideration and investigation.

Note: Failure to comply with this subsection is an offence (see subsection 1311(1))."

(41) In considering a client's personal circumstances ASIC has specifically established the need for a financial adviser to account for a client's tolerance to investment risk in PS175.104 which provides:

"[PS 175.104] Where advice relates to financial product(s) with an investment component, we consider that the "relevant personal circumstances" of the client will normally include the client's:"

"(d) tolerance of the risk of capital loss, especially where this is a significant possibility if the advice is followed;

(e) tolerance of the risk that the advice (if followed) will not produce the expected benefits;"

(42) Tolerance to the risk of capital loss or the failure of the expected benefits is generally determined through the process known as risk profiling.

(43) The risk profile can be determined in a number of ways each involving a subjective process. In my experience there are three broad methods used in the financial advice industry.

(a) Some financial advisers use a sophisticated psychometric testing process.

(b) The most common method is to ask the client a simple set of questions where the answers are weighted and equated with an asset allocation aligned with a risk profile.

(c) Another method is where a financial adviser will explain how investment markets behave and explain the role of risk. With this background, the adviser will explain the risk and return characteristics of the different investment options (aligned with risk profiles) and probable outcomes that the client can choose and then discuss with the client which investment option they think will best suit their tolerance to risk.

(44) The success of this process relies on two factors. One is the ability to sufficiently educate the client so that the client can make an informed judgment about his or her risk preference. The other is to avoid adviser bias in influencing the client to select a position that may not be suitable.[10]

(45) Generally, investors are identified as having one of the following standard risk profiles.

The standard risk profiles are:

---

[10] Refer to paragraphs 293-300 of the following Judgement. Australian Securities and Investments Commission v Cassimatis (No 8) [2016] FCA 1023

(a) *Conservative* – Low risk, bias towards secure income producing investments.
(b) *Moderate* – bias towards income producing but with more growth investments than conservative.
(c) *Balanced* – Balance between income producing and growth investments.
(d) *Growth* (also referred to as Moderately Aggressive) – Bias towards growth with a small component of income producing investments.
(e) *High Growth* (also referred to as Aggressive) – High risk, all growth and some speculative investments.

(46) There is a significant difference in the type of investments that a financial adviser would recommend to an investor in each of these categories. Consequently the identification of an investor's risk profile is critical in determining the advice that is appropriate to that person.

(47) To give some context to these descriptors, typical ratios of growth assets/defensive assets[11] in investment portfolios that are applied to clients with these risk profiles are;

- Conservative 20/80
- Moderate 40/60
- Balanced 60/40
- Growth 80/20
- High Growth 100/0

This observation is based on my experience in advising clients, managing financial planning businesses and examining many financial planning businesses since 1982.

(48) Growth assets (shares and property) generally provide high capital growth and low income. Defensive assets (fixed interest and cash) generally provide high income and low (if any) capital growth. Volatility and risk is generally higher in growth assets and lower in defensive assets.

(49) It is important to understand that although a client who wants 100% of their investments in growth assets will be determined to be a High Growth investor, this does not mean that all such clients will find high risk and speculative investments acceptable. Some clients want to invest conservatively in growth assets and such clients will typically hold property and blue chip shares.

(50) In their published "Policy Position on Risk Tolerance"[12], the FPA outline the following relevant principles.

Paragraph 5 (b)

(ii) "Financial advisers are in the best position to explain and educate clients on the investment risks associated with the recommendations being made and the relationship of these investment risks to the client's risk tolerance assessment.

---

[11] This is a succinct way of describing the broad asset allocation and therefore the risk and return characteristics of an investment portfolio. Generally shares and property are included in the growth component and fixed interest and cash are included in the defensive component.

[12] Dated October 2003

(iii) FPA emphasises that this educative relationship between the financial adviser and the client is acknowledged at Common Law [13]."

Paragraph 5 (c)

(iii) "Financial advisers would be expected to be able to advise clients about the range of outcomes they could reasonably expect to experience and to advise and discuss with clients, in terms they can easily understand, the financial implications of returns being at the bottom end of the possible range. For example, this may mean that retirement would need to be postponed for an extra year or lifestyle may need to be reduced in later years if they adopt the proposed strategy instead of opting for a risk free return such as an assumed cash return. It is also appropriate to consider the outcomes if normal market returns are experienced and even upside opportunity to allow clients to form a view about whether they value the potential benefits enough to justify the risk."

1.8 Relationship between objectives and risk profile

(51) A client's objectives and risk profile cannot be viewed in isolation. They are interdependent.

(52) The risk profile determines the asset allocation and therefore the risk and return character of an appropriate investment portfolio.

(53) A reasonably competent financial adviser will apply the available financial resources to the asset allocation determined by the risk profile. This will allow a projection of the value of the investment portfolio over time to see whether the objectives are likely to be satisfied.

(54) If the objectives are not likely to be satisfied then the client will need to take one or more of the following steps:

(a) either apply more financial resources,
(b) increase their timeframe;
(c) reduce their objectives; or
(d) take higher risk.

(55) Regardless of a client's objectives and risk profile, a financial adviser has a primary obligation to give advice that will not place a client in a position where the risk of their strategy could significantly affect their financial capacity to maintain their present financial position (based on the reasonable judgement of the financial adviser). For example:

In my opinion a retired couple who owned their home, had no debt and had a small amount invested would not be suited to the risk of negative gearing. The reason for this view is that if their geared investments declined in value they would generally not have the cash reserves nor surplus income to replace those investments or meet any margin calls. Additionally they generally would not have the surplus income to pay the

---

[13] *Paige v FPI Limited & Anor* [2001] NSWSC 627: Adviser found liable as a result of, inter alia, failing to advise the client that there were risks to his capital in the recommended investments. McClellan J noting at 198 that "a reasonable investigation would have ensured at the least that the clients were explained the elements of and practical application of their risk profile to the investments which he was recommending."

net investment costs (after allowing for investment income). In my opinion a negative gearing strategy for people in this position has the risk that it could significantly affect their financial capacity to maintain their present (before gearing) financial position. In my opinion a reasonably competent financial adviser would not advise clients in this position to take high risk or to leverage risk by negative gearing.

(56) Where a client insists on a strategy or particular objective that in the reasonable judgement of a financial adviser would place them in a position where the risk could significantly affect their financial position in a negative way, then the adviser has an obligation to explain those risks and possible outcomes and in some cases may refuse to give advice based upon that strategy. [14]

1.9 Research

1.9.1 General Obligation

(57) Although the Corporations Act applies to financial product advice, it is generally accepted in the financial advice community that the same standards apply to all financial advice.

(58) The primary obligation in s945A(1)(b) is the requirement that the financial adviser give such consideration to, and conduct such investigation of, the subject matter of a recommendation as is reasonable in all the circumstances. In my experience, reasonably competent financial advisers can either carry out research and analyse investments themselves or will use research and analysis generated from external sources. The extent of the research and analysis that it is reasonable to expect the financial adviser to do depends on the nature of the product or strategy that forms the basis of the particular recommendation and the needs of the client being advised.

(59) In RG 175.114 ASIC specifically identifies the obligation of a financial adviser as the providing entity[15] to conduct research on the subject matter of their advice.

"[RG 175.114] The obligation rests on the providing entity to investigate the subject matter of the advice. Depending on the circumstances, it may be reasonable for the providing entity to rely on information supplied by external research houses. A providing entity relying on such information should take reasonable steps to ensure that the research is accurate, complete, reliable and up-to-date."

(60) In my opinion, to provide advice appropriate to a particular client a financial adviser should, as a minimum requirement, consider economic and accounting information relating to markets and industries and securities respectively. This information, when analysed, forms the basis for judging future income and growth expectations and risk factors associated with recommended investments, individually and collectively, in an investment portfolio. The financial adviser is required to take those analyses into account

---

[14] Refer to paragraph 333 of the following Judgement. Australian Securities and Investments Commission v Cassimatis (No 8) [2016] FCA 1023

[15] S944A of the *Corporations Act 2001*

when selecting from competing products and formulating suitable investment strategies.

(61) A financial adviser should at any time be able to provide sufficient written information about the investments recommended so that the basis on which those investments were considered appropriate for the particular client can be understood.[16] It is expected that this information would usually be provided to the client before the client takes up the recommendation. It should also be easily accessible in the financial adviser's files relating to the client.

(62) These written reports should address both risk factors and return expectations. Some of the matters that should be disclosed include:

- (a) risks associated with the issuer. These include the qualities and experience of the issuer, associated companies, management company and trustee, as appropriate;
- (b) risks associated with the product, such as the quality of underlying assets and risk-return characteristics of the product;
- (c) market and economic risks, such as economic cycles, volatility and other capital market factors; and
- (d) capital and income prospects. [17]

1.9.2 The research obligation of a Licensee

(63) Licensees are responsible for the advice that is given by their ARs and they have a consequent obligation to supervise that advice. One of the tools of supervision that they employ is the Approved Product List (APL).

(64) It is normal practice for a Licensee to restrict their ARs so that they can only advise clients on the investments that are included on their APL.

(65) In my experience, a Licensee will undertake the following process or a process similar, in examining whether a financial product should be placed on the Approved Product List.

- (a) Due diligence on the manager of the financial product
- (b) Analysis of the PDS, prospectus, company or investment offer
- (c) Analysis of the assets, liabilities and investment methodology
- (d) Analysis of risks associated with the investment
- (e) Analysis of past performance (measurement of risk and return) versus objectives and relevant indices
- (f) Analysis of fees
- (g) Analysis of the effect of tax on net return
- (h) Analysis of capital market factors
- (i) Analysis of research on the product published by a research house.

(66) Some of the above analyses may be provided by a research house. It is common practice for many licensees to accept the recommendations and research of a research house on the basis that the research house has undertaken the above process. Effectively such Licensees have outsourced research.

---

[16] PS122.100, PS122.129, RG175.93(c)&(d), RG175.135(c) and S947C(2)(b) of the Corporations Act 2001

[17] PS122.109

1.9.3 The research obligation of a financial adviser

(67) In my opinion, the extent of research of a reasonably competent financial adviser in relation to a financial product that the adviser is considering to recommend to a client, will be to critically examine the prospectus, PDS or offer and read the research provided by the Licensee that relates to that product. It is reasonable for the financial adviser to rely on the integrity of the due diligence undertaken by the Licensee and on the research findings provided by the Licensee. It is not common for financial advisers to undertake research additional to the research of the Licensee.

(68) In my opinion, a financial adviser should be able to generally rely on the research, analysis and information provided by the Licensee. It is, in my opinion, unreasonable to expect financial advisers to duplicate the work of the Licensee. However, a reasonably competent financial adviser should review all information to examine it for reasonableness. By this I mean that such an adviser will understand the information provided to them and will form an opinion about the investment based on that information and will seek further information if the adviser judges that it is needed.

(69) A financial adviser should be kept up to date on approved products through research updates issued by the Licensee, professional development training and through the process of reviewing clients' investment portfolios at least annually. In this process, a reasonably competent financial adviser will review financial products that have been recommended to the client.

1.9.4 The research obligation with direct equities

(70) The role of a reasonably competent financial adviser in giving investment advice is to:

(a) determine an appropriate asset allocation (this defines the risk and return character of the portfolio); and
(b) select appropriate investments within each asset class.

(71) Some financial advisers (such as stockbrokers) are expert in company analysis and will select particular companies to be included in their client portfolios on the basis that they predict that those companies will out-perform others in terms of their risk and return qualities. Other financial advisers who are not expert in company analysis will select professionally managed funds to populate the asset classes for their clients.

(72) In my opinion the research required of a financial adviser who selects companies is greater than the research required of a financial adviser who uses professionally managed funds. The latter adviser has the benefit of a Product Disclosure Statement that generally describes the methodology of the fund manager in choosing companies and ensuring that the mixture of companies is appropriately correlated commensurate with the objectives of the fund. Further, the fund manager will undertake expert analysis to assist them to make daily decisions on what companies to sell or buy. A financial adviser who selects companies must undertake the same detailed research and analysis as is undertaken by professional fund managers.

(73) To select particular companies and direct investments for a client, a reasonably competent financial adviser would have regard to analysts' reports on each of the investments and analysts' reports on the relevant status of each market and factors likely to affect it. It is usual to consider more than

one analyst report because different analysts may express different views on such matters.

1.10 Risk and Return

(74) All investments carry risk and the expected return reflects the amount of risk. Consequently an investor expects to receive a lower return for cash and fixed interest investments (lower risk) compared with equity investments (higher risk).

(75) A fundamental principle of investment is that risk and return are related. An investment in government bonds is regarded as a risk free investment (on the basis that the government will not default). Investors in shares are taking more risk and expect to be rewarded with a higher return as compensation for higher risk. This higher return over the risk free return is called the risk premium.

(76) By measuring risk, it is possible to quantify the expected return. How to expose an investment portfolio to risk in the different asset classes[18] is the most critical decision to make in determining the return the investor can expect. If an investor invested in the whole market using, for example, an index fund then the investor will expect the market rate of return. The only way the investor can achieve a higher return in the usual course is to accept a higher risk.

(77) The key to an efficient investment portfolio is in making sure that the investor is rewarded for the risk that they take.

(78) Financial advisers deal with research on investment returns and measurement of risk in various markets on a day to day basis. They are familiar with the relationship between risk and return as well as the expected returns on different classes of investment. Financial advisers are trained to question and understand the source of investment return and the source of risk.

1.11 Borrowing to Invest

(79) The practice of borrowing to invest (gearing) increases risk as well as potential reward. For example, if an investor invests $100,000 of their own cash and borrows $100,000 from the bank to make a $200,000 investment, then here is an illustration of their experience if the investment rises and if the investment falls.

---

[18] This is called asset allocation

The effect of borrowing to invest				
	$	$	$	$
Cash invested	100,000	100,000	100,000	100,000
Borrowings @ 7%pa	0	100,000	0	100,000
Amount of investment	100,000	200,000	100,000	200,000
Investment increases by 15% in a year	15,000	30,000		
Investment decreases by 15% in a year			-15,000	-30,000
Investment sold at end of year	115,000	230,000	85,000	170,000
Less loan repayment (with interest)	0	-107,000	0	-107,000
Gross return	15,000	23,000	-15,000	-37,000
% return	15.0	23.0	-15.0	-37.0
Loan to valuation ratio (%)		50.0		50.0

The effect of taking a margin loan on investments that are funded by borrowings		
	$	$
Cash invested	0	0
Borrowings @ 7%pa	200,000	200,000
Margin loan @ 8% pa	150,000	150,000
Total amount of investment	350,000	350,000
Investment increases by 15% in a year	52,500	
Investment decreases by 15% in a year		-52,500
Investment sold at end of year	402,500	297,500
Less loan repayment (with interest)	-376,000	-376,000
Gross return	26,500	-78,500
Loan to valuation ratio (%)	100.0	100.0

(80) This illustration ignores investment and borrowing costs. Clearly in the event of markets falling, there is greater risk if geared. This risk is substantially increased if borrowed funds are used to purchase the assets on which a margin loan is based. Because of this, a reasonably competent financial adviser will generally recommend gearing with conservative investments that are less likely to fall in value and will only recommend gearing to clients who are prepared to assume more risk in connection with their investments.

(81) Because borrowing to invest leverages (increases) risk, in my opinion, a reasonably competent financial adviser would have undertaken the following process in considering this strategy.

(a) Consider whether the client's risk profile is suitable to the higher risk strategy of negative gearing (borrowing to invest). If the strategy was not suitable, because, for example, the client was a Conservative or even a Balanced investor then the advice would generally not be given. In my opinion a reasonably competent financial adviser would generally only advise an investor with a Growth or High Growth risk profile to borrow to invest. The reason for this is that investors with these risk profiles invest principally for capital growth and they are tolerant to higher risk. (It is generally inefficient to borrow to invest in fixed interest securities because the cost of borrowing almost always exceeds the return (unless they are high risk securities). Consequently it is not efficient to borrow to invest in (for example) a 60/40 investment portfolio because 40% is in fixed interest but it is efficient to borrow to invest in a portfolio of growth assets.)

(b) Conduct an analysis of the client's cash flow to determine their capacity to fund the costs associated with the borrowings and any margin calls to the extent not covered by income from the investments.[19]

(c) Prepare a sensitivity analysis to determine how the client could be affected if the investments performed badly as well as how they could be affected if the investments performed well.[20]

(82) As a general principle, where a client borrows to invest, a reasonably competent financial adviser will place all of their investments that are funded by debt in growth assets (shares/property). The reason for this is that the success of borrowing to invest is generally dependent on asset growth and the margin between the interest cost of borrowing and the investment return of debt investments (bonds) is either too narrow or negative to make borrowing against bonds an attractive strategy.

(83) The success of a borrowing to invest strategy relies on the asset growth and income return of investments exceeding the costs of borrowing and any other costs related to the investments.

(84) If the income return is insufficient to meet those costs and the asset growth either has not occurred or is insufficient or has not been realised, the client must have another source of funds available they are to meet these costs as they become payable.

(85) The strategy of borrowing to invest and managing expenses can work provided the assumptions are reasonable and the client has the capacity to fund the strategy through periods when markets fall or when unforeseen events occur. In my opinion, any advice to borrow to invest should only be given after conducting a sensitivity analysis to look at how the strategy and the client is affected when markets fall or when assumptions are not met.[21]

1.12 Basis for Recommendations

(86) Although the Corporations Act applies to financial product advice, it is generally accepted in the financial advice community that the same standards apply to all financial advice.

(87) Section 945A of the Corporations Act 2001 requires a financial adviser to have a reasonable basis for the advice

"(1) The providing entity must only provide the advice to the client if:
  (a) the providing entity:
    (i) determines the relevant personal circumstances in relation to giving the advice; and
    (ii) makes reasonable inquiries in relation to those personal circumstances; and

[19] Refer to paragraphs 286-290 of the following Judgement. Australian Securities and Investments Commission v Cassimatis (No 8) [2016] FCA 1023

[20] RG175.104 (d) and (e) and refer to paragraphs 274-284 of the following Judgement. Australian Securities and Investments Commission v Cassimatis (No 8) [2016] FCA 1023

[21] RG175.104 (d) and (e)

(b) having regard to information obtained from the client in relation to those personal circumstances, the providing entity has given such consideration to, and conducted such investigation of, the subject matter of the advice as is reasonable in all of the circumstances; and

(c) the advice is appropriate to the client, having regard to that consideration and investigation.

Note: Failure to comply with this subsection is an offence (see subsection 1311(1))."

(88) The s945A obligation to have a reasonable basis is further explained in PS175.101

"The client's relevant personal circumstances are 'such of the person's objectives, financial situation and needs as would reasonably be considered to be relevant to the advice'"

(89) In PS175.104 ASIC identified the key elements of a client's relevant personal circumstances that should be considered by a financial adviser as follows:

"[PS 175.104] Where advice relates to financial product(s) with an investment component, we consider that the "relevant personal circumstances" of the client will normally include the client's:"

(a) need for regular income (eg retirement income);
(b) need for capital growth;
(c) desire to minimise fees and costs;
(d) tolerance of the risk of capital loss, especially where this is a significant possibility if the advice is followed;
(e) tolerance of the risk that the advice (if followed) will not produce the expected benefits;
(f) existing investment portfolio;
(g) need to be able to readily cash-in the investment;
(h) capacity to service any loan provided in relation to a financial product; and
(i) tax position, social security entitlements, family commitments, employment security and expected retirement age.

Note: This is not an exhaustive list. The client's relevant personal circumstances (as defined in s761A) include any other matter that would reasonably be considered to be relevant to the advice. This would normally encompass any matter that the client indicates is important."

(90) While s945A is limited by its terms to retail clients, and only commenced operation on 11 March 2002, in my opinion the obligation to have a reasonable basis for advice was applied from the commencement of the *Corporations Act* 1989 and I consider that a reasonably competent financial adviser providing advice and recommendations to any client would need to have a reasonable basis for the advice and recommendations, taking account of the client's circumstances, objectives and tolerance to risk. The reason that I hold this view is because:

(a) It is logical to understand the personal circumstances of a client to ensure that the advice is appropriate to their circumstances. The function of advice is to achieve an outcome. It is not logical to give financial advice if you do not understand the client's intended outcome (objective). It is essential that financial advice suits an investor's tolerance to investment risk. Additionally an adviser must understand the subject matter of the advice.

(b) These principles are universal and apply when formulating advice for any client, including both retail and wholesale clients. In my opinion they are also the principles embodied in establishing a reasonable basis for advice pursuant to s945A of the *Corporations Act* 2001 and s851 of the *Corporations Act* 1989.

1.13 Standard of Advice

(91) PS122, that was issued on 3 March 1997, provides:

> "As a matter of best practice, a securities adviser giving a personal securities recommendation to a client should explain to that client why the recommendation is considered appropriate to the investment objectives, financial situation and particular needs of the client. The ASC considers it important that the adviser tells their client about any significant risks associated with the investment and any investment strategies recommended to the client."[22]

(92) Although PS122.100 is expressed to be "best practice" and has since been withdrawn, in my experience, the training that Licensees give their ARs and the relevant professional standards proceed on the basis that this principle is a matter of normal practice to be followed by a reasonably competent financial adviser.

(93) I note that predecessors to PS122, being SPN23 issued on 13 July 1992 and SPN41 issued on 27 November 1993, demonstrate that these standards were also in place at those earlier times.

1.14 Record Keeping

(94) On 3.3.97, the (then) ASC identified the records it expected a financial adviser to keep so that the financial adviser could demonstrate a reasonable basis for the adviser's advice. This included:

"[PS 122.126] Section 851 does not impose a specific obligation on a securities adviser to keep a record of a client's investment objectives, financial situation and particular needs (client profile) or the product research carried out (see [PS 122.108–122.111] for what is adequate product research)."

"[PS 122.127] However, according to the ASC's interpretation of the Law, a securities adviser cannot satisfy the s851 requirement to have a reasonable basis for making a securities recommendation unless adequate product research is conducted in light of the client's investment objectives, financial situation and particular needs. An adviser needs to keep records of the client's profile and product research conducted or used to formulate the recommendations. This should be kept as evidence that the adviser has in fact complied with their s851 obligation."

"[PS 122.128] Similarly, the ASC considers that a securities adviser who provides personal securities recommendations to a client should keep a record of that client's profile, which contains information that was accurate and up to date when making their personal securities recommendations. The

---

[22] PS122.100

records also should include any product research conducted or used in formulating the recommendations. Unless a client is given on-going advisory services, the client profile would not generally need to be updated."

"[PS 122.129] An adviser should, as a matter of best practice, record the reasons why certain products were considered appropriate for a particular client and any information on risks of investments and strategies recommended to the client."

"[PS 122.130] Such records may be kept electronically or in hard copy and must be accessible to the ASC and the client on request."

1.15 Application of the Relevant Standards

(95) The standards described above were applicable as a matter of normal practice throughout the relevant period.