RE-EVALUATING THE APPROPRIATE ADVICE RULE IN LIGHT OF THE GLOBAL FINANCIAL CRISIS

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A providing entity that provides personal advice to a retail client must comply with the appropriate advice rule: Corporations Act 2001 (Cth), s 945A(1). This rule requires the providing entity to 'ascertain the client's objectives and their financial situation and needs, investigate and consider the options available to the client, and base the advice on that consideration and investigation.' The appropriate advice rule is designed to protect consumers who rely on advice from financial advisers to help them make financial decisions. This paper re-evaluates the appropriate advice rule in light of the current global financial crisis and puts forward several law reform suggestions for consideration.

I. INTRODUCTION

A providing entity (i.e. a financial services licensee or an authorised representative of a licensee) that provides personal advice to a retail client must comply with the 'appropriate advice' rule set out in s 945A(1) of the *Corporations Act 2001* (Cth).

The appropriate advice rule is designed to protect consumers who rely on advice from financial advisers to help them make financial decisions. The rule 'is designed to address the lack of sophistication of retail investors who...may not be able to adequately analyse their investment needs or develop strategies to develop strategies to achieve their investment goals.'[1]

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1 Department of Treasury, *Financial Markets and Investment Products – Promoting Competition, Financial Innovation and Investment,* Corporate Law and Economic Reform Program Proposals for Reform: Paper No. 6 (1997), 103.

The appropriate advice rule - sometimes alternatively known as the 'know-your-client' rule or the 'suitability' rule - has been a cornerstone of the regulation of financial advisers in Australia since 1986.[2] While the appropriate rule has been in place for over 20 years, it re-evaluation is now warranted in light of the current global financial crisis. This is because the current crisis is likely to prompt many consumers to seek information or advice to help them make a variety of critical financial decisions, including:

a. whether to change investment strategy within a superannuation fund (e.g. to move from a 'balanced' to a 'cash' option within a superannuation fund);

b. whether to alter existing voluntary or salary sacrifice contribution levels into superannuation;

c. whether to sell any financial products (e.g. shares) currently held;

d. whether to move existing funds from one superannuation fund to another superannuation fund, or to redirect future contributions away from one superannuation fund to another fund ('superannuation switching');

e. whether to invest money held in 'safe' products, such as deposit products covered by the Australian Government guarantee;

f. whether to take out additional insurance (eg income protection insurance).

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[2] The appropriate advice rule has been a key part of the regulation of advice since 31 March 1986. It was first introduced into Australian law by the *Companies and Securities Legislation (Miscellaneous Amendments) Act 1985* (Cth), s191 (which inserted s 65A into the *Securities Industry Code*). The need for the 1986 rule was explained, rather briefly, as follows: 'concern has been expressed at the practice of advising clients to place funds into particular investments irrespective of whether there is a reasonable basis for that advice and irrespective of whether the investments are suitable for the clients': Parliament of the Commonwealth of Australia, *Companies and Securities Legislation (Miscellaneous Amendments) Bill 1985 - Explanatory Memorandum* [691]. It is not clear from the Explanatory Memorandum whether any particular model was used as the basis for drafting the 1986 rule. It is possible that the rule was modelled, at least in part, on the following proposed rule:

> A registrant shall not recommend a trade in a security to a customer unless he has reasonable grounds to believe that the recommendation is suitable for the customer on the basis of:
> (a) information furnished by the customer after reasonable inquiry as to his investment objectives, financial situation and needs; and
> (b) any other information known to the registrant.

See Philip Anisman *Proposals for a securities market law for Canada* (1979), Volume 1, 71.

This situation focuses attention on the regulatory regime designed to ensure that Australians have access to high-quality, yet affordable, financial advice. One critical aspect of this regime is the appropriate advice rule.

This paper addresses the following questions relating to the scope and operation of the appropriate advice rule:

a. When does the appropriate advice rule apply?

b. How do you comply with the appropriate advice rule?

c. What sanctions may apply where the appropriate advice rule is breached?

d. What information must be provided to consumers about the advice?

e. Conclusion: what changes to the law should be considered?

Unless otherwise stated, all legislative references in this paper are to the *Corporations Act 2001*(Cth).

II. WHEN DOES THE APPROPRIATE ADVICE RULE APPLY?

A. *Introduction*

The appropriate advice rule applies whenever *personal advice*[3] is provided to a retail client[4] by a providing entity[5], unless a relevant exemption applies.[6] Critically, the scope of application of the appropriate advice rule depends on the scope of the expression 'personal advice'.

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3 *Corporations Act 2001* (Cth) s 766B(3).

4 *Corporations Act 2001* (Cth) s 761G.

5 Where advice is provided by an authorised representative of a licensee, the authorised representative is the providing entity and not the authorizing licensee: Corporations Act 2001 (Cth) s 769B(7). Where the advice is provided by a licensee, the licensee is the providing entity. Where a representative (other than an authorised representative) of a licensee provides advice, the licensee will generally be the providing entity because the representative's conduct will be attributed to the licensee: Corporations Act 2001 (Cth) s769B.

6 Exemptions may be granted by regulation or by the Australian Securities and Investments Commission (ASIC). For example, certain advice relating to the establishment of a self-managed superannuation fund (SMSF) is excluded from the definition of 'financial product advice': Corporations Regulations 2001 (Cth) regs 7.1.29 and 7.1.29A. Note that this exemption applies to advice relating to establishing a SMSF, but does not apply to advice about the underlying investments of a SMSF. A review of the current SMSF exemption is arguably required in light of the acknowledged problems associated with the SMSF sector. In this regard refer to the following: The Honorable Nick Sherry, 'The Government's priorities in superannuation and financial services' (Speech delivered at the Institute of Actuaries Financial Services Forum, Melbourne, 19 May 2008). <http://minscl.treasurer.gov.au/DisplayDocs.aspx?doc=speeches/2008/013.htm&pageID=005&min=njs&Year=&DocType=> at 23 June 2008.

Personal advice is a type of financial product advice. All financial product advice is categorized as either personal advice or general advice.[7] The appropriate advice rule (and certain other obligations) apply whenever personal advice is provided, but not in relation to the provision of general advice. Far less onerous obligations apply to the provision of general advice compared with the provision of personal advice.

The expression 'financial product advice'[8] means:

> a recommendation or statement of opinion, or a report of either of those things, that is:
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> (a) intended to influence a decision[9] in relation to a particular financial product[10] or class of financial products, or an interest in a particular financial product or class of financial products; or
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> (b) could reasonably be regarded as being intended to have such an influence.

Financial product advice is 'personal advice' if the advice is given or directed to a person in circumstances where:

> (a) the provider of the advice has considered one or more of the person's objectives, financial situation and needs.....; or
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> (b) a reasonable person might expect the provider to have considered one or more of those matters.[11]

B. *Analysis of the definition of 'personal advice'*

Depending on the circumstances, 'personal advice' will include, for example, recommendations or statements of opinion provided to a client about:

a. whether to buy, sell or hold a financial product (such as a share in a listed company);

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7 *Corporations Act 2001* (Cth) s 766B(2).

8 *Corporations Act 2001* (Cth) s 766B(1).

9 The concept 'decision' includes a decision to buy, sell or hold a financial product as well as a decision to switch investment strategies within a particular financial product, such as a superannuation fund. The meaning of 'decision' is explained in: Australian Securities and Investments Commission, *RG 36 Licensing: Financial Product advice and dealing* (2007), 10-1.

10 *Corporations Act 2001* (Cth) ss 762A-765A. The expression 'financial product' includes (but is not limited to) shares, debentures, registered managed investment schemes, regulated superannuation funds, insurance and basic deposit products.

11 *Corporations Act 2001* (Cth) s 766B(3).

b. the selection of an appropriate superannuation fund for the client (including whether to move funds from one superannuation fund to another fund);

c. the investment strategy or insurance option that the client should select within a particular superannuation fund;

d. whether to make, cease making, or to vary the level of voluntary or salary sacrifice contributions made to superannuation;

e. whether to acquire an insurance product.

The definition of 'personal advice' is clearly not limited to the situation where a client is provided with a 'full' financial plan. Further, it is important to note that the expression 'personal advice' is not limited to *recommendations* to buy or sell specific financial products (or classes of financial product). Rather, 'personal advice' may encompass *mere statements of opinion* where the provision of the opinion by the providing entity has been influenced by a consideration of the client's objectives, financial situation or needs:

a. whether or not there is any *recommendation* relating to a financial product or a class of financial product;

b. whether or not the client buys a financial product from, or through, the providing entity;

c. whether or not the advice is described as 'advice' by the providing entity;

d. regardless of how the providing entity is remunerated.

It can be seen that the expression 'personal advice' potentially encompasses a wide range of communications relating to financial products delivered to a client (by any means, including computer-based mechanisms), but does not apply where:

a. the communication is *purely factual* in nature (for example, where the communication consists solely of factual information about the recent share prices);[12]

b. the communication relates solely to an financial instrument or investment which is not a financial product, such as consumer credit[13] or certain forms of real property investment;[14]

c. a relevant exemption applies.

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12 Above, n 9, 8-10

13 Corporations Act 2001 (Cth) s 765A(1)(h). Note the recent announcement that the Commonwealth will assume responsibility for consumer credit regulation. The new regulatory regime will require credit providers and brokers to obtain a licence from ASIC: Australian Government National Consumer Credit – Single, Standard, National Regulation of Consumer Credit for Australia (2008): <http://www.treasury.gov.au/documents/1381/PDF/NCC_Brochure_02102008.pdf>

C. *Is the definition of 'personal advice' too broad?*

Some industry groups consider that the definition of 'personal advice' is too broad. In particular, it is often claimed that the definition creates a problem for product issuers or financial advisers wishing to communicate with their existing clients without needing to comply with personal advice obligations, including the appropriate advice rule. This problem arises because advice provided to an existing client could often be said to be based, at least to some extent, on a consideration of the client's objectives, financial situation and needs and, therefore, arguably constitutes personal advice.[15] In the current financial crisis it would be unfortunate if product issuers and financial advisers were unduly inhibited in communicating with their clients due to concerns (whether justified or not) about the potential breadth of the definition of 'personal advice'.

The Financial Planning Association (FPA) has suggested that the definition of 'personal advice' in s766B(3) should be replaced with a new definition which states that a person (provider) gives personal advice where:

a. a person (provider) makes a statement that is a recommendation to a particular person that the person should deal in, or make a decision to increase, reduce or hold an interest in a particular financial product; and

b. a reasonable person under the circumstances would believe that the provider has made such a recommendation.[16]

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[14] The extent to which investments which relate to, or involve, real property fall within the current definition of 'financial product' – and whether any amendment to the current law is needed in this regard – are complex questions. Refer generally to the following:

a. Australian Securities and Investments Commission, *REP 05 Review of the financial advising activities of real estate agents*, Interim Report (1999);

b. Ministerial Council on Consumer Affairs Working Party, *Property Investment Advice*, Discussion Paper (2004);

c. Parliamentary Joint Committee on Corporations and Financial Services, Parliament of Australia, *Property Investment Advice – Safe as Houses?* (2005);

d. Law Reform Committee, Parliament of Victoria, *Inquiry into Property Investment Advisers and Marketeers*, Final Report (2008);

e. Department of Treasury, *Financial Services and Credit Reform – Improving, Simplifying and Standardising Financial Services and Credit Regulation*, Green Paper (2008).

[15] Although note that the mere fact that a product issuer or adviser possesses information about a client's objectives, financial situation and needs does not mean that the adviser has necessarily *considered* those matters: Australian Securities and Investments Commission, *RG 175 Licensing: Financial product advisers – Conduct and Disclosure* (2007), 6-8.

[16] Financial Planning Association, *Submission to the Financial Services Working Group* (2008), 14 <http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/Consultation_paper_97_FPA%20(Submission).pdf/$file/Consultation_paper_97_FPA%20(Submission).pdf> at 20 October 2008.

The FPA has further suggested that the new definition of personal advice should provide that:

> For the avoidance of doubt, a recommendation is not personal advice if it is not a statement to which s766B(3) applies and the following requirements are met:
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> i. the provider clearly and prominently states that the person should make their own decision whether the product is suitable for the person; and
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> ii. the statement in subparagraph (i) is made:
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> A. during the same meeting or telephone call; or
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> B. in the same document; or
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> C. on the same page of an Internet site; or
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> D. otherwise, at the same time,
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> as the recommendation.[17]

Aspects of the FPA's proposal have merit. In particular, the idea of limiting the definition of personal advice to recommendations (as opposed to mere opinions) is a good one. In this regard, it may be noted that the definition of personal advice under the current law is far broader than the scope of application of the reasonable basis for advice rule when that rule was first introduced into Australian law in 1986, which provided as follows:

> An adviser who:
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> (a) makes a recommendation with respect to securities or a class of securities to a person who may reasonably be expected to rely on the recommendation; and
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> (b) does not have a reasonable basis for making the recommendation to the person,
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> contravenes this sub-section.[18]

The current definition of personal advice is far broader than the scope of application of the 1986 rule in that it potentially covers situations where no express or implied recommendation is made to the client but where a mere statement of opinion is given to the client. Further, under the current law

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17 Ibid.

18 *Companies and Securities Legislation (Miscellaneous Amendments) Act 1985* (Cth), s191.

a recommendation or statement of opinion may constitute personal advice whether or not it was reasonable for the person to whom it was directed to rely on it.

Consideration should be given to narrowing the definition of 'personal advice' to more closely align it with the scope of the 1986 rule, by excluding:

a. statements of opinions which are not express or implied recommendations that a client make a decision (such as a decision to buy, sell or hold a financial product); and

b. any express or implied recommendation in circumstances where it would not be reasonable for the person to whom it was directed to rely on it. Disclaimers should be relevant to, but not determinative of, whether it would be reasonable for a person to rely on a recommendation.

Other aspects of the FPA'a proposal outlined above are not supported. First, advice relating to classes of financial product (as opposed to a *particular financial product*) should continue to fall within the scope of the definition of personal advice. Secondly, while disclaimers should be relevant in determining whether a communication constitutes personal advice, it should not be possible for a person to avoid their obligations merely by stating that the client should make their own decision about whether the product is suitable.

III. HOW DO YOU COMPLY WITH THE APPROPRIATE ADVICE RULE?

A. *Introduction*

To comply with the appropriate advice rule, the providing entity must 'ascertain the client's objectives and their financial situation and needs, investigate and consider the options available to the client, and base the advice on that consideration and investigation.'[19]

It can be seen that s 945A(1) imposes three separate (but inter-related) obligations on the providing entity when providing personal advice:

a. *the 'client inquiries' obligation*[20] - the providing entity must determine the client's relevant personal circumstances in relation to giving the advice

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[19] Parliament of the Commonwealth of Australia, *Financial Services Reform Bill 2001 – Explanatory Memorandum* [12.32]. Note that under the current law a person is not required to comply with the appropriate advice rule where the advice is (unlawfully) provided by a person who is required to, but does not in fact, hold a licence or authorization. This is because Division 3 of Part 7.7 (which includes s 945A(1)) applies only in respect of advice provided by a licensee or an authorised representative: *Corporations Act 2001* (Cth) s 944A.

[20] *Corporations Act 2001* (Cth) s 945(1)(a).

and must then make reasonable inquiries in relation to those personal circumstances;

b. *the 'subject-matter investigation' obligation*[21] - the providing entity must give such consideration to, and must conduct such investigation of, the subject matter of the advice as is reasonable in all of the circumstances;

c. *the 'appropriate advice' obligation*[22] - the providing entity must ensure that the advice is 'appropriate' to the client.[23]

Each of these three obligations must be satisfied.

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[21] *Corporations Act 2001* (Cth) s 945(1)(b).

[22] *Corporations Act 2001* (Cth) s 945(1)(c).

[23] It is interesting to compare the appropriate advice rule with similar obligations which exist in certain overseas jurisdictions:

(a) in the United Kingdom, a firm must 'take reasonable steps to ensure that a personal recommendation....is suitable for its client': *Financial Services Authority (FSA) Handbook*, COBS 9.2.1(1). When making such as recommendation the firm must 'obtain the necessary information regarding the client's (a) knowledge and experience in the [relevant] investment field.....; (b) financial situation; and (c) investment objectives so as to enable the firm to make the recommendation...which is suitable for him': *Financial Services Authority (FSA) Handbook*, COBS 9.2.1(2). The firm must seek to establish whether the client has the necessary experience and knowledge to understand the relevant investment risks and whether the client is able to bear those risks: *Financial Services Authority (FSA) Handbook*, COBS 9.2.2(1);

(b) in United States of America, the suitability rule of the National Association of Securities Dealers (NASD) states that 'in recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs': National Association of Securities Dealers (NASD), Rule 2310. This rule further provides that 'prior to the execution of a transaction .....a member shall make reasonable efforts to obtain information concerning:

(1) the customer's financial status;

(2) the customer's tax status;

(3) the customer's investment objectives; and

(4) such other information used or considered to be reasonable by such member ...in making recommendations to the customer';

(c) in Canada, the suitability rule of the Investment Dealers Association provides that 'each member, when recommending to a customer the purchase, sale, exchange or holding of any security, shall use due diligence to ensure that the recommendation is suitable for such customer based on factors including the customer's financial situation, investment knowledge, investment objectives and risk tolerance': *Investment Dealers Association of Canada*, Regulation 1300.1(q).

B. *The 'Client Inquiries' Obligation*

A providing entity must:

a. determine the client's relevant personal circumstances[24] in relation to giving the advice; and

b. make reasonable inquiries in relation to those personal circumstances.[25]

On one view this obligation is scaleable - that is, the extent to which inquiries must be made of the client's relevant personal circumstances varies depending on the advice *which is to be given* to the client. On this view, the appropriate advice rule does not require any particular form of advice (e.g. a 'full' financial plan) to be provided to the client. Nor does it necessarily require a 'full' client 'fact-find' to be undertaken by the providing entity before personal advice can be provided.[26] Rather, when providing personal advice, the providing entity must determine the client's personal circumstances which are relevant to *that particular advice* and must then make reasonable inquiries in relation to *those* personal circumstances.[27] On this view, a providing entity can provide 'limited' advice (e.g. advice limited to a particular financial product or advice limited to a particular purpose, such as whether the client should switch investment strategies within a superannuation fund), provided reasonable inquiries are made into those personal circumstances of the client that are relevant to *that* advice.

While this view seems reasonable, it must nevertheless be recognized that industry concerns about the regulatory requirements remain, in particular, where 'limited' advice is provided.[28] Given the current financial global crisis it would be unfortunate if product issuers and financial advisers failed to provide much-needed advice to their clients due to doubts about the applicable regulatory requirements. Accordingly, as foreshadowed by the Financial

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[24] A client's 'relevant personal circumstances' are 'such of the person's objectives, financial situation or needs as would reasonably be considered to be relevant to the advice': *Corporations Act 2001* (Cth) s761A.

[25] *Corporations Act 2001* (Cth) s 945A(1)(a).

[26] A full client 'fact-find' would seek to ascertain *all aspects* of the client's objectives, financial situation and needs.

[27] 'The level of inquiry and analysis required will vary from situation to situation and will depend on the advice requested by the client. The providing entity need only obtain and analyse sufficient information about the client to provide the advice requested or proffered. So, for example, a comprehensive analysis of the client's full financial position may not be necessary where the client has sought personal advice on a specific product': Parliament of the Commonwealth of Australia, *Financial Services Reform Bill 2001 – Explanatory Memorandum* [12.33].

[28] For example, see the Financial Planning Association, above n 16, 12-3.

Services Working Group,[29] it may be necessary for the Australian Securities and Investments Commission (ASIC) to provide further guidance in this area. Alternatively, the law could be amended to remove the doubt (if any) that the client inquiries obligation is 'scaleable'.

Where advice relating to an investment product is to be provided, the client inquiries obligation will typically require at least some level of consideration and investigation of the client's existing investment portfolio, need for regular income, desire for capital growth and investment risk tolerance, amongst other things. As a general rule, more extensive client inquiries are likely to be required where the potential negative impact on the client of inappropriate advice is high. Conversely, less extensive inquiries are likely to be required where the advice is for a relatively simple purpose. Where the client is confused about his or her objectives, the providing entity should seek to clarify the client's objectives. The need to help clients clarify their objectives is particularly important in the current financial crisis given the increased likelihood of consumer confusion or panic.

C. *The 'Subject-Matter Investigation' Obligation*

A providing entity must (having regard to the information obtained about the client's relevant personal circumstances) give such consideration to, and must conduct such investigation of, the subject matter of the advice as is reasonable in all of the circumstances.[30]

Where personal advice relates to a particular financial product ('product X'), such as a recommendation to buy or sell product X, or to switch investment strategies within product X, clearly product X must be investigated by the providing entity. A difficult issue which arises in these circumstances, however, is whether s 945A(1)(b) requires any consideration and investigation to be conducted into any financial product *other than* product X. The resolution of this matter depends on determining *the subject mater of the advice to be given* to the client. Where the providing entity does not purport to give advice on the relative merits of different financial products, it would generally be sufficient for the providing entity to investigate and consider only product X. However, if the providing entity's advice was, for example, to the effect that product X would be 'better' for the client than other financial products, then some investigation and consideration of those other products would be needed.

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[29] Financial Services Working Group, *Simple advice on choices within an existing superannuation account* (2008), 17.

[30] *Corporations Act 2001* (Cth) s 945A(1)(b).

Consider, for example, the situation where a providing entity recommends that a client move his or her accumulated superannuation savings from one superannuation fund (the 'from' fund) to a different superannuation fund (the 'to' fund). In such a situation s 945A(1)(b) would require the providing entity to consider and investigate both the 'to' fund and the 'from' fund.[31]

Having determined the subject matter of the advice, a reasonable consideration and investigation of that subject matter is required having regard to the information obtained about the client's relevant personal circumstances. So, for example, if the client wished to invest in a socially responsible manner, it would be necessary for the providing entity to give reasonable consideration to, and conduct a reasonable investigation into, the extent to which the subject matter of the advice satisfied that objective.

To what extent must a providing entity seek to obtain information or advice about a financial product which is not readily available from public sources (for example, from the Australian Securities and Investments Commission, the Australian Securities Exchange or from the product issuer's website, prospectuses, product disclosure statements or annual reports)? In some situations it may be necessary for the providing entity to send a letter to the issuer of a financial product seeking relevant information about the product (being information that is not already available from public sources). Further, in some situations it may be necessary for the providing entity to seek information or advice from another person such as an accountant, external research house or other market specialist.[32]

D. *The 'Appropriate Advice' Obligation*

A providing entity must ensure that the advice provided is 'appropriate' to the client, (having regard to the consideration and investigation of the subject matter of the advice conducted under s 945A(1)(b)).[33] While the expression

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31 Australian Securities and Investments Commission, *RG 175 Licensing: Financial product advisers – Conduct and Disclosure,* above n 15, 32. See also Australian Securities and Investments Commission, *RG 84 Super switching advice: Questions and answers* (2005). Whether s 945A(1)(b) is complied with in practice in relation to superannuation switching is another matter. In this regard, note that the ASIC report on superannuation switching surveillance concluded that most advisers giving superannuation switching advice made limited or no investigation of the 'from' fund: Australian Securities and Investments Commission, *REP 50 Superannuation switching surveillance* (2005).

32 Note that a providing entity that relies on information supplied by a research house must take reasonable steps to ensure that the research is accurate, complete, reliable and up-to-date: Australian Securities and Investments Commission, *RG 175 Licensing: Financial product advisers – Conduct and Disclosure,* above n 15, 38.

33 *Corporations Act 2001* (Cth) s 945A(1)(c).

'appropriate' is not defined, its ordinary meaning is 'suitable or fitting for a particular purpose.'[34] In other words, personal advice must satisfy the client's needs. So, for example, a recommendation to invest in a speculative investment would contravene the appropriate advice rule if 'low-risk' investing was one of the client's needs. In the wake of the current financial crisis, it will be interesting to observe whether there is an increase in claims being made against advisers who have recommended products which were not consistent with the investment risk tolerance of the client.

While personal advice must be appropriate, it need not be 'ideal, perfect or best' in order to comply with the appropriate advice rule.[35] As noted by the Parliamentary Joint Committee on Corporations and Financial Services, 'so long as disclosure requirements are met, it is legally permissible for an adviser to recommend a product privately knowing it is not the best option for the client.'[36] Note that the Industry Super Network has submitted that the current law is inadequate in this regard, and should require personal advice to be 'in the client's best interests'.[37]

Under the current law, determining whether advice is 'appropriate' will depend on accurately characterizing the substance of the advice actually given to the client. For example, where the providing entity does not purport to give advice on the relative merits of different financial products, but merely recommends that the client acquire product X, the advice would generally be appropriate if product X was fit for its purpose (i.e. satisfied the client's needs), even if other products may be available which would be even better products for the client. However, where the providing entity's advice is (expressly or by implication) to the effect that product X is 'better' for the client than another product or products, then advice to acquire product X would arguably not be appropriate unless product X was, indeed, better than those other product(s).

Determining whether one product is indeed a 'better' product for a client will involve balancing the respective advantages and disadvantages of the two products for that client. For example, consider 'superannuation switching

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34 *The Macquarie Dictionary: Australia's National Dictionary* (Macquarie Library, 2001). The term is also defined to mean 'suitable or proper': *Oxford Concise Australian Dictionary* (Oxford University Press, 2004). Refer also to: Australian Securities and Investments Commission, *RG 175 Licensing: Financial product advisers – Conduct and Disclosure,* above n 15, 38.

35 Australian Securities and Investments Commission, *RG 175 Licensing: Financial product advisers – Conduct and Disclosure,* above n 15, 38.

36 Parliamentary Joint Committee on Corporations and Financial Services, Parliament of Australia, *The structure and operation of the superannuation industry* (2007), 137.

37 Industry Super Network, Submission to the Financial Services Working Group (2008), 6 <http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/Consultation_paper_97_IndustrySuperNetwork.pdf/$file/Consultation_paper_97_IndustrySuperNetwork.pdf> at 20 October 2008.

advice'. It is clear that such advice would be inappropriate if the 'to' fund does not satisfy the client's relevant personal circumstances (for example, if the 'to' fund provides inadequate life insurance for the client). However, even if the 'to' fund *does* satisfy the client's relevant personal circumstances, the advice may still be inappropriate unless moving to the 'to' fund left the client 'better off', bearing in mind the possible benefits of switching funds (e.g. reduced overall fees that may arise from consolidating numerous superannuation accounts into one account) and the possible costs of switching funds.[38]

IV. WHAT SANCTIONS MAY APPLY WHERE THE APPROPRIATE ADVICE RULE IS BREACHED?

A. *Criminal Liability*

A providing entity (whether a licensee or authorised representative) that contravenes the appropriate advice rule may commit an offence. The maximum penalty is 200 penalty units or imprisonment for 5 years or both.[39]

However, a providing entity *that is an authorised representative* has a defence to criminal proceedings for breach of the appropriate advice rule if:

(a) the authorizing licensee had provided the authorised representative with information or instructions about the requirements to be complied with in relation to the giving of personal advice;

(b) the failure to comply with s945A(1) occurred because the providing entity acted in reliance on that information or those instructions; and

(c) the providing entity's reliance on that information or those instructions was reasonable.[40]

It is interesting to note that criminal sanctions did not apply in respect of breaches of the appropriate advice rule that existed before the enactment of the *Financial Services Reform Act 2001* (Cth).[41] As noted by Mr Doug Clark 'the policy reason for making this matter a criminal offence carrying the

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38 Australian Securities and Investments Commission, *RG 175 Licensing: Financial product advisers – Conduct and Disclosure*, above n 15, 33.

39 *Corporations Act 2001* (Cth), Schedule 3, Item 270A.

40 *Corporations Act 2001* (Cth) s 945A(2).

41 *Corporations Law* s 851.

42 Doug Clark 'FSR & the Stockbroking Industry' Presentation to Monash University FSR Forum 14 July 2006 <http://www.sdia.org.au/Portals/0/pdf/fsr_and_the_stockbroking_industry_140706.pdf> at 20 October 2008.

same penalty as the serious offence of market manipulation has never been adequately explained.'[42]

The Australian Law Reform Commission has stated that 'a key characteristic of crime, as opposed to other forms of prohibited behaviour, is the repugnance attached to the act, which invokes social censure and shame.'[43] Further, the Guide to Framing Commonwealth Offences, Civil Penalties and Enforcement Powers observes that:

> certain conduct should be almost invariably classified as criminal... For example, conduct that results in physical or psychological harm to other people...or conduct involving dishonest or fraudulent conduct... In addition, criminal offences should be used where the relevant conduct involves considerable harm to society...or Australia's national interests...[44]

Applying these considerations, it is difficult to see why the appropriate advice rule should be a criminal offence provision. Accordingly, it is suggested that consideration should be given to de-criminalising the appropriate advice rule. This would not alter the fact that a breach of s 945A(1) could lead to other results, such as the imposition of administrative sanctions (discussed below). Further, de-criminalising the appropriate advice rule would not alter the fact that a licensee may commit an offence if it breaches s945A(1) but fails to report the breach to ASIC under s 912D.[45] Alternatively, consideration could be given to implementing the recommendation of the Association of Superannuation Funds of Australia (ASFA) that a 'due diligence' defence should apply where a providing entity is charged with committing an offence against s 945A(1).[46]

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43 Australian Law Reform Commission, *Principled Regulation: Federal Civil and Administrative Penalties in Australia*, Report No 95 (2002) [2.10].

44 Minister for Justice and Customs, *A Guide to Framing Commonwealth Offences, Civil Penalties and Enforcement Powers* (2004), 12.

45 Consideration should also be given to whether s 945A(3) should be a criminal offence provision. That sub-section imposes an obligation on financial services licensees to take reasonable steps to ensure that their authorised representatives comply with the reasonable basis for advice rule. It is difficult to understand why s 945A(3) should be an offence provision given that the general obligation on licensees to take reasonable steps to ensure that their representatives comply with the financial services laws (s 912A(1)(ca)) is not an offence provision.

46 Association of Superannuation Funds of Australia, *Submission to the Financial Services Working Group* (2008), 9 <http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/Consultation_paper_97_ASFA.pdf/$file/Consultation_paper_97_ASFA.pdf> at 20 October 2008.

B. *Administrative Sanctions*

Where a providing entity (being a *licensee)* contravenes the appropriate advice rule ASIC may (subject to giving the licensee an opportunity to appear or be represented at a hearing):

a. suspend or cancel the licence.[47] The basis for this form of administrative action would be that the licensee has not complied with its obligations under s 912A[48], notably the obligation to comply with the 'financial services laws'.[49] (It may also be possible to argue that a licensee which has contravened the reasonable basis for advice rule has not provided the financial services covered by its licence 'efficiently, honestly and fairly');[50]

b. impose a licence condition on the licensee;[51]

c. make a banning order against the licensee.[52] A banning order could be imposed, for example, on the basis that ASIC has suspended or cancelled the licensee's licence[53] or on the basis that the licensee has not complied with its obligations under s912A.[54]

Where a providing entity (being an *authorised representative*) contravenes the appropriate advice rule ASIC may (subject to giving the authorised representative an opportunity to appear or be represented at a hearing) make a banning order against the authorised representative.[55] A banning order could be imposed on the basis that the providing entity has not complied with the 'financial services laws'.[56] Further, it may also be possible for ASIC to bring administrative action against the authorising licensee where one of its authorised representatives has breached the appropriate advice rule (action could be brought, for example, on the basis that the licensee had failed to take reasonable steps to ensure that its authorised representatives had complied with the reasonable basis for advice rule.)[57]

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47 *Corporations Act 2001* (Cth) s 915C.

48 *Corporations Act 2001* (Cth) s 915C(1)(a).

49 *Corporations Act 2001* (Cth) s 912A(1)(c).

50 *Corporations Act 2001* (Cth) s 912A(1)(a).

51 *Corporations Act 2001* (Cth) s 914A.

52 *Corporations Act 2001* (Cth) s 920A.

53 *Corporations Act 2001* (Cth) s 920A(1)(a).

54 *Corporations Act 2001* (Cth) s 920A(1)(b).

55 *Corporations Act 2001* (Cth) s 920A.

56 *Corporations Act 2001* (Cth) s 920A(1)(e). Note that under the current law a banning order cannot be issued against a representative on the basis that the representative has failed to act 'efficiently, honestly and fairly'; cf *Corporations Law* s 829(f).

57 *Corporations Act 2001* (Cth) s 945A(3).

ASIC has suggested that a 3-10 year banning order is indicative of the sanction that may be imposed where a person 'does not have a reasonable basis for advice provided, such as making inappropriate recommendations in high risk schemes.[58]

An important issue is whether a banning order can be made against a representative (*other than an authorised representative*) that provides personal advice on behalf of a licensee on the ground that the advice does not meet the requirements of s 945A(1). In such circumstances the representative will not have breached s 945A(1) because the obligation to comply with that provision is not imposed on representatives (other than authorised representatives). Accordingly it cannot be said that the representative has breached a financial services law and, therefore, a banning order could not be made against that person on that ground. This is inconsistent with the position as it applied before the enactment of the *Financial Services Reform Act 2001* (Cth). The problem is exacerbated by the fact that, under the current law, administrative sanctions cannot be imposed on *representatives* on the ground that they have not acted "efficiently, honestly and fairly". Again, this is inconsistent with the position which applied before the enactment of the *Financial Services Reform Act 2001* (Cth).[59] This situation is unsatisfactory. It is suggested that consideration should be given to amending the law to give ASIC the power to make a banning order against a representative (not being an authorised representative) that engages in conduct which results in a contravention of s 945A(1) by the representative's licensee.

V. WHAT INFORMATION MUST BE PROVIDED TO CONSUMERS ABOUT THE ADVICE?

A client who receives personal advice must generally be given a document known as a 'Statement of Advice' (SOA),[60] which is designed to help the client to decide whether to accept the advice or not. The SOA should:

> canvass the consideration given to the client's objectives, financial situation and needs and how the advice will address those objectives, financial situation and needs. It should illustrate how the recommendation made to the client addresses the request for advice originally made by the client, taking account of subsequent investigations and considerations on the part of the providing entity.[61]

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[58] Australian Securities and Investments Commission, *RG98 Licensing: Administrative action against financial services providers* (2006), 12.

[59] *Corporations Law* s 829(f).

[60] *Corporations Act 2001* (Cth) s 946A.

[61] Parliament of the Commonwealth of Australia, *Financial Services Reform Bill 2001 – Explanatory Memorandum* [12.53].

An SOA should enable the client to check that the information possessed by the providing entity about the client is accurate and should help the client understand the providing entity's advice, including why the advice is considered to be appropriate and the risks and disadvantages of the advice. In particular, the SOA should set out the main risks of the advice not satisfying critical aspects of the client's relevant personal circumstances.[62] In light of the current financial crisis, it will be interesting to see whether there is any increase in claims being made against providing entities on the basis of inadequate disclosure of risk and disadvantages in the SOA.

Whether a client will be in a position to make a fully informed decision about whether to accept personal advice he or she receives will depend on a range of matters, including the client's level of financial literacy, whether he or she receives an SOA[63], the quality of the disclosure in the SOA[64] and the extent to which the providing entity explains the advice verbally to the client and answers any questions the client may have about the advice. In this regard, the current law is arguably defective because it does impose any express obligation on providing entities to explain their advice *verbally* to their clients. While written disclosure is important (and some further effort may need to be devoted to ensuring that SOAs are comprehensible), many clients also need to receive a verbal explanation of the advice in order to understand it and to decide whether to accept it or not. The need for clear verbal explanation would seem to be even greater in the current global financial crisis given the increased risk of consumer confusion. Accordingly, consideration should be given to requiring providing entities to take reasonable steps to ensure that clients understand the advice they provide. There are several models which could be used as the basis for this obligation, including the following:

(a) the Rules of Professional Conduct of the FPA, which provide that an FPA member must take reasonable steps to place the client in a

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62 Australian Securities and Investments Commission, *RG 175 Licensing: Financial product advisers – Conduct and Disclosure*, above n 15, 42.

63 Note that an SOA does not need to be provided in all cases. For example an SOA is generally not required for advice relating to an investment amount of $15,000 or less: Corporations Act 2001 (Cth) s 946AA and Corporations Regulations 2001 (Cth) reg 7.7.09A. Further, an SOA is not required for advice about certain types of product, including some deposit products, cash management trust interests, and certain general insurance products: Corporations Regulations 2001 (Cth) reg 7.7.10.

64 Note that ASIC and the Financial Planning Association have issued guidance designed to promote the quality of SOA disclosure documents: Australian Securities and Investments Commission, RG90 Example Statement of Advice for a limited financial advice scenario for a new client (2005); Financial Planning Association, Simplifying Statements of Advice – FPA Example SOA (2008) <http://www.fpa.asn.au/files/PubFPASOAExample.pdf> at 20 October 2008.

position to comprehend the recommendations and the basis for the recommendations;[65]

(b) the Life Insurance Code of Practice (a policy of the former Insurance and Superannuation Commission), which required life insurance advisers to take reasonable steps to ensure that the customer can sufficiently comprehend the advice and the basis for the advice to place the customer in a position to make an informed choice.

VI. CONCLUSION: WHAT CHANGES TO THE LAW SHOULD BE CONSIDERED?

This paper has explored the scope and operation of the appropriate advice rule in light of the global financial crisis. This analysis has revealed several arguable problems with the current law. The following changes to the law should be considered to address these problems:

1. *Narrowing the definition of 'personal advice'*

The appropriate advice rule generally applies whenever personal advice is provided to a retail client by a providing entity. The current definition of 'personal advice' is arguably too broad. Consideration should be given to narrowing the definition of 'personal advice' to exclude:

a. statements of opinions which are not express or implied recommendations that a client make a decision (such as a decision to buy, sell or hold a financial product); and

b. any express or implied recommendation in circumstances where it would not be reasonable for the person to whom it was directed to rely on it. Disclaimers should be relevant to, but not determinative of, whether it would be reasonable for a person to rely on a recommendation.

2. *Clarifying that the 'client inquiries' obligation is scaleable*

In light of industry concerns, ASIC guidance or law reform may be needed to make it clear that the obligation to conduct client inquiries is 'scaleable'.

3. *Reconsidering criminal liability for breaches of the appropriate advice rule*

Criminal sanctions did not apply in respect of breaches of the appropriate advice rule which existed before the enactment of the *Financial Services*

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[65] Financial Planning Association of Australia, Rules of Professional Conduct, rule 113 <http://www.fpa.asn.au/files/PubCodeOfEthics.pdf> at 20 October 2008.

Reform Act 2001 (Cth). Consideration should be given to de-criminalising the appropriate advice rule or, alternatively, enacting a due diligence defence.

4. *Issuing banning orders against representatives engaged in conduct that results in a breach of the appropriate advice rule*

The appropriate advice rule applies to providing entities (licensee and authorised representatives) but not to other representatives. Consideration should be given to amending the law to give ASIC the power to make a banning order against a representative (not being an authorised representative) that engages in conduct which results in a contravention of s 945A(1) by the representative's licensee.

5. *Requiring providing entities to take reasonable steps to ensure that clients understand the basis for their advice*

A retail client that receives personal advice is generally required to be given a document knows as a SOA. However, the current law is arguably defective because it does not also impose an express obligation on providing entities to explain their advice *verbally* to their clients. Consideration should be given to requiring providing entities to take reasonable steps to ensure that clients understand the advice they provide.