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LAWYERS

Risk Tolerance Assessment in the Current Legal Environment

The old know your client rule remains a cornerstone standard in the financial services industry. Encompassed in Chapter 7 of the Corporations Act it has been expanded at section 945A to require financial services licensees and their representatives to make *reasonable* inquiries to determine a client's *relevant* personal circumstances to appropriately *investigate* and give consideration to those circumstances to ensure that any advice provided to the client is *appropriate* and *reasonable* having regard to that investigation and consideration.

Notwithstanding any legislative obligations that exist, it has long been accepted that those obligations have at their core the long-standing common law concept of *duty of care* which arises in the nature of the contract with the client as well as from the law of tort.

While a detailed consideration of the various elements required to establish breach of duty or negligence (and resulting liability) is tedious and for the purposes of this paper unnecessary, it is relevant to revisit the concept of duty of care in the context of the development and more importantly, the future, of the financial planning industry.

To identify where we are we need to look to the legal journey that has brought us here.

The concept of duty of care is characterised by a person being ".....placed in such a position with regard to another that everyone of ordinary sense would recognise that if he did not use ordinary care and skill in his own conduct with regard to those circumstances he would cause danger of injury to the person or property of the other...." (Heaven -v- Pender (1883) 11 QBD 503).

Relevantly for the financial planning industry has been the willingness of the Courts to find that the nature of the relationship that clients enjoy with the industry is that of a fiduciary. A fiduciary obligation exists whenever one person, the client, places special trust and confidence in another person and relies upon that person, the fiduciary, to exercise his discretion or expertise in acting for the client; and the fiduciary knowingly accepts that trust and confidence and thereafter undertakes to act on behalf of the client by exercising his, the fiduciary's, own discretion and expertise. This was the principle that underpinned part of the Victorian Supreme Court judgment in Ali -v- Hartley Poynton [2002] VSC 113.

In the early 20th century the Courts were willing to expand such duty of care to beyond the contract into an area that became known as the law of Tort. In 1932, the Court espoused the classic statement encapsulating the modern law of tort negligence:

> "*You must take reasonable care to avoid acts or omissions which you can reasonably foresee would be likely to injure your neighbour. Who, then, in law is my neighbour? The answer seems to be - persons who are so closely and directly affected by my act that I ought reasonably to have them in contemplation as being so affected when I am directing my mind to the acts or omissions which are called in question*" (Donoghue -v- Stevenson [1932] AC 562)

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Where such a circumstance exists, a duty arises to use ***ordinary*** care and skill to avoid such danger.

While the concept of a duty of care has been long established and today, even in the context of a fiduciary relationship may be seen as relatively static, what has been evolving is the notion of **ordinariness** in relation to the nature of the care and skill which must be employed by financial advisers in order to discharge the duty of care (whether in contract or as a fiduciary) owed to their clients and (in tort) also to others.

The obvious inference is that where an adviser fails to do what has come to be accepted as an "industry norm", they risk falling short of exercising what could be considered ordinary care and skill in relation to the provision of financial services.

The concept of assessing a client's risk tolerance has now been considered by the Courts in various cases[2] and while the nature of that consideration has not extended to a deliberation as to the merits or otherwise of the use of client risk tolerance assessment systems in general, the decisions appear critical of any approach that is not capable of independent verification, that is not backed by valid testing data. The obverse to this is that the Courts tacitly endorse the notion that the use of verifiable tools is generally accepted in the industry as ordinary. Indeed, the Administrative Appeals Tribunal decision in the case of Saxby Bridge Financial Planning Pty Ltd and Ors and Australian Securities and Investments Commission [2003] AATA 480 (28 May 2003) suggested that the manipulation, misstatement and mismatching of client risk tolerance levels and inadequate collection of client data were indicative of fundamental procedural failings on the part of the securities dealer.

ASIC would appear to agree. Its press release 02/187 makes clear that when framing the two year banning order for Mr Steer, it formed the view that he had failed to adequately assess his **clients' risk tolerance** so that certain clients were recommended inappropriately high risk investments.

If, as does ASIC, you consider that risk tolerance assessment is part of the financial planning process, how do you do ensure you are appropriately assessing that risk tolerance? It is particularly relevant to consider statements made by the Supreme Court of New South Wales in Paige v FPI Limited & Anor [2001] NSWSC 627 (27 July 2001).

In relation to certain software utilised by the financial planner to assess the clients' risk tolerance, the Court noted that, the first question required the client to provide an estimate of the long term inflation rate and an estimate of return on investments after tax. The Court questioned how the average and usually unsophisticated investor could usefully answer such question.

The form also included a question requiring the client to indicate how much of a risk taker they were, with no explanation of the elements the client should bring to bear in making such an evaluation, nor any explanation of the consequences of their answer.

The conclusion of the Court was that no true indication of risk tolerance could be gleaned from such an assessment. A reader of the judgement in Paige cannot help but think that the financial planner may well have been better off, in the light of the Court's scrutiny, if he had used no such risk tolerance assessment tool and yet, in context, the Court recognised the importance that risk tolerance played in the financial planning process. So much so, the Court attributed some responsibility and therefore liability to the planner for not commenting on the risks associated with a venture that the client entered without the advice of the planner;

> "....Although I accept that it was Mr Paige (the client) who decided to embark upon the boat venture, a duty fell upon Mr McDonald (the planner) to make plain that his recommended investment strategy was put at risk if the boat venture failed."

Because the Court was of the view that the planner was providing a holistic planning service, once they were on notice of an 'external risk' to the investment strategy, the planner came under a duty to identify and comment on that external risk! This common law duty must now be assesed against the section 945A *Know Your Client Rule* to make *reasonable* inquiries to determine a client's *relevant* personal circumstances and to appropriately *investigate* and give consideration to those circumstances.

Relevantly, the facts in Paige were in excess of 10 years old at the time of the Court's decision and as is so often the case, technological developments were such that the software used in that case had, by the time of hearing, been eclipsed and, while the Court sought to apply the standards which existed at the time the facts occurred, the light of development shone to clearly illuminate the deficiencies which were inherent in those standards.

Time and technology continue to march at an ever increasing pace and it can readily be seen that when, in 10 years time, the Court is considering an adviser's actions today, the light of development will shine even more harshly on the current tools being utilised by advisers.

The Courts have a long history of dealing with issues involving the psychological attributes of individuals and the assessment of those attributes. The Courts recognise that this is a specialised area of the social sciences calling for specialised skills and disciplines.

There exists in today's financial planning environment at least one specialised risk tolerance assessment mechanism backed by scientific testing which claims independently assessed statistically validated results and while, in 10 years time, such mechanisms will almost certainly have been enhanced, the basis of these will remain valid and defensible and THAT is what will afford the industry protection against liability.

Looking to the future, there is presently emerging under the duty of care the concept of unconscionability. This clearly arises under both the Trade Practices Act and the Australian Securities and Investments Commission Act and has come to the fore in the face of ACCC test cases on unconscionability in various industry sectors.

Originally, unconscionability was only found where the complaining party was in a fundamentally weaker position as a result of some deficiency arising from their physical or mental personal circumstances. This soon extended to educational weakness and today may include the level of client sophistication. This certainly motivated the Court in Paige when, in response to the planner risk assessment process the Court commented;

> "Quite how the average, and usually unsophisticated investor, could usefully answer these questions is not immediately apparent. *Presumably the reason a person placed themselves in the hands of an investment adviser was because of his or her lack of knowledge of financial matters* ...." (empahasis added).

Advisers must be aware of the potential application of the unconscionability provisions. Of particular relevance is that the notion of special disadvantage has been expanded for the purpose of unconscionability to include situational disadvantage arising from a party's financial characteristics and circumstances. It is no great leap to envisage a situation where a party is found to be at a particular disadvantage as a consequence of the information imbalance that is inherent between advisers and their (though educated) financially unsophisticated clients.

This expansionist view is bolstered by the inclusion, at section 945A of the Corporations Act, of an obligation to essentially undertake a due diligence of a client prior to the provision of any advice. In an unconscionability context, it might credibly be argued that in order to meet their legislative obligation, an adviser must undertake to investigate any aspect of a client's personal and financial profile which might place them at a special disadvantage, one of which must be their understanding of the role of risk and risk tolerance in the financial planning process.

The Financial Planning Association of Australia's Policy Position on Risk Tolerance endorses the concept that a financial planner's role is to assist clients to learn to embrace and manage reasonable investment risks to achieve their desired investment goals over realistic and relevant time frames and acknowledges that financial planners 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

The importance of risk as an issue for the financial services industry has been highlighted by section 912A of the Corporations Act which provides that a financial services licensee must...unless the licensee is a body regulated by APRA—have adequate risk management systems.

In addition, the Superannuation Safety Amendment Act 2004 which requires trustees to apply for a registrable superannuation entity licence, places, as a corollary to that licensing requirement, an obligation on superannuation trustees to develop and maintain a risk management strategy and risk management plan addressing how they will identify, monitor and manage fund risks.

There is some misapprehension among participants in the industry, many of who mistakenly believe that the requirement contained at section 912A only relates to the compliance function of the licensee business. It is imperative that licensees and advisers understand that significant risk to a financial services business arises from the provision of poorly formulated or inappropriate advice.

ASIC has previously made clear in its Organisational Capabilities Proposal Paper that the requirement to have adequate risk management systems is directed to all risks associated with the establishment and operation of a business and that risk management systems should promote consumer confidence in using financial services and the provision of fair, honest and professional services. Clearly, ASIC is primarily concerned with the risk of non compliance with the Corporations Act and associated legislation and is focussed on commercial and compliance risk, however, it does accept that a mismatch between the level of consumer sophistication and the products sold by a financial services business represents a considerable risk to the business. What it overlooks is that a mismatch between the risk tolerance of a consumer and the financial products promoted to that consumer represents one of the most significant financial services business risks.

However, this was not overlooked by the lawyers in Newman v Financial Wisdom Limited [2004] VSC 216 where a principal theme of the claims against the planner company and licensee were that *the investments recommended to clients by Pamacorp Holdings were and would be secure and carry a low financial risk for clients.* In a 242 page judgement there is much that the Court will have commented upon, once such comment was the view that;

> "there was negligence ..... in the failure to explain the risks involved and to ensure that they were within the risks which Mr Duncan (the client) was prepared to accept".

As if to reinforce the importance of the assessment of risk tolerance, there is emerging a 'shopping list' of supportive requirements.....

> ASIC Policy Statement 175 suggests that the relevant personal circumstances of the client would likely include the client's tolerance of the risk of capital loss and tolerance of the risk that the advice (if followed) will not produce the expected benefits.
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> The draft International Standard on Personal Financial Planning requires that in analysing and evaluating a client's financial status, the financial planner must identify areas of strength and vulnerability, comparing them against the client's goals, plans, restrictions and assessment of financial risk tolerance and personal risk assessment and should, in developing and presenting the financial plan, review, iterate and resolve with the client, issues pertaining to understanding the client's tolerance for financial risk.
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> The competency requirements identified in the draft Standard also require financial planners to be able to understand the general concepts of risk capacity and risk tolerance and how those factors combine to impact investment and other financial decisions, be able to gather the relevant information to assess risk tolerance, be able to analyse and evaluate a client's current investments and determine if they meet the stated objective and risk tolerance level of the client, understand personal financial risk tolerance and the risks in financial strategies and explain to the client how to reconcile any differences and assist the client in resolving such differences.
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> The position statement released by the Financial Planning Association of Australia provides that risk tolerance assessment forms an important part of meeting legislative

and common law obligations and endorses the PS 175 position. FPA Rules of Professional Conduct require members to consider a client's tolerance to risk as an essential factor of formulating appropriate financial strategies and product recommendations. Rule 111 specifically states: "in preparing oral or written recommendations to clients a member shall provide an explanation of the nature of the investment risks involved in terms that the client is likely to understand".

The simple tenet being expressed is that risk and the systematic management of it is clearly emerging as a principal issue.

If one accepts that the use of some form of risk tolerance assessment and communication process is necessary to ensure advisers adequately meet their legislative, regulatory and common law obligations, it is relevant to consider whether any particular method of testing has been recognised as superior in its application, or at the least, as Paige would suggest that a method presently employed is not below industry standards.

While the Courts have stopped short of endorsing any specific testing process, the decisions are nonetheless instructive. In Paige the Court suggested that the program was unsophisticated, to some extent distorted by a particular client's knowledge of financial matters and that the client had the potential, without the provision of additional information to the client during the testing process, to be inappropriately classified as a risk taker. Similarly, in Saxby Bridge, expert testimony suggested that simple data collection, even when undertaken in the context of a personal interview with the adviser was an inferior methodology in light of superior approaches which existed in the industry.

Endorsement of a defensible process must however come from the licensee. The aforementioned cases underscore the move to a consumerist approach both in the legislation and its interpretation and licensees must understand that they can no longer afford to take the hands off approach characteristic of licensee/adviser relationships in the past. Licensees must require advisers to conform to dictated procedures - failure to do so will inevitably place their business and their brand at risk.

Having regard to the evolving legislative, regulatory and common law obligations currently facing the industry and the potential for risk flowing from a failure to adequately discharge those obligations, a best practice approach to risk tolerance assessment demands that an independently verifiable and validated tool be utilised to ensure that risk is appropriately managed and communicated if industry participants are to have a demonstrably defensible position in the event of a claim of negligence or legislative breach.

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[1]Newman & Ors v Financial Wisdom Limited & Anor; Newman & Ors v Hold Pty Ltd & Anor [2004] VSC 216 (29 June 2004)
Saxby Bridge Financial Planning Pty Ltd and Ors and Australian Securities and Investments Commission [2003] AATA 480 (28 May 2003)
Paige v FPI Limited & Anor [2001] NSWSC 627 (27 July 2001)