



ASIC

Australian Securities & Investments Commission

REPORT 377

Review of advice on retail structured products

December 2013

About this report

This report summarises the results of a review of personal advice to invest in unlisted and unquoted retail structured products (structured products).

The report should be read by financial advisers and others involved in financial advice businesses who provide advice on structured products and other complex investments. It provides examples of good practices we identified, and highlights some of the risks and common pitfalls for advisers who advise on these products.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Disclaimer

This report does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

Examples in this report are purely for illustration; they are not exhaustive and are not intended to impose or imply particular rules or requirements.

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A Executive summary

- 1 As part of our recent focus on unlisted and unquoted retail structured products (structured products), this report follows the release in May 2013 of Report 340 *'Capital protected' and 'capital guaranteed' retail structured products* (REP 340) and our associated work on potentially misleading or deceptive advertising of structured products.
- 2 REP 340 identified a number of potential problems and challenges for retail investors who invest in these complex products. As a result, a number of issuers agreed to make changes to promotional materials,¹ particularly in relation to inappropriate comparisons between structured products and safer banking products, and to ensure that worked examples include fees and costs.
- 3 REP 340 also:
- (a) highlighted the use of unhelpful and potentially misleading phrases such as 'conditional protection' and 'contingent capital protection' when describing products where investors' capital is at risk of loss, with issuers agreeing to withdraw those claims from promotional and disclosure materials; and
 - (b) provided details of consumer complaints about financial advice on structured products, including allegations of product mis-selling and inappropriate financial advice.
- 4 To further investigate and understand the nature of advice being provided on structured products, we subsequently reviewed a sample of five advice files from each of 10 Australian financial services (AFS) licensees (50 advice files in total) where structured products were recommended to retail investors, and present the main findings in this report.
- 5 The sample of advice files obtained was relatively small and not intended to be representative of the whole market for structured products advice. For example, it included specific advice files and products where we perceived there was potential for inappropriate advice, although most files were not selected for this reason.
- 6 At the time the advice in the sample was provided, s945A of the *Corporations Act 2001* (Corporations Act) was in force. We assessed the advice to determine whether it complied with s945A. As part of the Future of Financial Advice (FOFA) reforms, on 1 July 2013, s945A was repealed and replaced with Div 2 of Pt 7.7A. Advice that did not comply with s945A would also breach Div 2 of Pt 7.7A.

¹ For example, see [REDACTED] Media Release (13-246MR) *ASIC concerns prompt banks to change promotional materials* (4 September 2013).

- 7 Section 945A provided that a providing entity must only give personal advice to a retail client if:
- (a) the providing entity determined the relevant personal circumstances in relation to giving the advice (s945A(1)(a)(i)) and made reasonable inquiries about those personal circumstances (s945A(1)(a)(ii));
 - (b) having regard to information obtained from the client about those personal circumstance, the providing entity gave such consideration to, and conducted such investigation of, the subject matter of the advice as was reasonable in all of the circumstances (s945A(1)(b)); and
 - (c) the advice was appropriate to the client, having regard to that consideration and investigation (s945A(1)(c)).
- 8 In this report, we refer to this obligation as the ‘former reasonable basis for advice requirement’.
- 9 This report is intended to provide useful information to the financial advice industry by identifying some common pitfalls, as well as reiterating what is now expected of advisers under current legislative requirements and in our existing regulatory guidance (available at www.asic.gov.au). While this report focuses on advice to invest in structured products, the findings are also relevant for other types of financial products and advice.

Key findings

- 10 While we found that approximately half of the advice files we reviewed complied with the former reasonable basis for advice requirement, we were concerned that in the remaining files there was insufficient evidence of compliance, with common features of the advice including:
- (a) narrowing of the scope of advice to a single structured product;
 - (b) inadequate consideration of the client’s needs and relevant personal circumstances, and alternative strategies/asset allocation, with a lack of diversification; and
 - (c) unsuitable gearing recommendations or lack of evidence to support gearing recommendations—for example, to clients who may not have been able to afford the loan interest payments or tax-driven advice where relevant risks were not highlighted.
- 11 In addition, we had a number of concerns with the disclosure, including:
- (a) misrepresentation of the features or nature of the products recommended, including the degree of safety or capital protection; and
 - (b) inadequate explanation of the basis for advice.
- 12 In many cases the margins and fees embedded in structured products are not immediately clear. There was no evidence that these costs were investigated

by advisers in most of the files we reviewed. In some cases, these embedded costs can result in relatively high commissions for advisers, which may have influenced their advice.

13 Further, we were concerned that in some cases advisers did not demonstrate expertise in the products they were recommending, or communicate the key features and risks accurately to clients.

14 We also found some instances of non-compliance with some aspects of the obligation on providing entities in Div 3 of Pt 7.7 to give retail clients who receive personal advice a Statement of Advice (SOA) containing prescribed information. A common feature of SOAs that did not comply with Div 3 of Pt 7.7 was the use of 'boilerplate' SOAs.

Next steps

15 Where we identified concerns with the advice provided, we are analysing the cause of the deficiency, and considering appropriate regulatory outcomes. In some cases, this has included a follow-up with the relevant AFS licensee. A number of licensees have provided ASIC with information about steps they have taken to address the issues identified, including changes to internal processes and risk controls, and follow-up meetings and correspondence with clients to ensure that the advice was appropriate and understood.

16 In other cases, we are conducting further surveillance with a view to enforcement action where merited. We are also ensuring that any client whose advice we considered to be inappropriate has their position appropriately reviewed by the AFS licensee.

B Background and methodology

Key points

As a follow-up to REP 340, we are releasing this report to highlight the key findings from our review of a sample of five advice files from each of 10 AFS licensees (50 advice files in total). The advice included recommendations to invest in different types of structured products issued by a range of product issuers.

We reviewed the advice for evidence of compliance with legislative requirements—in particular, compliance with the former reasonable basis for advice requirement and the content requirements for SOAs. We did not seek to identify minor technical breaches.

The sample was relatively small and not intended to be statistically representative of the industry. Compliance with the best interests duty and related obligations under the FOFA reforms, which have applied to advisers since 1 July 2013, was not assessed.

Background

- 17 REP 340 provided a review of the market for structured products. It reported our findings on product features and risks, marketing practices, investor attitudes and behaviour, and consumer complaints. The report identified a number of potential problems and challenges for retail investors who invest in these complex products. Structured products can be particularly complex and difficult for most investors and financial consumers to understand.
- 18 As part of that review, we also assessed marketing and promotional materials for structured products, focusing on advertising or claims that may have been potentially misleading. As a result, a number of issuers agreed to make changes to promotional materials, particularly in relation to inappropriate comparisons between structured products and safer banking products, and to ensure that worked examples include fees and costs.
- 19 Our review also focused on unhelpful and potentially misleading phrases such as ‘conditional protection’ and ‘contingent capital protection’ in materials describing products where investors’ capital is at risk of loss, with issuers agreeing to withdraw those claims from promotional and disclosure materials.
- 20 REP 340 also provided details of consumer complaints about financial advice on structured products, including allegations of product mis-selling and inappropriate financial advice.

- 21 To further investigate and understand the nature of advice being provided on structured products, we subsequently reviewed a sample of client files for compliance with the former reasonable basis for advice requirement in s945A of the Corporations Act (see paragraph 7), and present the findings in Section C of this report.

Future of Financial Advice reforms

- 22 The advice files assessed for this report were provided before the introduction of the FOFA reforms, which commenced on 1 July 2013. We consider that our findings remain relevant following the introduction of FOFA.
- 23 In particular, FOFA introduced new obligations on advice providers when giving personal advice. These obligations, set out in Div 2 of Pt 7.7A, include the following:
- (a) An adviser must act in the best interests of their client.
 - (b) An adviser must only provide advice to a client if it would be reasonable to conclude that the advice is appropriate to the client, had the adviser satisfied their duty to act in the best interests of the client.
 - (c) If an adviser knows, or reasonably ought to know, that there is a conflict between the interests of the client and the adviser, their AFS licensee, authorised representative or an associate, the adviser must give priority to the client's interests when giving the advice.

Section E of Regulatory Guide 175 *Licensing: Financial product advisers—Conduct and disclosure* (RG 175) contains detailed guidance on Div 2 of Pt 7.7A.

- 24 The obligations under Div 2 of Pt 7.7A apply to the 'advice provider', who is generally the individual providing financial advice to the client. This is in contrast to s945A, which applied to the 'providing entity' (i.e. either the authorised representative or the AFS licensee). The obligation to give an SOA under Div 3 of Pt 7.7 also applies to the providing entity.
- 25 Advice that breached s945A would also breach the current Div 2 of Pt 7.7A. As stated in RG 175, the new provisions should lead to a higher quality of advice being provided compared to the general standard of advice previously being provided under s945A: see RG 175.214. Therefore, it is possible that some advice that complied with s945A would breach Div 2 of Pt 7.7A.

The research sample and methodology

- 26 We obtained and reviewed five advice files from each of 10 AFS licensees (50 advice files in total) where structured products described as having some

‘capital protection’ or ‘capital guarantee’, or described with similar terms such as ‘contingent’ or ‘conditional’ protection, were recommended to retail investors. The files were obtained in late 2012 and generally related to advice provided in 2011 and 2012.

- 27 We requested all relevant documentation, including SOAs, Product Disclosure Statements (PDSs), client ‘fact finds’, file note correspondence with clients, and product research when provided to clients.
- 28 Reviews were undertaken by suitably experienced and qualified members of ASIC’s Financial Advisers team. Each file was reviewed by at least two members of staff.
- 29 We considered whether the advice complied with the former reasonable basis for advice requirement. We also looked at aspects of the disclosure to investors, in the SOA and in other documents.
- 30 Some advice was selected for review after data we obtained raised concerns about the potential for inappropriate advice. Warning signs included:
- (a) advice that resulted in an unusually high allocation of clients’ investible assets in structured products (in some cases 90–100%);
 - (b) products or advice that involved relatively high commission payments for advisers; and
 - (c) advice to invest in medium-risk or high-risk products that appeared inconsistent with clients’ risk profiles or their circumstances.
- 31 However, it is important to note that not all advice files were chosen for their perceived risk of inappropriate advice. Further, we stress that the sample of files obtained is relatively small and is not intended to be representative of all retail investors in structured products, or of all advisers active in recommending these investments.

AFS licensees in the sample

- 32 Based on information obtained from issuers about the advice and distribution channels for their structured products, we selected AFS licensees that were:
- (a) affiliated with, or fully owned by, retail banks and other financial institutions that issue structured products (‘institutionally owned licensees’), which included several banks that tended to rely on affiliated or in-house advisers for a significant portion of their structured product sales; and
 - (b) licensees not owned by or aligned with issuers (‘non-aligned licensees’), which were not ‘independent’ advice providers as defined by s923A because they generally were paid commissions from the issuers whose products they recommended.

Table 1 provides a summary of the AFS licensees in the sample.

Table 1: AFS licensees in sample

Licensee type	Number	Percentage
Institutionally owned licensees	6	60%
Non-aligned licensees	4	40%
Total	10	100%

Product types in the sample

33 We sought to include advice that covered recommendations to invest in a mix of product types from different issuers. The product types are described in REP 340, and include:

- (a) 'bond plus call' style products;
- (b) limited recourse loans, including 'protected equity' loans;
- (c) 'internally geared' structured products; and
- (d) 'capital-at-risk' products, such as 'reverse convertibles'.

34 REP 340 provides a detailed analysis of these products, whose legal forms include deferred purchase agreements, managed investment schemes, limited recourse loans, and securities and preference shares in unlisted companies.

35 There were no 'constant proportion portfolio insurance' (CPPI) products included in the sample because very few new CPPI products have been issued or marketed in recent years. Many of these products went into 'cash-lock' during and after the global financial crisis.

36 Table 2 shows the breakdown of products in the sample.

Table 2: Product types in sample

Product type	Number of files	Percentage of files
Bond plus call	10	20%
Limited recourse 'protected equity' loan	13	26%
Internally geared	19	38%
Capital-at-risk	8	16%
Total	50	100%

Clients in the sample

- 37 The sample included retail clients with a range of circumstances, including:
- (a) personal investors;
 - (b) self-managed superannuation funds (SMSFs); and
 - (c) people at different ages or life stages, including young investors, pre-retirees and people in the draw-down phase of superannuation.

C Key findings

Key points

While we found that approximately half of the advice files we reviewed complied with the former reasonable basis for advice requirement, we were concerned that in the remaining files there was insufficient evidence of compliance.

Common features of the advice files where there was insufficient evidence of compliance included:

- the scope being limited to a single structured product;
- advice that was based on incomplete client information; and
- unsuitable gearing recommendations.

We also found some instances of non-compliance with some aspects of the obligation on providing entities in Div 3 of Pt 7.7 to give retail clients who receive personal advice an SOA containing prescribed information.

Overview of findings

38 In approximately half of the advice files we reviewed, we could see evidence that the providing entity had complied with the former reasonable basis for advice requirement because it had:

- (a) determined the relevant needs, circumstances and objectives of clients;
- (b) made reasonable inquiries into clients' circumstances;
- (c) considered and investigated the subject matter of the advice; and
- (d) provided appropriate advice based on those considerations and investigations.

In addition, there was often good disclosure, such as advisers taking steps to clearly explain the reasons for the complex products being recommended in the context of the clients' relevant personal circumstances and needs.

39 However, in the remaining advice files we were concerned that there was insufficient evidence of compliance with the former reasonable basis for advice requirement. In some cases, it was clear that the providing entity had failed to comply with one or more of the requirements in s945A.

40 Common features of advice that failed to comply with the former reasonable basis for advice requirement included:

- (a) narrowing of the scope of advice to one specific structured product (see paragraphs 44–48);

- (b) inadequate consideration of the client's needs and relevant personal circumstances, and alternative strategies/asset allocation (see paragraphs 49–52); and
 - (c) unsuitable gearing recommendations (see paragraphs 53–56).
- 41 In addition, we had a number of concerns with the disclosure, including:
- (a) misrepresentation of the features or nature of the products recommended, including the degree of safety or capital protection (see paragraphs 57–59); and
 - (b) inadequate explanation of the basis for advice (see paragraphs 60–64).
- 42 We were also concerned that:
- (a) in some cases, conflicts of interest may have contributed to inappropriate advice (see paragraphs 65–68); and
 - (b) some advisers either did not demonstrate expertise in the products they were recommending, or did not communicate the key features and risks accurately to clients (see paragraphs 69–76).

Non-compliance with Statement of Advice requirements

- 43 We also found evidence of non-compliance with the SOA requirements in Div 3 of Pt 7.7, including:
- (a) boilerplate SOAs;
 - (b) failure to disclose risks;
 - (c) description of relatively risky financial products as safe or protected; and
 - (d) execution of the product transaction a considerable time before an SOA was provided to the client—without a valid reason (e.g. the advice was not time critical). This appeared to breach the requirement under s946C(1) that an SOA must be given to the client before the providing entity provides another financial service to the client that arises out of, or is connected with, the advice, such as arranging for a financial product to be issued to the client (see RG 175.145 for further information).

Scope of advice

- 44 A feature of the majority of the advice in the sample was that the scope of advice was limited to consideration of a specific structured product (about two-thirds of the advice files). Often, there was no consideration or comparison of alternative strategies or products to meet the client's needs.

- 45 In some cases, the narrow scope of advice appeared to have been requested by clients who were seeking advice on specific products and were made aware of the limitations of the advice.
- 46 However, in many cases, we considered that there was no evidence of compliance with the former reasonable basis for advice requirement. This included where there did not appear to be reasonable inquiries made of the client's relevant personal circumstances. In other cases it appeared the client's objectives and needs may have been better met with other more simple and cost-effective strategies or products (e.g. repaying debt or starting a savings plan).
- 47 In some cases, the single-product advice we reviewed, while provided as personal advice with an SOA, had features of 'execution-only' product sales (i.e. where no advice is provided), rather than personal advice that followed the necessary steps under s945A.
- 48 There were also many cases where we were concerned that the client's objectives or needs, and the scope and subject matter of the advice, may have been 'contrived' by the adviser to match the particular structured product being sold or recommended. For example, we reviewed advice where the client's objectives were listed as wanting to gain exposure to a very specific overseas index or commodity, with their second objective listed as wanting to invest in a specific structured product, which was named, and which offered that exposure. The client was advised to invest in that product.

Example

In the case of one AFS licensee, all clients in the sample had ticked a box in the 'fact find' indicating that they were interested in minimising the tax they paid. Identical SOAs were generated for all of these clients, with the advice limited to one specific loan product where the client's loan interest payments would be tax deductible. There was no consideration of alternative strategies or products.

In some cases, this resulted in advice that may have been inappropriate. For example, one client's fact find specifically indicated that she did not wish to borrow to invest or to take investment risks. Despite this, the product that was recommended entailed both borrowing and the potential to lose money.

Consideration of alternative strategies and asset allocation

- 49 Related to the scoping of advice, in some cases the focus of the advice appeared to be on recommending specific structured products to the exclusion of other strategies and products, rather than on first identifying the

client's needs and relevant personal circumstances, and then considering strategies (and products where appropriate) to meet those needs.

- 50 In some of the advice we reviewed, structured products would play a limited and strategic role in a well-diversified portfolio, in line with the client's objectives and risk profile.
- 51 However, other advice resulted in a high concentration of the client's portfolio or assets in single structured products, resulting in very little diversification of risks.
- 52 Many of the SOAs had the features of product marketing and product disclosure documents. They promoted the benefits and advantages of products, and referred to some of the risks and downsides, but without providing the necessary layer of analysis to help clients decide if the product was right for them. In some of these cases, we were concerned that the client would not have a sufficient level of detail to decide whether to act on the advice, as required under Div 3 of Pt 7.7.

Example

A client had a modest income, a small amount of bank savings and superannuation, and relatively substantial personal debts. The client's objectives in seeking financial advice were to repay the debt and to start investing to save a property deposit in the medium term.

The providing entity recommended a structured product that entailed a compulsory loan, which required the client to pay loan interest and fees upfront to gain exposure to the performance of the Australian share market (this exposure was obtained 'synthetically'—through derivatives). In addition, because the client did not have sufficient cash to cover the cost of the interest and fees (the value of the loan, for example, was higher than the client's annual income), the providing entity recommended a second loan available with the product to cover the cost (fees and interest) of the first loan. This added to the client's overall interest expenses.

The providing entity did not consider or compare other simple strategies that may have been more appropriate and beneficial for the client—for example, prioritising repayment of the personal debt, rather than diverting funds into the leveraged structured product.

On implementing the advice, all of the client's investment funds would be in this single product, and there were no indications or projections for how it would help achieve the stated medium-term goal of saving for a property deposit. Finally, the second loan was recommended for its tax deductibility, but this may not have been particularly relevant for a client in a low marginal tax bracket, and given the client's other circumstances and objectives.

We were concerned that the advice file did not contain evidence of a reasonable basis, and that the advice was inappropriate. The advice appeared to focus on advising on a single product, rather than on identifying a strategy that was suitable for the client.

The risk that the investment may not break even (after net costs) and that the client may lose money was not sufficiently articulated in the SOA.

Gearing and leverage recommendations

- 53 We saw several examples of advice where gearing was recommended, but where there was no evidence of compliance with the former reasonable basis for advice requirement. For example, gearing advice we reviewed included:
- (a) advice to borrow money using a ‘protected equity’ loan, where the client did not have sufficient cash flow to service the interest-only payments. In some cases, a second loan was recommended to enable the client to pay the interest on the first loan, without a sufficient explanation of why this was considered appropriate;
 - (b) a recommendation to use a protected loan to purchase highly speculative shares when the client’s objective was to use the money for a deposit on a house in the short term. The client had existing debts and relatively few savings;
 - (c) a gearing recommendation provided to a retired client who had no apparent need to take investment risks. Although the loan was limited recourse (or ‘protected’), there was still the potential for the client to experience a net loss after fees and interest; and
 - (d) advice to invest in geared products primarily for tax deductions, where the products had not been subject to an Australian Taxation Office (ATO) product ruling. While an ATO product ruling is not mandatory, the providing entities did not compare other prominent and similar products that have rulings, which provide certainty of tax treatment.
- 54 As highlighted by REP 340 (published after the advice in this sample was provided), there is some uncertainty about the tax deductibility of certain ‘synthetic’ or ‘notional’ loan structured products, which are equivalent in economic substance to purchasing call options and may not entail the transfer of funds from a lender to a borrower.²
- 55 Following the publication of REP 340, the ATO has stated that it is ‘examining products where it appears no actual finance or financial accommodation is provided to investors’, and has also warned that deductions may not be available on the ‘notional interest’ incurred to invest in these products.³

² PDSs for recent ‘synthetic loan’ or ‘internally geared’ structured products have noted that the ATO may deny tax deductions on these products, on the basis that the products are in substance exotic call options, the premiums for which are likely to be a non-deductible capital cost. This follows our warning in REP 340, which noted that when the main economic rationale for a product appears to be tax deductibility, there is a risk that the ATO may view the product as a tax avoidance scheme, particularly if investors could achieve a similar benefit (apart from the tax deduction) by purchasing other financial instruments such as call options, and where there is no ATO product ruling.

³ ATO website, ‘Capital protected and capital guaranteed financial products that use notional finance’, retrieved 19 November 2013.

56 In some of the above cases, there may have been valid reasons for recommending gearing strategies and products. However, the SOA and other documents did not always provide sufficient evidence or basis to support these recommendations.

Disclosure about the degree of safety or ‘capital protection’

57 The ‘capital protection’ or ‘capital guarantee’ offered by certain products appeared to have been attractive to many investors in the sample, and SOAs generally provided details of the limitations and exclusions that applied to this protection or guarantee.

58 In some cases, where the investor’s capital was at risk of potential loss, the providing entity took steps to ensure that the client understood this risk by requiring the client to specifically acknowledge the risk before the investment could be provided. For example, one AFS licensee’s SOA for ‘reverse convertible’ products described clearly how they did not offer capital protection or potential for capital growth.

59 However, in a small number of cases, the nature of the ‘protection’ or ‘capital protection’ provided by products may have been misrepresented. For example:

- (a) ‘Internally leveraged’ products with compulsory gearing, where all of the investor’s outlay is at risk if reference assets do not perform sufficiently well, were described as offering ‘safety’, ‘minimal risk’ and ‘capital protection’. This may have misled clients as to the nature of their investment and the potential to lose money.
- (b) Consistent with marketing materials from some issuers at the time of the advice, some reverse convertible products were described as providing ‘conditional’ or ‘limited’ capital protection, ‘reasonably low risks’ and a ‘guaranteed income’, or derivations of those terms. However, investors in these products may lose some or most of their money if the value of one reference asset falls by a certain amount—as happened in some cases.
- (c) Some reverse convertibles were inappropriately described to clients as being like bank term deposits; others were described as offering the benefits of investing in a basket of shares (this is not the case—the investor may have limited or no exposure to the positive performance of shares, and is not entitled to the dividends that ordinary shareholders receive).

Disclosure of the basis for advice

- 60 A common finding of our review was inadequate explanation of the basis for the advice, including why the advice or recommendation was considered appropriate for the client, in the SOA.
- 61 In some cases, it would have been difficult for clients to decide whether to implement the recommendations, due to the absence of this information. Division 3 of Pt 7.7 provides specific details of what is required in an SOA.⁴ In particular, ‘the level of detail about a matter that is required is such as a person would reasonably require for the purpose of deciding whether to act on the advice as a retail client’.
- 62 In some cases of advice on complex structured products, borrowing arrangements and related strategies, we considered that the SOA would have been improved by inclusion of information about the investment performance required for the investor to at least break even or make a profit after net fees and expenses. While disclosure of a break-even point is not specifically mandated, this type of analysis was often missing. For example, one set of SOAs for internally geared structured products failed to include any consideration of the substantial performance required for the investment to break even, despite worked examples and scenarios having been provided in the PDS.
- 63 Further, in some advice recommending ‘protected equity’ loans, the SOAs did not clearly explain what client funds were at risk of loss (e.g. loan interest payments and protection fees, which in some cases were very high relative to the value of the ‘protected’ shares).
- 64 We also saw examples of clear and accurate disclosure that would enable the client to make an informed decision about whether to proceed with the advice.

Example

In one advice file where a reverse convertible product was recommended, our view was that despite the product’s complexity, the advice was provided in a way that the client was likely to understand, with the adviser taking care to explain the nature and risks of investing. The SOA contained plain language with clear disclosure of the risks.

The SOA was likely to have enabled the client to make an informed decision about the appropriateness of the product recommendation and whether to proceed.

⁴ Sections 947B and 947C list the content requirements for an SOA. These requirements include, among other things, a statement setting out the advice, information about the basis on which the advice is or was given, the name and contact details of the providing entity, and information about remuneration. There are additional requirements in s947D when the advice recommends the replacement of one product with another.

Managing conflicts of interest

- 65 Under the pre-FOFA law, AFS licensees had an obligation to manage their conflicts of interest, but there was no specific requirement that representatives give priority to the client's interests in the event of a conflict. There is now such a requirement in s961J of the Corporations Act. Nevertheless, in most cases, we did not see evidence that advisers were unduly influenced by conflicts of interest such as commissions. Further, in some cases where significant product fees or commissions were available to advisers, they were reduced on agreement with the client.
- 66 However, in some cases conflicts of interest may have contributed to inappropriate advice. For example, at the time the advice was provided (before the introduction of the FOFA reforms), some 'internally geared' or leveraged structured products offered extremely high commissions for advisers compared with most other financial products in the market. This may have influenced the advice.
- 67 With several of these products, the loan establishment fee was 2% of the loan amount or the notional investment exposure, all of which may be paid to the adviser and AFS licensee as an upfront commission (in some cases, the adviser chose to reduce this commission). For an investor paying interest at 8% per annum plus a 2% loan establishment fee (i.e. 10% of the notional exposure in total), and fully geared into the product, this upfront commission represents 20% of their outlay in the first year. Further, the trail commissions paid each year to advisers, when expressed as a percentage of the client's net outlay in subsequent years, could be relatively high.
- 68 We were concerned that in some cases these products enabled advisers to extract high fees or commissions from the limited money these clients had available to invest. We expect that the recent ban on asset-based fees on borrowed amounts will reduce the likelihood of this problem occurring in the future with respect to these products.⁵

Example

One providing entity recommended that a client exit a structured product early (thereby suffering a net loss, after costs), and advised that the client commence another structured product from the same issuer. The new product was almost identical to the previous one, which had performed poorly. The upfront commission for the new product was approximately 20% of the client's outlay (the money they had to invest) in the first year, or 2% of their 'notional exposure', with ongoing commissions applying in subsequent years.

⁵ From 1 July 2013, AFS licensees and authorised representatives that provide financial product advice to retail clients are generally prohibited from charging asset-based fees on borrowed amounts that are to be used to acquire financial products by or on behalf of a client: see s964D and 964E of the Corporations Act, and RG 246.

We were concerned that the providing entity had ‘churned’ the client from one product to another with no discernible benefits to the client, increasing the adviser’s commission revenue in the process.

Demonstrating product expertise and understanding

- 69 Many of the products and strategies in the advice we reviewed were highly complex. Some structured products embed contingent options (derivatives) that determine the payout at maturity, as well as complex structures including the use of special purpose vehicles and novel legal structures.
- 70 It is not surprising, then, that many investors may have difficulty understanding these investments and will rely on advisers to decipher the technical details and make appropriate recommendations. This view is supported by research by Investment Trends, which found that nearly half of investors who had used an adviser for their most recent ‘capital protected’ product investment had limited or no understanding of their investment, implying that they trusted or relied on their adviser to understand these products, explain them and make appropriate recommendations to them.⁶
- 71 Some advisers clearly demonstrated that they had expertise in complex products and strategies, and their clients benefited from this advice.
- 72 However, we were concerned that in other cases advisers did not demonstrate expertise in the products they were recommending, or communicate the key features and risks accurately to clients.⁷ This concern is based on documents including SOAs, adviser file notes, and communication with clients including in emails and letters, which we reviewed as part of the advice. Examples included advisers who:
- (a) promoted capital-at-risk products such as reverse convertible products as suitable for clients seeking ‘capital growth’. However, while the products offered a predetermined income (subject to issuer credit risk), they offered no participation in the growth of the reference assets, and exposed investors to the downside risks if the value of those assets fell;
 - (b) inappropriately described reverse convertibles as being ‘like term deposits’;
 - (c) described a key attraction of a reverse convertible product as ‘capital protection’ to ‘reduce risk’, while also stating that the product was expected to outperform a share portfolio in all but strongly rising

⁶ *Capital protected products report*, Investment Trends, December 2012.

⁷ Investment Trends found that, in 2012, a third of financial planners who had used capital protected products had encountered problems with them, and those who had stopped recommending these products were likely to cite product complexity as a problem; 28% of the advisers who had encountered problems stated that the products were complicated and difficult to understand and explain, with 19% of planners who were using the products citing this as a barrier to using them: see *Capital protected products report*, Investment Trends, December 2012.

markets. However, there were many other scenarios when the product may have underperformed the share market, including if just one of the reference shares performed poorly;

- (d) recorded the value of a leveraged structured product's 'notional exposure' as an asset in the investor's balance sheet, without a corresponding entry in the client's liabilities. The effect was to grossly overstate the client's net assets after the advice had been implemented;
- (e) referred to the relevant disclosure document as being a PDS for a managed fund, when it was actually a prospectus for the offer of unlisted shares in a foreign company; and
- (f) advised that 'notional loan' products without ATO product rulings were tax deductible in unambiguous terms. Further to our discussion of this issue in paragraph 54, we note that the ATO has recently warned that some 'notional loan' products may be tax avoidance schemes and, for investors, may not be tax deductible. The ATO recommends that investors considering investing in such products obtain their own tax or legal advice about the tax consequences from an adviser who is not involved in selling the product.

73 In addition, advisers rarely attempted to explain the underlying nature of the products they were recommending, and in some cases may have misrepresented them as being less complex than they were. Examples included:

- (a) failure to explain the meaning and significance of counterparty risk, particularly for products where the issuer was of little financial substance (e.g. a special purpose vehicle);
- (b) failure to explain the use of derivatives that were embedded in most of these products (see REP 340). The embedded costs are often unclear to investors, and in some cases may represent relatively poor value for investors. That risk and cost was not investigated by advisers in most of the files we reviewed;⁸ and
- (c) some advisers incorrectly stated that the client would obtain the benefits of a direct investment in shares or other assets, when in some cases they would not be entitled to dividends or capital growth.

⁸ While we are not aware of similar studies for the Australian structured products market, the European Securities and Markets Authority (ESMA) found that, based on a sample of 76 products sold in the European Union and maturing between 2008 and 2011, structured products have hidden costs and are sold to retail investors with a significant 'issuance premium' estimated at around 4.6% of the notional value of the product, or 5.5% including issuer credit risk. ESMA suggested that these fees may in part be based on the difficulties that retail investors have in evaluating the intrinsic value of structured products and the costs that might be embedded in the selling price. Further, ESMA's analysis of a sample of around 2,750 products over a 14-year period found that, on average, the performance of structured products with 100% capital protection was less than that of a risk-free investment: see *Retailisation in the EU*, Economic Report No. 1, ESMA, 3 July 2013.

- 74 In some cases, we were concerned that this conduct may have breached s945A. In addition, we were concerned that in some cases the advisers did not demonstrate expertise in the products they were advising on.
- 75 Advisers are required to meet the competency and training standards set out in Regulatory Guide 146 *Licensing: Training of financial product advisers* (RG 146) when providing financial product advice, and AFS licensees are required to ensure their representatives are adequately trained and competent: s912A(1)(f).
- 76 Following the introduction of FOFA, if an advice provider chooses to meet the 'safe harbour' steps for complying with the best interests duty, they must assess whether they have the expertise to provide advice on the subject matter of the advice sought by the client. If, as a result of making this assessment, they determine that they do not have this expertise, they must not provide advice on that subject matter: see s961B(2)(d) and RG 175.298.

Key terms

Term	Meaning in this document
advice	Personal advice given to retail investors
advice licensee	An AFS licensee that provides personal advice to retail clients
advice provider	<p>A person to whom the obligations in Div 2 of Pt 7.7A of the Corporations Act apply when providing personal advice to a client. This is generally the individual who provides the personal advice. However, if there is no individual that provides the advice, which may be the case if advice is provided through a computer program, the obligations in Div 2 of Pt 7.7A apply to the legal person that provides the advice (e.g. a corporate licensee or authorised representative)</p> <p>Note: These obligations commenced on 1 July 2013: see paragraph 24 for the previous obligation under s945A.</p>
adviser	<p>A natural person providing personal advice to retail clients on behalf of an AFS licensee who is either:</p> <ul style="list-style-type: none"> • an authorised representative of a licensee; or • an employee representative of a licensee
AFS licence	<p>An Australian financial services licence under s913B of the Corporations Act that authorises a person who carries on a financial services business to provide financial services</p> <p>Note: This is a definition contained in s761A.</p>
AFS licensee	<p>A person who holds an AFS licence under s913B of the Corporations Act</p> <p>Note: This is a definition contained in s761A.</p>
ASIC	Australian Securities and Investments Commission
ATO	Australian Taxation Office
authorised representative	<p>A person authorised by an AFS licensee, in accordance with s916A or 916B of the Corporations Act, to provide a financial service or services on behalf of the licensee</p> <p>Note: This is a definition contained in s761A.</p>
best interests duty and related obligations	The obligations in Div 2 of Pt 7.7A of the Corporations Act
capital protected or capital guaranteed	<p>These terms are used in a variety of inconsistent ways across the financial services industry. Products that are described as offering capital protection may range from deposits with prudentially regulated entities to leveraged investments with limited recourse loans, and structured notes where the investor's capital return bears the risk of the reference assets</p>

Term	Meaning in this document
capital-at-risk products	See paragraph 119 of REP 340 for an explanation of these structured products
client	A retail client as defined in s761G of the Corporations Act and Div 2 of Pt 7.1 of Ch 7 of the Corporations Regulations
Corporations Act	<i>Corporations Act 2001</i> , including regulations made for the purposes of that Act
Corporations Regulations	Corporations Regulations 2001
CPPI products	Constant proportion portfolio insurance products, as described in paragraphs 96–99 of REP 340
ESMA	European Securities and Markets Authority
financial advice	Personal advice given to retail investors
financial product	A facility through which, or through the acquisition of which, a person does one or more of the following: <ul style="list-style-type: none"> • makes a financial investment (see s763B); • manages financial risk (see s763C); • makes non-cash payments (see s763D) <p>Note: This is a definition contained in s763A: see also s763B–765A.</p>
FOFA	Future of Financial Advice
former reasonable basis for advice requirement	The requirement that a providing entity must only give personal advice to a retail client if the requirements in s945A are met: see paragraph 7 of this report
limited recourse 'protected equity' loan	See paragraph 86 of REP 340 for an explanation of this structured product
personal advice	Financial product advice that is given or directed to a person (including by electronic means) in circumstances where: <ul style="list-style-type: none"> • the person giving the advice has considered one or more of the client's objectives, financial situation and needs; or • a reasonable person might expect the person giving the advice to have considered one or more of these matters <p>Note: This is a definition contained in s766B(3).</p>
Product Disclosure Statement (PDS)	A document that must be given to a retail client in relation to the offer or issue of a financial product in accordance with Div 2 of Pt 7.9 of the Corporations Act <p>Note: See s761A for the exact definition.</p>
reverse convertibles	See paragraph 119 of REP 340 for an explanation of these structured products

Term	Meaning in this document
s945A (for example)	A section of the Corporations Act (in this example numbered 945A)
safe harbour for the best interests duty	The steps set out in s961B(2) of the Corporations Act. If an advice provider proves they have taken these steps, they are considered to have met their obligation to act in the best interests of their client
Statement of Advice (SOA)	A document that must be given to a client for the provision of personal advice under Subdivs C and D of Div 3 of Pt 7.7 of the Corporations Act Note: See s761A for the exact definition.
special purpose vehicle	See Table 2 of REP 340 for an explanation
structured products	Unlisted and unquoted retail structured products: see paragraph 11 of REP 340 for a more detailed definition

Related information

Headnotes

capital guaranteed, capital protected, derivatives, leverage, limited recourse borrowing, options, protected loans, structured products

Regulatory guides

RG 146 *Licensing: Training of financial product advisers*

RG 175 *Licensing: Financial product advisers—Conduct and disclosure*

RG 244 *Giving information, general advice and scaled advice*

RG 246 *Conflicted remuneration*

Legislation

Corporations Act, Div 2 of Pt 7.7A, Div 3 of Pt 7.7, s761A, 945A, 945B, 947B, 947C, 947D

Reports

REP 201 *Review of disclosure for capital protected products and retail structured or derivative products*

REP 279 *Shadow shopping study of retirement advice*

REP 340 *'Capital protected' and 'capital guaranteed' retail structured products*

REP 341 *Retail investor research into structured 'capital protected' and 'capital guaranteed' investments*

Media releases

13-093MR *ASIC health check on capital protected products* (1 May 2013)



13-246MR *ASIC concerns prompt banks to change promotional materials* (4 September 2013)