New rules to undo bad financial advice

DAVID HUGGINS

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From October 1, the position of clients who have received bad financial advice will potentially be improved.

The new laws that come into effect on that day — Friday — create a four-stage process.

The new laws apply from when a financial advisory firm becomes aware that negligent advice may have been provided to a client. These situations will often arise when one client makes a complaint about bad financial advice and it becomes apparent that other clients of the firm are also in the same situation.

In these circumstances the first stage is that the firm must notify all affected clients that negligent advice may have been provided within 30 days. Under the old system, the firm did not have to notify affected clients, with the result being that clients would be aware that they had lost money but not realise that the loss was caused by their adviser's negligence.

The second stage is that also within 30 days after becoming aware of the issue, the firm must begin an investigation. As part of that investigation, it must identify what has gone wrong and quantify the loss that clients are legally entitled to recover.

Under the old system, firms did not have an obligation to conduct these types of investigations. If they were aware of an issue they would not investigate to see if any other clients had been affected and they did not have to calculate the amount of loss that had been suffered by a client.

The third stage is that within 10 days after the completion of the investigation, clients will have to be notified about the outcome, including the fact that the client is entitled to receive compensation and the amount. Under the old system clients had to work out for themselves whether they had received negligent advice and the amount of compensation they were entitled to recover.

The fourth stage is that the financial firm within 30 days after the conclusion of the investigation must pay compensation to the client.

Importantly, this payment does not affect the rights of the client to pursue a claim at the Australian Financial Complaints Authority or at court, but the amount paid would have to be offset against the amount that is subsequently claimed by the client.

Under the old system, there was no obligation to make payment for losses that a client could have potentially pursued at AFCA or in court. Firms knew that many people who could made a claim for compensation would not do so for various reasons and would not pay compensation unless a client pursued a claim.

The approach taken was to see whether any clients would make a claim and if they did, defend the claims and try and settle for what the clients were willing to take, not what the claims were actually worth.

The new system looks to be a significant improvement on the old but in the legal world there is a big difference between how things are meant to work and how they actually operate. Unfortunately the new system will be gamed by unscrupulous firms. This will be done in a number of ways, with the most obvious being how loss is calculated.

The calculation of loss that flows from bad financial advice is a complex task that requires assumptions to be made about what would have happened if the correct advice had been provided.

Making assumptions that are the least favourable to a client will significantly lower the amount of compensation that is payable.

For this reason clients who receive compensation payments for bad financial advice should be very sceptical about whether they are receiving everything that they are actually entitled to recover.

David Huggins is a lawyer who specialises in financial services related disputes