REGULATING INVESTMENT RISK: INDIVIDUALS AND THE GLOBAL FINANCIAL CRISIS

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I INTRODUCTION

This paper will consider three main ideas. The first is the individual or retail investor, and the development of mass financial markets. Those investors have lost large sums, sometimes all their retirement savings in the global financial crisis ('GFC'). The GFC has made very urgent the finding of solutions to the difficulties of retail investors in financial markets. The losses of retail investors in the GFC underline the degree to which risk has devolved to the retail investor in providing personal and household services, once provided by the government. What the GFC shows is that retail investors have made losses on investments such as superannuation, which have been promoted by government as a safe functional equivalent for government provided retirement income. They have made these losses because they have suffered the general reverses of the market seen during the GFC. They have also suffered losses because they have not understood the risks involved in using retirement assets in much more risky financial services such as margin borrowing and stock lending.[1] In the course of this shift from government or state provision to market relation, high expectations have been placed on the retail investor. He or she has become in the parlance of financial regulation and policy, a 'financial citizen' on whom responsibilities have fallen, including exercising choice in relation to investment risk. The GFC events provoke us to consider the degree to which the 'financial

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1 The paper will discuss extensively the practices of Storm Financial Limited which recommended margin loans to most of its clients, and collapsed with large retail investor losses in December 2008. It will also mention the collapse of Opes Prime Stockbroking Limited, which offered stock-lending services. The trouble was that many of the retail clients of Opes Prime thought they were merely mortgaging their shares to secure a margin loan, and did not understand that they had no equity of redemption in the shares and that the margin lenders could sell them under the financing arrangement: *Beconwood Securities Pty Ltd v Australian and New Zealand Banking Group* (2008) 26 ACLC 512; *Immobilari Pty Ltd v Opes Prime Stockbroking Ltd* (2008) 525 ALR 41.

citizen' has the capability to choose wisely about risk, and whether it is time to recalibrate the balance between market efficiency and investor protection.

The second idea is how risk is treated in retail financial regulation and its perception by retail investors generally. We now have a rich seam of research on how individuals perceive and react to risk, and the GFC makes it timely to ask how this might be taken into account in regulation. My overall thesis is that risk is downplayed – that regulation allows an undue emphasis on return – and that again the GFC has made this plain. The mass departure of retail investors from national financial markets during the height of the GFC contributed significantly to the greater price and volume volatility that was experienced in late 2008. This fact is at the same time a measure of the extent of retail investor participation and the risks of that participation. The risk is demonstrated clearly in the case of superannuation accounts. There is a whole cohort of retirees with dramatically reduced retirement income because their retirement coincided with the huge drops in investment value caused by the GFC. They will suffer, through no fault of their own, for all of their retired years, from the bad luck of having to retire (and crystallise their losses) at the time of the dramatic collapse of value. They suffered from a combination of general market risk, and timing risk. Did governments intend this as a possible result when they privatised retirement income provision through superannuation? Did retail investors, who are also voters, perceive this as a possible risk of the privatisation of retirement income provision? Did regulators ever warn (or require providers to warn) retail investors about these risks?

It is reasonable to assume that readers are familiar with the idea that risk is a constructed concept that in financial markets is partly constituted by legal relations and partly by culture.[2] Mostly I want to consider the question of risk in retail financial markets, not from a theoretical perspective, but from that of the empirical evidence we have of investor perceptions of risk and how well that equips them to make decisions as 'financial citizens'. Or put another way, how well have retail investors survived the GFC, and does anything need to be done in response?

Thirdly, this paper will make some suggestions, with the lessons of the GFC in mind, for the future regulation of risk in retail investment. Risk is at the heart of investment, yet for retail investors it is obscure: how that might be addressed is the regulatory problem this paper elaborates and tries to address.

These three ideas will be illustrated by referring to what appear to be the facts of the advisory relationships established between Storm Financial, an

2 Michael Powers, *The Risk Management of Everything: Rethinking the Politics of Uncertainty* (2004); David Garland, 'The Rise of Risk' in Richard Ericson and Aaron Doyle (eds) *Risk and Morality* (2002) 48.

Australian financial advisor, and its mostly retiree customers.[3] Storm Financial had approximately 14 000 financial advisory customers, of which approximately 3000 seem to have been left in ruinous financial circumstances by the global financial crisis and the collapse of Storm Financial.[4] The majority of its customers appear to have been retirees, or those nearing retirement. The Storm Financial *modus operandi* often began with attracting clients to the business through investment education seminars. Clients were encouraged to think of themselves as on a 'Journey to Capitalism'. Part of this journey involved being educated about investment. Part of it involved being spoiled and treated as guests of Storm Financial: some clients even went on trips overseas. All of it involved building a relationship of trust with the client. Storm Financial advised its clients to speed their journey to capitalism by using their assets as security to borrow for investment. The aim was to arrive at a position where clients would be wealthy and live on the labour of others, through income derived from their capital.

Clients were encouraged to expect a much higher level of income from their capital than they had initially anticipated. Storm Financial advised them to increase their borrowing in order to hold a larger capital base from which this higher income could be derived. The Statements of Advice claimed to keep liabilities at a safe level, and complex forward cash flow figures for each year of the plan were set out in worksheets attached to Storm Financial Statements of Advice. Although these cash flow figures were described as a 'viability test', which assumed unfavourable conditions, and not as forecasts or projections, they were influential in persuading clients to adopt the Storm Financial advice model.

That model advised clients either to sell or to heavily mortgage their real estate to raise funds for investment in index funds. Storm Financial advised the

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3 The facts of the Storm Financial story have been taken from the details of the Storm Financial business model, advice model and the stories of the ruined investors at Parliamentary Joint Committee on Corporations and Financial Services, 'Inquiry into financial products and services in Australia' (2009) <http://www.aph.gov.au/senate/committee/corporations_ctte/fps/index.htm> at 15 September 2009. There the reader will find the facts in submissions by the Financial Planning Association of Australia, the Australian Securities and Investments Commission and many of the Storm Financial investors. The reader will also find submissions made by the banks involved in providing the home and margin loans which were invested according to the Storm Financial advice model: the Commonwealth Bank of Australia, the Australia and New Zealand Banking Group and Macquarie Bank Group. The reader will find further discussion of the details of the Storm Financial lending practices and recovery action on the website of the Storm Financial Consumers Action Group ('SICAG'), <http://www.sicag.info/> at 15 September 2009. Information about the winding-up of Storm Financial (rather than the continuation of administration) at *Australian Securities and Investments Commission, in the matter of Storm Financial Limited (Receivers and Managers Appointed) (Administrators Appointed) v Storm Financial Limited (Receivers and Managers Appointed) (Administrators Appointed)* (2009) 71 ACSR 81 (26 March 2009) and an unsuccessful attempt by Storm Financial to injunct the Commonwealth Bank of Australia from communicating with Storm Financial clients in relation to margin loans where there was a dispute as to who should be administering margin calls in relation to these: *Storm Financial Limited v Commonwealth Bank of Australia ABN* [2008] FCA 1991 (24 December 2008).

4 The 11 000 clients who did not suffer losses were acquired by Storm Financial in the period before the collapse from other dealer groups. They had not yet had their affairs reviewed and recommendations made in line with the Storm Financial advice model. The other 3000 were longer standing Storm Financial clients.

cashing in of superannuation assets for the same purpose. It advised the use of cash or investments in index funds as security for margin loans, to further extend clients' investment holdings. From the dividends and growth in value on these index fund investments the cash flow worksheets persuaded clients that they could service the loan interest, and enjoy a higher than expected income for personal and household use. Many clients had ceased all forms of work, so there was no question of them servicing these liabilities and providing personal income from other sources.

Storm Financial had been advising the adoption of their advice model for a few years. In a rising market as enjoyed from the mid-2000s many of Storm Financial's clients may have done well from the Storm Financial advice model.[5] The large interest bills they paid on their loans and affluent lifestyles seemed to be met by returns to capital and dividends. However, in the last quarter of 2008 it became clear that as a result of the GFC the value of assets held by many clients advised by Storm Financial had dropped to such a degree that margin calls were likely. In a letter dated 8 October 2008, sent in identical terms to virtually all clients, Storm Financial advised their clients to convert their investments to cash.

The Storm Financial investors who lost their retirement funds in this way were not stupid or irresponsible. Their stories show they had worked, budgeted, saved and some had invested successfully up until engaging Storm Financial. They took advice, but they were unlucky: they struck the steepest drop in the worldwide financial markets since 1929. That alone would have done them damage. But because of the investing approach recommended by Storm Financial, the market risk was exponentially increased by the fact that they had borrowed money to invest, in some cases twice over. Further, it is now admitted that along with the high risk investment approach from Storm Financial, there were serious operational deficiencies from the bank lenders and possibly also from the operators of the index funds into which the Storm Financial clients were invested.[6] The other risks were further augmented by provider risk. In short, a variety of different financial risks, some of them quite remote, wiped them out.

The questions this paper asks are: as 'financial citizens' could Storm investors really identify and analyse the risks they were taking, and the practical consequences? Should investors have been expected to 'second guess' the advice, especially in the face of the authority of Storm Financial's recommendations, and its partnerships with highly respected banks as margin lenders and investment managers? And what, if anything, should the regulatory response be?

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5 For example Ian Jones who thought 'it was a wonderful thing to be in and why not share it with my friends': 'Some Fall a Long Way After Collapse', *Sydney Morning Herald* (Sydney), 12-13 September 2009, News Review 7.

6 'CommBank to help 3000 Storm investors', *Sydney Morning Herald* (Sydney), 12-13 September 2009, News Review 7. See also account on the Storm Investors Action Group site, above n 3, of the Commonwealth Bank funding the lawyers Slater & Gordon to conduct a case-by-case review of all investors, and to recommend settlement terms.

II THE EXTENSION OF RETAIL INVESTMENT AND THE 'FINANCIAL CITIZEN'

A The Creation of 'Mass Markets' in Retail Investment

In the last 20 years there has been a radical extension of the levels of participation of ordinary individuals in investments and other financial products such as insurance and credit facilities. As others have observed,[7] this is due to a combination of government privatisations, individual provision for needs previously provided for by the state, such as education and retirement income,[8] and because of growing affluence.

The market has responded with a huge variety of instruments that are designed to meet the purposes of the very wide economic, educational and social attributes of the new investing class.[9] Not only have investment forms diversified radically, but so have the means of participation in them. Through online investing and the tide of information on broker websites it is now possible for retail investors to have most information as promptly as professional investors, and the financial analysis tools to make sense of it. Though limited mostly to securities in listed entities, they can also execute buy and sell orders, again in a fashion not very different from their professional counterparts. All this can be done by computer, independently of a broker and their advice – and more cheaply.

Related to this, but lurking beneath the policy surface, lies a fundamental change in the vision of the citizen which is rarely discussed in financial markets regulation. The extension of retail investor market participation 'all leaves unasked one crucial question – where should responsibility for citizens' longer-term financial security lie?'[10] In the last generation western economies have concluded that after government provides basic welfare services,[11] if individuals want greater provision, they must save and invest themselves.[12] In other words an implicit social and political consensus has developed that individuals will bear the risk of investing in financial markets to provide for long-term personal

7 Joanna Gray and Jenny Hamilton, *Implementing Financial Regulation* (2006), 88–190.

8 Dimity Kingsford Smith, 'Superannuating the Second Sex: Law, Privatisation and Retirement Income' (2001) 64(4) *Modern Law Review* 519–42.

9 Gray and Hamilton, above n 7.

10 Ibid 224; see also Kingsford Smith, above n 8, and Toni Williams 'Empowerment of Whom and for What? Financial Literacy Education and the New Regulation of Consumer Financial Services' (2007) 29(2) *Law & Policy* 226–256; and Gail Pearson, 'Risk and the Consumer in Australian Financial Services Reform' (1999) 28 *Sydney Law Review* 99, 104.

11 In health, education and the age pension for example.

12 If dramatic institutional failure threatens the safety of the financial system, governments may alleviate the worst effects. See, for example, Maxwell pension fund failure in the UK, HIH Insurance in Australia, Northern Rock Bank in the UK and even an investment bank, Bear Stearns and American International Group Inc. in the US.

welfare.[13] They will bear the risk even if it is rare, uncontrollable, and like the GFC, 'results in an epidemic of capital destruction.'[14]

The shifting of risk to the individual is particularly evident in retirement income provision. It is even more noticeable in a country like Australia which has moved to compulsory superannuation, managed by private financial sector institutions and not by government. On one hand the compulsory extension of superannuation to all working Australians is demotic. It aims to spread the taxation benefits associated with superannuation more widely than the salaried executives who were the main beneficiaries of schemes prior to that reform. On the other hand it has a number of effects that individualise risk in the provision of retirement income. Compulsory superannuation in Australia is a defined contribution system, not a defined benefit system. That means that individuals bear the risk that the combination of their contributions and the return on their investments will be insufficient to meet retirement income needs. By contrast, most government-run programs,[15] which are funded by taxes over time, and most corporate schemes up to that time used a defined benefits system where the risk of not having sufficient funds to pay the benefits lies with the scheme promoter not the investor.[16] Government programs and corporate schemes are more collective in nature and share the investment risk over a large number of individuals and over time.

Investor choice has been added as an aspect of superannuation: the availability of choice is one of the features that have accompanied the extension of retail investing generally. Making their own choice and exercising investor sovereignty is another dimension in which retail investors are encouraged to shoulder investment risk. The choice in superannuation is of both the fund to which the investor contributes and the level of risk in the plan the investor

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13 Otherwise, governments will not rescue people from investment failures – even when the investment itself is mandated by government such as in Australia's compulsory but privately managed superannuation system. Commonwealth of Australia, *Financial System Inquiry Final Report* (1997) 91–92.

14 'You have to think of this like there is an epidemic going on — an epidemic of capital destruction,' said James L. Melcher, president of the hedge fund Balestra Capital, on 14 September 2008: 'An Epidemic of Capital Destruction' *New York Times* (New York), 13 September 2009 <http://www.nytimes.com/2009/09/13/weekinreview/13word.html?_r=2> at 15 September 2009.

15 For example in the UK the State Earnings Related Pensions Scheme ('SERPS') replaced with State Second Pension ('S2P') since 2002 is a pension at retirement (in addition to the basic flat rate age pension) that is calculated with respect to career average earnings. Because there is a percentage of average salary that is guaranteed, the scheme (and the government's revenues) takes the long-term risk that returns to the fund of invested contributions will be lower than pay-outs. There is also an element of retirement income redistribution to the calculation of the pension: R Nobles 'Pensions Act 1995' (1996) 59 *Modern Law Review* 241, 243.

16 Although more secure even this is not an entirely risk-free system, for the bad times may make corporate schemes insolvent too and even the corporations that sponsor them: see the circumstances of General Motors Holden in the US, where it has been said that there is more health care and pensions expense in each car produced than steel. The company went into chapter 11 bankruptcy in June 2009, with a 'bail-out' by the US government equal to 61 per cent of the company's equity capital value.

desires: a spectrum of risk from 'growth', through 'balanced' to 'conservative'.[17] This sovereignty of choice is replicated in most other retail investing contexts, as the investor makes asset allocation and product choices from a complex and growing range of possibilities in the financial product market.

B The 'Financial Citizen'

So returning to our question – where should responsibility for citizens' longer-term financial security lie? – the answer seems more and more to be that it lies with the citizen if they wish to have more in retirement than the very modest level of income provided by government. The same applies to other services traditionally provided by government such as medicine and education. Financial regulators have developed policies and embarked on programs that seek to 'build capacity' in investors and at the same time encourage the idea that for full participation in the life of the community a citizen should be a 'financial consumer', or as Gray and Hamilton describe it a 'financial citizen'.[18] It is in examining this concept of 'financial citizen' that we can get closer to answering the question – 'where should responsibility for citizens' longer-term financial security lie?'

Citizenship is traditionally thought to have three dimensions: a 'legal-judicial' conception referring to a person's formal or official membership of a state, having rights under and being subject to its laws; 'political citizenship' being a potentially influential and activist member of a political community exemplified by deliberation and voting; and 'affective citizenship' which captures the feelings of civic belonging, loyalty and solidarity.[19] These dimensions of citizenship concentrate on the legal and political status of citizens in relation to the nation-state. But the concept of citizenship has developed in other ways which are more obviously relevant to the idea of 'financial citizenship'.

No account of citizenship could be complete without considering the work of TH Marshall,[20] whose view was that 'social' citizenship demanded a minimum level of economic security, so that the promise of political citizenship could be realised, and a person could meaningfully participate in their society, rather than merely survive.[21] This view was influential in the post-World War II years, and one of the confluences of opinion supporting the extension of socioeconomic provision by the welfare state. Although Marshall called his variant 'social' citizenship, it is clearly economic as well, since it involved the state redistributing resources through taxation, social security and other programs. It

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17 Provided for by *Superannuation Legislation Amendment (Choice of Superannuation Funds) Act 2004* (Cth).

18 Gray and Hamilton, above n 7.

19 Stephen Coleman and Jay Blumler, *The Internet and Democratic Citizenship* (2009) 4–5.

20 Thomas Harold Marshall 'Citizenship and Social Class' in *Class, Citizenship and Social Development: Essays by T H Marshall* (1964).

21 On the application of this idea in the context of retirement income, see Kingsford Smith, above n 8.

resulted, as Dahrendorf memorably put it, in a 'revolution in life chances,'[22] which the welfare state, along with full employment policies gained for millions in developed economies during those decades. Ironically, just as Dahrendorf was writing, post-war economic growth was slowing and some states were rejecting the post-war largesse of the welfare state and the socialdemocratic politics that went with it. Some states looked for ways to reduce the expenditure and the influence of the welfare state and full employment policies and turned to market based policies instead.[23] This turn, to the provision of personal and domestic services such as retirement income through the market, and the practical necessity for individuals to use the finance markets to manage that, is our central concern. It is in this context that the term 'financial citizen' has been adopted by financial regulators, with the associated idea that the retail investor should take greater responsibility for long-term financial decisions.

The idea of the 'financial citizen' is in sync with other developments in the idea of citizenship, which have been occupying theorists recently. The first is that a strong connection with a nation state is no longer a prerequisite, even of legal or political citizenship more generally. Coleman and Blumler identify 'incumbent democracy' citizenship which is statecentered and by contrast 'democratic' citizenship which:

> 'to put it simply, assumes the space of governance emanates from the demos rather than constituting it. …characterized by a diminishing sense of obligation to government; a rejection of voting in favour of other more consumerist, communitarian or transnational forms of participation.'[24]

This attenuation of connection with the state is seen in the reorientation of the citizen to the market for once central state services. It is also implicit in the pushing up of much decision-making to the transnational level,[25] at least at the level of principles of regulation, which are then adopted through the legislative and administrative processes of the nation-state.

The other way the diminished connection to the state is identified is in the porosity and interweaving of the public and the private in the provision of services once those of the state alone. There are now very few areas of personal or household welfare which are the preserve of the state only. Health is just one example of where there is now a matrix of government, business, non-governmental and civil society providers. This pattern is replicated in financial services policy, with basic governmental provision being augmented through workplace union organizations, both financial and non-financial sector businesses and even civil society and self regulatory bodies involved. The result is a complex picture of different providers, networked together by entrepreneurial opportunity, government regulation, professional association and information

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22 Ralf Dahrendorf, *Life Chances: Approaches to Social and Political Theory* (1980).

23 Stuart White, *The Civic Minimum: On the Rights and Obligations of Economic Citizenship* (Oxford S'ship Online, 2003) 3–4.

24 Coleman and Blumler, above n 19, 6.

25 Dimity Kingsford Smith 'Networks, Norms and the Nation State: Thoughts on Pluralism and Globalised Securities Regulation' in C Dauvergne (ed) *Jurisprudence for an Inter-Connected Globe* (2002), 93–126.

provision serving the need of retail investors to find financial services. Providers in this picture go in and out of enrolment in the financial system[26] as government policy, market conditions, technologies and investing fads come and go. No longer is retirement income, for example, provided solely through tax revenue with government setting rates and exclusions, and always grappling with insufficient information and limited capacity to respond to new circumstances.[27]

Some writers have characterised this state of affairs, either descriptively or normatively, as the 'hollowing out' of the state, and the triumph of the market.[28] The premier position given in regulation to disclosure to investors, investor choice and the supposed voluntary assumption of risk, is argued to be evidence of the greater role of the market.[29] However, regardless of the number of private actors involved, it is not accurate to assume that the state is out of the picture. The state is and should be there setting the norms and policies for the cooperative arrangements with the business and civil society participants that this new 'decentred' approach to welfare provision involves.[30] The best results are found when government at least develops the vision, and steers the vessel, even if it leaves rowing to others. As the events of the GFC show, particularly in the last four months of 2008, government can and will hold the ring, even nationalising crucial businesses, when necessary. What, then, are the details of regulation and policy evidencing this picture of the 'financial citizen'?

The term 'financial citizen' seems to have been used first by Gray and Hamilton. As they explain it, the term captures wider socioeconomic trends which in the financial sphere result in forces which 'shift downwards the responsibility for longer-term financial security from the government to the individual citizen…[and are] designed to incentivise citizens to invest in the markets.'[31] They go on to discuss various policies and programs of the UK Financial Services Authority 'to foster the development of the 'financial citizen' as a knowledgeable, competent, confident, self-reliant and willing market participant.'[32] Writing more or less simultaneously Condon and Philipps in Canada consider the 'economic citizen' a term employed in a wider sense in discussion of access to and regulation of labour markets as well as financial

26 Julia Black, 'Enrolling Actors in Regulatory Processes: Examples from UK Financial Services Regulation', Spring (2003) *Public Law* 63.

27 Julia Black, 'Decentring Regulation: Understanding the Role of Regulation and Self Regulation in a "Post-Regulatory" World' (2001) 54 *Current Legal Problems* 103; and Julia Black, 'Critical Reflections on Regulation' (2002) 27(1) *Australian Journal of Legal Philosophy* 1.

28 John Michael Roberts and Fiona Devine, 'Hollowing Out of the Welfare State and Social Capital' (2003) 2(4) *Social Policy and Society* 309; Stefan Svallfors and Peter Taylor-Gooby, *The End of the Welfare State? Responses to State Retrenchment* (1999).

29 Dimity Kingsford Smith, 'Financial Services Regulation and the Investor as Consumer' in Ramsay Howells et al (ed) *The International Handbook of Consumer Law & Policy* (2009) in press.

30 Black, above n 27; Colin Scott, 'Accountability in the Regulatory State' (2000) 27(2) *Journal of Law and Society* 38.

31 Gray and Hamilton, above n 7, 187.

32 Ibid 188.

markets.[33] Like Gray and Hamilton, Condon and Philipps identify the use of the term 'economic citizen' as partly designed to 'emphasise individual citizens as bearers of obligations rather than rights' and that 'delivery of benefits by the state is now considered less legitimate than if they are provided by private market transactions.'[34] Like Pearson, I prefer the term 'financial citizen'[35] because of its linguistic association with financial markets, whilst acknowledging the wider welfare and economic associations referenced by 'economic citizen'.

Returning to Gray and Hamilton's account of the 'financial citizen': they emphasise the implementation of relevant policies by the Financial Services Authority such as fine tuning retail disclosure and improving financial awareness and literacy.[36] They also identify the transplantation of consumer law and terminology to the investing domain, characterising the 'financial consumer' as confident and empowered by information and capability building education, to take investment decisions and responsibility for them.

While acknowledging the desire of states to promote the use of markets, Williams is critical of the use of investor education policy, and its power to 'responsibilise' investors as 'financial citizens'.[37] She sees such strategies not as benefiting retail investors, but as part of states' programs extending financial markets and assisting financial regulators to manage investors' expectations about the levels of protection that regulation can deliver. Similarly, in other work I have criticised the reliance on consumer law as an appropriate response to regulating retail investment, particularly in relation to the regulation of risk.[38]

In Australia, similar policies have found favour with government and with the regulator the Australian Securities and Investments Commisison ('ASIC'). As Pearson points out, ASIC has regulatory purposes that demand that market and retail investor objectives be made to coexist in the implementation of regulation.[39] In Australia too, retail disclosure and how to make it more 'clear, concise and effective' has been a regulatory priority and the location of a series of reforms.[40] As in the UK, investor literacy programs have also been the location

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33 Mary Condon and Lisa Philipps 'Transitional Market Governance and Economic Citizenship: New Frontiers of Feminist Theory' (2005) 28 *Thomas Jefferson Law Review* 105, 115; see also Alice Kessler-Harris 'In Pursuit of Economic Citizenship' (2003) 10(2) *Social Politics* 157; White, above n 23; and Curtis Jolly, Mary Knapp and Tridoyo Kusumastanto 'U.S. Competitive Position and Capital Investment Flows in the Economic Citizen Market' (1998) 57(2) *American Journal of Economics and Sociology* 155. A contribution to the idea of the economic citizen which takes an instrumental role in seeing the priority of liberty and private initiatives in the strengthening of the market is Ute Schumacher and Gladstone Hutchinson 'William E Simon's Capacities Approach to Liberty: An Essay in Economic Citizenship' (2003) 31(3) *Atlantic Economic Journal* 283.

34 Janet Siltan, Paradise Paved? Reflections on the Fate of Social Citizenship in Canada, (2002) *Citizenship Studies* 395, quoted in Condon and Philipps, above n 33, 125.

35 Gail Pearson, *Financial Services Law and Compliance in Australia* (2009) 2.

36 Gray and Hamilton, above n 7, 187.

37 Williams, above n 10.

38 Kingsford Smith, above n 29.

39 *Australian Securities and Investments Act* 1989 (Cth), s 1(2)(b) requiring ASIC regulate for 'confident and informed decision-making by consumers'; see Pearson, above note 35, 8.

40 See ASIC, *Better Prospectus Disclosure*, Draft Policy Statement, April 2006.

of regulatory action, designed to get the financial citizen to understand the products on offer, reinvigorate budgeting skills and careful spending and promote wise decision-making in relation to investment risk.[41] As Pearson says of Australia too, all this is 'education for the responsibilities, rights and obligations of financial citizenship … directed at creating the civically virtuous financial citizen through education.'[42]

After this outline of what government and regulators hope 'financial citizens' will be and be capable of, it is tempting to dismiss the idea as at best a vision of future investors, and at worst a cynical strategy to simultaneously cut back state provision and enrich financial intermediaries. As presented above the 'financial citizen' is a thin concept, lacking much of the rights content that even the spare liberal conception of legal or judicial citizenship has in the political arena. The idea of the 'financial citizen' is very underdeveloped and indeterminate.[43] There is no content in the idea to impel individuals toward a common understanding, identity or demos. The only aspect which refers to any sense of collective imagining or 'common good' is that, by investing carefully the 'financial citizen' is contributing to investor confidence and the overall prosperity of the economy and society. The consequences of the withdrawal of the 'financial citizen' from investing are not trivial, as the GFC shows.

Most of the idea of 'financial citizen' is individualistic and self-referential. This is so both in the concentration on 'investor choice' or 'investor sovereignty' and in the idea that it is the responsibility of the 'financial citizen' to be well informed, prudent and energetic in their own financial interests. The renewed emphasis on individualism is seen in the reduced role of collective risk bearing structures such as government programs or corporate superannuation. Despite this, consent or choice is more apparent than real: in Australia superannuation is compulsory, as it often was under employment contracts before state compulsion arrived. Further, since some personal and household financial services that citizens need are offered only through the market, and there is no comparable public option the retail investor is practically compelled to use the market. So in practice the individual cannot avoid becoming a 'financial citizen' at some level. Any sense of legitimacy that comes from being involved in the creation of the laws one is subject to, and truly giving consent, is attenuated by the belief promoted by some that market relations are inevitable, 'the notion that "economic forces cannot be resisted."'[44]

In the primacy given to the individualistic picture of the 'financial citizen' there is little room for anything reminiscent of the collective agency of political

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41 Consumer and Literacy Taskforce, *Australian Consumers and Money: Full Version - a Discussion Paper*, June 2004, < http://cfltaskforce.treasury.gov.au/content/_download/DiscussionPaper/Full_Version_no_cover.pdf > at 15 September 2009.

42 Pearson, above n 35, 17, fn100.

43 Condon and Philipps , above n 33.

44 Ibid 128.

citizenship.[45] There are few obvious fora for interaction between 'financial citizens' or mutual awareness – except perhaps through shareholder and investor action groups, should investments fail. Citizenship, even in its thinnest variations, is by nature a collective pursuit, but there is virtually nothing of this in the idea of 'financial citizen' in current financial regulation and policy. There is also nothing obviously deliberative or democratic about 'financial citizenship'.

It is tempting to dismiss the concept of the 'financial citizen' as a mere label for a bunch of regulatory policies convenient for governments keen to get the liabilities of the welfare state off their balancesheets. But the retrenchment of the state from the provision of services and its redirection of citizens to the markets as investors is too important for us to be content with this off-hand dismissal. So we need to work on the adaptation of these ideas of political citizenship so they 'can be extended to those areas of social life understood to be governed by market forces.'[46] Otherwise 'financial citizenship' will cease to matter, and the chance for influencing the terms under which the retail investor takes on investment risk for basic personal and household financial services will have slipped away.

We could start developing greater content for the 'financial citizen' idea by analogy with the recent scholarship on political citizenship in a post-national, multicultural and globalised world. Like contemporary political citizenship we could demonstrate that financial 'citizenship could be exercised in a multiplicity of "sites" both below and above the nation-state'.[47] It could be exercised in both public and private fora of the 'decentred' financial system. Just how public debate between mutually aware 'financial citizens', their democratic participation and accountability to them in relation to markets is to be carried forward, must remain a work in progress. However, the work must be done in order for the idea of the 'financial citizen' to have substance, and to be more substantial than just a convenient label for a bundle of regulatory policies addressed to retail investors.

In the meantime the question persists: 'where should responsibility for citizens' longer-term financial security lie?' While putting aside for now the issues in the last paragraph, there is one dimension of this persistent question that we must consider. Until we tackle this dimension, all the other issues of 'financial citizenship' are beside the point. Regulatory policy exhorts individuals to become 'responsibilised' and capable 'financial citizens': but are they capable of it? Or putting it another way, given that information seeking and analysis about risk is crucial to investor choice and risk bearing, are individual investors up to the task of doing this well most of the time? For if they are not, then government policy in pushing individuals out into the market is at best acting too

45 Compare for example the vision of shared understandings and acceptance of democratically formed values drawn by Julia Black, 'Mapping the Contours of Contemporary Financial Services Regulation' (2002) 2(2) *Journal of Corporate Law Studies*, 253–287.

46 Condon and Philipps, above note 30, 115.

47 Dominique Leydet, 'Citizenship' *Stanford Encyclopaedia of Philosophy*, <http://plato.stanford.edu/entries/citizenship/> at 15 September 2009.

early in the evolution of the 'financial citizen', and at worst is sending lambs to the slaughter.

III RISK AND RETAIL INVESTORS

A The Nature of Risk in Investment

The radical extension in the numbers, types and means of participation in financial markets parallels the extension of mass markets for consumer goods. And that has understandably led to parallels in the arguments for the regulation of investing and other financial transactions. However, there are important differences between the concepts of 'investor' and 'consumer', the main one being the different way that risk is allocated by the legal system.

When a consumer buys a good or a service they almost always start to use it – or consume it. Mostly they have had the chance to inspect the good or service first. Even with a complex product like a car, using it will usually reveal whether it is of merchantable quality or fit for purpose. If it doesn't work, then the consumer can complain. Goods and services wear out – they are consumed. So the seller's responsibilities to the consumer are high at the point of sale, but they run down over time – indeed they usually expire by the end of the warranty period.

By contrast, an investor does not usually consume their investment.[48] Usually it is quite the opposite. The investor expects the investment to earn a return. The investor wants more from the investment over time, not less. Also, it is rarely the case that the investor will have the investment in their control. By contrast with the consumer of goods and services who can usually tell by use if they have been sold a 'lemon', the investor is in the dark until one or more of the variety of disclosure obligations is triggered.[49] Even then, with some investments like superannuation, whether they are 'performing' may not be known for decades.[50] So by contrast with consumers, the investment issuer has responsibilities not only at the point of sale, but for the duration of the investment.

And now we have arrived at the really cardinal difference between a consumer and an investor. The seller of a product or service usually guarantees the performance of what they sell – they bear the risk that it will work. That is what the sale representations and warranties are designed to secure for the

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48 Just as valuable paintings, furniture, gemstones etc are goods having an investment quality (ie the owner hopes they will appreciate in value), there are some financial products which are in a sense 'consumed'. Both general and motor insurance are risk shifting services which decline in value (though not in value of the cover) as a policy period expires. Consumer credit contracts might be seen in the same way – certainly you don't hope to get more back at the end than you started with, which is the case with an investment.

49 Shareholders for example do not have rights to the company accounts and board papers. Instead they must be satisfied with continuous and periodic disclosures of various sorts.

50 Ron Sandler, *Medium and Long-Term Savings in the UK*, (2002), 45–46.

consumer.[51] But in most investments, the return to the investor is paid because and only because *the issuer does not guarantee performance*. It does not guarantee the rate of income; it does not even guarantee the return of the capital that the investor has handed over for the issuer to manage. There *the investor is paid for taking the risk* that the capital it has paid over will not be returned, or will not earn income, or both. Market and legal relations have been arranged[52] so that the investor becomes a kind of co-venturer with the issuer to the value of the investment. In good times of course, the investor may get more than expected. In bad times it may get nothing, a fact the GFC has reinforced.[53]

B The Varieties of Retail Investment Risk

In this discussion we have already noted that 'risk' is not of one undifferentiated type that an investor buys with all investments. In truth financial risk is quite variegated and applies with different intensities to different investing situations. As we began to do in the discussion of Storm Financial it is possible to segregate and analyse various risks, some of which apply more to retail investing than to wholesale investing. Some risks apply more to some financial products than others, to different financial providers and so on. To illustrate more finely some of the risks of retail investing it is convenient to return to the narrative of Storm Financial, the Australian financial advisor which was placed into insolvent administration in January 2009, and court-ordered winding up in March 2009.

There is no doubt that the investors in the Storm Financial story were partially harmed by market risk[54] – in October and November 2008 the markets of the world dropped by unprecedented amounts – the ASX 200 dropped by 41 per cent, because of the general lack of confidence triggered by the failure of the Lehman Bros investment bank in mid-September 2008.[55] The decline in value was the greatest since October 1929 at the time of the Great Depression. As a result the value of the investments in the index funds held by Storm Financial's customers was dramatically reduced. Theoretically at least, market risk is what investors are paid for taking on. It is irreducible in an individual account, though it can be spread over time and investor numbers, when long-term collective investment forms are adopted. Importantly for our discussion, market risk is not risk that individual investors can control.

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51 Pearson, above n 35,104.

52 The socially constructed nature of risk, and that the legal system is central in its nature and allocation is well accepted: Ulrich Beck, *Risk Society: Towards a New Modernity* (1986).

53 As the Wallis Committee into the Australian financial markets remarked in 1997: 'Unlike the consumption of products or services in general, many investments provide a return to investors based on their bearing a share of the risks which are intrinsic to financial activity. This clearly distinguishes the act of investment from the act of consumption'. *Financial System Inquiry*, above n 13, 251.

54 The price of the stock market as a whole or particular indexes fluctuates up and down – this is 'beta' risk, which cannot be diversified away. The higher rate of return earned from investing as opposed to depositing in the savings system is the price for this market risk or beta. By contrast the measure of the correlated volatility of a particular investment relative to the entire market is called 'alpha' risk.

55 For a gripping and detailed account of the details see Lawrence G McDonald, *A Colossal Failure of Common Sense: the Inside Story of the Collapse of Lehman Brothers* (2009).

One of the reasons that Storm Financial gave for advising customers to invest in index funds was to diversify away the other main type of risk in investing – the risk attached not to the market but to the stock or the corporation issuing the stock held by the investor. Index funds, because they seek to replicate performance of the equity securities which comprise the overall market,[56] attempt to cancel out what is known as alpha risk attached to a particular security against others in the index. That way much of the alpha risk is removed (at least in theory) and the investor is taking on mostly the market or beta risk.

As we have said the market risk that caused loss to the Storm Financial investors was augmented by the loans they took on to purchase the investments in the index funds. These were secured on their homes and other real estate or the funds were sourced from the selling of superannuation assets. With some customers further loans were raised by using the interests purchased in the index funds as collateral to borrow yet more funds to invest through margin loans. As they say in Wall Street, 'leverage on leverage'. The risk to investors was greatly amplified by the introduction of these borrowing strategies to the overall investment plan. The wider index funds were at the safe end of investing in the equity markets, but doing so using borrowed funds or double leverage greatly increased the risk of loss should there be a market decline. As with most catastrophes it is an accumulation of factors which causes disaster. The unusual drops in market value of October 2008 (beta risk) triggered the leverage risk (margin and home loans), and the selling of holdings and repayment of loans crystallised losses that having left the workforce most of the Storm Financial investors could never recover.

Finally, the Storm Financial investors also suffered from provider risk. That is they suffered the risk that the provider of the financial services failed in some way. Storm Financial may have given investors unsuitable or misleading and deceptive advice.[57] Further, it is being wound up, so that investors are most unlikely to realise any compensation for loss caused if investor losses were caused by defective advice. Provider risk was also shot home to Storm Financial investors when the index funds they had invested in were closed by the responsible entities promoting them.[58] Then investors were paid out of the fund assets realized at a low value, crystallising losses that may have been recovered if the funds had survived and value regained in time. Absolutely finally, Storm Financial investors paid very, very high fees and although this was not strictly speaking a risk, it markedly reduced the amounts that investors had for investment.

56 Index funds are market capitalization weighted in the weights that each of the equity securities comprises in the overall market. Some of the best known examples are the S&P 500 which approximately represents the 500 most widely held equities in the US and in Australia the S&P 200 representing the most widely held 200 companies in the Australian market. Indexes may also replicate the market capitalisation of a particular sector, such as technology or resources.

57 See above n 3.

58 Ibid.

C Retail Investor Perceptions of Risk

As we have seen, regulatory policy has encouraged the shifting of a variety of investment risks to the individual in a number of areas where previously risk was assumed more collectively – by government or large corporations. It has also encouraged the idea of the investor taking greater responsibility for investment decision-making, and its consequences. The strongest evidence for this is the very great reliance that has been placed on disclosure in retail investing in the last 20 years. Over and over, complex problems such as the fees and charges associated with retail investments[59] or the control of commission paid to advisors,[60] have been dealt with by more detailed disclosure. At the same time the amount of disclosure overall has increased with long prospectuses, product disclosure statements, continuous disclosure, annual reports and takeover statements commonplace – all of which a conscientious and newly 'responsibilised' 'financial citizen' should read. This is leaving aside entirely the analysis and interpretation of information that is available to the online investor from broker websites, charting programs and so on.

Until relatively recently very little thought has been given to whether enough of this information is read by retail investors, to make a disclosure policy defensible empirically or in terms of investor welfare. We know now that many investors do actually try quite hard to read disclosure, but they are turned off by the prolixity, technicality and disguised nature of much disclosure.[61] The best of them become what might be called 'strategic readers',[62] homing in on what they see as key elements of the disclosure. The rest are either sceptical of the benefits of reading disclosure because there is little or nothing they can do to change the disclosed circumstances,[63] or simply do not try to read disclosure. The empirical evidence from the Financial Services Authority ('FSA') in the UK is that there is a large group of individuals who simply do not wish to be engaged in the

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59 Ian Ramsay, *Disclosure of Fees and Charges in Managed Investments*, 2002 (ASIC commissioned report).

60 Angela A Hung, Noreen Clancy, Jeff Dominity, Eric Talley, Claude Berrebi, Farrukh Suvankulor, *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers* (2008) <http://www.rand.org/pubs/technical_reports/2008/RAND_TR556.sum.pdf> at 15 September 2009.

61 Ian Ramsay, 'Use of Prospectuses by Investors and Professional Advisers' (Centre for Corporate Law and Securities Regulation) 2003; Investment Company Institute, Summary of the Research Findings of *The Profile Prospectus: An Assessment by Mutual Fund Shareholders*, < http://www.ici.org/pdf/rpt_profprspctus3.pdf> at 15 September 2009; Investment Company Institute, *The Profile Prospectus: An Assessment by Mutual Fund Shareholders,* vol1 (1996).

62 This is confirmed by the analysis of as yet unpublished research derived from a national interview program that is part of the work of the Regulating Online Investment project at the Law Faculty, University of New South Wales <http://www.cyberlawcentre.org/onlineinvesting/> at 15 September 2009; the term is also contemplated by Edward Rubin, 'The Internet, Consumer Protection and Practical Knowledge' in J Winn (ed) *Consumer Protection and the Age of the 'Information Economy'* (2006) 33–58; a similar idea is mentioned by Geraint Howells, 'The Potential and Limits of Consumer Empowerment by Information' (2005) 32(3) *Journal of Law and Society* 349–370, 364.

63 Ibid.

investing process, and not reading disclosure is one way in which they demonstrate this.[64]

This research on disclosure takes us to a consideration of disclosure that deals with risk. As we have already seen, the distinguishing feature of an investment is assuming a variety of risks of future performance. So in the sale of investments, disclosures that deal with risk are central.

Research done for the UK FSA on risk disclosure demonstrates that 'many investors 'have only a superficial understanding that their investments are not guaranteed'[65] and for most investors 'the desire for [capital] security far exceeded any interest in the opportunity to maximise growth.'[66] Loss of capital is such a great fear that it entrenches many in the savings system who might otherwise take the leap and become investors.[67] The research also shows that particularly amongst those of low financial sophistication there is a tendency to deny that risks apply to them and to push them away and switch off when explanations of risk are made.[68] This expectation is not counteracted by the fact that advisors who want to sell investments may steer conversations about risk to the risk appetite of the investor, rather than the risk level of the product, and that investors have a poor recollection of discussions of risk.[69]

Hamilton and Gillies in reporting the UK FSA's research on uptake of KFD discuss the fact that investors tended to read the 'risk' information in the KFD as a disclaimer, not as a warning.[70] They go on to argue that the business of analysing risk, especially in relation to the complex packaged products that characterise retail investment markets, is just so difficult that most investors use one of the heuristic shortcuts to make choices. Instead of analysing risk information, retail investors resort to trust and existing relationships to decide. This is often manifested as a choice to go with a well-known financial services brand or issuer. This is in line with recent psychological research that sees emotional responses not as 'sand in the machinery' of decision-making, but often as a more efficient or 'fast and frugal' way of processing decisions.[71] Of course such decisions based on trust (or brand) may be misdirected, but often too they are 'one of the tools that allow agents to make adaptive inferences and choices' successfully.[72]

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64 Financial Services Authority ('FSA'), *Informing Consumers: Product Disclosure at the Point of Sale* (February 2003); FSA, *Informing Consumers: A Review of Product Information at the Point of Sale* (November 2000).

65 FSA, *Informed Decisions? How Consumers Use Key Features: a Synthesis of the Research on the Use of Product Information at the Point of Sale* (November 2000),18.

66 FSA, *Consumer Understanding of Financial Risk*, November 2004, 6.

67 Ibid 4.

68 Ibid 3–4.

69 Ibid 3.

70 Jenny Hamilton and Lorna E Gillies, 'The impact of e-commerce developments on consumer welfare – Information disclosure regimes' (2003) 11(4) *Journal of Financial Regulation and Compliance*, 329, 336.

71 Roberta Minamatsu and Yaniv Hanoch 'Emotions as a Mechanism for Boundedly Rational Agents: the Fast and Frugal Way' (2005) 26(2) *Journal of Economic Psychology* 201.

72 Ibid 202, quoting R W Levenson.

Compounding this approach to risk are the conclusions that have been reached by researchers in behavioural psychology about investment decision-making. This shows that investors have biases (or heuristics) which strongly influence their decision-making. The most robust finding is that investors suffer from over-confidence in their own capacity.[73] Later work has shown that this and other biases are exacerbated when investors move to online investing.[74] Similarly, it has also been shown that investors think they have greater knowledge than they do, and they imagine this gives them greater control than in fact they have. Another bias shows investors have a cognitive conservatism – they tend to keep assets longer than they should after they have begun to make a loss. Yet another, the salience bias, is a tendency to give more weight than is warranted to recent and accessible information – especially if it is framed as a 'crash' or 'catastrophe'.[75] These biases, heuristics or short-cuts are shared by people of all intelligences and education levels, and they are not easily unlearned.[76] They tend to continue even when the bias has been drawn to an investor or consumer's attention. This last observation should also make us more cautious about the claims we make for the transformative capacity of investor education in regulation.[77]

Pulling together the ideas we have traversed so far, we can see that participation in retail investment markets has become a commonplace for many middle class individuals. The restructuring of the state to devolve much commercial and financial activity to a mix of public entities and the private sector has promoted this. Governments and regulators have in turn, attempted to link this participation with the idea of the 'financial citizen'. The 'financial citizen', by contrast with previous eras of welfare provision where the risk often lay with government or employer corporations, must assume the risk of personal and household financial provision for him- or her-self, often using the financial markets. By contrast with markets for real consumer goods, risk in investing has been constructed to fall on the buyer of investments, not on the seller.

Regulatory policy now promotes the idea that the financial citizen must be 'responsibilised' in relation to investing, and in particular educated about the features of the investing process, including the assumption of risk. However, the GFC has made it impossible to ignore that there are some risks that no matter how expert or diligent, retail investors cannot control. Further, the research on retail investor consumption and understanding of disclosure information about risk is not encouraging. It gives a picture of very disengaged 'financial citizens' who are easily turned off by the tasks of investing and have limited personal and educational resources for analysing and interpreting information about risk. The

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73 Brad Barber and Terrence Odean 'Online Investors: Do the Slow Die First?' (2002) 15(2) *Review of Financial Studies* 455, 479–82; Donald C Langevoort, 'Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation', (2002–3) 97 *Northwestern University Law Review* 135.

74 Barber and Odean, above n 73.

75 Howells, above n 62; and Williams, above n 10, 244.

76 Howells, above n 62, 359.

77 Williams, above n 10, 244.

research and the Storm Financial story, also tell us that confronted by the complex and fragmented nature of risk in investing, investors may resort to trust as a short-hand way of making investment decisions. Since risk is both central to investment decision-making and tricky to assess, and the 'financial citizen' is the one who must choose what risk to assume and live with the choice, the next question is: how is risk treated, and how should it be treated, by regulation?

IV REGULATION OF RISK IN RETAIL INVESTING

In the last section of the paper it was argued that too much weight has been placed on disclosure as a regulatory tool in retail investor markets. In particular research has demonstrated that retail investors have greater difficulties with risk, than other aspects of disclosed financial information. This section of the paper considers the state of the Australian law in relation to disclosure of risk. It also considers related obligations on financial intermediaries dealing with retail investors that might help them make successful investment decisions about risk. These obligations on intermediaries are: first, not to act in a way that is misleading or deceptive and second, to recommend only those financial products which are suitable for the retail investor's circumstances. This part of the argument is undertaken to determine whether existing regulation is adequate in relation to risk, or whether something different is required.

A Disclosure of Risk

We have seen already that in retail investment disclosure is a less than perfect regulatory technique. However, like democracy, though imperfect, disclosure is still one of the best regulatory techniques we have devised, and still important. As risk is so important in investing, and crucial to the fortunes of the 'financial citizen', I now consider how effectively it is dealt with in disclosure under Australian financial services laws.

Many Australian retail investors hold shares.[78] The sources of disclosure relating to shares are many.[79] However, continuing the investigation of point-of-sale disclosure begun with the research discussed above, let us look at disclosure of risk in prospectuses and other point-of-sale documents under Australian Law. Perhaps surprisingly, there is no express requirement that prospectus disclosure by an issuer include disclosure of the risks of acquiring shares. The closest the prospectus comes to disclosure of risk is a legal requirement that the issuer disclose information about 'the rights and liabilities attaching to securities' so

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78 ASX Share Ownership Study 2008 reports that 41 per cent of adult Australians own shares. This is down from 46 per cent in 2006, a trend already in train but accelerated by the GFC: Australian Securities Exchange, *2008 Australia: Share Ownership* Study (2008) <http://www.asx.com.au/about/pdf/2008_australian_share_ownership_study.pdf> at 15 September 2009.

79 Mark Blair and Ian Ramsay 'Mandatory Corporate Disclosure Rules and Securities Regulation' in Gordon Walker and Brent Fisse (eds), *Securities Regulation in Australia and New Zealand* (1st ed, 1994) ch 12.

that 'investors and their professional advisers [can] make an informed assessment' of those rights and liabilities.[80] Nowhere is the word 'risk' used, though it is a reasonable argument that good prospectus disclosure would include a discussion of some risks in order to satisfy the requirement to include disclosure about 'liabilities'. But which risks are in fact disclosed, and how and to what extent that risk disclosure takes place, is left to the issuer. There is no place where the legislation identifies and requires particular risks to be disclosed, which would be of common interest to investors and important in deciding whether or not to acquire shares. As we have seen already, risk is a variegated concept, and the Storm Financial story makes it clear that in one loss there may be several different risks in play. There is no express requirement in Australian prospectuses that any particular risk be addressed, not even those which are relevant to a specific investing situation.

By contrast the disclosure made by Product Disclosure Statement ('PDS') that is made at point-of-sale to retail investors for financial products other than shares does expressly require the PDS to address risk.[81] It mandates that the PDS include 'information about any significant risks associated with holding the product.' This disclosure is definitely more useful to the 'financial citizen', though of course we already know that there might be a gap between the disclosure on the page and the reading and understanding of the investor.

Another disclosure document important in the protection of retail investors in Australia is the Statement of Advice ('SOA'). This sets out advice for intending investors, prior to their undertaking a particular investment. It is the means of setting out the investment recommendations made by an advisor to an investor. This document too is free of any express legislative requirement that the investor be advised about particular risks, or even just those risks that are relevant to the recommendation being made.[82] It is this omission which has permitted SOAs to concentrate not on risks to the investor if a recommendation is implemented, but on the supposed risk appetite of the investor.[83]

What this admittedly brief review of retail investor disclosure tells us is that risk, though at the centre of investing decisions, is not clearly at the centre of what issuers and advisers are required to tell the 'financial citizen'. There are however, two additional obligations that may push issuers and advisors in the direction of better risk disclosure, in the absence of express disclosure requirements.

B Misleading and Deceptive Disclosure of Risk

Australia has one of the toughest commercial moralities in the world when it comes to conduct that is misleading and deceptive. This applies to consumer transactions in trade and commerce, across the board from real economy

80 *Corporations Act 2001*(Cth) s 710.

81 *Corporations Act 2001* (Cth) s 1013D(1)(c).

82 *Corporations Act 2001* (Cth) s 947B contains the requirements for an SOA.

83 This practice seems to be supported by the requirement in *Corporations Act 2001* (Cth) s 947B(2)(b).

transactions such as sale of goods and services, to financial economy products and services. Both affirmative conduct and omissions are actionable, and no intention is required by the maker – only reliance by the receiver on the misleading or deceptive conduct. It is in short a strict liability prohibition, although in most instances it allows for civil liability, not criminal liability.[84]

However when misleading statements or omissions are in a regulated document such as a prospectus, product disclosure statement or statement of advice, defences of due diligence[85] or reasonable steps[86] make it difficult for investors to pursue misleading conduct about risk.[87] This blunts the incentives that the misleading and deceptive conduct provisions could provide to issuers and advisors to make sure that conduct, especially omissions from what they disclose about risk are not misleading. In short because of the 'due diligence' and 'reasonable steps' defences, misleading and deceptive conduct provisions are of less help in plugging the gaps in disclosure requirements about risk than they could be.[88]

C Having a Reasonable Basis for Advice (Unsuitable Advice)

The approaches to regulating risk just considered are about informing a potential investor frankly, comprehensively and clearly what the terms of an investment or other financial product are. Having a 'reasonable basis for advice'[89] or recommending products and services only when they are suitable for the investor,[90] is supposed to match or fit the investor's appetite for risk with the risk of what is recommended. All advisers of retail investors are required to conduct an inquiry into the customer's personal circumstances and to collect information about the client's financial affairs to allow advice that is appropriate to the client to be given. The advisor must also undertake an investigation of the

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84 See, eg, *Corporations Act 2001* (Cth) s 1041H or *Australian Securities and Investments Commission Act 1989* (Cth) s 12DA.

85 *Corporations Act 2001* (Cth) s 731, with accompanying defences in ss 732–733.

86 *Corporations Act 2001*(Cth) s 1022B(7), and s1013F provides for further limitations on the extent to which information needs to be included in a Product Disclosure Statement. In relation to Statements of Advice, s 953B(6) *Corporations Act 2001*also provides that where 'reasonable steps' are taken to ensure the disclosure document was not defective, there will be no liability. See further: Dimity Kingsford Smith, 'Is Due Diligence Dead? Financial Services Disclosure Under the Financial Services Reform Act 2001' (2004) 22 *Company & Securities Law Journal* 128.

87 It is no coincidence that one of the very few cases in which an Australian prospectus has been found by a court to contain misleading and deceptive statements was decided before the due diligence defences referenced in the above notes were legislated: see *Fraser v NRMA Holdings Ltd* (1994) (1994) 52 FCR 1; affirmed in part (1995) 55 FCR 452.

88 It is true that when statements are made by financial services intermediaries outside a regulated document, those defences do not apply: the strict liability prohibition applies. But the understandable practice of issuers and advisers is to make everything that is said otherwise, conditional upon and subject to, the statements in the regulated documents.

89 *Corporations Act 2001* (Cth) s 945A

90 This is the way the same requirement is put in US securities law; see Robert Baxt, Ashley Black and Pamela Hanrahan, *Securities and Financial Services Law* (7th ed, 2008), 554; Nancy Liblin and James Wrona 'The Securities Industry and the Internet: A Suitable Match?' 2001 *Columia Business Law Review* 601, 654–5.

investment alternatives that might match or fit the client's financial purposes and then give only advice that is appropriate for the customer. Further, if the customer does not wish to fully brief the adviser about their personal information the adviser must warn them that any advice is based on partial or incorrect information.[91] In a similar vein, if only general advice is being given, that has not considered the circumstances of an individual customer, then a warning must be issued that the advice does not take account of the customer's objectives, financial situation or needs.[92] In short, these rules are an attempt to match or fit the recommended investment to the circumstances of the customer. They are important in our consideration of risk, because if they mean anything, they must mean that any recommendation must match or fit the customer's financial circumstances and desire for risk to the product or strategy recommended.

How effective is this reasonable basis or suitability requirement likely to be? The story of AMP Financial Planning well summarised by Pearson does not suggest strong grounds for optimism.[93] There ASIC required an enforceable undertaking to require significant changes to the adviser's business model and training and supervision practices as well as restitution to damaged customers, when it was discovered that 45 per cent of the files reviewed by ASIC showed inadequate disclosure of a reasonable basis for advice. It was subsequently revealed that the failures were identified in relation to 35,000 customers. A 'shadow shopping' exercise by ASIC around the same time revealed similar failings in a wide range of financial planning businesses not just at AMP Financial Planning.[94]

The apparent failings at Storm Financial[95] suggest unsuitable advice, particularly in relation to risk. Storm Financial customers were advised to take on high levels of debt even though many of them were retirees. The approach to advising was to adopt the Storm Financial investment model: index funds and high leverage, for all customers. The principal of Storm Financial has described this 'one-size-fits-all' approach to a Senate Parliamentary Inquiry as 'like McDonalds selling a Big Mac' using the analogy of a 'production line' to explain why everyone got the same advice.[96] As a result one of the regulatory filters to stop customers being sold financial strategies or products that involved levels of risk inappropriate for their situation may have been sidelined. This means that Storm Financial customers perhaps had more leverage risk than many of them appreciated and may also have suffered provider risk if Storm Financial failed in its statutory duty to ensure that its recommendations had a reasonable basis. Reviewing these two case studies, it seems that the requirement to have a

91 *Corporations Act 2001* (Cth) s 945B.
92 *Corporations Act 2001* (Cth) s 949A.
93 Pearson, above n 35, 201–204.
94 ASIC Report 69: *Shadow Shopping Survey on Superannuation Advice* (April 2006).
95 See above n 3.
96 Stuart Washington, 'Storm founder defiant on loans' *Sydney Morning Herald* (Sydney), 4 September 2009, 1.

reasonable basis for a recommendation to a customer is not in practice a potent regulator of the level of risk that a retail investor may take on.

At a legal level, that conclusion seems to be repeated. Firstly, the breach of the requirement for recommendations to have a reasonable basis or give suitable advice is a criminal offence[97] – but I have not been able to find any instances of prosecution by ASIC. It is legally possible that because the suitability requirement is part of the 'financial services laws',[98] a breach of it could lead to license suspension or revocation. Again, there seem to be no case in which an instance of breach has led to or contributed to loss of license. Indeed, the case of AMP Financial Planning above, led to neither prosecution nor loss of license, even though 35 000 instances of failure to have a reasonable basis for advice were identified.

Finally, on this point, there is a question of whether customers can get compensation when they suffer loss because of recommendations made without a reasonable basis. The statute itself provides for such action,[99] but again where are the actions seeking loss for breach? Further the terms of reference of the Financial Ombudsman Service[100] will not entertain actions for breaches of the unsuitability requirement, unless they are accompanied by misleading and deceptive conduct.[101] But of course not all instances of absence of reasonable basis will involve misleading conduct, or at least it need not involve affirmative misleading conduct.

Take for example the advice to enter loans collateralised on residential homes given by Storm Financial. Those loans greatly increased the risk assumed by investors, but did the advice have to expressly state 'you may lose your home if you adopt this financial strategy'? The principals of Storm Financial say this advice was expressly given. The investors disagree.[102] They point to long statements of advice containing standard form generic discussion of the risks of investing. It will be a delicate question as to whether these generic discussions of risk are sufficient to say that Storm Financial discharged its reasonable basis duty, or whether statements about risk in much more graphic terms that investors can directly understand, are required. Given that the market or beta risk that was a substantial contributor to triggering the leverage risk occurs only every 30 years or so,[103] what level of specificity should be used? Should Storm Financial

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97 *Corporations Act 2001* (Cth) s 945A(1) together with s 1311.

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

99 *Corporations Act 2001* (Cth) s 953B(1)(c).

100 This is the main dispute resolution venue for retail investors in Australia, see <http://www.fos.org.au/centric/home_page/about_us/terms_of_reference.jsp> at 15 September 2009.

101 Financial Ombudsman Service, *Investments, Life Insurance & Superannuation Terms of Reference*, [14.1(c)], which requires that any complaint about the investment performance of an investment is excluded (and unsuitability claims usually arise because of lack of performance) unless there is a misleading statement or omission.

102 Account of proceedings at the Parliamentary Joint Committee on Financial Services and Products, evidence of Emmanuel Cassimatis the principal of Storm Financial. See Stuart Washington, 'CBA Panic led to Storm collapse: Cassimatis' *Sydney Morning Herald* (Sydney), 3 September 2009, 18.

103 The markets dropped by over 40 per cent in 1929, they dropped 41 per cent in 1972, and they dropped again this time by nearly 50 per cent in 2008.

investors have been expressly advised ‘at the level of borrowings we have advised, there is a small risk you may lose your home. Past performance (which is not a good predictor of the future) suggests the risk of a drop in market value that may cause loss of your home, occurs every 30–40 years’?

We must conclude that an action for loss because of unsuitable recommendations, whether or not involving misleading or deceptive conduct, is not a very retail investor friendly technique to assist with investor decision-making in relation to risk. This too, is an imperfect regulatory tool for ensuring that the ‘financial citizen’ has adequate means to make choices about investment risk.

IV IS THE RETAIL INVESTOR CAPABLE OF ‘FINANCIAL CITIZENSHIP’? ANALYSIS AND SUGGESTIONS FOR REFORM

One of the mysteries of the Storm Financial circumstances is that although great losses were made, the press so far has reported no fraud or clear illegality in relations with clients to explain this. The difficulties are more nuanced, though still devastating. For example the loan to asset valuation ratios adopted by Storm Financial in its margin lending advice, were high, but not higher than some other financial advisors. The fees were very high, but they were disclosed. The underlying investments in index funds were relatively straightforward and diversified. So what went wrong? Was it the GFC and unforeseeable drops in the entire market that caused losses? Were Storm Financial investors wiped out by beta risk that they were being paid to take on but could not control? Or, are governments just asking too much of individuals when they expect them to be able to analyse risk and make complex decisions about investment such as for retirement income?

A Specific Disclosure About Investment Risk

Part of the problem at Storm Financial goes back our persistent question: ‘where should responsibility for citizens’ longer-term financial security lie?’ We have seen that government wishes the answer to that question to be, that more and more, it lies with the individual – the ‘financial citizen’. However, for ‘financial citizens’ such as Storm Financial investors, there is a mismatch between this aim of devolving risk to individuals, and the implementation of that policy through financial services laws. As we have seen, in prospectuses and statements of advice, there has been a failure to provide an express requirement that the ‘financial citizen’ be told the risks they are taking on. In this aspect Storm Financial’s disclosure of risk is likely little different from many other statements of advice. As the law does not compel anything more, the general picture is that disclosure about risks seems to have been in general terms that did not either address individual circumstances or set out the practical consequences of the risks coming home to roost (for example, losing your home). The financial services laws relating to misleading and deceptive conduct and having a reasonable basis for investment recommendations provide little further incentive

to close this gap in disclosure. Actions for misleading and deceptive conduct face the hurdles of issuer and advisor defences, and there seems to be a dearth of enforcement action in relation to failures to have reasonable grounds for making a recommendation.

So one important recommendation of this paper is that changes in the law redress the gap in legislative disclosure requirements about risk in prospectuses and statements of advice. This and guidance from ASIC should provide that when investors are offered securities such as shares or receive an investment recommendation, they are given specific and practical information about the risks they face, if they go ahead. Any such guidance from ASIC should also apply to the existing requirement in Product Disclosure Statements, so that there is disclosure of any significant risks associated with holding the product sold using the statement.

What would this mean in disclosure practice? Let us assume for example that work sheets attached to Statements of Advice commonly assume that the share market will rise. Given that investors have a bias towards over confidence this assumption of rising markets really feeds that bias. There is no anecdotal or other evidence that, for example, work sheets showing the effects on the value of the client's assets and ability to service liabilities if the share market drops, are ever included in statements of advice. Explaining risk in this way too, may temper the bias as well as provide balanced practical information.

Similarly, work sheets attached to statements of advice could, as well as projecting growth in assets as a result of investing borrowed funds, also include information about the effect of losses. Hypothesising again, let us consider what kind of risk disclosure might be adopted to show the effect on the value of a family home from common drops in the share market, where home mortgage borrowings are invested. The disclosure could take this further and show the additional effect on home equity if investments bought with home mortgage funds were in turn added to with a margin loan.

Percent Market Drop	**Home Loan & Super**	**Margin Loan Assets**	**Combined Loss**
Initial investment	$1,000,000	$800,000	
10%	$900,000	$720,000	$180,000
20% *LVR exceeded	$800,000	$640,000	$360,000
30% (+10% buffer)	$700,000	$560,000	$540,000

This simple table assumes that the client had a home worth A$1million, and that A$500,000 was raised in borrowings secured on the home. Then A$500,000 of cashed in superannuation was added. These funds are invested in shares which are in turn used as collateral for a margin loan for a further A$800,000. A total fund of A$1,800,000 is assumed to be invested.

With a loan to valuation ratio ('LVR') of 80 per cent on the margin loan, a drop of 20 per cent in the market means a loss of over 30 per cent in the underlying amount of funds borrowed against home equity. A drop of 30 per cent in the market (and the ASX 200 dropped 41 per cent in 2008) means a drop of

over 50 per cent in the underlying funds borrowed against home equity. It shows how more than a half of the equity of a home or all of the superannuation money can be lost with a drop of 30 per cent in one of the standard share market indexes. True it is that the GFC involved very unusual drops in the share market. But from this table can be seen that even a 20 per cent drop (which is not unusual) can cause a significant erosion of value of the underlying asset.

While the research on risk shows that investors are over confident, paradoxically it also shows that for most the desire to preserve capital far exceeds a desire to maximize growth.[104] It seems at least feasible that if many of the Storm Financial clients had seen a table like that set out above, that discloses as much about risk as about reward, they would not have chosen to act according to the Storm Financial Advice Model.

Finally on this point, regulators have for the last decade been fiddling with disclosure presentation, trying to make it more 'user-friendly' and actually readable. As the research discussed above shows, there are serious limits to this approach – the policy suggestions below, which complement disclosure, are made on the basis that its limits have pretty much been reached. But if, as is likely, we are to persist with a disclosure based approach still central to retail investor regulation, then we should think boldly. We may decide to adopt a graduated approach to disclosure. This involves using technology (or paper) to provide disclosure first in a document of three pages, which sets out the basic terms of an investment or of advice. This would contain a hyperlink (or other reference) to a longer document for those wanting more information. Finally, full disclosure about an issuer should be available in a document which would be the same as that currently required, again available through technology (or paper) with the additional functionality of 'key word' searching and scrolling that format allows. The idea here is that retail investors may in fact read a shorter document and retain more information from it, than if the only document available is impenetrable and lengthy. They also have the remainder of the disclosure at their finger-tips if desired.[105]

B Merit Regulation Along-side Disclosure

Another contributor to the losses suffered by the Storm Financial investors, is as we have seen, that even when there is disclosure, individuals find risk difficult to understand, and tend to both deny it and be overconfident about their prospects. Instead, the research tells us, investors who are confronted with

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104 See discussion in text surrounding notes 64–9 above.

105 For more detail on this proposal see: Dimity Kingsford Smith, 'Importing the E-world into Canadian Securities Regulation' in *Canada Steps Up – Maintaining a Competitive Capital Market in Canada* (October 2006), for the Task Force to Modernise Canadian Securities Legislation (initiated by Investment Dealers Association and Capital Markets Institute, University of Toronto) <http://www.tfmsl.ca/docs/V5(6)%20Kingsford%20Smith.pdf> at 16 September 2009. See also the recent discussion of a similar approach by the US Department of the Treasury, *Financial Regulatory Reform a New Foundation: Rebuilding Financial Supervision and Regulation* (17 June 2009) 65.

complexity and the difficulties of decision-making under uncertainty resort to trust. This is a short-hand, practical and often successful way to make decisions. It seems that Storm Financial actively cultivated trust in its relationship with clients. The tone of some of the material on its website was tutelary and paternal. It promoted investing seminars and saw the 'Journey to Capitalism' as partly a matter of investor education, as one of teacher/advisor and student/investor. Similarly the advisor investor relationship was also one of tasting the kind of life-style that the Storm Financial approach to investing could provide, when treats and trips were provided. All this, was designed to develop trust. And trust we know means that investors may be less inclined to scrutinise closely, to ask difficult questions (say about risk), and to be testing of what they are told. They will be more likely to take an intuitive short-cut.

How should we respond to this? What, if anything can we do to adjust financial services laws to the fact that governments want people to invest for their long term financial needs, even though there is evidence that many people lack the capability and even the interest to do so?

There are two stand-out possibilities. One is introducing an element of merit regulation to lessen the reliance of investors on disclosure. The other is a more graduated approach to investor capability that would qualify investors to enter certain sorts of financial products or services matched with different levels of risk. Both these suggestions would apply only in retail investment.

The first possibility would involve product regulation – an unfashionable regulatory approach, but one that has important investor protection effects. In some instances it may be desirable not just to regulate product terms, but to prohibit a product altogether. So for example regulators may follow the example of the US Securities Exchange Commission and not permit retail offering of contracts for differences ('CFDs'), a highly leveraged derivative product that is for trading not investing, and would only very rarely be suitable for a retail investor.[106] Alternatively they could follow the lead of the UK with CATS and 'stakeholder' products designed for the needs of modest investors that have been launched with regulated terms.[107] A proposal to require limited prescription of product terms has also been adopted by the US Department of the Treasury in its recent proposals for the reform of financial consumer law.[108] One use of regulated terms would be to require consumer financial products to be designed so that the financial choices people have to make are simpler. Building sensible choices into financial products, so that the one suitable for most people is the default option, would do this. Then the majority of people who are disinclined to seek information and make active decisions, will by doing nothing make the most appropriate choice. They will not have to 'opt in' as is often the case at present;

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106 Investment Dealers Association of Canada, *Regulatory Analysis of Contracts for Differences* (6 June 2007) 14.

107 The 'Sandler Suite' of 'stakeholder' products where product features are mandated and CAT products where minimum standards as to charges (C), access (A) and terms (T) must be met: Sandler, above n 50, 100–8.

108 US Treasury, above n 105, 66.

they can just do nothing. This approach is particularly appropriate for long term savings products like superannuation.

C Certifying Investor Capability for Certain Financial Products and Services

The second possibility builds on the insight that there are different types of investors. The picture of the investor is now more nuanced.[109] At one end of the retail spectrum there are internet investors who are encouraged to see themselves, and who often are, very knowledgeable about and engaged with investing. They feel they have the capacity, and want to be treated, like sophisticated investors. The image suggests they don't need advice, they want state-of-the-art research tools to analyse 'live' information feeds and demand cheap execution services. Discounts for volume encourage 'trading' rather than investing and margin loans and exotic high risk products finish off the image of competence and 'empowerment'. The 'day trader' image in particular mimics those who really are sophisticated or professional investors.[110]

By contrast a great deal of the research discussed in this paper paints a different picture of the retail investor. That picture is of people who are very unengaged by financial matters, whose education is not up to analysing financial documents, who even after investing for years do not understand basic matters such as the calculation of fees.[111] So the picture of the modern investor is multiple and contradictory. Investors may be treated differently depending say on mode of investing (internet or not), or type of product (packaged or exchange traded), or legal categorisation – 'retail'[112] or 'consumer,'[113] certified 'sophisticated'[114] or 'professional'.[115] This shows the beginnings, already in our legislation and practice, of a greater variation in regulatory treatment of investors. Even within certain categorisations like 'retail' investor, the research we have considered shows wide variations between the most competent and the least sophisticated.

Already the purposes of this differentiation are on one hand to provide protection to retail investors,[116] and on the other to acknowledge that this is likely unnecessary and unwanted for professional and wholesale investors. In between there are investor classes where an advisor or accountant must certify that an individual has the assets and knowledge or experience to be treated as a

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109 Kingsford Smith, above n 29.

110 Caroline Bradley 'Disorderly Conduct: Day Traders and the Ideology of 'Fair and Orderly Markets' (2000) 26(1) *Journal of Corporation Law* 63, 90.

111 Hung et al, above n 60, 87 stated: 'Even those who have employed financial professionals for years do not understand the fees for their services.'

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

113 *Australian Securities and Investments Act 2001* (Cth) s 12BC.

114 *Corporations Act 2001* (Cth) ss 708(8) and (9), or s 761GA.

115 *Corporations Act 2001* (Cth) ss 7 and 708(11).

116 *Corporations Act 2001* (Cth) ch 7, though one of the difficulties of the current scheme is that most of the protection is delivered through disclosure, which we have seen already has significant limits in effectiveness.

sophisticated investor. Using this existing frame-work, it would be relatively straightforward to develop a certification system that would, for example, let a sophisticated investor invest using margin loans or contracts for differences. The former of course were used by the retail investor clients of Storm Financial with such unfortunate consequences. Although margin lending will soon be regulated as a 'financial product'[117] and a recommendation to use it will require a 'reasonable basis'[118] we have seen the limits of this already.[119] If governments wish 'financial citizens' to invest to provide retirement income and so on, with what we know about the lack of capacity of many retail investors, it makes sense to take a fine-grained approach to matching what they can invest in with their demonstrated capability for investment decision-making.

D A Retail Investors' Compensation Scheme

The last suggestion for regulatory change is really the most controversial, and the most thorough-going: it is the establishment and management of a financial services compensation scheme. There is already provision in the licensing regime for Australian Financial Services Licensees that they have both approved dispute resolution arrangements[120] and compensation arrangements.[121] In the case of compensation, regulations provide that licensees can do this through professional indemnity policies of insurance,[122] rather than the establishment of a compensation fund, as in the UK for example.[123]

Compensation schemes are a vast and complex topic,[124] which like much else in modern retail financial markets are an interesting mix of public and private arrangements. They are often industry based and funded. Financial services compensation arrangements vary from purpose created statutory compensation

117 *Corporations Legislation Amendment (Financial Services Modernisation) Bill 2009*, to bring margin loans and share lending within the retail investor protections of Chapter 7 of the *Corporations Act 2001* (Cth).

118 *Corporations Act 2001* (Cth) s 945A.

119 See text surrounding footnotes 89–103.

120 *Corporations Act 2001* (Cth) ss 912A(1)(g) and 912A(2).

121 *Corporations Act 2001* (Cth) s 912B.

122 *Corporations Regulations 2001* (Cth) 7.6.02AAA.

123 The Financial Services Compensation Scheme < http://www.fscs.org.uk/consumer/> at 16 September 2009.

124 See for further detail: Companies and Securities Advisory Committee, *Retail Client Compensation in Financial Markets* (September 2001); Commonwealth of Australia, *Compensation for Loss in the Financial Services Sector* (September 2002); Choice, *Submission by Choice on Draft Regulation for Compensation Arrangements for Financial Services Licensees* (December 2006); ASIC *CP 87 Compensation and insurance arrangements for AFS licensees* (23 July 2007); ASIC, *Compensation and Insurance Arrangements for Financial Services Licensees*, RG 126 (November 2007). ASIC, *Compensation and Insurance Arrangements for AFS Licensees – Regulatory Guide 126*, (March 2008) and Consultation Paper 87 (July 2007) and *Compensation Arrangements for Financial Services Licensees – Research into the Professional Indemnity Insurance Market* (December 2006).

schemes of which the UK Financial Services Compensation Scheme ('FSCS')[125] is the most developed example, to patchy voluntary entry to professional indemnity insurance by financial advisers who do not handle client money. In between there is a patchwork of capital requirements for those intermediaries who do handle and hold client funds, depending on their financial function and the quantum of funds held.[126]

For retail investors, the best arrangements are where compensation is provided both when the intermediary is solvent and when it is not. Ideally professional indemnity and/or capital and liquidity requirements supply adequate funds to meet claims during solvency, and statutory compensation funds provide a safety net when the intermediary is insolvent or disappeared. This is the position in the UK. By contrast with the UK, arrangements in Australia and the US are less mature and they rely heavily on private professional indemnity insurance ('PII'). Unless regulatory requirements steer PII terms the achievements of industry dispute resolution schemes could be undermined.[127] For example, unless the regulator stipulates the scope of cover and the amount insured, these could turn out to be inadequate to cover the nature and quantum of an intermediary's liabilities. There is a long list of other features of PII that makes it very unsatisfactory for compensating retail investors.[128] PII is a helpful component of a more general compensation system, such as provided for in the UK, but to be effective in mass investor markets, it needs to be accompanied by a compensation scheme.

Australia has probably gone further in some aspects, than any other advanced democracy in the creation of the 'financial citizen' because they have made the contribution phase of superannuation compulsory.[129] For most individuals that means at retirement they must become investors to manage their retirement income. They have little practical alternative to becoming a 'financial citizen'. Given the range of risks that the retiring 'financial citizen' must conjure, and the limited ability to control those risks, the limited capability for investing possessed by many, and the serendipitous nature of compensation through current arrangements, it seems only fair to place dispute resolution and compensation on a straightforward and rationalised basis, rather than the multiplicity of arrangements currently in operation.

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125 Established under the Financial Services and Markets Act and though independent, closely articulated with the FSA and the Financial Ombudsman Service; see <http://www.fscs.org.uk/> at 16 September 2009. Compensation funds for market transactions on stock exchanges are probably the oldest examples: in Australia, the National Guarantee Fund ('NGF') < http://www.segc.com.au/> at 16 September 2009; In US, the Securities Investor Protection Corporation ('SIPC') < http://www.sipc.org/who/who.cfm> at 16 September 2009.

126 *Compensation for Loss in the Financial Services Sector*, above n 124, Ch 3 and Attachment B, especially note 104.

127 Obviously this reliance will be less if a licensee is required to have capital requirements in addition. But in the case of advisers compensation arrangements require only PII.

128 Kingsford Smith, above n 29.

129 Indeed, where self managed superannuation funds are used by investors, the very upper limits of the 'financial investor' idea are reached because the individual is controlling all phases and functions of the retirement income process.

Again, the position of the investors in Storm Financial is a good illustration of the argument. Despite the relative liberality in the rules for establishing class actions in Australia,[130] a class action is not contemplated. [131] This is likely because the clients of Storm Financial were each individually advised, and there was no common Product Disclosure Statement or information memorandum containing the identical representations required to constitute a class.[132] This is disappointing legally, since on the face of things the 'cookie cutter' quality of Storm Financial's Advice Model suggests that there may be sufficiently common issues of law or fact.

Further the degree to which Storm Financial investors will be compensated depends on whether the insolvency and winding-up of Storm Financial yields anything – a most uncertain prospect. The arbitrariness of this is demonstrated again, by the mixed fortunes of Westpoint investors. It has been announced that one of the financial advisors has agreed to compensate Westpoint investors they advised,[133] while other investors who took the same product remain uncompensated because their advisor has ceased to hold an Australian Financial Services Licence and is under administration.[134] The unpredictable treatment of investors continues at Storm Financial with compensation also depending on how much a provider has been willing to admit wrong-doing: the Commonwealth Bank of Australia has agreed to systematic compensation arrangements for the investors it dealt with, but the Bank of Queensland has refused, denying any breaches of law or regulation.[135] These facts demonstrate that a more consistent approach is required, and a compensation system that applies regardless of insolvency is the only fair way to meet the fact that much of the risk of investing falls on the 'financial citizen' in a fashion which challenges their capacities and some dimensions of which, they cannot control.

V CONCLUSION

This paper has concentrated on risk because it is cardinal to investing, generally poorly disclosed and often complex to present or understand. There are

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130 Geoffrey Miller, 'Some Thoughts on Australian Class Actions in the Light of the American Experience' in K E Lindgren (ed), *Investor Class Actions* (2009), 2–17.

131 Slater & Gordon Lawyers (2009) 'Potential Legal Action Against Storm Financial Limited and Other Parties – Frequently Asked Questions' < http://svc015.wic046p.server-web.com/pages/class_action_westpoint.aspx> at 16 September 2009.

132 By contrast with the Westpoint investors where class actions have begun: ibid.

133 Stuart Washington, 'Planner concedes to Westpoint compo,' *Sydney Morning Herald* (Sydney), 15 September 2009, 14l.

134 In 2006 the Federal Court decided that the Financial Ombudsman Service (then FICS) had jurisdiction over Deakin Financial Services Pty Ltd in relation to claims by disappointed Westpoint investors: *Financial Industry Complaints Service Ltd* v *Deakin Financial Services Pty Ltd* (2006) 157 FCR 299. Then Deakin ceased to hold an Australian Financial Services Licence on 27 August 2007 and is now in external administration.

135 Stuart Washington, 'CommBank to help 3000 Storm investors', *Sydney Morning Herald* (Sydney), 12–13 September 2009, 7.

also obvious reasons why advisors may wish to down-play it. I have argued that the true risk based nature of investment has been over-looked in the haste to create the 'financial citizen' active in mass financial markets. There is growing empirical evidence that individuals do not engage readily with financial matters, and that especially in relation to risk, they have difficulty investigating and understanding its consequences. Further, psychological biases tend to exacerbate the individual tendency to forget discussions of risk, to deny or down-play it, and to use trust as an intuitive short-cut to decisions about risk which otherwise involve difficult and detailed decision making under conditions of uncertainty. The GFC has shown that there are aspects of risk that however engaged and capable, retail investors cannot control.

The Storm Financial advice model presented a very complex package of decisions about risk for a client. While the underlying index fund investments were relatively straightforward, the borrowing arrangements to release equity in non-financial assets to cash, introduced higher risk. The risks of these gearing, and even double gearing strategies, were not demonstrated to Storm Financial clients in the same detailed fashion as the advantages. In short, risk was down-played. The details of risk are often buried in detailed work sheets in Statements of Advice and in accounts in prospectuses, which only the most diligent client would scrutinise and far from all would understand. Many packaged investment products especially designed to be sold to retail investors are also complex - a complexity which is the enemy of the 'financial citizen'. These circumstances present a textbook case of the limits of disclosure in retail investing markets. The paper has gone on to recommend some improvements: more focus on disclosure of risk as well as return, some merit regulation of financial products and some restrictions on the circumstances in which retail investors may acquire higher risk products such as margin lending, share lending and contracts for differences. It has also proposed a retail investors' compensation scheme.

There is further work to be done to develop a more substantial content for the idea of 'financial citizen' – a content which should justify the attachment of this term to citizenship as understood politically and socially. In the meantime our constantly recurring question 'where should responsibility for citizens', longer-term financial security lie?' remains. Much of what has gone before has analysed a prior question – are 'financial citizens' actually capable of the tasks expected of them? Examining this allows us to see that if we continue with the view that 'financial citizens' long term financial security lies with them, we have to make some adjustments. The GFC has had a tectonic effect on financial markets: it has shaken the consensus that market risk has been managed by central banks and regulators and that it is safe for retail investors to transact there. Retail investors have suffered serious, and sometimes ruinous losses, as a result. Governments, regulators, financial institutions, non-governmental organisations and investors are now reconsidering market efficiency and the risks it implies, and balancing that with a return to more investor protective regulatory techniques. That reconsideration needs to include the research discussed here on the capabilities of investors and the variety of risks that may cause them loss. Only then will we be

able to say fairly where the responsibility should lie for the future welfare of ‘financial citizens’. Watch this space.