

BUSN603 Corporate Governance and Risk Management

Semester 1, 2017

ASSESSMENT 2

CASE STUDY:

TERRA AUSTRALIS FINANCIAL PLANNING LIMITED (TAFP)

The following case study is based on actual events involving an Australian bank. The reasons for changing some aspects of the case are, first, to highlight matters relevant to corporate governance and enterprise risk management, and, second, to focus your attention on the generic issues rather than encourage you to search for analyses of actual cases which you can then summarise as responses to the questions asked.

In other words, the emphasis in this assessment is on interpreting the 'facts' of the case in light of the concepts discussed in the unit.

Therefore, you are not asked to do any investigative work for this case. There is no need for you to look up ASIC records, newspaper reports, court judgments etc. What you must do is analyse the case as it is presented, and respond to the questions drawing on your learning in this unit.

Case overview

Terra Australis Financial Planning Limited (TAFP), the financial planning arm of Terra Australis Bank (TAB), was involved in a huge fraud scheme from 2003 to 2012. Rogue financial planners at TAFP manipulated their clients' files and forged documents to invest their clients' monies in extremely high-risk investments, with the aim of earning higher commissions and bonuses. Such fraudulent financial advice caused hundreds of Australians to lose their life savings, some running into millions. Despite tipoffs by whistleblowers within TAFP, the Australian Securities and Investments Commission (ASIC) was criticised for being inexplicably slow and inadequate in its response. Meanwhile, TAFP's efforts to compensate the victims were also criticised as covering up for their rogue planners while trying to bully their victims into settling for minimal compensation.

The objective of this case is to assess the impact of "pay for performance" on behaviour; governance in company groups; management's and directors' roles in ensuring compliance; the role of regulators and the media in corporate governance; whistleblower protection; the link between governance and ethics; and what constitutes an effective enterprise risk management strategy.

Clouds over Sunnyvale

Terra Australis Bank (TAB) is a large Australian bank, holding over 20% of all household deposits in Australia. Terra Australis Financial Planning Limited (TAFP) is a subsidiary that falls under the wealth management division of TAB, and was led by the Head of Wealth Management, Fred

Smith, from 2006 to 2011. In February 2008, as part of a surveillance program by the regulatory body, the Australian Securities and Investment Commission (ASIC), a warning notice was sent to TAFP, indicating that 38 of its planners had been classified as a “critical risk” for non-compliance with appropriate financial planning advice protocols. That was when Joe Bloe, a newly hired financial planner at the Sunnyvale, New South Wales branch, sensed something amiss in the bank.

Dodgy Don

One of the 38 names highlighted in the warning notice, Donald (Don) Vanvo, was hauntingly familiar to Bloe. Don was a fellow financial planner who sat just a couple of feet away from Bloe at the Sunnyvale Branch. He was one of the top writers of TAFP, amassing 1,300 clients who had invested their money with him. In 2007, Don was top on TAFP’s Financial Planners league table, managing portfolios worth A\$39,064,657 for the bank that year alone, grossly exceeding his annual target by more than three-fold.

But Don’s ascent to the peak was a tad dubious. Better known by his colleagues as “Dodgy Don”, he had a sinister reputation of notching sales through unscrupulous means. After personally witnessing some of Don’s dishonest acts, an outraged Bloe alerted his team’s Financial Planning Manager. To his disbelief, the manager brushed the issue aside. Bloe’ colleagues later explained that Don was under management protection due to his status as a top earner for TAB.

You get what you pay for

More than half of a TAB financial planner’s total annual remuneration depended on short-term incentives such as bonuses. Commissions were pegged to the risk levels of investment assets sold, hence financial planners had an incentive to encourage their clients to opt for as risky an investment portfolio as possible. Furthermore, the tone at the top was unforgiving - meet your sales targets, or surrender your rice bowl. Such was the aggressive culture TAB had nurtured through an ambitious sales-driven and excessively short-term remuneration incentive scheme - one driven by a myopic chase of bonuses with little place for honesty.

Don’t bet on the TAB

Clients soon started to see the value of their investment portfolios plunge to almost nothing within a short span of months, and started inundating the bank with complaints. Against the backdrop of a global financial meltdown, it made no financial sense for the clients, especially the retirees, to opt for such aggressive and risky investment portfolios. Sensing something amiss, Bloe took the matter to middle management, but once again, the response he got was one of nonchalance and evasiveness.

However, growing public pressure forced TAB into a formal investigation, and it was discovered that Don had secretly manipulated the risk profiles of his clients into adopting hyper-aggressive investment portfolios for his own benefit of drawing higher commissions. In particular, an extraordinary number of clients’ files “requested” a 50% portfolio allocation to Listed Property Trusts, an extremely risky investment asset. Don had deceived and manipulated his clients into thinking their monies were lost because of misfortune. In September 2008, Don was suspended for fraud and compliance failures.

Meanwhile, complaints from clients of other planners in TAFP, most notably Steve McDuck and Adam Gillespie, continued to flood in. To make matters worse, many of Don’s frustrated clients who were left without a planner constantly barraged the bank for explanations. TAFP needed someone to douse the flames - someone who could discourage the clients from pursuing their

complaints. Incredulously, on 15 October 2008, not only was Don reinstated, he was also promoted to the position of a Senior Financial Planner.

Bloe soon came to the realisation that an internal resolution to the matter would never succeed as the management themselves were covering up for the planners' fraudulent acts. Yet Bloe wanted to keep his cover as he lacked faith in the regulator's whistleblower protection policies, and required more time to continue gathering evidence against Don's wrongdoing. On 30 October 2008, together with two other long-serving colleagues, Bloe finally spilled the beans on Don. Under the alias of "The Three Mouseketeers, they faxed a report to ASIC, voicing the need for urgent action.

However, months passed and there was no sign of ASIC taking decisive action to obtain evidence from TAFP, despite the whistleblowers' tip-off that the clients' files were already being sanitised. Instead, ASIC opted for discussions with TAFP in December 2008, which resulted in the joint solution to "closely supervise" Don and subject his advice to "vetting before approval". Exasperated, "The Three Mouseketeers" then decided to take the issue to Clarke Kent, a journalist of the trade journal *Gotham Investor* in May 2009.

Breaking Don

A series of articles spelling out details of Don's fraudulent acts was published by Gotham Investor from May to June 2009. It was brought to light that TAB knew of "at least 14 cases of forgery as early as October 2008", yet did nothing to remedy the problem. TAB attributed the fraud to "a few bad apples", rather than the lack of compliance within the bank, or any conflicts of interest in their financial planning arm. In fact, to prevent certain documents from being accessed in the likely event of a client lawsuit, senior management arranged for these documents to be processed by the legal department so that these would be given protection of legal privilege. TAB also allowed some of the fraudulent financial planners to resign and move on to other companies instead of giving them the boot, so as to avoid "bad press".

The whistleblowers also sent an anonymous email to TAB Group Security and TAB's Senior Management, alleging TAFP management's attempts to cover up for its rogue planners. This time, it succeeded in triggering a massive knee-jerk response within the bank. TAB Group Security launched a thorough investigation within TAFP, where it was found that an alarming number of Don's client files were missing.

On 3 July 2009, Don resigned citing ill health, which allowed him to draw a lifetime A\$70,000 payout per annum under TAB's group insurance policy. To make matters worse, the annual bonuses of Chief Risk Officer, Harry Divine, and Head of Wealth Management Division, Fred Smith, increased by approximately A\$4.5 million and A\$2.1 million respectively from 2008 to 2010. All these came amidst dismal media stories of terminally ill victims who had lost their life savings due to the rogue planners, and were struggling to seek any reasonable form of compensation from TAB.

At the same time, Bloe felt immense pressure from the top management, which resolved to identify the source of leaks to the media. With their covers blown and yet no action by ASIC in sight, The Three Mouseketeers were left defenceless.

On 24 February 2010, 16 months after the first anonymous fax Bloe had sent to ASIC, the whistleblowers finally stormed through the doors of the ASIC office, demanding that client files be seized and decisive action be taken. "They told me I had Whistleblower Protection from that day. He then went on to say, basically, that it wouldn't be worth much," recalled Bloe of his conversation with one of the frontline officers in ASIC. Ironically, Australian Government had just revised the Corporations Act in 2004 to provide stronger protection for whistleblowers. However,

Bloe was not surprised by this - it was a common view in the finance industry that ASIC was not the most trustworthy of regulators.

Divide and conquer

On 24 March 2010, ASIC issued an order to TAFP, giving them two weeks to hand over client files undergoing investigation, marking the first sign of confrontation between ASIC and TAFP. TAB was also pressured to devise a compensation scheme to pacify the affected clients. In November 2010, TAB finally proposed a voluntary compensation scheme for the victims. The strategy, however, was to divide and conquer - each victim was isolated so they would have limited knowledge of the greater scheme of things, allowing TAB to incur minimal expenses in the compensation

Mary Jones and her husband Bert were two of Don's most famous victims. In 2002, the couple entrusted A\$1 million of their retirement savings to Don, on hearing of his reputation as the "star planner" of TAB. Yet Don only had his eyes fixed on maximising his commissions. Ignoring the couple's clear instructions of preserving capital, Don forged Braund's signature to transfer their capital to high- risk products that were eventually wiped out when the financial crisis struck in 2009.

Under the compensation scheme, Jones was initially offered A\$200,000. With good fortune, she had a note that indicated that "the Jones's had a conservative profile and they were extremely concerned and did not wish to use any of their capital in retirement." Using this note as a bargaining chip for negotiation, her compensation quantum was raised to A\$215,000 and subsequently A\$880,000. Unfortunately, not all victims had such great bargaining power; most received a less than satisfactory amount of compensation.

Facing the facts

ASIC's investigation confirmed the frauds of Don and other financial planners in TAFP. On 26 October 2011, TAB entered into an Enforceable Undertaking (EU) with ASIC for two years. The EU was targeted at reviewing TAB's risk management systems, its internal risk profiling, and the monitoring of its financial planners. During this time, three other financial planners were required to "remove themselves from the industry".

At the same time, Jones' patience was running out with the inadequate responses to her complaints at TAB and ASIC. Despite Jones being granted interviews with ASIC to tell her story, she was adamant that not enough was being done to appease the anger and anguish of the victims. Her repeated complaints to TAB and ASIC had generally fallen on deaf ears, and she was disgusted at TAB's ostensible attempts to cover up. She finally decided to take her story to Facebook Media. The Facebook reports triggered a Senate Inquiry the following month, on 20 June 2013, centering on two key issues - the misconduct of financial advisers in TAFP and ASIC's general poor performance.

The final report of the Senate Inquiry was released on 26 June 2014. It contained scathing criticisms of both ASIC and TAFP. "There was forgery and dishonest concealment of material facts," as reported in the inquiry. Committee chairman Senator Alexander Pope said TAFP's actions were "facilitated by a reckless, sales-based culture and a negligent management, who ignored or disregarded non-compliance and unlawful activity as long as profits were being made". He also commented that "ASIC appears to miss or ignore clear and persistent early warning signs of corporate wrongdoing, or troubling trends that place the interest of consumers or investors at great risk". Among a whole host of findings with regard to ASIC and TAFP, one was to demand for a royal commission into the saga, though it was eventually rejected.

Venus emerges

The negative publicity from the Senate Report that slammed TAB's financial planning arm created ripples around Australia. Seven days later, on 3 July 2014, Sam Venus, CEO of TAB, who had made an effort to stay inconspicuous, was forced to issue a public apology for the first time and propose a new compensation scheme for the victims. The compensation scheme, titled the Open Hands Review Program, which became operational in mid-August 2014, offered an assessment of any received financial advice. After the assessment, a compensation offer would be made by an "independent customer advocate" funded by TAB. If victims still felt that compensation offers were inadequate, they would be able to appeal to an independent panel, chaired by former High Court judge Ivan Cardinal, whose decision would then be binding.

Yet, questions had been asked about whether the review process was truly independent, as the first stage of this process was still conducted by TAB. Bloe even went so far as to dismiss TAB's new scheme as "first-class window-dressing", and disagreed with the 'pull' nature of the review process. "The problem with the process is that customers have to complain," Bloe said, adding, "I suspect very few will"

Business as usual

Paradoxically, the share price of TAB did not experience any sustained adverse impact during the saga. The only period during which the share price saw a substantial drop was from 20 May 2013 to 10 June 2013, when the price dipped 11.5% from A\$73.49 to A\$65.02. Since then, the stock has grown from strength to strength to close at A\$80.48 as of 31 October 2014. An analyst report by Morgan Stanley even showed calculations of both the financial impact of compensation and the potential impact on revenues due to reputational damages with an eventual price target of A\$87.20.

One step back, two steps forward

The reputational damage borne by TAB was coupled with uncertain financial repercussions. Customer satisfaction ratings of TAB have suffered a drastic drop. Under Roy Morgan's "most-favoured institution" satisfaction assessment, TAB slipped from first place at the start of 2014 to third place in September 2014. This would cause management to lose one quarter of their long-term bonuses. The introduction of TAB's new compensation scheme also led to new claims surfacing daily. At present, A\$52 million in compensation has already been paid out, with up to A\$250 million possibly required eventually.

In light of the TAFP scandal, questions have been asked about the integrity of the financial planning sector, with a lack of customer protection being a major concern. The Australian government has quickly responded by putting new measures in place, including a proposal to establish an enhanced, industry-wide public register of financial advisers to increase transparency in the industry. Additionally, in September 2014, a Corporations Amendment Regulation with regard to the Statements of Advice was made to increase clients' accessibility to information and to minimise possible conflicts of interest.

ASIC has also responded quickly to the criticisms of its role in the Senate Report, establishing an Office of Whistleblower to allow quicker response to whistleblowers and commencing an organisation-wide improvement process of its communications and transparency.

QUESTIONS

Each question is worth a potential 5 marks of a total potential assessment mark of 30

Attempt all questions

1. Describe the actions taken and behaviour displayed by senior management throughout this saga in terms of enterprise risk management. Discuss if these actions and behaviour were not only inappropriate but potentially high risk, and whether they aggravated the situation. If you were in the position of Sam Venus, what would you have done differently during the crisis to address the risk involved, and what might you put in place to mitigate similar future risk?

Note: in order to answer this question properly, you need to identify the risks involved, as well as suggesting ways of managing them.

2. *“Show me a company’s various compensation plans, and I’ll show you how its employees behave”* - Jack Welch, Former CEO of General Electric

Examine the key areas of concern in TAB’s remuneration plan. To what extent do you think these influenced the corporate culture and employee behaviour in TAB? What changes, if any, would you make to the remuneration plan to minimise agency conflicts?

3. In the Senate Inquiry Final Report, ASIC was described as *“waiting for complaints, investigating a minute proportion of them, and prosecuting even fewer.”* Critically evaluate the actions taken by ASIC throughout the course of the financial planning scandal, while highlighting difficulties ASIC might have faced during its investigations.

4. The media played an important role in exposing the fraud in TAFP. Discuss the role of the media in promoting good governance. Are there factors which limit its effectiveness? Can social media also play a role in enterprise risk management? If so, how?

5. Briefly discuss the importance of a good whistleblower protection policy. Do you think the policy sufficiently protected Bloe and his fellow whistleblowers? What further improvements can be made to encourage those who are aware of wrongdoings in an organisation to come forward, instead of remaining silent?

6. TAB had an excellent reputation amongst its customers but TAFP severely damaged it. What are the challenges faced by an organisation like TAB in promoting ethical behaviour, compliance and good governance throughout the group?