



Australian Government

Wholesale and Retail Clients Future of Financial Advice

Options Paper
January 2011

CONSULTATION PROCESS

Request for feedback and comments

The Government seeks the views of interested parties on the options presented in this paper for the criterion under which a client is considered to be wholesale or retail in the context of the receipt of financial advice. To assist those wishing to make a submission, questions for consultation can be found throughout the paper. However, you should feel free to address any issue raised in this paper, and should not feel obliged to address every question.

All information (including name and address details) contained in submissions will be made available to the public on the Treasury website unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like all or part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request made under the *Freedom of Information Act 1982* (Cth) for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please email responses in a Word or RTF format. An additional PDF version may also be submitted.

Closing date for submissions: 25 February 2011

Email: futureofadvice@treasury.gov.au

Mail: Future of Financial Advice
Department of Treasury
Langton Crescent
Canberra ACT 2600

Enquiries: Enquiries can be directed to Dr Richard Sandlant.

Phone: 02 6263 2955

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1. INTRODUCTION

1.1 As part of the Future of Financial Advice (FOFA) reforms, the Government announced that it would consider the appropriateness of the distinction between wholesale and retail clients (also referred to as ‘investors’ in this paper) is appropriate. The *Corporations Act 2001* establishes a regulatory framework which distinguishes between retail, wholesale, sophisticated and professional investors. Section 761G(4) states that a financial product is only provided to a person as a wholesale client if it is not provided to the person as a retail client. Insurance and superannuation are treated differently, but investors in other financial products can be treated as wholesale clients if they satisfy a wealth, occupational or other threshold test.

1.2 Problems with the definition of wholesale client were exposed during the recent global financial crisis (GFC) as clients who did not have the necessary experience investing in complex financial products were able to access these on the wholesale market. Internationally there are moves to clarify the treatment of retail and wholesale clients, including new definitions. The International Organisation of Securities Commissions has conducted a survey on international practices which provides a good evidence base for considering new definitions.

1.3 This paper will consider the appropriateness of the distinction between wholesale and retail clients in light of recent experience. As it is relatively easy to satisfy the wealth test in sections 708(8)(c) and s761G(7)(c), given the appreciation of assets and current levels of household wealth compared to when this test was originally introduced, it may be appropriate to reconsider how we distinguish between retail and wholesale clients. Accordingly this paper will pose a number of questions and propose draft options for further consideration.

1.4 The scope of this paper does not extend to considering the present distinction between wholesale and retail clients with regard to insurance contracts. This will be considered in greater detail as part of the review of risk insurance during the FOFA review.

2. RATIONALE

2.1 A distinction between retail and wholesale clients was inserted into the *Corporations Act* by the *Financial Services Reform Act 2001* (FSR Act), which was the main piece of legislation in the sixth stage of the Corporate Law Economic Reform Program developed in response to the recommendations of the Financial System Inquiry (Wallis Inquiry) released in March 1997.¹ The Wallis enquiry set out a framework for the regulation of the financial system. The main motivation for drawing the distinction between retail and wholesale clients was to identify those considered in need of regulatory protection, as well as the desire to allow certain clients to participate in wholesale markets, which tend to trade more complex products. Recommendation No. 20 in the Wallis Report advocated removal of prohibitions on retail participation in over-the-counter (OTC) derivatives markets. The Report suggested that clear definitions of retail clients entitled to disclosure and other consumer protection should be established. Accordingly, the explanatory memorandum to the FSR bill read as follows:

¹ Although in substance, the distinction pre-existed securities and collective investment regulation.

“The FSR Bill draws a distinction between retail and wholesale clients. Generally, the consumer protection provisions will apply only to retail clients, as it is recognised that wholesale clients do not require the same level of protection, as they are better informed and better able to assess the risks involved in financial transactions.”²

Retail clients

2.2 The new definition in section 761G related in different ways to different products. For example, individuals purchasing insurance or superannuation or retirement savings are treated as retail clients if they are purchasing specific products such as motor vehicle insurance or personal or domestic property insurance. All other financial products are subject to four tests: product value, individual wealth, professional investors and small businesses. It is now opportune to review these tests.

2.3 The threshold for product value was set at \$500,000,³ as compared to average total earnings for Australian full-time workers which were around \$29,300⁴ in 1991 rising to around \$67,700 in 2010. The level of \$500,000 is a level now within reach of an increasing number of Australians, given that in June 2010 the median value of a house in Australia was \$558,540⁵. The other main asset now owned by most Australians is superannuation. The Australian Bureau of Statistics (ABS) has estimated that of the approximately 2 million Australians who had received, or were receiving, a superannuation benefit in 2007, 55 per cent had taken their superannuation benefit entirely as a lump sum, 35 per cent as a pension and 10 per cent as a combination of the two⁶. An asset purchased in 2000 for \$500,000 would now be worth \$681,855 if it just appreciated at the prevailing rate of inflation. Accordingly, even taking into account just inflation on average weekly earnings, it would seem that the threshold of \$500,000 needs to be revised to keep pace with inflation.

2.4 As Australians increasingly have access to significant sums of money, the Government is trying to increase levels of financial literacy. ASIC is updating their www.fido.gov.au and www.understandingmoney.gov.au websites to help consumers better understand investment basics, including diversification, asset allocation and risk return issues. ASIC has developed an “investing between the flags” initiative to promote financial literacy for pre-retirees and retirees (in particular). ASIC is also developing interactive website resources which are designed to take consumers from the acquiring knowledge stage through to setting goals and supporting them in the implementation of those goals.

2.5 The threshold for individual wealth is \$2.5 million in net assets, or gross income for each of the last two financial years of at least \$250,000 per annum. Small businesses are considered to be

² Commonwealth of Australia, *Explanatory Memorandum*, Financial Services Reform Bill 2001, para 2.27.

³ The \$500,000 threshold was effectively a carryover from the same figure adopted as the point of exclusion of prospectus requirements in 1991.

⁴ ABS Cat. No. 6302.0 Average Weekly Earnings, Australia. 1991 was used as a benchmark year, as this was the commencement date of the Corporations Law which included the \$500,000 threshold

⁵ Australian Property Monitors, *House Price Report*, June 2010. p1.
http://www.homepriceguide.com.au/media_release/APM_HousePriceSeries_JuneQ10.pdf.

⁶ Commonwealth of Australia, *Super System Review final report part 2, 2010*, p198.

retail clients, but small community organisations or local governments are not (provided they meet the definition of professional investor in s9). Professional investors include financial services licensees, bodies regulated by APRA other than superannuation trustees acting for a trust holding less than \$10 million in net assets, persons controlling \$10 million or a body corporate or unincorporated body that carries on a business of investment in financial products, interests in land or other investments following an offer or invitation to the public. The tests separate out retail clients from professional investors who invest for a living, but could result in retail clients opting to be treated as wholesale clients whilst not possessing the knowledge or experience to properly gauge the risks of the products in which they might invest (but which they might still obtain from professional advisers to cover any deficiencies in their knowledge or capability). ASIC has warned about this risk.⁷ The tests could also prevent those who have the requisite knowledge, but not the requisite income from being able to access wholesale products.

Wholesale clients

2.6 Chapter 7 of the *Corporations Act 2001* contains a number of tests in relation to specific products. A wholesale client is defined in s761G(4) as a person that is not a retail client. The definition of retail client for general insurance differs from the definition of retail client for superannuation products and retirement saving accounts products and for traditional trustee company services as well as for other financial products. The point of these different definitions is to reflect the different value placed on and risks associated with particular products, but could be confusing to investors, issuers or licensees.

Sophisticated investors

2.7 In 2007, a definition of 'sophisticated investor' was introduced to Chapter 7 of the *Corporations Act* (s761GA). This new section mirrors s708(10) and aims to apply the same tests that apply to securities and debentures in Chapter 6D of the *Corporations Act*. This provides a more consistent approach for determining which investors would receive disclosure information and which will not. This was to promote consistency of regulation where possible across a larger range of financial products. Those classed as sophisticated investors waive the rights to disclosure granted to retail investors. The class of sophisticated investor is intended to be a subset of wholesale client. The explanatory memorandum stated that:

Although the existing tests adequately address the circumstances of many investors, there are some investors who are defined in the legislation as retail investors and are unable to access wholesale status. For reasons such as experience or professional training, these investors may wish to be treated as wholesale investors. Such investors may consider retail disclosure an unnecessary hindrance to activities they well understand and would prefer to access wholesale investor status. They may also wish to access wholesale-only products.⁸

⁷ 'The effect of harmonisation on the regulator and regulation' An address by Alan Cameron AM, Chairman, Australian Securities and Investments Commission at a Committee for the Economic Development of Australia (CEDA) seminar 'CLERP 6 - Government's blueprint for a single regulatory regime', Sydney, 11 February 2000

⁸ Commonwealth of Australia, Explanatory Memorandum, *Corporations Legislation Amendment (Simpler Regulatory System) Bill 2007*, para 1.18

2.8 Section 761GA states that a client will not be treated as a retail client if, among other things:

(d) the financial services licensee is satisfied on reasonable grounds that the client has previous experience in using financial services and investing in financial products that allows the client to assess:

- (i) the merits of the product or service; and
- (ii) the value of the product or service; and
- (iii) the risks associated with holding the product; and
- (iv) the clients' own information needs; and
- (v) the adequacy of the information given by the licensee and product issuer

2.9 In addition, the licensee is required to certify in writing their reasons for being satisfied, and the client must also acknowledge in writing that they have not received the documents usually provided to retail clients, such as a Product Disclosure Statement.

Arguably the approach to defining "sophisticated investors" in sections 761GA and s708(10) is a more appropriate way to distinguish whether are able to deal with complex financial products than a simple wealth test. Although the subjective nature of the 'sophisticated investor' places the onus on the licensee, creates less certainty and makes it difficult to determine if a certificate was properly issued.

Professional investors

2.10 Section 9 of the *Corporations Act 2001* defines the term 'professional investor' as including Australian Financial Services (AFS) licensees, bodies regulated by APRA, bodies registered by the *Financial Corporations Act 1974*, trustees of superannuation funds or trusts, persons controlling at least 10 million, listed entities and body corporates that carry on certain investment businesses. That is entities that have already satisfied certain licensing, registration or listing requirements and, or, having control of a substantial sum of money.

This paper will examine the implications of the tests in subsequent sections.⁹

3. RELEVANT PROVISIONS

3.1 This section considers the implications for the definitions of retail, wholesale and sophisticated investors, including the following:

- *Corporations Act 2001 (Cth)*;
- *Corporations Regulations 2001 (Cth)*;
- *Income Tax Assessment Act 1997(Cth)*; and
- *ASIC Market Integrity Rules*.

It would be desirable to have a uniform understanding of the meanings of these terms across all these legislative instruments, taking into account whether the same definitions or thresholds might appropriately vary given their relevance for different purposes.

⁹ Although terminology other than 'sophisticated' may be desirable to avoid people agreeing to being treated as sophisticated out of sheer pride.

3.2 The experienced investor test in part 6D of the *Corporations Act 2001* focuses on competence levels in securities generally, rather than particular products. It is the same as the s761GA sophisticated investor test in that s761A focuses on experience in relation to financial products or financial services generally.

3.3 The terms ‘retail’, ‘wholesale’ and ‘sophisticated’ are used in a wide variety of circumstances, for example in the issuing of market licences (s798A), in disclosure requirements for investors (one example is s1012D(2B)) and imposing accreditation requirements for those who provide financial product advice for futures and option contract to retail clients (MIR 2.4.1) to name but a few.

3.4 Another term used to distinguish retail clients is the term ‘consumer’ which is used in the ASIC Act and the Trade Practices Act. This term applies to those who purchase values less than \$40,000 worth of goods and/or services or goods and services that are ordinarily acquired for personal, household or domestic use.¹⁰ Various protections are available to consumers that appear to not be available to those who trade in higher volumes and do not acquire goods or services for personal, domestic or household use or consumption. No changes are contemplated to the term consumer given the wide ranging implications of the term, which go well beyond the treatment of investors.

4. PROBLEMS IDENTIFIED DURING THE GLOBAL FINANCIAL CRISIS

4.1 Serious implications with the current distinction between retail and wholesale clients became more obvious during the recent global financial crisis (GFC). The well publicised case of *Lehman Brothers Asia Holdings Limited (in Liquidation) v City of Swan & Ors; Lehman Brothers Holdings Inc v City of Swan & Ors*¹¹ highlighted the issues faced by councils who invested in complex financial instruments such as collateralised debt obligations (CDOs) sold by Lehman Brothers. Although the court case was about whether the councils could recover their money from Lehman Brothers, it is worth examining the background to the case as an example of the problems that arise from entities without the necessary financial expertise being treated as wholesale clients. The costs that may be incurred if the definition were to be changed will also be considered.

4.2 During the GFC, retail clients' problems mainly occurred in relation to investments in listed CDOs (which retail clients could access), which suffered substantial losses in market value due to the impact of the GFC on the value of the underlying assets. Prior to the GFC, around \$700 million was invested in CDOs listed on the ASX. As of late 2009 the market capitalisation of ASX-listed CDOs had fallen to around \$230 million¹².

4.3 Lehman Brothers in Australia operated by soliciting funds from investors that were used to purchase cash, bonds or other low risk financial products. However Lehman then used these low risk assets in far riskier credit default swap agreements which were intended to generate higher

¹⁰ There is also a small business limb s12BC(1)(c) of the ASIC Act.

¹¹ [2010] HCA 11

¹² While this is a decrease in value of \$470 million, it is likely that not all of this decrease is directly attributable to the GFC. Some of the loss in value may be due to the CDOs being paid out or removed from quotation over the relevant time period.

returns for their investors. Some investors have claimed that Lehman Australia and other Lehman companies were negligent, or misleading or deceptive.

4.4 A good example of the way these investments were marketed to investors is the way that the Torquay fund was marketed to Parkes Council (one of the parties to the High Court case). The Parkes Council claims that it was not made aware of the risks of investing in CDOs. Between 2005 and 2007, the Parkes council put more than \$13.5 million of its savings into CDOs. The investments offered a return of 1.2 percentage points above the Australian bank borrowing rate and a double-A credit rating from Standard & Poor's. Prior to this Parkes Council's finance manager Bob Bokeyar "typically invested money in Australian bank deposits for periods of no more than a year, to make sure it would be available when needed."¹³

4.5 According to the councils, the risks of investments in CDOs were not adequately explained. As wholesale clients, there was no requirement for them to receive a prospectus or Product Disclosure Statement, or even general warnings on the risk of the class of investment. Torquay was exposed to five of the seven major defaults that occurred in 2008: Lehman Brothers, Washington Mutual, Freddie Mac and Icelandic banks Kaupthing and Glitnir. Accordingly in its financial statements, Parkes has recognised a \$7 million loss on its \$13.5 million invested in CDOs.

4.6 If local councils had been classified as retail clients, they would have been entitled to a number of protections (outlined below) which are not extended to wholesale clients. Potentially these protections would have allowed the councils to decide that the risks of CDOs were too great for the councils to countenance.

4.7 Protections for retail clients are set out in Parts 6D.2 and 7.6 - 7.9 of the Corporations Act and include:

- When a licensee provides a financial service, they must provide a written statement called a Financial Services Guide (FSG), setting out the terms and basis of their services (s941A).
- If a licensee provides advice specific to the client's needs, they must provide a written Statement of Advice (SoA), which sets out the basis of that advice, as well as the amount and source of any commissions or other remuneration they receive from product providers (s946A, s947B, s947C, s947D).
- Product issuers must generally give retail clients a Product Disclosure Statement (PDS) before issuing a financial product (s1012B). The PDS should provide essential details about that product. For CDOs, the preparation of a prospectus instead of a PDS is required when what is being offered is a security (as defined in s700). However, the objectives of the two documents are similar in aiming to provide clients with the information they require to make an informed investment decision.
- All providers of financial services must maintain a dispute resolution system for their retail clients, including access to one of the independent complaint services to which

¹³ Quoted in Mark Whitehouse and Serena Ng "Synthetic CDOs hit local councils on other side of world" *The Australian* December 26, 2008 <http://www.theaustralian.com.au/business/news/cdos-hit-local-councils/story-e6frg90x-1111118407924> accessed 6 August 2010.

every licensee that provides financial services to retail clients is required to belong. Complaint handling by these bodies is free to the consumer. (s912A (2)).

- If a financial services licensee provides a financial service to persons as retail clients, the licensee must also have arrangements for compensating those persons for loss or damage suffered because of breaches of the relevant obligations by the licensee or its representatives. (s912B).
- Those that provide advice to retail clients are also subject to stricter training requirements set out in ASIC's Regulatory Guide 146 *Licensing: Training of financial product advisers* (unless exempted).

5. WHICH INVESTORS NEED PROTECTION? WHERE SHOULD THE LINE BE DRAWN?

5.1 The current distinction between retail and wholesale clients may also be excluding people who may be classified as retail clients from making the financial decisions that they are otherwise equipped to make. A Coredata study (2008) commissioned by the Financial Planners Association found there are just over 5 million Australians who are currently engaged with, and using the services of advisers. This represents 31.8 per cent of the adult population or 23 per cent of the total population¹⁴. By contrast a recent survey found that 68.3 per cent of the Australian population own a wealth management product¹⁵.

5.2 Investors may be divided into a number of groups, with different needs. Although individuals are presumed to be retail clients, those that qualify on the grounds of wealth or sophistication may be classified as wholesale clients. Small businesses are also presumed to be retail clients, though some small business owners may wish to be classified as sophisticated. Large businesses, licensees, listed entities, trustees of superannuation funds with net assets of at least \$10 million and other bodies that are non-superannuation trustees that are regulated by APRA are presumed not to be retail clients on the basis that they are 'professional investors'.

5.3 Individuals have varying degrees of financial literacy, derived from their education, demographic and experience levels.¹⁶ The results of the 2008 ANZ financial literacy survey point to a strong association between financial literacy and demographic/socio-economic characteristics. Older Australians who have had some experience in purchasing a home or other investments have higher levels of financial literacy than younger Australians. Those living in higher income households have the highest levels of financial literacy.

5.4 However, this does not necessarily imply that all members of these households have high levels of financial literacy. At least 6 per cent of those with household incomes of \$150,000 plus had financial literacy scores that fell in the lowest 20 per cent of all scores¹⁷. The reason for higher

¹⁴ Coredata-BM, Financial Advice 2013 –White Paper, 2008

¹⁵ Roy Morgan p20

¹⁶ A framework for assisting financial literacy and superannuation investment choice decisions July 2010 <http://www.docs.fce.unsw.edu.au/fce/Research/ResearchMicrosites/CPS/2010/Gallery.pdf>

¹⁷ ANZ survey p2

levels of financial literacy may be ‘reverse causality’ whereby experience with investment increases financial literacy, rather than financial literacy influencing the decision to invest.¹⁸

5.5 Accordingly, using wealth as a proxy of financial literacy will be appropriate for most cases, but will not be suitable for all. This means that there may be those who suddenly acquire a significant amount, through inheritance or through the sale of their home or superannuation who are then placed in a position where they may make significant financial decisions for which they are not equipped.

5.6 Drawing the line between retail and wholesale clients could be based on a range of factors, rather than the current wealth tests. For example, all clients could initially be presumed to be retail, but should be able to upgrade to ‘sophisticated’ status.

6. INTERNATIONAL COMPARISONS

6.1 This section will provide a summary of measures currently being taken in comparable jurisdictions.

6.2 At the multilateral level, the G20 has called for action to review business conduct rules¹⁹, and the International Organisation of Securities Commissions (IOSCO) is in the process of reviewing suitability obligations relating to intermediaries’ distribution of complex financial products to investors. IOSCO has conducted a survey of regulatory frameworks around the world including the criteria used to classify investors and products. It found that the scope of the wholesale client definition varies to a significant extent from jurisdiction to jurisdiction.

United States of America

6.3 In the United States, an accredited (wholesale) investor is defined as follows:

1. a bank, insurance company, registered investment company, business development company, or small business investment company;
2. an employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of \$5 million;
3. a charitable organization, corporation, or partnership with assets exceeding \$5 million;
4. a director, executive officer, or general partner of the company selling the securities;
5. a business in which all the equity owners are accredited investors;
6. a natural person who has individual net worth, or joint net worth with the person’s spouse, that exceeds \$1 million at the time of the purchase;

¹⁸ Financial Management in Australia cited in A framework for assisting financial literacy and superannuation investment choice decisions July 2010
<http://www.docs.fce.unsw.edu.au/fce/Research/ResearchMicrosites/CPS/2010/Gallery.pdf> p14

¹⁹ At the G20 meeting held in Washington, D.C. on November 15, 2008, Heads of State set forth a number of common principles for reform of financial markets that intertwine with IOSCO’s current and prospective work. The key points include the promotion of financial markets integrity by encouraging a review of business conduct rules to protect markets and investors.

7. a natural person with income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year; or
8. a trust with assets in excess of \$5 million, not formed to acquire the securities offered, whose purchases a sophisticated person makes.²⁰

6.4 The United States have definitions similar to the Australian definition of professional and wholesale investors. However, their wealth standard is to be reviewed periodically by the Securities Exchange Commission (SEC)²¹.

6.5 Brokers are also required to have reasonable grounds that their recommendations are suitable for their customers²². Brokers must obtain the customer's financial status, tax status, investment objectives and other reasonable information.

United Kingdom

6.6 In the United Kingdom (as with other European jurisdictions) suitability rules derive from primary and secondary legislation implementing the EU Markets in Financial Instruments Directive (MiFID)²³. The European Commission is considering amendments to MiFID in order to address issues emerged after its initial implementation, including lessons learned after the crisis. The Financial Services Authority (FSA) is currently undergoing a major review of the retail distribution of investment products regime, known as the Retail Distribution Review.

6.7 The UK applies two tests, 'suitability' and 'appropriateness'.

Suitability

6.8 MiFID firms must take reasonable steps to ensure that a personal recommendation, or a decision to trade, is suitable for its client.

6.9 When making a personal recommendation or managing a client's investments, the firm must obtain the necessary information regarding the client's:

- knowledge and experience in the investment field relevant to the specific type of designated investment or service
- financial situation
- investment objectives.

²⁰ Securities Act 1933, Rule 501, Regulation D.

²¹ Sec 413 of the Dodd-Frank Act states that the Commission shall adjust any net worth standard for an accredited investor so that the individual net worth of any natural person (or joint net worth with their spouse) is more than \$1 million excluding the primary residence of the natural person.

²² FINRA's NASD Rule 2310

²³ It is worth noting that in Australia, suitability obligations exist for some products regulated by ASIC, such as margin loans under s985F of the *Corporations Act 2001*

6.10 A firm must obtain from the client such information as is necessary for the firm to understand the essential facts about the client and have a reasonable basis for believing, giving due consideration to the nature and extent of the services provided, that the specific transaction to be recommended, or entered into in the course of managing the client's affairs:

- meets [the client's] investment objectives
- is such that [the client] is able financially to bear any related investment risks consistent with [their] investment objectives
- is such that [the client] has the necessary experience and knowledge in order to understand the risks involved in the transaction or in the management of [their] portfolio.

Appropriateness test

6.11 Appropriateness applies where a firm provides services other than investment advice (in the form of personal recommendations) or discretionary portfolio management. A firm must ask clients to provide information about their knowledge and experience in the investment field relevant to the specific type of product or service offered or demanded to enable the firm to assess whether the service or product is appropriate. Firms must either offer to clients or transact for them only those products that are appropriate. However, if the client demands a product that is assessed as inappropriate, the client must be warned that the product is inappropriate. If the client still wants to proceed, the firm should consider whether to do so under the circumstances.

6.12 A firm is entitled to assume that a professional client has the necessary knowledge and experience in order to understand the risks involved in relation to particular products or service²⁴.

New Zealand

6.13 New Zealand is presently going through a period of reform. Currently the Securities Markets Act does not distinguish between wholesale and retail investors. The draft Financial Advisers Act makes a distinction between retail and wholesale investors, however concerns have been raised about the level of protection to be applied to wholesale and retail investors. Accordingly it is likely that an exemption for advisers dealing with wholesale clients will be considered. The exemption would cover clients that have the necessary negotiating power and sophistication in financial matters to make informed decisions. Advice given to wholesale investors would still be subject to statutory conduct obligations, such as an obligation to act with due care, skill, and diligence and a requirement not to engage in misleading or deceptive behaviour. The proposed new definition of wholesale investors is as follows:

- people who receive financial advice in the course of their business and whose business is defined as a financial service provider or financial adviser;

²⁴ The UK definition of professional client includes credit institutions, investment firms, other authorised or regulated financial institutions, insurance companies, collective investment schemes and their management companies, pension funds and their management companies, commodity and commodity derivative dealers, large undertakings meeting relevant size requirements, national and regional governments, public bodies that manage public debt, central banks and international and supranational institutions, and other institutional investors whose main activity is to invest in financial instruments, including entities dedicated to the securitisation of assets or other financing transactions.

- a person whose principal business is the investment of money or who habitually invests money in the course of and for the purposes of their business;
- medium and large entities who can prove that during the last two accounting periods they have gross assets of \$1 million or an annual turnover of at least \$1 million;
- local authorities, State enterprises, and Crown entities, and specified statutory financial institutions;
- ‘eligible clients’, which might be either entities or individuals, who have certified in writing that they have sufficient knowledge, skills, or experience in financial matters to assess the value and risks of financial products and the merits of the service and that they are aware of the protections being lost through certification. To be eligible, this certification must be accepted by an authorised financial advisor or qualifying financial entity (QFE) who is permitted to accept the certification because they are subject to authorisation requirements. Other advisers could also accept a client’s self-certification, but this would be subject to additional enforcement provisions to prevent unscrupulous persons who were not authorised financial advisers or QFEs from attempting to persuade clients to self-certify inappropriately.

Hong Kong

6.14 Hong Kong has also recently reviewed the distinction between wholesale and retail investors. There is a requirement for an intermediary to assess a professional investor’s knowledge and expertise in paragraph 15.3 of the Code of Conduct. Intermediaries may adopt a holistic approach in conducting the assessment and reach a reasonable conclusion as to whether the investor could be treated as a professional investor under the Code of Conduct in the particular product and/or market in question.

6.15 Hong Kong did not change current minimum portfolio requirement of HK\$8 million, for professional investors as it is comparable to other jurisdictions (for example: higher than that in the United Kingdom and lower than that in Australia and Singapore).

Canada

6.16 On May 26, 2010 the Minister of Finance of Canada released a draft bill for a new Canadian Securities Act. It will create a national securities regulator to oversee Canada’s capital markets. It does not distinguish between wholesale and retail investors. The definition of an investor is “a person who has indicated an intention to purchase or trade a security or for whose account an order is or would be placed.”²⁵ Protections available to investors include the following:

- A person must not, in relation to a trade or to investor relations activities, engage in an unfair practice, including:
 - (a) putting unreasonable pressure on another person to purchase, hold or sell a security; and
 - (b) entering into a transaction with another person who is unable or does not have the capacity to reasonably protect their own interest because of physical or mental disability, illiteracy, age or other inability to understand the

²⁵ Canadian Securities Bill (draft), section 9.

character, nature or language of any matter relating to a decision to purchase, hold or sell a security.²⁶

7. POSSIBLE OPTIONS FOR A NEW REGIME

7.1 This section considers a broad range of possible options for change to the Australian model. In addition to a description of the options, possible pros, cons and associated discussion questions are included.²⁷

7.2 Some important factors for consideration in reviewing the tests to distinguish wholesale clients from retail clients include:

- Providing adequate protection and disclosure to clients who need it;
- Ensuring that any test takes into account the financial literacy of the client, including their ability to assess the merits, value and risks associated with particular financial products, as well as understanding their own information needs and the adequacy of information provided by the intermediary;
- Whether an client is willing and able to pay for professional advice;
- Ensuring that the investor is fully aware/ informed of their status as a retail or wholesale client;
- Encouraging efficiencies in the financial services industry;
- Ensuring that any regulation which prohibits or limits access to certain wholesale products is justified;
- Ensuring that the test is easy to use, clear and as objective as possible to give industry sufficient certainty;
- Ensuring there is some consistency across the *Corporations Act*;
- Ensuring that the test will remain relevant with time; and
- Considerations of international consistency.

²⁶ Canadian Securities Bill (draft), section 121.

²⁷ It is important to note that distinctions between consumers or investors based on means and/or financial literacy are included in many legislative provisions. The terms “retail client”, “wholesale client”, “sophisticated investor”, “professional investor”, “professional adviser” and “consumer” appear in the Corporations Act 2001, Corporations Regulations 2001, Australian Securities and Investments Commission Act 2001, ASIC Market Integrity Rules, Trade Practices Act 1974 and Income Tax Assessment Act 1997. Additionally, by virtue of the inclusion of general insurance products in the Corporations Act, the terms “retail client” and “wholesale client” are also relevant to the Insurance Contracts Act 1984. The options for change presented in this options paper are primarily concerned with the use of terms to distinguish between different types of investors in the Corporations Act 2001, Corporations Regulations 2001 and Australian Securities and Investments Commission Act 2001 and ASIC Market Integrity Rules. The use of these terms in the Trade Practices Act 1974 and Income Tax Assessment Act 1997 will remain in their current form. The associated use of these terms in the Insurance Contracts Act 1984 will be considered in greater detail as part of the review of risk insurance during the second stage of the FOFA review.

Option 1 – Retain and update the current system

7.3 Option 1 is to retain the current distinctions between retail and wholesale clients but update them to better reflect and take account of the problems encountered during the GFC and the time which has elapsed since the current tests were enacted. There are various mechanisms for implementing this option which are outlined below. Please note these mechanisms are not mutually exclusive and multiple mechanisms could be adopted to achieve the policy outcome.

7.4 Update the Product Thresholds

One possible step is to update the threshold for the price of the provision of the financial product, or the value of the financial product to which the financial service relates under section 761G(7)(a) and associated regulations 7.1.18 – 7.1.24.

The current product limit above which clients are classified as wholesale is \$500,000. The suggested new threshold limit for this test is \$1,000,000.

This new threshold recognises the 20 years which has elapsed since the original test was first introduced into the Corporations Law for securities established; and accounts for the fact that an increasing number of investors without high financial literacy are able to meet the current \$500,000 limit. Additionally, it is consistent with recent changes in the USA where the financial product value threshold has been increased to \$1,000,000.

An additional amendment to the product threshold tests would be to specifically revise the limit in regulation 7.1.22. This regulation does not work in a similar way to the thresholds used for other products as it is based on the face value of a derivative, which can be misleading or manipulated. A suggested amendment is to base the threshold amount on the fee the client actually pays by way of option fee or margin.

Advantages

It retains the objective and easy to use framework of the current test. It also recognises that there is some positive correlation between wealth and financial literacy.

Disadvantages

It retains an arbitrary way to separate wholesale clients from retail clients, and that a \$1,000,000 threshold is itself an arbitrary figure. Further, in many instances wealth is not an accurate proxy for financial literacy and, or, an effective indicator as to the preparedness of an individual to seek and pay for professional advice.

Questions for consideration:

- Is an arbitrary but objective test preferable to a subjective test which more accurately reflects the individual circumstances of the client?
- Should all 3 thresholds be updated (that is, the product value test and the two tests based on personal wealth in s761G(7)(c)), or just the \$500,000 product value threshold?
- Is \$1,000,000 an appropriate new threshold limit for the product value test?

- Is information available on how many investors would meet the proposed new limit for their products?
- Is there any specific reason why regulation 7.1.22 should not be amended to more accurately reflect the investment a client actually makes in a derivative?

7.5 Introduce an indexing mechanism

Another step is to introduce an indexing mechanism to ensure that the existing three wealth and product value threshold tests under section 761G(7) and associated regulations 7.1.18 – 7.1.24 and 7.1.28 continue to remain relevant with time.

The threshold limits have not been updated since they were introduced. An indexing mechanism for the thresholds would enable the same test to remain relevant well into the future.

Such an indexing mechanism would need to be easy to use, and threshold limits easy to determine at any point in time. It is important that with three different thresholds, indexing does not make the classification of a client as retail or wholesale prohibitively difficult. Additionally, the mechanism used would need to accurately reflect changes in the time value of money.

Advantages

Indexing would ensure that each of the wealth and product value threshold tests would remain relevant into the future. This would eliminate the need for periodic policy reviews of the distinction; and minimise the probability of the threshold limits being too low for a time before they are periodically reviewed.

Disadvantages

Indexing significantly increases complexity and implementation costs and reduces transparency. As time progresses, it will be increasingly difficult to determine exactly what the thresholds are, particularly after the first indexing period, as the actual figure will not be included anywhere in legislation. Further, there are very few domestic or international indexing mechanisms in legislation which can be used as a model to base this option on.

Questions for consideration:

- How could a simple and relevant indexing mechanism be introduced?
 - An example of a simple mechanism may be to assume a certain percentage growth per annum and legislate that the thresholds must be updated to a round number based on that growth rate with effect every 5 years.
- Will three different threshold limits and constant indexing be too difficult or confusing to implement?
- What value should be used as the basis for indexing?
- How often should the 3 limits be indexed?

7.6 Exclude Illiquid Assets

Another option is to exclude illiquid assets from the net asset wealth threshold test. The current test states that a client will meet the wholesale classification if they have net assets of \$2,500,000. The wealth tests were originally included as high net wealth often accords with high financial literacy, however correspondingly higher financial literacy likely results from actually dealing with financial products. High wealth in illiquid assets may not reflect a high level of dealings in financial assets by a particular client.

Therefore, specific illiquid assets, such as the client's primary residence and superannuation could be excluded from the net wealth threshold.

Advantages

Removing superannuation from the net asset test would arguably recognise that some clients do not engage with their superannuation savings, and a high account balance again would not necessarily accord with a high level of dealings in financial products. Excluding the client's primary residence would be consistent with the model in the USA.

Disadvantages

One drawback of this aspect of the option may be that in excluding the client's primary residence and/or superannuation, the wholesale net assets threshold could be more easy to satisfy for those who do not own a home, who may have taken time out from the work-force or be self-employed and therefore do not have a large superannuation balance, or who choose to place their wealth in other assets.

Questions for consideration:

- Are there any reasons why a primary residence should/should not be included in the net assets test?
- Are there any specific reasons why superannuation should/should not be included in the net assets test?
- Would excluding some assets cause too much difficulty or confusion for industry?
Which assets?
- Would this work prohibitively to exclude clients who should be classified as wholesale?

7.7 Amend the Deeming Process

A further step would be to amend the process by which clients are deemed to be wholesale. Currently an investor can be deemed as a wholesale client as soon as the price of the provision of a financial product, or the value of the financial product to which the financial service relates equals or exceeds \$500,000; or a qualified accountant provides a certificate which states that the client's net assets are equal to or exceed \$2,500,000 or that the client's gross income for the last 2 financial years is equal to or exceeds \$250,000 per annum.

Based on these processes, there are examples of instances where clients have been deemed wholesale without their knowledge or consent.

This amendment would clarify that a client must specifically acknowledge instances when they will be classed as a wholesale client and ensure that they understand they will not receive the benefit of protections provided to retail clients.

Advantages

This would ensure that investors are more engaged in their financial product investments, and more aware of the protections and disclosures to which they are specifically entitled. Advisers and intermediaries would be held to a higher standard of care and provide more frank and open communication with their client about their legal entitlements.²⁸

Disadvantages

Like many aspects of the financial products and services industry, it is likely that firms would implement this via standard forms, and there is a risk that the true policy objective of ensuring that investors are aware of their status and their legal protections may be lost or avoided when clients are asked to sign another form which they may not even read.

Questions for consideration:

- Would an explicit opt-in make investors sufficiently aware of what protections they are afforded?
- Would an explicit opt-in be prohibitively inefficient for industry?
 - What would be a more appropriate test for investor opt-in?
- Would the true policy objective and message be easy to avoid via standard forms?
- Should investors be able to elect to be treated as a retail client even when they meet the wholesale wealth threshold tests?

7.8 Two out of Three Requirements

Another variant of this option would be to introduce a new requirement that investors must meet 2 of the 3 threshold tests, rather than just 1. To be classified as wholesale, currently investors need only meet the income test or net assets test or product value test. This amendment would recognise that demonstrating wealth in 2 respects may be a better indicator of financial literacy than only meeting 1 test.²⁹

²⁸ Italy has implemented a strict version of this amendment via a 3-step mechanism: once an investor meets 1 or more of the wholesale thresholds, they must actively opt-in to being treated as a wholesale by (1) stating in writing that they wish to be treated as a wholesale investor; (2) the intermediary must give clear written warning of the protections and rights that the investor may lose; and (3) the investor must respond in writing stating that they are aware of the consequences of losing these protections.

²⁹ This aspect of Option 1 would accord with the laws in many international jurisdictions, as tests based on meeting at least 2 out of 3 criteria are used broadly in Europe and in Hong Kong.

The objective and simple nature of the test would remain, but investors would need to prove their financial wealth in at least 2 aspects to be classified as wholesale. This provides a further mechanism to exclude investors from being classed as wholesale when they have high wealth in one aspect of their finances but not a corresponding high level of financial literacy.

Advantages

It is more likely that if an investor meets 2 of the 3 tests that they will be more familiar with dealing in financial products and have a greater understanding of the information and protections that they need. This is particularly true for investors who, for example, inherit a reasonably large sum of money but have little previous experience in investing.

Disadvantages

Although it makes the mechanism by which investors are classed as wholesale more robust, the fundamental basis for the test is still arbitrary and does not address concerns that wealth is not always a proxy for financial literacy. Further, such a strict requirement may exclude investors who lack means but have high financial literacy and want to access wholesale products.

Questions for consideration:

- Are there any specific reasons why meeting 1 out of 3 requirements is better than meeting 2 out of the 3 (or vice versa)?
- Is meeting 2 of the 3 requirements likely to be a better proxy for financial literacy than the current test?
- Would this requirement be prohibitive for investors who wish to be classed as wholesale?

7.9 Introduce extra requirements for certain complex products

It may also need to be recognised that certain products or classes of products are, by their nature, inherently risky. It is therefore worth considering whether the products that are offered themselves should have any bearing on a client's status as a retail or wholesale client. The law already recognises that for some classes of products (for example, certain types of insurance) investors are deemed to automatically be either retail or wholesale clients. There may also be certain types of complex investment products for which there should be a higher threshold before a client is classified as wholesale.

Advantages

This would recognise that particularly complex products, such as CDOs and Contracts for Difference (CFDs) may contain complex risk elements that are harder for clients to discern than 'vanilla' investments, such as managed funds or exchange-traded equities. This option would ensure that greater risk to the client should be accompanied by greater responsibility on the part of the intermediary. This would directly recognise that many large-scale losses by wholesale clients during the GFC were related to complex and risky products.

Disadvantages

A major disadvantage would be increased complexity and regulation due to different thresholds applying to different products. There may also be difficulty in determining which specific products are deemed complex or risky enough that separate threshold limits should apply. Furthermore, any arbitrary mechanism such as this is likely to catch some sophisticated investors as retail when in fact a wholesale classification would be more appropriate.

Questions for consideration:

- What are the complex products that the higher threshold should apply to?
- What is the higher threshold that should apply to these products?

7.10 Repeal the ‘Sophisticated Investor’ Test

The sixth and final variant would be to repeal the ‘sophisticated investor’ test under section 761GA of the Corporations Act. By strengthening several aspects of the wealth threshold tests in section 761G, there could be less need for a subjective test which may also be used to classify investors as wholesale.

Advantages

This change has the benefit of ensuring that the tests for classifying wholesale clients is based solely on objective factors, and accords with other overseas jurisdictions where tests based on wealth thresholds are the primarily or singular method for distinguishing between retail and wholesale clients. Preliminary feedback from industry also indicates that the subjective test is difficult to administer and many licensees fear liability if they are deemed to have incorrectly classified an investor as a wholesale client.

Disadvantages

While objective tests are generally the favoured alternative by industry, this change does eliminate any ability for investors with less financial means that do not allow them to meet the product value or personal wealth tests but high financial literacy to access certain products only offered to wholesale clients, such as over-the-counter derivatives, foreign exchange contracts, CDOs and CDSs

Questions for consideration:

- Should investors with less wealth but high financial literacy have some way of accessing wholesale products?
 - If yes, how might this be operationalised in an objective manner?
- Given that industry favours objective tests over subjective tests, is this a strong enough reason to repeal the section entirely?
- Should the section be retained even if it is scarcely used?

Option 2 – Remove the distinction between wholesale and retail clients

7.11 In order to minimise the problems and complexities associated with having 2 separate classes of investor, this option would eliminate the distinction between wholesale and retail clients.³⁰

All investors (except professional investors as defined in section 9 of the Corporations Act) would receive the protections and disclosures currently afforded only to retail clients. This would remove distinctions which can sometimes be arbitrary and difficult to administer and ensure that there is consistency and simplicity across the Corporations Act.

Advantages

This test ensures high levels of investor protection and recognises the importance of information and disclosure. The complexities associated with administering objective wealth threshold tests and subjective financial literacy tests are eliminated allowing industry to focus resources elsewhere.

Disadvantages

Despite its apparent simplicity, there are several drawbacks with this option, including a lack of certainty for intermediaries. As part of the broader FOFA reforms, a duty obliging advisers to act in the best interests of their clients will be introduced. If the distinction between different classes of investor is removed, advisers would need to verify the suitability of investments for each investor when providing them with personal financial advice. Further, under this option, there may be increased difficulty in acting as an intermediary for large-scale product offerings to investors who have significant financial means and investment experience, as well as a loss in efficiency due to the protections and disclosure mechanisms that would need to be extended to investors who were formerly classed as wholesale clients.

Questions for consideration:

- Would the financial advice industry be willing to undertake a suitability and best interests verification for each retail client that personal advice is provided to under the retail client definition proposed in this option?
- Is the loss in efficiency offset by greater investor protection?
- Is it appropriate to remove the distinction from the entire Act?

Option 3 – Introduce a ‘sophisticated investor’ test as the sole way to distinguish between wholesale and retail clients

7.12 The most accurate distinction between wholesale and retail investors would likely be based on the actual financial literacy of the investor. This option recognises that a distinction based on wealth is arbitrary and that a true measure of financial literacy should be the test used to distinguish retail clients from wholesale clients. Investors with high financial literacy have less need for

³⁰ There is some international precedent for this option, as Brazilian regulations make no specific distinctions between retail and wholesale investors.

specific disclosure due to their ability to understand the merits, value and risks of a particular financial product; and less need for specific protections (such as access to external dispute resolution scheme) as they are more able to protect their own rights and interests..

Advantages

A subjective test administered by industry would likely eliminate the wealth threshold tests in section 761G and expand the application of section 761GA to all distinctions between retail and wholesale clients in the Corporations Act. If administered accurately by industry, this option would ensure that investors are given the protections and disclosures that are commensurate with their experiences, as well as giving investors with high financial literacy broader access to complex products.

Disadvantages

As discussed in Option 1, section 761GA has not been well-received by industry due to the difficulty and potential liability associated with administering a subjective test. Many intermediaries may take a cautious approach resulting in inefficiencies and very few investors being classified as wholesale clients. Additionally, a subjective test requires more work by intermediaries in determining whether each investor meets the subjective criteria – under section 761GA, this must be done for every investor and every product accessed by the investor.

Questions for consideration:

- Is the test under section 761GA a true indication of financial literacy?
- Is there any way that section 761GA can be amended to allay fears of licensees being exposed to legal liability while maintaining investor protection?
- Is it possible for a subjective test to be easy to administer and ensure that intermediaries are not unduly cautious?

Option 4 – Do Nothing

7.13 Despite the apparent problems experienced during the GFC due to the current distinction between wholesale and retail clients, it is possible to retain the existing tests and thresholds.

Advantages

This option would not result in increased compliance costs for industry and retains the current tests which industry are familiar with.

Disadvantages

This option fails to recognise the time value of money or the problems with the current system. Additionally, it ignores the problem that the wealth thresholds have not been updated since they were introduced. This option would also be inconsistent with what other comparable jurisdictions are doing.

Questions for consideration:

- Is there any reason why the current tests should be retained in the face of problems experienced during the GFC?
- Are the monetary threshold limits still relevant?
- Should they be increased? If so, by how much?

8. FURTHER CONSIDERATIONS

8.1 In addition to the options canvassed above, a supplementary question for consideration is whether the definition of ‘professional investor’ in section 9 of the Corporations Act is still relevant. The professional investor definition has not been significantly amended since FSR. Professional investors are generally excluded from all retail client protections, given their resources and assumed high level of financial literacy.

Questions for consideration:

- Is the professional investor definition still valid?
- Do any classes of investor need to be added or removed from the list of professional investors?
- Should professional investors continue to be subject to the same protections and disclosures that they currently receive?

8.2 A final question for consideration is whether clarification is needed regarding the interpretation of s761G. There is currently some confusion regarding whether “in relation to a superannuation product” in s761G applies to financial services and product made available to the trustee of a superannuation fund (other than superannuation products).