



**Wholesale and Retail
Clients**

**BT Financial Group submission
04 March 2011**



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1. Executive Summary

BT Financial Group (BTFG) welcomes the opportunity to make a submission on the options paper for *Wholesale and Retail Clients (Options Paper)*.

BTFG supports the Future of Financial Advice (FOFA) Reform's policy intent to increase the quality of financial advice and improve the level of trust that consumers have in financial planners and the financial planning industry. However in implementing such reforms, we believe care must be taken to ensure that they do not place an unreasonable burden on financial planners which could result in increasing the cost of advice and reducing access for consumers.

Wholesale investors generally have a better understanding of financial markets and the risks of investing in those markets. As a result, a distinction has been drawn between retail and wholesale investors to reflect the fact that wholesale investors generally will not require the same level of protection as retail investors. Recent events such as the global financial crisis (**GFC**) have not changed this distinction and we support an on-going ability for investors to be classified as wholesale.

The Options Paper highlights the need to review and update the current definitions within the *Corporations Act 2001* (Cth) (**Corporations Act**) given concerns which arose during the GFC. In particular, concerns about whether investors are being inappropriately classified as wholesale customers and whether investors have been deemed to be wholesale investors without their knowledge or consent.

We believe it is difficult to determine the financial literacy of an investor and recommend retaining the use of objective tests. However given that being treated as a wholesale investor removes entitlements to a number of protections, we believe it is important that investors are made aware of the implications of being treated as a wholesale investor should they qualify.

Our recommendations

In summary we support Option 1, and recommend:

- The distinction between wholesale and retail investors is retained.
 - The wholesale test is made consistent across products and services, such that the treatment is consistent when investing directly or when using the services of a financial adviser.
 - The test for determining an investor's classification as a wholesale investor is one of the following :
 - (i) Product value is \$500K or more (per product); or
 - (ii) Accountant certificate is provided stating the person has either:
 - \$3.5m in net assets,* or
 - Taxable income of \$250K p.a. for last 2 financial years; or
 - (iii) The person qualifies as a "professional investor" as defined in Corporations Act Section 9.
- * Includes the net value of an individual's principal residence, and the value of any non-defined benefit superannuation savings.
- The wholesale test should be supplemented with an 'opt-in' requirement for the investor, with more detailed consultation on how this could be implemented.

Please refer to Appendix A for a table outlining our recommendations and how we envisage the 'opt-in' could work in practice.

We do not support Option 2 as we believe distinction between wholesale and retail clients remains relevant; nor do we support Option 3 as we believe the introduction of a subjective test for distinguishing between wholesale and retail investors will only add to any uncertainty that already exists.

We would welcome the opportunity to discuss our recommendations in more detail.

A handwritten signature in black ink, appearing to read 'M Spiers', with a stylized, cursive script.

Mark Spiers
General Manager - Advice
BT Financial Group

2. The distinction between wholesale and retail investors remains relevant

As outlined in the Options Paper, the distinction between wholesale and retail investors was inserted into the Corporations Act following recommendations from the Financial System Inquiry (Wallis Inquiry) released in March 1997.

The distinction appropriately sets out who would be considered to be a retail investor and the relevant levels of protection that should be made available to these investors. For example, where a licensee provides a financial service to a retail investor, the licensee must:

- provide a Financial Services Guide (FSG) to the investor before the financial service is provided
- provide a Statement of Advice (SOA) if advice is provided that is specific (or personal) to the investor's needs
- give a Product Disclosure Statement for products the investor is going to invest into, and
- ensure the investor has access to a dispute resolution system.

Similarly, the distinction also recognises that there are investors who may be considered to be more financially literate and have a greater understanding of the operation of financial markets. Such investors should not be precluded from accessing more complex investments and products which are generally not available to retail investors. In recognition of this, the level of protection afforded to these wholesale investors is not as great as that available for retail investors.

As commented on in the Options Paper, there were a number of examples during the course of the GFC where wholesale investors suffered a financial loss as a result of the investments they were placed in. It is important however to recognise that classification of an investor as wholesale or retail did not impact on the performance of those investments and that financial losses were suffered irrespective of the classification of the investor.

The examples do however raise the question of the appropriateness of the classification of an investor as a wholesale or retail investor and in our submission we provide our views on how investor certainty and protection can be provided whilst maintaining this distinction.

Recommendation: The Corporations Act should continue to provide a distinction between wholesale and retail investors.

3. The wholesale test should be consistent across products and services

Under the existing law a different wholesale test applies depending on the classification of a product as a security or other financial product, and depending on what service is being provided to a client.

Currently Chapter 6D of the Corporations Act regulates disclosure requirements in respect of “securities” and Chapter 7 regulates disclosure requirements in respect of other financial products.

Whilst similar in intent, we believe there are unnecessary inconsistencies between these different provisions:

- Chapter 6D uses the terms “sophisticated investor” and “professional investors”, whereas Chapter 7 uses the term “wholesale client”.
- Chapter 6D uses gross assets in respect of the \$10 million control test, whereas Chapter 7 refers to controlling “at least \$10 million”.
- Chapter 6D does not include the small business test nor the limitation on the accountant’s certificate test that it cannot be used in respect of a product/service provided in connection with a business.
- Chapter 6D does not include additional specific rules regarding products that are superannuation products or RSA products or services that relate to superannuation products or RSA products.

As a result, the test for when an investor receives a disclosure document may differ depending on whether the product is a security or other financial product.

Further anomalies are introduced where a financial service other than the issue or sale of a financial product is provided to an investor (e.g. financial product advice). Whether the service is provided to a wholesale or retail investor is determined under Chapter 7 of the Corporations Act. Given the different rules under Chapter 7, where a financial service is provided in relation to a security, it is possible that an investor is a sophisticated investor under Chapter 6D but not a wholesale client under Chapter 7.

In practice, this could lead to a situation where a financial planner is required to treat the investor as retail in respect of the advice (i.e. provide an FSG, SOA and comply with other retail investor requirements) but is not required to provide a disclosure document in respect of the security as that is regulated under Chapter 6D.

Recommendation: Amend the Corporations Act to ensure the wholesale test is consistent across securities, financial products and services.

(Please refer to Section 4 of this submission for details on what we believe the wholesale test should be).

In addition to the inconsistencies outlined above, there is also a great deal of uncertainty in relation to the wholesale test for financial services provided to superannuation funds.

The uncertainty arises from a lack of clarity regarding the meaning of the words “relates to a superannuation product or RSA product” in Section 761G(6)(b) of the Corporations Act. The issue is whether this provision means that any service provided to a superannuation fund is provided to the fund as a retail client unless the fund meets the \$10million gross assets test.

Recommendation:

The provision of a service to a superannuation fund should be subject to the same wholesale test that applies to other entities.

With the exception that if a financial product issued to a person is an APRA regulated superannuation product or an RSA product, the product is issued to the person as a retail client.

In addition, we also acknowledge that individuals are currently considered retail clients if they purchase motor vehicle insurance or personal or domestic property insurance. We believe this treatment should remain.

Recommendation:

Continue to treat individuals as retail clients for the purchase of motor vehicle insurance or personal or domestic property insurance.

4. The wholesale test should be based on existing methodology

Broadly speaking, the current methodology for determining an investor's classification as a wholesale investor is one of the following:

- (i) The product value is \$500K or more (per product); or
- (ii) Accountant certificate is provided stating the person has either:
 - (a) \$2.5m of net assets, or
 - (b) Gross income of \$250K p.a. for last 2 financial years; or
- (iii) The person qualifies as a "professional investor" as defined in Corporations Act Section 9.

We support using this methodology across all financial products and services, with some modifications and clarification.

Please refer to Appendix A for a summary table of how we believe the wholesale test should apply across different types of investors.

4.1 The product value test should remain in its current form

The product value test currently looks to the amount to be invested in a particular product. If the amount to be invested exceeds \$500,000 the investor can be classified as a wholesale investor.

The Options Paper questions whether this limit should be increased to \$1,000,000. We believe that any increase in amount for the product value test is purely arbitrary and is not a reflection on the financial literacy of the investor. That is, there is nothing to suggest that a person willing to invest \$1,000,000 into a particular product is more knowledgeable or more capable of accommodating any risks associated with the investment than a person willing to invest only \$500,000. Financial literacy and risk tolerance are concepts that can only be assessed on an individual by individual basis and should not be generalised.

We do not believe the test should be precluded given that the preclusion could result in a situation where a knowledgeable client who does not hold significant assets or income in their own name, is excluded from investing into a particular investment product that is only available to wholesale investors.

Recommendation: The product value test should remain in its existing form.

4.2 The net assets threshold should be raised to \$3.5m and include principal residence and super

The net assets test can currently be satisfied by an accountant certifying that an investor's net assets are equal to or exceed \$2,500,000.

Given that this threshold was put in place some time ago, we would support a one-off increase to \$3,500,000, which is in line with a CPI indexation of the original \$2,500,000 level. We do not support a continual indexation of the net assets threshold each year as it would give rise to unnecessary administrative complexity and cost.

We also believe that it is important to provide greater clarity and certainty as to what assets should be considered in this assessment and suggest the following amendments:

1. There should be no distinction made between liquid and illiquid assets – either type should count towards meeting this threshold requirement.

Many investors may have substantial property holdings, with property generally regarded as an illiquid asset. However, depending on the location and condition of the property and the prevailing property market, at times real property may be regarded by some investors as a liquid asset as it could be readily sold.

Similarly, during the course of the GFC, there were some managed funds that were unable to be traded or investments redeemed, and became regarded as “frozen funds”. Managed funds would normally be regarded as liquid assets, but at times may prove to be otherwise.

2. The net value of an investor’s principal place of residence should continue to be included.

The Options Paper questions whether a person’s principal place of residence should be excluded from the net assets test. If it was to be excluded you would also expect that the level of any debt remaining relating to the acquisition of that property should also be excluded; that is, it would be the net value of the residence that is excluded.

We do not support the exclusion of a person’s principal place of residence as we believe it could lead to a client making poor decisions about whether or not to pay off the debt on their home, particularly in a situation where they are not advised by a financial planner.

For example, assume Glenn has \$2,450,000 of assets, plus a principal residence valued at \$1,000,000 property with a \$500,000 mortgage. Currently, his net assets would be valued at \$2,950,000 and he would qualify as a wholesale investor under the accountant certificate test. If you excluded the \$500,000 net value of his property, his net assets would fall to \$2,450,000 and he would no longer qualify. If in the next year Glenn had \$50,000 of surplus income he may be incentivised to simply leave that amount in cash in order to have \$2,500,000 of net assets and qualify as a wholesale investor rather than making what may otherwise be a sound financial decision to reduce his non-deductible mortgage by \$50,000.

In order to ensure that the legislation does not inadvertently result in investors making choices purely for the purpose of qualifying under these rules, we recommend that the net value of the principal residence continue to be included in the net assets test.

3. The value of an investor’s superannuation (other than via a defined benefit arrangement) can be included in a net asset calculation.

Many investors appropriately use superannuation as the vehicle to accumulate their wealth and superannuation balances can become significant in value. Where this active choice is being made by an investor, they would view it as representing part of their overall net worth and it would therefore be appropriate to include it. Indeed, if the only contributions being made to their superannuation fund were compulsory superannuation guarantee contributions, it would make little difference to an investor’s overall net worth.

It is appropriate to exclude any defined benefit arrangements as an investor’s actual entitlement is not known until the occurrence of a specified event at a future point in time, such as retirement, and is based on a formula calculation performed at that time.

Recommendation: The net assets test should be raised to \$3,500,000 and provide clarity that:

1. The net value of an investor's principal residence is to be included in the calculation; and
2. The value of any non-defined benefit superannuation savings can be included in the calculation.

4.3 The gross income threshold should be defined as taxable income

Similar to the net assets test, the income test can be met by an accountant certifying that in each of the two preceding financial years, the investor's gross income was equal to or exceeded \$250,000 per annum.

This test remains appropriate as an initial objective measure to determine if an investor could be classified as a wholesale investor.

However, the Corporations Act does not define what is meant by "income" and accountants may apply differing interpretations to this term. For example, some may base this on salary and investment income only, whilst others may use assessable income (for tax purposes) and others may use a cash income concept.

To ensure consistency, the Corporations Act should be amended to provide clarity as to what the correct measure of income should be. We recommend that taxable income be used as the appropriate definition as:

- there is legislation in place, through the Income Tax Assessment Act 1997 (the Tax Act), to provide certainty as to how this amount is determined
- the Tax Act will provide a consistent methodology for determining an investor's ability to qualify, and
- it is readily identifiable due to the need for investors to prepare tax returns on an annual basis.

Recommendation: The income test should remain in its existing form, but clarity provided that income is defined as taxable income.

4.4 The threshold tests should equally apply to a SMSF

Practical difficulties arise when looking to apply a wholesale definition to a superannuation fund, particularly in relation to a self managed superannuation fund (**SMSF**). These difficulties arise when compared to trusts more generally as no single person could be viewed to control a SMSF¹. Our comments below are made specifically in relation to SMSFs, and not superannuation funds generally.

Under existing Corporations law, a company or trust can be classified as a wholesale investor if the controller (a natural person) of that company or trust can meet the wholesale definition.

For a SMSF (which is a special form of a trust) however, no one person could be said to control the SMSF as all trustees (or directors of the corporate trustee) are bound and liable for any actions undertaken in the name of the SMSF. That is, no trustees have control in their own right, yet all trustees have 100% responsibility.

¹ Control with one person can exist for a single member SMSF established with a corporate trustee as only a single director of the corporate trustee is required. This distinction is excluded for the purposes of this submission.

Further complications arise as SMSFs may be managed and operated on a segregated basis or a pooled basis. In a segregated fund situation, it is possible to identify the specific investments of the SMSF that make up a particular member's account balance and no individual assets are shared across members. Under a pooled arrangement (which commonly arises where some of the fund's assets are direct real property investments), all members have a share (proportional to their individual account balances) in each asset of the fund. In our experience, most SMSFs operate on a pooled (or un-segregated) basis, at least whilst members are in accumulation.

As SMSFs are closely managed due to their limitation to a maximum of 4 members, and the increased likelihood that a high net worth investor (who generally qualify as wholesale investors) may have a SMSF, it is important to allow a SMSF to be classified as a wholesale investor. However, it is important that there are clear objective criteria to determine if this classification can be achieved.

We recommend that the three threshold tests (subject to our recommendations for increased clarity) should equally apply to determine if a SMSF can be classified as a wholesale investor.

Under the income test, however, contributions and roll-overs received by the SMSF for its members should be excluded in determining the fund's gross income.

Recommendation: The threshold tests applying to a person should also be applied at a fund level in determining if a SMSF qualifies as a wholesale investor, with some slight adjustments and specific exclusions.

4.5 Specific exclusions

There are some situations which we believe should be specifically excluded from the wholesale test outlined above:

1. For an SMSF, given that all members must also be trustees:
 - Where each SMSF member qualifies as a wholesale investor in their own right, the SMSF should be deemed to be a wholesale investor.
 - Where an individual member qualifies as a wholesale investor in their own right, and the fund is operated on a segregated basis, the member should be afforded wholesale treatment for their segregated assets within the SMSF.
2. If a financial product issued to a person is an APRA regulated superannuation product or an RSA product, the product is issued to the person as a retail investor (as per current legislation).
3. If a financial product or service is provided for use in connection with a business that is not a small business, then the product or service is provided to the person or entity as a wholesale investor (as per current legislation).
4. If an individual purchases motor vehicle insurance or personal or domestic property insurance, the product is provided to the person as a retail investor (as per current legislation).

Recommendation: The Corporations Act should be amended to allow for specific exclusions to the general wholesale test.

5. The wholesale tests should be supplemented by an ‘opt-in’ requirement for the investor

The wholesale test provides initial objective criteria to determine when an investor could be regarded as a wholesale investor. However, to ensure that an investor is not dealt with on a wholesale basis without their informed knowledge and consent, we recommend that an investor be required to actively opt-in (by way of a **wholesale acknowledgment**) to the wholesale treatment before they can be advised or otherwise dealt with on this basis.

By choosing to opt-in as a wholesale investor, an investor will be acknowledging that they understand the differences in being treated as a wholesale investor compared to their rights as a retail investor and are therefore providing their informed consent to this treatment prior to any investment being made.

We envisage that a standard form or standardised information could be produced and adopted by the industry which sets out the differences between a wholesale and retail classification. In practice the opt-in could be obtained in writing or verbally and work as follows:

1. If the person qualifies as a wholesale investor they must sign an “opt-in”, or else be treated as a retail investor.
 - a. In relation to a financial product, the “opt-in” must be obtained at the time an interest in the financial product is first acquired. That is, via appropriate disclosure and consent in the application form.
 - b. In relation to a financial service, a prescribed “opt-in” form must be signed, and is valid for a period of 2 years*.
2. If the SMSF qualifies as a wholesale investor they must sign an “opt-in”, or else be treated as a retail investor. For an SMSF, given that all members must also be trustees (or directors of the trustee), all members must sign the “opt-in”.
 - a. In relation to a financial product, the “opt-in” must be obtained at the time an interest in the financial product is first acquired. That is, via appropriate disclosure in the offer document.
 - b. In relation to a financial service, a prescribed “opt-in” form must be signed, and is valid for a period of 2 years*.

* The period of 2 years was chosen as it aligns to the validity of the accountant’s certificate. We recommend this period be reviewed and aligned to any other “opt-in” arrangement that is implemented for financial advice under the Future of Financial Advice Reforms.

We would also like to note that the use of an opt-in requirement can be challenging for certain products, especially where an application form is not utilised in the process. For example, sales of securities such as bonds or entry into derivatives, both of which are usually executed verbally and without signed application forms.

If an opt-in requirement is adopted we strongly recommend further consultation across the industry on how it could apply, and whether it would be required for all products and in all circumstances

Recommendation: The threshold tests should be supplemented by a requirement for the investor to actively opt-in to treatment on a wholesale basis, and further discussion with the industry on how practically this could be achieved.

Please refer to Appendix A for a summary table of how we believe the “opt-in” requirement should apply across different types of investors.

6. AFSL holders and financial planners must retain the ability to opt-out of providing wholesale advice

Whilst it is important that clarity and certainty is provided to investors, it is important that this is not provided to the detriment of the financial services industry.

Australian Financial Services Licensee holders and their representatives must retain the ability to choose not to apply a wholesale approach for investors. This allows an AFSL or their representative to elect not to treat an investor, who may otherwise qualify and elect to opt-in as wholesale, as a wholesale investor if they have grounds to believe that this is inappropriate or not in the best interests of an investor.

For example, as part of their discussions with an investor, a financial planner may determine that the investor does not have a significant level of financial literacy and is better served by undertaking the full financial planning process (such as data collection and provision of a Statement of Advice), even though the client's income or net asset levels would allow them to qualify as a wholesale client.

Recommendation: Australian Financial Services Licensee holders and their representatives must retain the ability to choose not to apply a wholesale approach for investors.

7. Other issues

6.1 Indexation of the threshold test amounts

The Options Paper raises the issue about whether the threshold test amounts should be subject to some form of on-going indexation.

We do not support indexation of these thresholds as it will only add to greater levels of confusion and uncertainty. For example, what is the appropriate method of indexation to use? Should it be based on movements in the CPI, AWOTE or the share market on a year by year basis?

As an alternative, it would be preferable to establish a mechanism by which the thresholds are reviewed, for example every five years, and an assessment made at that time as to whether or not they should be adjusted and to what level.

We believe that any issues associated with indexation will be largely overcome by a requirement for an investor to opt-in for treatment on a wholesale basis (see Section 5 of this submission).

6.2 Application to investments via a company or trust

Under existing Corporations Act requirements, a company or trust may be treated as a wholesale investor if the controller of that company or trust can be classified as a wholesale investor in their own right.

We submit that this existing treatment should continue to apply, subject to the recommendations made in Section 4.4 of this submission in respect of superannuation funds, particularly self managed superannuation funds.

8. Appendix A – Summary of proposed wholesale test and opt-in requirements

	Person (as defined in s761A of the Corporations Act 2001)	Self Managed Superannuation Fund (SMSF)	APRA Regulated Super Fund
Wholesale Test Applies to a financial product or service (subject to some exclusions)	A person qualifies as a wholesale investor if they meet one of the following tests: (i) Product value is \$500K or more (per product); or (ii) Accountant certificate is provided stating the person has either: (a) \$3.5m in net assets,* or (b) Taxable income of \$250K p.a. for last 2 financial years; or (iii) The person qualifies as a "professional investor" as defined in Corporations Act Section 9.	A SMSF qualifies as a wholesale investor if it meets one of the following tests: (i) Product value is \$500K or more (per product); or (ii) Accountant certificate is provided stating the SMSF has either: (a) \$3.5m in net assets*, or (b) Taxable income of \$250K p.a. for last 2 financial years; or (iii) The SMSF qualifies as a "professional investor" as defined in Corporations Act Section 9.	APRA regulated funds already qualify as a "professional investor" as defined in Corporations Act Section 9.
Opt-in requirements	If the person qualifies as a wholesale investor they must sign an "opt-in", or else be treated as a retail investor. → In relation to a financial product, the "opt-in" must be obtained at the time an interest in the financial product is first acquired. → In relation to a financial service, a prescribed "opt-in" form must be signed, and is valid for a period of 2 years.	If the SMSF qualifies as a wholesale investor they must sign an "opt-in", or else be treated as a retail investor. For an SMSF, given that all members must also be trustees, all members must sign the "opt-in". → In relation to a financial product, the "opt-in" must be obtained at the time an interest in the financial product is first acquired. → In relation to a financial service, a prescribed "opt-in" form must be signed, and is valid for a period of 2 years.	No opt-in requirements.

* Includes the net value of an individual's principal residence, and the value of any non-defined benefit superannuation savings.

** We recommend this period be reviewed and aligned to any "opt-in" arrangement for financial advice which may be imposed by the Future of Financial Advice Reforms.

Specific exclusions:

- For an SMSF, given that all members must also be trustees:
 - Where each SMSF member qualifies as a wholesale investor in their own right, the SMSF should be deemed to be a wholesale investor.
 - Where an individual member qualifies as a wholesale investor in their own right, and the fund is operated on a segregated basis, the member should be afforded wholesale treatment for their segregated assets within the SMSF.
- If a financial product issued to a person is an APRA regulated superannuation product or an RSA product, the product is issued to the person as a retail investor (as per current legislation).
- If financial product or service is provided for use in connection with a business that is not a small business, then the product or service is provided to the person or entity as a wholesale investor (as per current legislation).
- If an individual purchases motor vehicle insurance or personal or domestic property insurance, the product is provided to the person as a retail investor (as per current legislation).

9. Appendix B – BT Financial Group contact details

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