07 March, 2011

Mr Geoff Miller
General Manager, Corporations and Financial Services Division
c/- The Future of Financial Advice
The Treasury
Langton Crescent
Canberra ACT 2600

By email: futureoffinancialadvice@treasury.gov.au

Dear Geoff,

Wholesale and Retail Clients Future of Financial Advice – Options Paper

The Financial Services Council (FSC) represents Australia's retail and wholesale funds management businesses, superannuation funds, life insurers and financial advisory networks. The Council has 128 members who are responsible for investing $1.7 trillion on behalf of more than 11 million Australians.

The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Stock Exchange and is the fourth largest pool of managed funds in the world. The Financial Services Council promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

The FSC thanks Treasury for the opportunity to comment on the proposed definition alternatives raised in the Options Paper.

The FSC supports the Government's objective to increase levels of trust and confidence in financial advice and the policy intent announced in The Future of Financial Advice (FoFA) reform package – to see more Australians access financial advice.

We acknowledge the Government's review of the definitions which distinguish a wholesale and retail investor is an important aspect of the FoFA package, given the definitions were set almost 10 years ago, and more importantly, because the reform package is aimed at increasing investor protection for retail investors.

As with other elements of the FoFA package, it is important that this measure strikes the right balance between protection for retail investors and enabling market participants to provide products and services efficiently and cost effectively.

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Importantly, we note that any proposed changes to the current framework that may result from this review of wholesale and retail definitions has potentially broad and deep implications not just for financial advice providers but across the entire financial services industry. Given the limited timeframe within which the industry was asked to respond to the range of issues outlined in the Options Paper, we have not been able to assess the full implications and potential unintended consequences of any proposed amendments to the existing wholesale/retail investor regulatory framework.

We also note that the scope of the paper does not extend to considering the present distinction between wholesale and retail clients with regard to insurance contracts and that this will be considered in greater detail as part of the review of risk insurance during the FOFA review. As Treasury will appreciate, general insurance and life insurance products are currently subject to separate and distinct definitions of retail and wholesale investors under the Corporations Act. We question therefore whether the statement about the insurance definition being considered under the review of risk insurance applies to both life and general insurance. For the purposes of completing this submission, we have assumed that it does and believe that this is appropriate.

Given these observations, the FSC seeks a commitment from Government to consult further with industry in order to determine the most appropriate definition, implementation processes and procedures to minimise distortions and unintended consequences. We also seek clarity from Government of the next steps in the consultation process.

Our submission aims to provide you with an overview of what we consider to be the key issues as well as a more detailed response to the questions posed in the Options Paper.

Should you have any questions, please feel free to contact me on 02 9299 3022.

Yours sincerely

Cecilia Storniolo
Senior Policy Manager, Advice and Investments

KEY ISSUES

Consultation with members has highlighted the following key issues:

1. General comments – what problem are we trying to address?
2. Preferred Option
3. Consumer protection of retail investors;
4. Wholesale and Retail investor and "relates" to superannuation and RSA products;
5. The Threshold tests should also apply to Self Managed Super Funds (SMSF)
6. Opt-In
7. Protection of public monies invested by Local Councils;
8. Consistency of definition between the ASIC Act and the Corporations Act; and
9. Transition considerations
10. Summary of Recommendations

1. GENERAL COMMENTS – WHAT PROBLEM ARE WE TRYING TO ADDRESS?

In reviewing and considering the options raised by Treasury for response, members of the FSC queried what impetus had given rise to the need for the review (and potential restructure of the entire system) which Treasury and/or the Government were aiming to address. The assessment contained within the Options Paper highlighted that the need for the review stemmed predominantly from the fact that wholesale investors (in particular councils), through lack of expertise or competency, made investments which resulted in losses as a consequence of the global financial crisis (GFC). We comment further on this matter in item 5 of the key issues. However, we assume that the rationale for the review is not simply to address investment decisions made by Councils but by the fact that the Government has concerns about investors being inappropriately classified and treated as wholesale and therefore falling outside the protection mechanisms. On this basis the FSC does not support Option 4 – Do nothing, as articulated in Treasury's Options Paper.

The Options paper also highlighted international examples for consideration which could be leveraged for a future Australian system based on a survey completed by the International Organisation of Securities Commissions (IOSCO) Standing Committee 3 (SC3). The FSC queries the appropriateness of this review at this time given IOSCO's SC3 is:

- still examining the issue of suitability standards for the sale of complex financial products applicable for both retail and non-retail investors; and
- has yet to report or develop general principles applicable to suitability requirements for distributors to retail investors.

The FSC is concerned that changes to the Australian regulatory system in advance of these global developments may result in further changes to the wholesale/retail definitions, creating further confusion and imposing unnecessary costs on the industry.

The FSC recommends that the Government wait for the recommendations and report from the IOSCO SC3 before making its final decision on definition changes.

2. PREFERRED OPTION

The FSC submission is premised on three over-riding principles:

i) The concept of retail investor whilst multi-limbed today is understood and is embedded throughout the entire financial services system;

ii) That the distinction between retail and wholesale investor remains relevant and should be retained; and

iii) A simpler objective test is preferable over subjective tests.

The concept of the retail investor permeates the Corporations Act and all aspects of financial services regulation. It affords those investors who need to be protected not only protection (for example dispute resolution mechanisms etc) but also ensures that financial services and product providers produce appropriate and comprehensive disclosure documentation to enable an investor to be better informed and therefore better able to make an informed investment decision.

The FSC believes that wholesale investors, including professional and sophisticated investors, generally have greater levels of understanding of financial markets and investment and should continue to be recognised and treated as non-retail investors.

The FSC also supports objective tests over a subjective test on the basis that there is greater clarity to the end consumer and that it supports compliance and administration processes that are less cumbersome and more cost effective.

Objective tests are simpler to administer and also provide investors and financial service/product provider with greater certainty. Certainty therefore provides financial services and product providers with a practical way to determine which clients are retail and require greater levels of disclosure and protection, but also allows the market to determine which service model to operate within – enabling greater competition and ultimately greater efficiencies.

On this basis we submit that Option 3 within the Options Paper which introduces a subjective "sophisticated investor" test as the sole test to determine a wholesale investor is untenable. The subjective test whilst today useful to enable a small subset of investors to be treated as wholesale is not a practical test for broader implementation. Further, a subjective test lends itself to interpretation complexities, greater compliance cost implications across the industry and

affords investors the opportunity to shop around for the interpretation that provides them with the result they want.

The fact that the notion of a retail investor does permeate so many aspects of legislation and regulation means that even small changes in the definition/tests has ramifications for both investors and market participants. As such, any substantive change in definitions like those recommended in Option 2, which we reject, would result in significant compliance/restructuring costs to financial services and product providers without corresponding benefits. We submit a regulatory impact assessment would need to be undertaken which considers the significant costs of compliance viz a viz the potentially minor protection extension this measure could afford.

The FSC supports:

- The retention of a distinction between wholesale and retail investors.

- Objective tests over subjective tests; and

- Supports Option 1 – Retain and update the current system.

3. CONSUMER PROTECTION OF RETAIL INVESTORS

FSC members are cognisant of the fact that the existing product threshold limit has not been reviewed or altered for a number of years whilst the value of investors' assets (like superannuation balances) may have increased in this corresponding period. "Wealth" generally has also increased during this time – thereby placing some retail investors within the high net worth retail category and probably pushing these investors within the definition of a wholesale client. On this basis we are generally supportive of Option 1 in the Options Paper which retains the current system with proposed updates.

We also appreciate the protection afforded retail investors and the Government's aim to ensure that true retail investors continue to benefit from greater investor protection and disclosure regarding the products and services they are investing in and the protection mechanisms in the Law.

Our response aims to strike the balance between capturing more investors within the definition of a retail investor, thereby ensuring their protection, and minimising the impacts of increased cost of compliance that ultimately impact the affordable and efficient delivery of financial services and products in the market.

The Corporations Act permits investors meeting **one** of the following circumstances to be treated non-retail (i.e. wholesale) today:

- The product value test is $500,000 or more per product; or
- Individual wealth test via an accountant certificate that states the individual has either:
    - Met the net asset test – of $2.5M or
    - An individual income test – of $250,000 pa over the previous 2 years; or
- Body or individual meets a professional investor test; or
- The individual qualifies as a "sophisticated' investor.

We recommend the methodology generally remain intact but that the dollar limits could be amended as follows:

Retail Investor product threshold limit

The FSC supports an increase of the product value test as follows:
- From an advice perspective – an increase to $1M on an aggregated level.
- From a product manufacturers' perspective – an increase to $1M on a per product basis.

From an ***advice perspective*** we support the increase of the price/value limit from $500,000 to $1 million ($1M). We submit that the threshold for the price/value of financial products is an objective test that is simpler to implement and administer. Further, we only support the increase to $1M on the basis that the price/value limit retains an aggregation of financial products view as currently permitted by regulations (R7.1.17B of the *Corporations Regulations 2001*).

To demonstrate how aggregation is applied, if the aggregate value of investment-based products within a portfolio is greater than $1M after superannuation sourced monies, borrowed amounts and any accrued fees relating to the products assessed under the aggregation rules are deducted, a Licensee can classify the client as wholesale with respect to the financial service being provided. Take for example the service of financial advice. The outcome of advice may be a recommendation for a client to invest in a retail product especially where the amount to be invested into a single product is less than $1M, acknowledging that the product will form part of a total portfolio which may significantly exceed $1M in value.

The definition of investment-based product under the Corporations Act 2001 is quite broad and extends to cover:

a. Deposits;
b. Stocks;

c. Managed Investment Schemes; and
d. Debentures/Bonds.

Investment-based products do not include assets held in the superannuation environment.

Therefore, to ensure that retail investors do not arbitrage between an advised or non-advised transaction, we submit that the product price/value limit also increase from $500,000 to $1M from the ***product manufacturers' perspective,*** (like a wholesale fund manager), on a per product basis. We propose that **the only** test an investor need meet to be treated as a wholesale investor is the minimum threshold limit, one of their other test and potentially a minimum disclosure statement be included on the application form of the Investment Management Agreement documentation.

Wealth test (accountant certificate) Corps Act section 761G(7)(c)

We believe the test contained within 761G(7) (c) should be retained. However, recognising the concerns Government has with regards to retail investor protection, we support a one off increase to the test as follows:

Asset limb of the test

Increase the net asset limb of the test from $2.5M to $3M – this amount should include the investor's non-defined benefits superannuation balance and their principle residence.

Income limb of the test

We submit that the personal income limb of this test should remain at $250,000 on that basis that AWOTE has only increased from approximately $47,000 pa to approximately $67,000 in the period this test has been in place. Further, according to Taxation Statistics 2007-08 (published in March 2010 for the tax year 2007/2008) only 2.7% of resident individual tax payers in Australia had a taxable income greater than $150,000. Given that wages have seen marginal growth generally across Australia during and off the back of the GFC we do not see any rationale nor support an increase to this limit.

The FSC supports a one off increase in the net asset limb of the test in s761G(7)(c) from $2.5M to $3M. The FSC supports the inclusion of an individual's non-defined benefit superannuation balance and their principle residence in this test.

Whilst we support this current test remaining unchanged, we seek greater clarity for certainty be provided regarding the term "gross income". The Corporations Act does not currently 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.

The FSC recommends that the income test should remain in its existing form, but clarity provided that gross income is defined as taxable income.

Other tests

The FSC does not support any changes to the professional investor test nor the 'sophisticated investor' test. There is marginal use of the 'sophisticated investor' test today but it does afford the few who can leverage it today the opportunity to do so.

The test has been in place for a few years now, tested by the GFC and there is no evidence of inappropriate use of this test.

Consideration could be given to the inclusion of a 'sophisticated business' test. Where a representatives of a business can satisfy the criteria to conduct transactions, trades or investments on behalf of the business as a wholesale investor, relief should apply and the business should be treated as a wholesale investor.

The FSC recommends that the 'sophisticated' investor test be retained.

Indexing

The FSC does not support the introduction of a statutory indexing mechanism to update the dollar thresholds. Rather we prefer the dollar thresholds be reviewed periodically and amended via regulation as required.

Indexing will impose a considerable cost on the industry and arguably is not a relevant measure of changes in wealth. We submit that a review of the dollar limits periodically be regulation is preferable to the indexing method.

The FSC does not support the introduction of a statutory indexing mechanism to update the dollar thresholds.

4. WHOLESALE AND RETAIL INVESTOR DEFINITION AND 'RELATES TO' A SUPERANNUATION OR RSA PRODUCT

It was clear that when the wholesale and retail investor tests were developed and incorporated into the Financial Services Reform Bill (FSR Bill) that the legislature wished to draw distinction between the treatment of persons acquiring superannuation products or RSA products, or financial services relating to those products and persons who were being provided with another financial product or financial services in relation to other products.

When the FSR Bill was enacted, separate wholesale client and retail client tests were created for:

- General insurance products
- Superannuation products and RSA products; and
- Other kinds of financial products

Section 761G(6) as currently drafted is clear that if a financial product which is provided is a superannuation product or an RSA product (but not an interest in a pooled superannuation trust), the product is provided to the person as a retail investor1. Where it fails is in its efforts to identify the circumstances in which an investor is taken to be a retail investor by reference to when a service is provided which 'relates to' a superannuation product or RSA product.

Section 761G(6)(b) specifies that, unless a person is covered by (c)(i) or (ii) of section 761G(6), then a financial service which 'relates to' a superannuation product or an RSA product is taken to be provided to the person as a retail investor. Accordingly, and unlike the approach taken in section 761G (7), the price of the product or the value of the product is irrelevant to determining whether an investor is wholesale or retail.

However, under Section 761G(6)(c), if a financial service (other than the provision of a financial product) is provided to a person who is:

(i) the trustee of a superannuation fund, an approved deposit fund, a pooled superannuation trust or a public sector superannuation scheme (within the meaning of the Superannuation Industry (Supervision) Act 1993 that has net assets of at least $10 million; or

(ii) an RSA provider (within the meaning of the Retirement Savings Accounts Act 1997;

and relates to a superannuation product or an RSA product, that does not constitute the provision of a financial service to the person as a retail client.

[1] Section 761G(6)(a) and (aa)

It is not clear what the phrase 'relates to a superannuation product or an RSA product' is meant to encompass.

ASIC has taken a broad view of the meaning of the phrase 'relates to'. In its Frequently Asked Question QFS 150 'When financial services are provided to a trustee of a superannuation fund, are they provided to a retail client?' ASIC appears to take the view that any service which is acquired by the trustee for the benefit of the operation and investment of the fund would be taken to relate to a financial product and the trustee ought to be approached as a retail client, unless the net assets of the fund exceed the $10 million threshold referred to above.

However, while this is ASIC's view of the meaning of the phrase 'relates to', it is not necessarily a view which is shared by the industry. If it were the case that the phrase 'relates to' a superannuation product, then the legislature could have proceeded without the use of the words 'relates to' and instead simply specified that any financial service provided to a superannuation trustee acting in that capacity was to be treated as a financial service provider to a retail client.

Further, the phrase used in the legislation refers to a 'superannuation products' whereas the services discussed in QFS 150 generally relate to the operation of the overall fund rather than to a fund interest (or product).

Further, an anomaly is created by the different approaches taken to the definition of wholesale and retail investor in respect of:

- the provision of financial products to a superannuation trustee and
- the provision of financial services to a superannuation trustee.

A superannuation trustee being provided with a financial product may be treated as a wholesale client under section 761G(7) (where the product is not a superannuation product or an RSA product) because the superannuation trustee is assessed as a wholesale client under section 761G(7).

However, if a broad approach is taken to the meaning of the phrase 'relates to' a superannuation product or an RSA product, then that same trustee may be treated as a retail client in relation to any financial services provided in respect of that financial product (such as general financial product advice provided in an information memorandum).

This anomaly can be difficult for entities which provide financial products and also general financial product advice in relation to those financial products to superannuation trustee clients, as they can be required to treat them simultaneously as wholesale clients and retail clients.

The above analysis is a technical assessment of the difficulties arising from the current approach to superannuation products. We question whether there is a significant benefit in continuing a situation where different tests are applicable to superannuation trustees and investors in superannuation products in certain, but not all, circumstances.

The FSC recommends that the provisions be redrafted so that there is only one test, such as that in section 761G(7), but that in relation to a limited range of situations, some of those tests be inapplicable, for example, the product value, small business and individual wealth tests should not apply to:

- ***the provision of a superannuation product or an RSA product to a person; or***
- ***the provision of financial product advice on a superannuation product or an RSA product to a person.***

5. THE THRESHOLD TESTS SHOULD ALSO APPLY TO SELF MANAGED SUPER FUNDS (SMSF)

Difficulties arise when looking to apply a wholesale definition in relation to a self managed super fund (SMSF). These difficulties arise when compared to trusts more generally, as no single person could be viewed to control a SMSF[2]. Comments made 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.

However, for a SMSF (which is a special form of a trust), 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.

As SMSFs are closely managed due to their limitation to a maximum of 4 members, and there is increased likelihood that a high net worth investor (who generally qualifies 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.

[2] 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.

Alternatively an additional possibility is to accept a broad definition of "control" (which is currently in the legislation - s50AA) and if the fund is controlled by a person who qualifies as a wholesale investor then the fund ought to be able to invest as one.

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

The FSC recommends that 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.

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).

The FSC recommends that the Corporations Act should be amended to allow for specific exclusions to the general wholesale test.

6. OPT-IN

The wholesale test provides initial objective criteria to determine when an investor can 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 an **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 investor. In practice the opt-in could be obtained in writing or verbally and could 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

The FSC recommends that 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.

7. PROTECTION OF PUBLIC MONIES INVESTED BY LOCAL COUNCILS

In Part 4 of the Options Paper, Treasury has given the example of the losses resulting from local councils investing in collateralised debt obligations (CDOs). The suggestion is that if local councils had been classified as retail investors, the protections available to retail investors may have prevented these losses.

We do not believe that broadening the definition of retail investors to include local councils is an appropriate response to this issue for the following reasons:

- it is unlikely that the losses would have been avoided even if the councils had been classified as retail investors.
- the protections available to retail investors would not have provided any material assistance either in preventing those losses or in taking action to recover them.
- the underlying causes of the failure of the CDO market worldwide were wholly unrelated to the definition of retail and wholesale investors in Australia.
- adequate remedies are currently available to wholesale investors to address any misleading or deceptive disclosures of the nature and the risks of CDOs under the Corporations Act, Trade Practices Act and other legislation.
- the broadening of the definition of retail investors to include local councils would have significant unintended consequences, including the potential to include a much wider range of genuinely institutional investors as retail investors and thereby excluding them from the wholesale market; and excluding local councils from products and services available only in the wholesale market which, given their size and the resources available to them, should be available to local councils for the benefit of their ratepayers.

While local councils suffered losses in the CDO market, it should also be borne in mind that many large and sophisticated financial institutions around the world made substantial losses on CDOs. The major causes of these losses were a discrepancy between the risk inherent in the product and the credit rating assigned by international credit rating agencies (which, as the Options Paper notes, were generally rated AA or better) combined with extreme market conditions. These structural issues in the international financial system would not have been addressed by classifying these councils as a retail investor, whereby it would have obtained a statement of advice from an adviser qualified. It is hard to see how a retail financial adviser would have prevented these risks and difficult to conceive how providing a retail statement of advice, a financial services guide and a PDS instead of a prospectus, would have prevented the losses resulting from CDOs.

Similarly, resolving the complex issues and claims around defaulting CDOs would not have been appropriate for a retail dispute resolution system, such as the Financial Ombudsman Service (FOS). FOS is most appropriately used to resolve smaller, relatively simple disputes between retail investors and product providers. There are existing remedies available to local councils and other CDO investors under the Corporations Act, Trade Practices Act and other legislation (and their international equivalents), and given the complexities of the products and the claims against the international investment banks selling them, they are most appropriately dealt with in the courts rather than a retail dispute resolution forum designed to process large numbers of small claims quickly.

Local councils control large budgets, have chief financial officers and staff responsible for investments, and generally have detailed investment policies. It would be contrary to the interests of local councils and their ratepayers to exclude them from the wholesale market for financial products. It would also have a distorting effect on the wholesale market as a whole to exclude large institutions which might also be caught by a broader definition.

In NSW, the Local Government Investment Order of 12 January 2011 requires local councils to invest in a limited range of products, in accordance with a defined investment policy. It is submitted that the appropriate way to limit the risk of local council investments is through monitoring and restricting as appropriate the investment powers and investment policies of local councils through state Government administrative orders such as the NSW Order referred to above. Given the resources available to local councils, they should also be encouraged through State Government guidance to obtain expert advice where appropriate, and as wholesale investors they have access to a broad range of advisers, including investment and financial consultants which are not available to retail investors.

The FSC does not support any changes to the definition of wholesale/retail investors to include councils as retail investors.

8. CONSISTENCY OF DEFINTION BETWEEN THE ASIC ACT AND THE CORPORATIONS ACT

The Options Paper notes that another term used to distinguish retail clients is the term 'consumer' in the ASIC Act. While that term is very differently defined, the Paper states that no change is contemplated to the use of that term in the ASIC Act 'given the wide ranging implications of the term, which go well beyond the treatment of investors'.

However, FSC believes that it would be appropriate to make the definitions and terminology consistent between the ASIC Act and the Corporations Act, at least in relation to financial products regulated under the Corporations Act. The purpose of the consumer protection provisions of the ASIC Act and the retail client protections in the Corporations Act is broadly the same - to protect purchasers of retail financial services and products. Alignment of the definitions would lead to more consistent outcomes for industry and consumers alike.

FSC recommends that either the term 'consumer' should be replaced in the ASIC Act with the term 'retail client' as defined in the Corporations Act or that the definition of 'consumer' in the ASIC Act should be amended to refer to the definition of 'retail client' in the Corporations Act for the financial products regulated under Chapter 7 of the Corporations Act.

9. TRANSITION CONSIDERATIONS

The FSC submits that transitional issues also be considered given the complexity of the issues raised in the Option Paper and the limited time market participants have had to consider alternative solutions and potential impacts.

We reiterate that further consultation is critical prior to draft legislation being issued on the possible 'opt-in' measure in relation to the $1M product level test. This requirement will be challenging for certain products, especially where an application form is not utilised in the process (e.g. share or derivative purchases).

We also note that most FSC member Licensees automatically treat all their clients as retail. We would like to ensure that any opt-in measure potentially adopted in the future does not compel all Licensees to do so. That is, Licensees who wish to treat all their clients as retail investors should not be prohibited from doing so by the law. This is particularly relevant from a 'scalable' advice perspective as it affords Licensees efficiency and flexibility and all of their clients the full protection of the law.

The FSC recommends that arrangements (investments) already in place at the time any legislative changes come into effect are grandfathered so that investors are not inappropriately divested from their holdings as a consequence of definition changes.

That is, that an investor treated as a wholesale investor up to the date prior to the legislative coming into affect should remain a wholesale investor.

Further, we submit that were a wholesale investor is deemed 'non-retail' because of an accountant certification, that they remain classified as a wholesale client beyond the effective application date of any changes to the legislation/regulation until the date their certification expires.

The FSC recommends that:

- ***Any changes in thresholds apply to new provision of financial services and issue of new interests in financial product only; AND***
- ***Investors deemed non-retail pursuant to the accountant certification test, retain non-retail status post the effective change in legislation/regulation until the expiry of the certificate they held at the date the change came into affect.***

10. Summary of the Key Recommendations

General

1. The FSC recommends that the Government wait for the recommendations and report from the IOSCO SC3 before making its final decision on definition changes.

2. The FSC supports:

   – The retention of a distinction between wholesale and retail investors.

   – Objective tests over subjective tests; and

   – Supports Option 1 – Retain and update the current system.

Threshold tests

3. The FSC supports an increase of the product value test as follows
   – From an advice perspective – an increase to $1M on an aggregated level.
   – From a product manufacturers' perspective – an increase to $1M on a per product basis.
4. The FSC supports a one off increase in the net asset limb of the test in s761G(7)(c) from $2.5M to $3M. The FSC supports the inclusion of an individual's non-defined benefits superannuation balance and their principle residence in this test.

5. The FSC recommends that the income test should remain in its existing form, but clarity provided that gross income is defined as taxable income.

6. The FSC recommends that the 'sophisticated' investor test be retained.

Indexing

7. The FSC does not support the introduction of a statutory indexing mechanism to update the dollar thresholds.

"Relates to"

8. The FSC recommends that the provisions be redrafted so that there is only one test, such as that in section 761G(7), but that in relation to a limited range of situations, some of those tests be inapplicable, for example, the product value, small business and individual wealth tests should not apply to:
   – the provision of a superannuation product or an RSA product to a person; or

   – the provision of financial product advice on a superannuation product or an RSA product to a person.

SMSFs

9. The FSC recommends that 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.

10. The FSC recommends that the Corporations Act should be amended to allow for specific exclusions to the general wholesale test.

Opt-In

11. The FSC recommends that 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.

Councils are not retail investors

12. The FSC does not support any changes to the definition of wholesale/retail investors to include councils as retail investors.

Consistency of definitions

13. FSC recommends that either the term 'consumer' should be replaced in the ASIC Act with the term 'retail client' as defined in the Corporations Act or that the definition of 'consumer' in the ASIC Act should be amended to refer to the definition of 'retail client' in the Corporations Act for the financial products regulated under Chapter 7 of the Corporations Act.

Transition

14. The FSC recommends that any changes in thresholds apply to new provision of financial services and issue of new interests in financial product only.

15. The FSC recommends that investors deemed non-retail pursuant to the accountant certification test, retain non-retail status post the effective change in legislation/regulation until the expiry of the certificate they held at the date the change came into affect.

Detailed Responses to the questions posed in the Options Paper

Option 1 – Retain and update the current system

Introduce an indexing mechanism

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?**

The FSC does not support indexing of the 3 tests. Annual or regular indexing would add to the complexity and reduce certainty for all participants.

We would submit that a review of the dollar limits periodically by regulation is preferable to the indexing method.

Exclude Illiquid Assets

Are there any reasons why a primary residence should/should not be included in the net assets test?

Our recommendation supports the inclusion of the primary residence in the net asset test. The inclusion of the primary residence (on the asset side) and corresponding debt (on the liability) side is more likely to ensure that the investor make more appropriate investment decisions including paying off their mortgage in place of a decision to enable them to qualify as a wholesale investor.

For example, David has $2,450,000 of assets, plus a principle residence valued at $1,000,000 (which has a $500,000 mortgage). David's net assets would be valued at $2,950,000 classifying him as a wholesale investor. If you exclude the net $500,000 equity David has in his primary residence from the accountant test, David would fall below the test threshold at $2,450.000. In the following year, if David had $50,000 or greater investible assets, David may be incentivized to hold the monies as cash to push him over the limit rather than pay the monies off his mortgage.

That is, the test is a holistic assets test that minimises the opportunity for investors on the margin being reclassified as wholesale investors.

Are there any specific reasons why superannuation should/should not be included in the net assets test?

The FSC supports the inclusion of investor's superannuation monies being included in the net assets test. This is particularly relevant for but not limited to SMSFs – which the Cooper report highlights should be able to make appropriate investment choices regarding the investment of their super monies.

Amend the Deeming Process

Would an explicit opt-in make investors sufficiently aware of what protections they are afforded?

The FSC submits that an explicit opt-in to wholesale should be sufficient – given it will be in conjunction with meeting other thresholds first.

From an ***advice perspective***, an *intermediation* process in writing or verbally, where a financial service provider can explain what protections an investor would give up and what benefits they may gain from opting into wholesale should make the investor sufficiently aware.

From a ***product issuer perspective***, an explicit opt-in is prohibitively inefficient– specifically, the wholesale product issuer perspective.

As highlighted in the Key Issues section, further consultation on what forms are applicable to what part of the process and for which products is critical because the benefits of the protection need to be weighed against inefficient and costly processes/practices to affect this measure.

Would an explicit opt-in be prohibitively inefficient for industry? What would be a more appropriate test for investor opt-in?

We note that implementation of such a requirement would be more manageable in situations where there is an advisory or other intermediary relationship. An explicit opt-in is prohibitively inefficient from the produce issuer perspective – specifically, the wholesale product issuer perspective.

The FSC suggests that an education campaign or FIDO guide on wholesale investing run by ASIC would be beneficial to accompany these measures. In particular, the educational material could help investors understand the impacts of being classifies as a wholesale investor.

Would the true policy objective and message be easy to avoid via standard forms?

In principle, the FSC believes the policy objective could potentially be met via standard forms – in the provision of financial services like advice. However, opting in is not appropriate in the same manner for wholesale product issuers, since they would not be able to re-structure products for those investors who did not wish to opt in to the wholesale structure.

As indicated previously in the Key Issues section, further consultation on what forms are applicable to what part of the process and for which products is critical because amongst other things – not all products are issued by signing a form (e.g. buying a share).

Should investors be able to elect to be treated as a retail client even when they meet the wholesale wealth threshold tests?

Yes. The FSC supports an investor's right to determine how they wish to be classified and what protections they wish to retain.

As noted above, investors cannot elect to be treated as retail investors in relation to a wholesale product, without the product issuer being effectively obliged to re-structure the product and create retail offer documents.

A consequence of this means that retail investors wishing to be treated as retail will forgo investing into wholesale products (which offer cheaper pricing and which may only be offered in the wholesale market).

Two out of Three Requirements

- **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?**

Complexity already exist in the tests – for example, where financial services are provided in relation to a security it is possible that an individual is a 'sophisticated investor' under Chapter 6D but not a wholesale client under Chapter 7.

For product issuers, administering multiple tests will increase costs and may lead fund managers to exclude a large proportion of the wholesale market from access to their products, due to the difficulty of making the products available. That is, any increase in financial literacy testing resulting from satisfying more than 1 requirement is likely to be negligible, but the additional costs and administrative burden will be significant.

The ideal is to provide clarity and certainty not only for consumers but for market participant. A two out of three test simply adds to the cost and confusion to an already complex part of the law without capturing greater numbers of investors within the retail definition.

Introduce extra requirements for certain complex products

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

The FSC does not support this proposal. Primary to our rejection of this proposal is that there is no definition of a 'complex' product for example some Australians would deem superannuation 'complex'. The notion is subjective and complexity may bear no relationship to the nature of the risk assumed.

The FSC submits that the Government can achieve its aims of ensuring greater numbers of Australian investors are protected, by updating the existing system. Indeed, the FSC's support of the increase in the product threshold test to $1M is not just a recalibration of CPI indexing (which would bring the number closer to $650,000) but sets the test for the future protection of investors.

Repeal the 'Sophisticated Investor' Test

- **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?**

The FSC does not support any changes to the 'sophisticated investor' tests. There is marginal use of the 'sophisticated investor' test today but it does afford the few who can leverage it today the opportunity to do so. The test has been in place for a few years now, tested by the GFC and there is no evidence inappropriate use of this test.

The FSC recommends that the 'sophisticated' investor test be retained unchanged.

Option 2 – Remove the distinction between wholesale and retail clients

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**?

The FSC does not support Option 2.

The FSC supports the retention of a definition distinction between wholesale and retail investors.

Wholesale investors generally have a better understanding of financial markets and the risks of investing in those markets and as such should be able to continue to benefit from the cost benefits wholesale investing affords them.

From a product issuer perspective, a wholesale/retail distinction is critical. There are a large number of products designed for the wholesale and, in particular, the institutional market, for which retail structures and documentation are not appropriate. It would be a travesty to impact innovation and cost efficiency structures by placing investors who do not need the protection within the realms of protection.

Further, the definition and notion of a retail investor permeate so many aspects of current legislation and regulation which means that even small changes in the definition/tests has ramifications for both investors and market participants.

As such any substantive change in definitions like that recommended by Option 2, which we reject, would result in significant compliance/restructuring costs to financial services and product providers without corresponding benefits.

If this Option is pursued, we submit that a regulatory impact assessment would need to be undertaken which considers the significant costs of compliance viz a viz the potentially minor protection extension this measure could afford.

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

- **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?**

The FSC does not support this Option. However, we submit there is still a place for the use of this test, albeit in narrow circumstances, which affords investors and the market flexibility.

The use of a subjective test only, to classify individuals as wholesale is not tenable from a compliance cost and practical implementation perspective and the resultant liability placed on financial services and product providers would potentially result in all investors deemed retail (ie defaulting to Option 2).

Whilst potentially possible from an advice perspective, this approach is not a balance solution for product issuers. A true indication of financial literacy would involve a detailed assessment of the state of each investor's knowledge. In practice this would be extremely burdensome and costly, and may be impossible for product issuers, who often have no direct relationship with the underlying investor. It would also create difficulties in dealing with corporations and other entities. As a true assessment of financial literacy cannot in practice be undertaken by product issuers, appropriate objective criteria provide the best alternative.

Option 4 – Do Nothing

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?**

Yes there is rationale for supporting a status quo. The current tests are well understood and relatively easily administered. The problems experienced during the GFC relate more to disclosure issues about the structure and risks of some products and the assessment by investors of those risks, rather than the retail/wholesale distinction.

Given the increase in asset values in particular since the implementation of the monetary thresholds in 2002, there is merit from a protection perspective to update the tests.

FURTHER CONSIDERATIONS

Is the professional investor definition still valid?

Yes.

Should professional investors continue to be subject to the same protections and disclosures that they currently receive?

Yes. We support the retention of the current system and disclosure requirements.

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).

See Key Issues section 4 page 8 of the paper.

The FSC recommends that the provisions be redrafted so that there is only one test, such as that in section 761G(7), but that in relation to a limited range of situations, some of those tests be inapplicable, for example, the product value, small business and individual wealth tests should not apply to:

- the provision of a superannuation product or an RSA product to a person; or
- the provision of financial product advice on a superannuation product or an RSA product to a person.