

ISN SUBMISSION ON RETAIL AND WHOLESALE CLIENTS OPTIONS PAPER

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About Industry Super Network

Industry Super Network (ISN) is an umbrella organisation for the industry super movement. ISN manages collective projects on behalf of a number of industry super funds with the objective of maximising the retirement savings of five million industry super members. Please direct questions and comments to:

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| SUMMARY

Introduction

ISN supports the reconsideration of definitions of retail and wholesale investors in the *Corporations Act 2001* and appreciates the opportunity to make a brief submission on this issue.

The definition of retail investor serves a critical purpose in the Corporations Act, triggering key consumer protections in the delivery of financial services. ISN submits that the underlying principle of the policy setting should be to cast the definition of retail investor broadly to ensure that any investor who might potentially be vulnerable is captured by the definition. While not specifically raised in the Options Paper, ISN strongly supports the continued inclusion of all financial products/services relating to superannuation and insurance within the definition of retail client irrespective of the product value being invested.

We submit that the current system for differentiating between retail and wholesale investors should continue to be used with some modifications to the actual test to expand the definition of retail investor. There is no question that it is better to err on the side of caution given the dire consequences which can follow from inexperienced investors being treated as wholesale clients. ISN therefore submits that the financial thresholds should be increased as well as requiring that individuals meet at least two of the tests before meeting the test of wholesale client.

Following are more detailed responses to the questions posed in Treasury's Options Paper *Wholesale and Retail Clients – Future of Financial Advice* (January 2011).

Option 1 – Retain and update the current system

ISN supports retaining the current system with modifications to the definition of retail client to update the financial thresholds to ensure that they reflect current levels of wealth and require investors to meet two of the three tests to be defined a wholesale client.

1.1 Update the product thresholds

- *Is an arbitrary but objective test preferable to a subjective test which more accurately reflects the individual circumstances of the client?*

While financial thresholds are somewhat crude and arbitrary measures of financial capability, they are still clearer and more efficient than applying a subjective measure as the primary basis for financial services providers to determine whether to treat an individual as a retail investor in need of higher levels of consumer protection. While subjective tests *may* be more accurate they either rely on an individual self identifying themselves as 'wholesale' or on the licensee taking responsibility for certifying that an individual should be treated as 'wholesale'.

ISN strongly supports the maintenance of objective tests as the primary mechanism for differentiating between retail and wholesale clients.

- *Should all three 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?*

ISN submits that all three thresholds should be updated. We believe that \$1,000,000 is an appropriate limit for the product value test. We believe the personal wealth tests should also be updated. It seems that it

would also be logical to base the threshold for derivative products on the option fee or margin which reflects more accurately the value of that investment.

1.2 Introduce an indexing mechanism

- *How could a simple and relevant indexing mechanism be introduced? 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 three limits be indexed?*

It is logical to introduce some indexing mechanism for the thresholds but it will also lead to increasing the complexity of the definition. ISN submits that the key threshold requiring more regular updating is the product value threshold. ISN submits that a growth rate per annum should be applied, which is rounded to the nearest \$50,000, applied every 5 years.

1.3 Exclude illiquid assets

- *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?*

ISN believes that the primary residence and superannuation should be excluded from the net assets test. The net assets test is meant to act as a proxy for financial literacy/investment experience, whereas an accumulation in these illiquid assets often is more reflective of increase in capital value. Excluding superannuation would also make it consistent with the treatment of super in the product value test.

- *Would excluding some assets cause too much difficulty or confusion for industry? Would this work prohibitively to exclude clients who should be classified as wholesale?*

ISN does not believe that excluding the primary residence or superannuation would cause difficulty or confusion for industry. As noted above, ISN believes that the policy setting should aim to broadly define retail client to ensure that all individuals in need of consumer protection are captured.¹

1.4 Amend deeming process

ISN supports the amendment of the deeming process to ensure that all clients must specifically acknowledge instances where they will be classified as a wholesale client to increase the likelihood that all wholesale clients understand that they will not receive the benefit of consumer protections extended to retail clients. However, if clients do not 'opt-in' they should continue to be treated as retail clients.

1.5 Two out of three requirements

ISN supports that an individual should meet 2 of the 3 threshold tests before being classified as a wholesale client. In keeping with our overarching policy, the definition of retail investor should be broad to ensure that all persons in need of consumer protection are afforded it. The sophisticated investor mechanism should be retained to provide a safe mechanism for persons who wish to access wholesale markets but who fall within the definition of retail investor.

¹ ISN also supports maintaining the 'sophisticated investor' mechanism which would allow individuals to access wholesale markets where a licensee certifies that they are sophisticated.

1.6 Introduce extra requirements for certain complex products

There are products which are inherently so complex that they should be excluded from retail clients. ISN does not believe that this would lead to unnecessary complexity in the definition.

1.7 Repeal the 'sophisticated investor' test

ISN does not favour repealing the sophisticated investor test. Even if this test is little used, if the definition of retail investor is updated and broadened, it make sense to leave open some mechanism for investors with higher levels of financial literacy to gain access to wholesale markets. ISN believes that it is important for the licensee to bear responsibility for certifying that clients are sufficiently experienced and literate to be able to be treated as wholesale clients, in order to ensure this mechanism is not exploited. While this test involves a subjective measure based on the investor's financial sophistication, this should not prove to be inefficient or problematic as it is not the primary or default mechanism for classifying investors. While Treasury has noted that intermediaries have taken a cautious approach resulting in very few investors being classified as wholesale clients, this is not necessarily undesirable.

Option 2 – Remove the distinction between wholesale and retail clients

ISN does not support Option 2.

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

ISN does not support Option 3.

Option 4 – Do Nothing

ISN does not support Option 4.

Further Considerations

ISN is not aware of any issues relating to the interpretation of s761G and whether it is inadvertently capturing the provision of services/products to the trustee of a super fund. We are however happy to consult with industry super funds if more specifics can be made available.

