

Future of Financial Advice

Department of Treasury

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Wholesale and Retail Clients – Future of Financial Advice – Options Paper

Introduction

This submission is made in response to the Government's options paper "*Wholesale and Retail Clients – Future of Financial Advice – Options Paper – January 2011*" ("**Options Paper**") by Morgan Stanley Smith Barney Australia Pty Limited ("**MSSB**"). MSSB provides a range of investment, advisory, financial planning and stockbroking services to individuals, superannuation funds and trusts, companies and other entities.

The Options Paper outlines four broad options for reforming the regulatory framework dealing with the classification of investors as wholesale or retail clients for the purposes of the *Corporations Act 2001 (Cwth)* ("**Corporations Act**"):

- retain the existing regulatory framework, which primarily relies on objective tests of product value/price, wealth and income, to determine whether investors are wholesale or retail clients, but update this framework by imposing stricter tests for determining wholesale status (option 1);
- remove the distinction between retail and wholesale clients, with all investors other than 'professional investors' (defined in section 9 of the Corporations Act) being classified as retail clients for the purposes of the Corporations Act (option 2);
- introduce a 'sophisticated investor' test as the sole way of distinguishing between retail and wholesale clients (option 3); or
- take no action and retain the existing regulatory framework as it is (option 4).

Concerns with increasing the existing objective thresholds used to determine wholesale status

MSSB's submission is that increasing the existing objective thresholds used for determining wholesale status (i.e. product value/price, wealth and income) or otherwise imposing stricter objective tests (e.g. by requiring investors to satisfy two out of the three objective tests) is unwarranted. Our view is that increasing the existing objective thresholds (or tightening them) in order to protect financially illiterate or inexperienced investors is misconceived. Such measures appear to seek to ensure that financially illiterate or inexperienced investors are protected from harm by excluding a further (and potentially sizeable) segment of investors from participating in wholesale markets (e.g. wholesale product offerings and capital raisings). Excluding a further segment of investors from participating in wholesale markets has its own costs, such as reducing the investment options available to such investors and impacting on financial businesses that operate in the wholesale products space (such as MSSB). Based on MSSB's significant experience in raising capital for companies via wholesale/sophisticated capital raisings, this reduction in market participants would act to further constrain access to capital for small to medium companies, who use such raisings as a meaningful source of capital. In the post-GFC environment, the ability for smaller to medium companies to access debt funding sources has been and remains constrained. Any further constraints on available capital sources have the potential to adversely impact the small to medium enterprise (SME) sector and, through this, broader national economic activity. The same costs would apply to Option 2, except they would be more extreme. Option 2 would effectively exclude all investors apart from institutional investors from participating in wholesale markets and wholesale offerings. It is also arguable that increasing the existing objective thresholds could have a negative and unintended effect by arming astute investors, who would have been previously classified as wholesale clients, with the means to litigate against financial service providers.

The costs involved with excluding a further segment of investors from wholesale markets may be justified if a substantial proportion of these investors do not in fact possess the experience or financial literacy to participate in wholesale markets. However, in our view, there is a real risk that this would not be the case. Our concern is that simply increasing the existing monetary limits may not achieve the Government's aim of identifying those additional investors (who are currently classified as wholesale clients) that require additional protection and disclosure. MSSB agrees that, as a general rule and starting point, investors with low financial means (e.g. income below the national average) are more likely to possess poor or modest levels of financial literacy and investment experience. However, once a person's income exceeds \$250,000 or their assets exceed \$2.5 million or they have the means to invest \$500,000 in a class of financial products (i.e. the

person's income or wealth satisfies the existing objective thresholds and comfortably exceeds relevant national averages), there is no evidence to suggest that further increases in the existing objective tests will continue to correlate with financial literacy and experience. For example, the Options Paper cites the experience of Parkes Council, whom the Options Paper suggests did not have the financial literacy and experience to invest in collateralised debt obligations ("CDOs"). The Options Paper hypothesises that, if Parkes Council had been classified as a retail client and been entitled to the protections afforded to retail clients (especially the disclosure obligations applying to retail offerings) these protections may have allowed the council to properly evaluate the CDOs being offered to it and decide that the risk of investing in the CDOs was too great to countenance. We agree that Parkes Council (and particularly, its finance manager) did not appear to have the financial literacy or experience to invest in CDOs. However, the Options Paper suggests that Parkes Council was a 'professional investor' when it invested in the CDOs, because it appears from the Options Paper that the council had or controlled more than \$10 million in gross assets at that time (e.g. it was able to invest \$13 million in CDOs). Parkes Council is a good example of how financial literacy and income and/or wealth may not be well correlated, especially once a person (or organisation in this case) reaches a minimum level of income and/or wealth. In the case of Parkes Council, even if Option 2 had been adopted at the time (which we submit is an extreme option that would completely eliminate wholesale client markets), this still would not have led to Parkes Council being classified as a retail client and qualifying for additional protections and disclosure obligations under the Corporations Act. Adopting Option 1 (by increasing or tightening the existing objective thresholds) would have done nothing further to protect Parkes Council from incurring financial losses.

In light of the above we strongly recommend maintaining the existing regulatory framework with no change. An increase of existing financial tests does not equate to financial literacy. The options suggested for changes to the existing framework are more likely to result in investors who meet current monetary thresholds and who possess high financial literacy from being excluded from wholesale markets which is sub optimal for the investors and more widely has an adverse impact on fundraising activity.

Please feel free to contact me on (03) 8643 9448 if you would like to discuss any aspect of this submission.

Yours sincerely

A handwritten signature in black ink, consisting of a series of loops and a long horizontal stroke extending to the right.

Harry Parkinson

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