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

By email: [futureofadvice@treasury.gov.au](mailto:futureofadvice@treasury.gov.au)

Dear Sir or Madam,

## **Wholesale and Retail Clients - Future of Financial Advice**

### **1. Introduction**

Standard & Poor's (Australia) Pty Ltd, Standard & Poor's Information Services (Australia) Pty Ltd and Standard & Poor's Securities Evaluations, Inc. (collectively referred to as "**Standard & Poor's**") are pleased to make the following submission in relation to the Department of Treasury's ("**Treasury**") Options Paper 'Wholesale and Retail Clients – Future of Financial Advice'.

### **2. Background Information about Standard & Poor's**

It is helpful to begin with a brief description of Standard & Poor's and our role in financial markets.

Standard & Poor's Ratings Services ("**S&P Ratings Services**"), operating in Australia through Standard & Poor's (Australia) Pty Limited, is a leading international credit rating agency, which has been assigning credit ratings since 1916. With its head office in New York, S&P Ratings Services has a global network of over 5,000 employees in 20 countries. S&P Ratings Services assigns credit ratings to entities in over 100 countries and has been providing credit ratings in the Australian market for over 30 years. S&P Ratings Services has held Australian financial services ("**AFS**") license number 337565 since 1 January 2010 which authorises it to provide 'general advice'<sup>1</sup> to wholesale clients only by issuing a credit rating'.

Standard & Poor's Funds Services ("**S&P Funds Services**") operating in Australia through Standard & Poor's Information Services (Australia) Pty Ltd, maintains a broad coverage of managed fund research in the local market and employs one of the largest fund rating teams in the Australian market. S&P Fund Services fund ratings are forward-looking qualitative assessments of a manager's ability to consistently generate superior risk-adjusted fund returns, net of fees, relative to relevant investment objectives and peers. Our approach is 100% qualitative and involves in-depth interview-based research. S&P Fund Services has operated under an AFS License (number 258896) since 3 March 2004. S&P Fund Services

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<sup>1</sup> S&P Ratings Services believes consistent with global standards that a credit rating is not financial product advice and nothing in this document should be construed as an admission or concession that a credit rating is advice.

is authorised to provide financial product advice to wholesale and retail clients for several classes of financial products.

Standard & Poor's Securities Evaluations, Inc. ("**S&P Securities Evaluations**") provides independent and transparent valuations of complex illiquid assets and fixed income securities to assist clients with risk mitigation, alpha generation and cost control. S&P Securities Evaluations relies on Australian Securities & Investments Commission ("**ASIC**") class order 03/1100 which conditionally exempts foreign companies regulated by the U.S. Securities and Exchange Commission from the need to hold an AFS license on the condition that it only provides financial services to wholesale clients in Australia in a manner that, if the financial services were provided to clients in their home jurisdiction in like circumstances, would comply as far as is possible with their home regulatory requirements, subject to the conditions described in the class order.

A review of the appropriateness of the distinction between wholesale and retail clients resulting in a variation to the definitions of retail and wholesale clients could impact Standard & Poor's due to the various licensing arrangements we have in place. We have detailed our views below on the various options proposed.

### **3. Executive Summary**

Standard & Poor's agrees with Treasury that there are several important factors in reviewing the tests to distinguish wholesale clients from retail clients. Standard & Poor's considers it essential that any test provides adequate protection and disclosure to those clients who require it and that the test takes into account the financial literacy of the client. However, it is important that any changes allow those with the sufficient knowledge, experience and skills to freely participate in wholesale financial markets without adding compliance burdens on financial service providers servicing such clients. We also believe that the distinction between retail and wholesale clients should be clear, objective, and straight forward while providing sufficient certainty and efficiencies for the financial services industry. We are particularly concerned that the introduction of a subjective test as the sole criteria for determining whether a client is retail or wholesale could result in very few clients being classified as wholesale. This could require businesses with 'wholesale only' licenses, such as S&P Ratings Services, to make an assessment of an individual's personal circumstances only to then inform them that they cannot be provided any financial services. This will be time consuming, inefficient and frustrating for those prevented from accessing S&P Ratings Services' products and services. S&P Ratings Services is also concerned that introducing a subjective test as the only mechanism for identifying the client status could result in a reduction in transparency of credit ratings, an outcome that is contrary to the goals of the International Organization of Securities Commissions' ("**IOSCO**") Code of Conduct Fundamentals for Credit Rating Agencies ("**CRAs**"), as revised in May 2008 (the "**IOSCO Code**").<sup>2</sup> For these reasons we encourage the Treasury to ensure that appropriate, easy to administer objective tests are included as a mechanism for determining the status of a client. It is also important for an international company such as Standard & Poor's that any changes to definitions are internationally consistent. We have provided detailed comments below.

### **4. Detailed comments**

#### **4.1 Option 1 – Retain and update the current system**

Standard & Poor's is supportive of retaining the current system and believes this is the most suitable option from those proposed. We do acknowledge that some time has passed since the current

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<sup>2</sup> Clause 3.4 of the IOSCO Code provides that 'except for "private ratings" provided only to the issuer, the CRA should disclose to the public, on a non-selective basis and free of charge, any rating regarding publicly issued securities, or public issuers themselves, as well as any subsequent decisions to discontinue such a rating, if the rating action is based in whole or in part on material non-public information.'

mechanisms were implemented and it may be prudent to update the current regime to better reflect an appropriate distinction between retail and wholesale clients. Standard & Poor's believes that increasing the current product and personal wealth thresholds is the most effective and efficient way to update the current regime.

We consider that an objective test provides the simplest framework for financial service providers. A subjective test is likely to require considerable resources to implement and make an assessment of the clients' status on a case by case basis. This will substantially increase the cost of providing financial services, a cost that will ultimately be borne by clients. For a business such as Standard & Poor's, who either does not provide financial services to retail clients (in the case of S&P Ratings Services and S&P Securities Evaluations) in Australia or does not generally provide financial services directly to retail clients and provides financial services as a secondary service provider<sup>3</sup> (in the case of S&P Fund Services) it would be very difficult to administer a subjective test to determine the individual circumstances of the client. We are concerned that the introduction of a subjective test could require a business such as Standard & Poor's to make an assessment of an individual's personal circumstances only to then inform them that we cannot provide them any financial services. We do not consider it possible or appropriate for an organisation such as S&P Ratings Services to make such an assessment. S&P Ratings Services does not have a direct relationship with all the many investors who access our freely available credit ratings on our website. S&P Ratings Services' credit ratings have an important, but limited role, *i.e.*, they are opinions about creditworthiness, primarily expressed as the relative likelihood of a security defaulting. They do not speak to market value, volatility or liquidity, or suitability as an investment. They are but one tool among many that investors can consider in their decision-making process. They are not a substitute for independent investment analysis and advice. We believe the better approach, and the approach consistent with global recognition of credit ratings as opinions, is to retain and update the existing regime which allows a financial services provider to readily identify whether a client is retail or wholesale.

For the sake of completeness, we have provided comments for each of the proposed mechanisms for updating the current system that are relevant to the financial services provided by Standard & Poor's:

- Update the product thresholds: Standard & Poor's believes that updating the three thresholds (that is, the product value test and the two tests based on personal wealth<sup>4</sup>) is the most suitable method for updating the current regime. We agree with Treasury's assessment that this 'retains the objective and easy to use framework of the current test. It also recognises that there is some positive correlation between wealth and financial literacy'<sup>5</sup>. Standard & Poor's also believes that retaining and updating these tests will have the least negative impact on the financial services industry whilst ensuring that the values are a reflection of individual wealth by today's standards.
- Introduce an indexing mechanism: Standard & Poor's has no strong views on whether an indexing mechanism is an appropriate tool for ensuring the existing wealth and product value threshold tests continue to remain relevant. If the Government believes an indexing mechanism is appropriate, we would encourage the mechanism to be designed in a simple and easy to administer manner. For example, the dates on which the thresholds may change should be clear and there should be a reasonable period between each review date (eg., 5 years).

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<sup>3</sup> Corporations Regulations 2001, reg 7.7.02(7)

<sup>4</sup> Section 761G(7)(c) Corporations Act

<sup>5</sup> 'Wholesale and Retail Clients – Future of Financial Advice', Options Paper, January 2011, Department of Treasury, page 16

- Exclude illiquid assets: Standard & Poor's is concerned that excluding illiquid assets from the net asset test would add a layer of complexity that is unnecessary. We question the logic of excluding illiquid assets and consider the better approach would be to review the net asset threshold test to better reflect an appropriate value that corresponds with a higher likelihood of financial literacy and, therefore, suitable treatment as a wholesale client.
- Amend the deeming process: Standard & Poor's is concerned that a deeming process such as the one proposed is unworkable. For businesses such as S&P Ratings Services and S&P Securities Evaluations to require a client to specifically acknowledge instances when they will be classified as a wholesale client and ensure they understand they will not receive the benefits afforded to retail clients, is impractical. The reality is that if the client did not acknowledge they are a wholesale client, then they will receive no financial services from S&P Ratings Services and S&P Securities Evaluations. S&P Ratings Services is not licensed to provide financial services to retail clients, and S&P Securities Evaluations exemption from licensing is conditional on it only providing services to wholesale clients. We would further note that an opt-in process would be extremely inefficient and costly to implement. We would discourage the implementation of an opt-in deeming process and believe the policy objectives of this proposal could be better achieved by alternatives such as risk warnings, disclosure or updating the tests for wholesale clients so that the values are a reflection of individual wealth by today's standards.
- Two out of three requirements: Standard & Poor's considers that to require two out of three threshold tests to be met to classify a client as wholesale would introduce unnecessary complexity and uncertainty into the process. We believe that updating the tests for wholesale clients so that the values are a reflection of individual wealth by today's standards is the better approach.

#### **4.2 Option 2 – Remove the distinction between wholesale and retail clients**

Standard & Poor's does not support this proposal. Removing the distinction between wholesale and retail clients will result in increased costs and burdens on the financial services industry. For example, an AFS licensee who only provides financial services to wholesale clients is likely to have increased costs incurred as a result of providing additional protections to all clients that are currently only available to retail clients (for example, the cost of producing and distributing disclosure documents, meeting stricter training requirements, maintaining a dispute resolution system including membership of an external dispute resolution scheme and maintaining arrangements for compensating clients). In our view, the cost of providing these additional protections to all clients substantially outweighs the benefit of removing the distinction between wholesale and retail clients. We believe the better solution is to refine the current system by amending the product and individual wealth thresholds to ensure that the definition of retail client is appropriate having regard to what groups of persons are most in need of the protections currently available to retail clients.

S&P Ratings Services is also extremely concerned about the impact of this proposal where the substance of credit rating opinions – forward-looking statements made at one point in time about the likelihood that a particular obligor will pay back principal and interest in the future – could be subjected to review by an External Dispute Resolution (“EDR”) scheme such as the Financial Ombudsman Service. Removing the current distinction between wholesale and retail clients could require S&P Ratings Services to join an EDR scheme. We are concerned that subjecting credit ratings to an EDR scheme could interfere with the analytical independence of CRAs. The analytical independence of rating analysts and their opinions must be preserved, and the “second guessing” of ratings opinions could chill the exercise of independent judgment and be detrimental to the markets. An EDR scheme that allowed for second-guessing of forward-looking opinions made in good faith could expose many of them to groundless challenges based on hindsight and speculation. The need for credit ratings to be free from

substantive review by regulators is explicitly recognised by legislation in the United States<sup>6</sup> and Europe<sup>7</sup>. Any EDR scheme directive to change the substance of a rating could result in the extraordinary creation of dual credit ratings - an Australian “EDR” credit rating and a “rest of the world” credit rating, which would create investor confusion and harm to the markets. We would further note that there is a need for international consistency in regulatory oversight. Ratings are issued and used globally. There is no international precedent for having credit ratings subject to review by an EDR scheme. As mentioned above, the US and EU regimes expressly prohibit regulating the substance of a credit rating or the methodology by which ratings are determined. Finally, an EDR scheme could require the provision of information that is commercially confidential, highly sensitive and proprietary to third parties. For these reasons, we do not support the proposal to remove the distinction between retail and wholesale clients. If the Government were to proceed with such a proposal we request that, consistent with other regulatory regimes for CRAs that recognise the need to preserve the analytical independence of CRAs and their ratings, there is an explicit recognition in legislation that CRAs are exempt from the requirement to join an EDR scheme.

S&P Ratings Services understands that the Australian retail market benefits from objective benchmarks such as credit ratings. We want to support this market while at the same time preserving the analytical independence of our analysts and credit ratings. We urge the Treasury to take this opportunity to remove altogether the current requirement for CRAs to join an EDR scheme in order to hold a retail financial services license. Since the licensing requirements became effective in January 2010 and S&P Ratings Services applied for a wholesale-only license due to concerns, which we believe other global CRAs share, about ratings being subject to second-guessing under an EDR scheme, we believe the Australian market has been disadvantaged and market participants have been frustrated by the inability to make credit ratings issued by global CRAs available to retail investors. For the reasons discussed above, we believe the EDR scheme requirement is not appropriate for CRAs and that the Australian market would be best served if all investors once again could have access to the ratings of global CRAs, as is the case in other jurisdictions.

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

Standard & Poor’s does not support this proposal. Introducing a ‘sophisticated investor’ test as the sole way to distinguish between wholesale and retail clients will create an unacceptable administrative burden and cost on the financial services industry. A requirement for financial services providers to assess each client to determine whether they have previous experience in using financial services and investing in financial products, and for licensees to provide written reasons of that assessment and obtain the client’s acknowledgement before the services are provided<sup>8</sup>, creates a complicated regime that could lead to financial service providers taking a conservative approach and assessing very few clients as wholesale. We do not agree with Treasury that this is the most accurate distinction between wholesale and retail clients. Concerns about potential liability for some licensees and the increased costs associated with licensees assessing the financial literacy of each client could lead to few clients being assessed as wholesale. Consequently, those clients who do have sufficient financial literacy to access wholesale financial markets could be excluded. Similarly to removing the distinction entirely between wholesale and retail clients, as mentioned above, this will lead to added costs on the industry - costs that will ultimately be borne by the client.

As mentioned above, requiring a subjective test as the only mechanism to determine whether a client is wholesale or retail could require a business such as Standard & Poor’s to make an assessment of an

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<sup>6</sup> Section 15E(c)(2) of the United States Securities Exchange Act of 1934

<sup>7</sup> Article 23(1) of the Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies

<sup>8</sup> Section 761GA, Corporations Act 2001 – Meaning of retail client – sophisticated investor

individual's personal circumstances only to then inform them that we cannot provide them any financial services. As noted above, we do not consider it possible or appropriate for an organisation with no direct relationship with all the investors that access our ratings to make such an assessment. The introduction of a 'sophisticated investor' test as the sole way to distinguish between wholesale and retail clients is inappropriate in the context of businesses providing financial services to wholesale clients or those providing services to retail clients as a secondary service provider. As highlighted above, we believe the better approach is to retain and update the existing regime which allows a financial services provider to readily identify whether a client is retail or wholesale.

S&P Ratings Services is also concerned that if fewer clients are treated as wholesale due to potential concerns regarding increased liability and costs, there could be a reduction in the transparency of credit ratings. This could lead to unintended market consequences that negatively impact the transparency and efficiency of capital markets in Australia due to a potential reduction in the number of wholesale clients who can freely access credit ratings. As highlighted above, we believe that this is not consistent with the goals of the IOSCO Code.

It is also important to highlight that requiring a CRA to obtain a license for providing financial product advice through a rating is not consistent<sup>9</sup> with the global standards for regulation of CRAs.<sup>10</sup> As mentioned above, S&P Ratings Services' credit ratings have an important, but limited role, *i.e.*, they are solely statements of opinion and not statements of fact or recommendations to purchase, hold, or sell any securities or make any other investment decisions. In the interests of working with ASIC in a constructive manner, S&P Ratings Services applied for and was granted an Australian financial services (wholesale-only) license. Despite this, S&P Ratings Services continues to believe that, consistent with global standards and approaches to regulation, a credit rating is not financial product advice. For these reasons we are concerned that the introduction of a subjective test to determine the status of a client could put the regulatory regime for CRAs in Australia further out of step with the global standard for regulation of CRAs. Requiring S&P Ratings Services to assess each client to determine whether they have previous experience in using financial services and investing in financial products before granting them access to credit ratings is not consistent with the important, but limited, role of CRAs and credit ratings. As ratings are issued and used globally, globally consistent regulation is of fundamental importance to our business and to the smooth functioning of the global capital markets. For these reasons, we strongly urge the Government to resist introducing a subjective test as the sole mechanism to determine whether a client is wholesale or retail.

#### **4.4 Option 4 – Do nothing**

As mentioned above, Standard & Poor's acknowledges that some time has past since the current mechanisms were passed and it may be prudent to review the current system. Consequently, following review of the proposed options, our preferred position is to retain and update the current system by reviewing the current product and personal wealth thresholds.

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<sup>9</sup> Page 4 of the May 2008 IOSCO Report "The Role of Credit Rating Agencies in Structured Finance Markets": "While some observers and market participants believe that a CRA rating represents a judgment on the worthiness of an investment..., the opinions of CRAs relate solely to the likelihood that a given debt security will perform according to its terms. As described in previous IOSCO reports, a high credit rating does not necessarily indicate that a security is a good investment, nor does a low credit rating necessarily make the security a poor investment." Also noteworthy here is IOSCO's reference to what the CRA produces as an "opinion", not "advice".

<sup>10</sup> For example, when the US adopted credit rating agency regulation it did not do so through amendment of its investment advisory law (the Investment Advisers Act of 1940), but through the principal federal statute governing securities markets (the Securities Exchange Act of 1934), implicitly recognizing that the nature of a credit rating agency's activities are fundamentally different from those of an investment adviser.

Standard & Poor's appreciates the opportunity to comment on the Treasury Options Paper. Please feel free to contact me or Jodie Henson, Senior Regulatory Counsel, on (03) 9631 2234 or by email at [jodie\\_henson@standardandpoors.com](mailto:jodie_henson@standardandpoors.com) if you require any further information.

Yours sincerely,



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