AUSTRALIAN BANKERS' ASSOCIATION INC.

Steven Münchenberg
Chief Executive Officer

Level 3, 56 Pitt Street
Sydney NSW 2000
Telephone: (02) 8298 0401
Facsimile: (02) 8298 0402

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Mr Geoff Miller
General Manager, Corporations and Financial Services Division
The Treasury
Langton Crescent
PARKES ACT 2600
futureofadvice@treasury.gov.au

Dear Mr Miller,

Future of Financial Advice (FOFA) reforms – Wholesale and Retail Clients

The Australian Bankers' Association (ABA) welcomes the opportunity to provide comments on the *Wholesale and Retail Clients Future of Financial Advice* options paper.

1. Introductory remarks

The ABA notes as part of the Future of Financial Advice (FOFA) reforms, the Federal Government announced that it would consider whether the distinction between wholesale clients and retail clients contained in the law is appropriate, especially in the context of the global financial crisis (GFC). We are pleased the Government is examining the application of the retail/wholesale client distinction tests contained in the *Corporations Act 2001*. We consider this is an opportunity to address concerns of industry and investors with how the financial services laws capture different types of clients, and therefore apply certain legal obligations and protections.

The ABA believes that the FSR regime should facilitate market efficiency and integrity, product innovation, market confidence and informed investors. Therefore, it is important for Government and industry to continue to work together to reduce unnecessary regulatory burden and compliance costs without compromising the consumer protection intent of the law. We consider that any changes to the retail/wholesale client distinction tests should not undermine the ability for market participants to offer financial products and services efficiently and cost effectively and should strike a balance between protections for consumers and legal certainty and administrative simplicity for banks and other financial services providers.

The ABA notes that the explanatory memorandum to the FSR Bill recognised that wholesale clients do not require the same level of protection as retail clients. We consider that the law should continue to provide retail clients with additional legal protections (such as provision of disclosure documents, access to dispute resolution mechanisms, access to compensation arrangements, and provision of advice from qualified advisers) and also allow sophisticated clients, sophisticated businesses, professional investors and wholesale clients to participate in the markets without facing unnecessary market barriers or incurring unnecessary transactions costs.

The ABA believes that certain problems identified during the GFC with regards to the participation of some retail investors raises a number of issues for Governments and regulatory authorities; banks, financial services providers and market participants; and investors around the world, including the quality of financial advice, quality of disclosure documents, practices of certain product issuers and financial intermediaries, behaviour of some investors, behaviour of some regulatory and supervisory authorities, and the level of financial understanding of certain investors. We consider that many of the mis-selling practices evident in some overseas markets have not been experienced in Australia. However, we recognise that it is important for the regulatory framework in Australia to take account of domestic and international experiences with regards to the legal and regulatory structures surrounding our financial and capital markets. It is also important for any changes to the retail/wholesale client distinction tests to be considered along with other FOFA reforms (such as 'best interests' duty) and existing legal obligations.

The ABA believes that the current "retail/wholesale client distinction tests" provide a practical and certain way of distinguishing classes of investors and applying differing levels of protections accordingly. In doing so, retail investors have been afforded additional protections and generally wholesale clients have been able to efficiently participate in wholesale markets (with the exception of some instances where small businesses are captured unnecessarily within the regulatory framework as retail clients). It is important for the law to continue to provide appropriate levels of protection for retail investors. It is also important for the law to enable transaction efficiencies for experienced and professional investors, and thereby not result inadvertently in a reduction of offerings, limitation on financial product advice or increased product costs for these investors.

Therefore, we consider that the current retail/wholesale client distinction tests and definitions should generally be retained. Even though we do not consider that there has been a systemic failure of the legal and regulatory settings in Australia warranting changes being made to the current system – product value test, individual wealth test, business test, professional investor test and sophisticated investor test – we broadly support Option 1. We also support changes to better accommodate the informed and efficient participation of all investors – individuals and businesses.

The ABA notes that any changes are likely to have implications not just for banks and other financial services providers, but all market participants and investors. Given the limited timeframe provided for industry to respond to the issues and proposals outlined in the options paper, we have not been able to assess fully the potential impact or the likelihood of unintended consequences with any change made to the existing framework.

2. Specific comments

Currently the Corporations Act permits investors meeting one of the following circumstances to be treated as a wholesale client (i.e. non-retail):

- Product value test – $500,000 or more per product; or
- Individual wealth test – via certification by an accountant that an individual has either:
    - Net assets of at least $2.5 million; or
    - Annual income of $250,000 over the previous 2 years; or
- Professional investor test – definition includes AFSL holders, bodies regulated by APRA outside of superannuation, trustees of public superannuation funds and persons controlling at least $10 million.

Furthermore, an individual can qualify as a "sophisticated investor". A business can be deemed wholesale where it is not a "small business".

2.1 Option 1 – Retain and update the current system

2.1.1 Update the product threshold limit

The ABA in principle supports increasing the product threshold from its current level. We recognise that even though the threshold is necessarily arbitrary, the threshold provides an objective test. Furthermore, the threshold has not been adjusted for some years and the existing threshold is generally not consistent with thresholds in other jurisdictions. However, we consider that increasing the threshold could have adverse and unintended consequences by encouraging less investment diversification and concentration of risk – that is, a higher threshold could encourage investors to enter into a higher level of investment in a single product or asset class.

Therefore, we do not believe that $1,000,000 is necessarily an appropriate new level for all products. Some banks suggest that $1,000,000 might be appropriate if applied to certain products and if aggregated, e.g. managed investments at the fund or platform level and not the individual investment or product level. Some banks suggest that $650,000 would be a more accurate reflection if the original threshold were indexed. Some banks suggest that the existing threshold remains valid and the current threshold is important for market efficiency as it is structured into the operation of areas of the wholesale markets, e.g. corporate bond issuances.

Therefore, we suggest that further consultation should be conducted via an industry roundtable to identify a practical way of capturing a product threshold test and clarifies the application of the thresholds to certain financial products, such as managed funds, superannuation, managed discretionary accounts, wrap accounts, etc.

The ABA believes that the income threshold ($250,000 annual income) and the net assets threshold ($2.5 million total assets) remain valid. Given that the average earnings for a full-time Australian worker is $67,700 and given that only 1.5% of taxpayers have a reported income above the highest marginal tax threshold of $180,000, the $250,000 threshold means that it applies only to high income earners. However, we suggest that further clarification is required to ensure consistency across industry; for example, "income" is not defined in the Corporations Act and accountants may apply different interpretations.

The ABA does not support any changes to Regulation 7.1.22. Amending the threshold to the amount paid (i.e. option) rather than the amount (or size) of the transaction would create uncertainty and increase compliance costs through complex calculations of the investment into the derivative.

2.1.2 Introduce an indexing mechanism

The ABA does not support implementing an indexing mechanism for the dollar thresholds contained within the retail/wholesale client distinction tests. Indexing would introduce significant complexity for AFSL holders and their clients. Identifying an appropriate value for indexing will be difficult. Applying indexing to all tests will not be straightforward and will create significant administrative complexity. Many banks and financial services providers maintain a register of sophisticated clients (and professional and wholesale clients) and different thresholds and constant indexing would create substantial compliance risks. It is also unclear how new thresholds and indexing would impact on clients that qualified as wholesale via certification by an accountant. Ultimately, indexing would create significant confusion for staff and impracticalities for investors.

Therefore, we suggest that to ensure the product and wealth thresholds remain appropriate into the future, a periodic review, say every 5 years, should be conducted by the Government with reference to CPI during this period.

2.1.3 Exclude illiquid assets

While in principle the ABA is sympathetic to excluding illiquid assets from the wealth threshold, in practice this would likely result in a number of potentially adverse and unintended consequences. Furthermore, determining which specific illiquid assets to exclude would be a difficult regulatory task.

On the one hand, many Australians do not engage with their superannuation or identify their primary place of residence (family home) as an investment even though these can be substantial assets for some people. A superannuation balance or the value of the family home are not necessarily good indicators of a client's sophistication or investment experience. An increased balance or value of these assets may take place without any financial decisions being made since initial acquisition or investment decisions were made.

On the other hand, some people may actively choose not to place their savings in superannuation or property assets and select other investments. Choices made about asset classes may mean that certain investors are treated differently under the law but maintain similar total investments. Ultimately, the total portfolio of investments is a client's total wealth and excluding certain assets may have perverse outcomes on investors' selection of savings and investment options.

Given the different lifestyle choices and different taxation arrangements associated with a decision to acquire a primary place of residence, we consider that it may be sensible to exclude this asset from the net assets threshold. However, we suggest that further consultation should be conducted via an industry roundtable to identify any impacts or unintended consequences of such a change; for instance, it would be necessary to reassess whether the existing net assets threshold remains relevant as it was introduced to include all property assets. We consider that superannuation should be included in assessing a client's total wealth. Even though superannuation savings are unable to be accessed until retirement, superannuation is investment in asset classes which is controlled by the superannuant, especially with regards to SMSFs.

The ABA notes that any changes to the net assets threshold will raise legacy and compliance issues. Excluding the primary residence is likely to exclude a number of clients who are currently classified as wholesale. Transitional provisions will need to take account of implications for AFSL holders systems and procedures and some investors' expectations about their existing market participation. It will be important for appropriate mechanisms to be available to ensure all clients continue to engage and transact in a manner appropriate for them.

2.1.4 Amend the deeming process

The ABA in principle supports a mechanism to inform clients where the threshold tests have a practical impact of moving them from being a retail client to a wholesale client. We support a requirement for clients to acknowledge that they are wholesale when initially provided with a service or product. Investors should be required to renew this acknowledgment every 2 years, with the exception of sophisticated investors and professional investors where acknowledgement is an additional and unnecessary compliance burden.

The ABA notes that sophisticated investors and investors that qualified as wholesale via certification by an accountant have been recognised as having experience which is unlikely to change and in practice have opted in to be treated as wholesale. Professional investors need to meet distinct criteria which ensures their awareness of being treated as such a class of investor. We note that the implementation of such a requirement would be administratively more manageable in circumstances where the client has an adviser or intermediary relationship.

The ABA in principle supports a standard '1 pager' disclosure document. A standard form of words for the 'opt-in' disclosure should provide a consistent and efficient process of informing a client of their ability to access certain investments and those protections that may no longer be available to them as a wholesale client. However, development of a standard disclosure document should be the subject of consultation with industry representatives.

The ABA believes that investors should generally be able to choose to be treated as retail, even though they may qualify or meet the test of a wholesale client. However, AFSL holders should not be required to offer any product or service to a retail client. Many banks and financial services providers have business models established for wholesale clients only. If a client was able to elect to be retail and continue to have access to certain products or services, this would likely have substantial practical and compliance issues. Therefore, a client should be aware that if they elect to be treated as retail, they may not have access to the same range of products and/or services and may have to go to a different provider to access certain products or services.

2.1.5 Two out of three requirements

The ABA does not support amending the retail/wholesale client distinction tests so that two out of three product and wealth thresholds must be met for an investor to be classified as wholesale. While we recognise that affordability tests may not always correlate with a client's knowledge and experience, these tests provide an objective test. We consider that in practice a requirement to have two out of the three tests met would introduce an unnecessary level of complication to compliance systems and processes for AFSL holders and unnecessary documentation requirements for all clients without necessarily any additional protection for retail clients, especially if the product threshold is adjusted. A strict requirement may also exclude clients with high levels of financial literacy, especially if there is not an adequate sophisticated client or 'opt-out' mechanism.

2.1.6 Introduce extra requirements for certain complex products

The ABA does not generally support implementing rules to attach additional requirements to certain products, impose higher thresholds for certain products (subject to comments made in section 2.1.1) or prohibit the offer of certain products to retail clients. Introducing extra requirements will result in additional complexity when classifying types of clients and investments.

While the ABA recognises that there is a spectrum of different types and classes of financial products from simple products to complex products, we consider that the basis of the FSR regime should be maintained and retail clients and wholesale clients should be able to freely participate in the financial and capital markets, subject to appropriate protections as already contained in the law for retail clients. Furthermore, additional requirements would increase regulatory complexity due to the different thresholds and requirements applicable to different products. Product innovation would necessarily mean that it would be difficult for the regulatory framework to keep up with new products available in the market.

The ABA supports:

- Further consideration of streamlining existing legal and disclosure obligations relating to 'simple products' rather than imposing additional requirements on complex products; and
- Further consultation between Government and industry representatives to identify improved risk disclosure practices, especially in relation to products with gearing or potentially unlimited downside, and improved provision of appropriate advice to appropriate organisations and individuals.

2.1.7 Repeal the sophisticated investor test

The ABA does not support repeal of the sophisticated investor test contained in section 761GA of the Corporations Act. Instead, we believe that the sophisticated investor test should be retained and amended so that industry is able to satisfy on reasonable grounds that an individual has the specified experience and a business has staff or representatives with the necessary competence and knowledge to be treated as wholesale.

Therefore, we consider that the sophisticated investor test should be amended to streamline processes for AFSL holders and their clients as well as to include businesses, and in doing so extend the wholesale client treatment to companies and trusts where transactions are executed by an individual which meets the sophisticated investor criteria (or alternatively, amendments should address concerns with the small business test[1]).

The ABA believes that the sophisticated investor test should be strengthened and made consistent across industry. A standardised approach or prescriptive rules should be used to establish a client's level of sophistication by applying points for certain factors including education, investment history and employment history. Furthermore, the tests should be refined so that there is consistency between the definitions in section 708 (Chapter 6D) and section 761GA (Chapter 7) and the associated Regulations.

[1] The ABA notes that many businesses with large turnovers and/or assets are treated as 'small businesses' because they fail the employee number threshold as currently contained in the law or highly trained individuals fail the net worth test. In the past, the ABA has advocated for modifications to be made to the small business test as a preferred way of addressing concerns with inconsistent definition and application across financial products for small businesses.

The ABA believes that the existing sophisticated investor test is problematic and it is difficult for banks and other financial services providers to implement appropriate compliance systems and processes to ascertain the level of knowledge of an investor. While the ABA recognises that the sophisticated investor test is a subjective test, we consider that due to the inherent arbitrary nature of the product and wealth thresholds there is a need to have some form of 'opt-out' mechanism. Currently some investors treated as retail investors find the retail disclosures unnecessary as the activities and products are well understood, and therefore for financial services providers such retail disclosures are unnecessary costs.

The ABA believes that the sophisticated investor designation for investors, individuals or small businesses, which may currently be caught by the retail client provisions, would hold benefits for both industry and these retail investors. At present the various retail/wholesale distinction tests in the law are convoluted for individual customers and small business customers. These arbitrary distinctions may be adversely impacting the efficiency of financial service provider-client relationship as well as compromising the effectiveness of the consumer protections within the law.

Some ABA comments on the existing sophisticated investor test:

- *Investors*: It is unclear whether this excludes those managing a financial risk. We suggest the law should be amended refer to 'sophisticated clients'.

- *Documentation excluded*: Financial services providers are restricted from giving their clients a FSG, PDS, SOA or other document that can be provided to a retail client. It seems nonsensical that where a bank or other financial services provider gives their client information about a product or service that this would exclude them from taking advantage of the relief. It also seems nonsensical for investors to be prevented from receiving such documents. It is our view that where the client has acknowledged that they will be treated as 'sophisticated', that there should be no reason why they should not be able to get product and service information at the discretion of the financial services provider. We suggest subsections 761GA(f)(i) and 761GA(f)(ii) should be repealed.

- *Transaction*: Financial services providers and their clients should not be required to provide written statements for each trade, transaction or investment (i.e. on a one-off basis). This will create administrative problems as well as potentially disadvantage clients; for example, foreign exchange markets move very quickly and time is a critical factor. It is our view that the written statement should be defined to cover a class or sub-class of financial products (i.e. on a product basis) and that the retail investor shall be treated as a wholesale investor for the ongoing provision of financial services for that class or sub-class of financial product(s). This would mean that an investor could be treated as wholesale for some products and retail for others commensurate with their knowledge and/or experience. It would also be useful to include an 'opt-out' mechanism for retail clients to choose not to be treated as a retail client for the purpose of advice in relation to a range of products.

- *Reasonable grounds*: Financial services providers must be satisfied on 'reasonable grounds' that the client has previous experience. It is our view that financial services providers should not have the onus of having to establish the investor's capabilities. As the client must provide a written acknowledgement, this alleviates some uncertainty as to establishing knowledge and/or experience as it provides time for the client to give consideration to the implications of their written acknowledgement. The test would apply on the basis of the client's competence and experience with a particular financial product, their comprehension of financial

product and market concepts, and any formal qualifications, training or employment experience of the client (although formal training would not be the only determining factor). It is important that both the client and the licensee are satisfied on reasonable grounds that the client can be treated as 'sophisticated'. In the case of a dispute, we would envisage that the client's written acknowledgement would offer some protection for AFSL holders.

- *'Sophisticated businesses'*: Staff or representatives of businesses that are authorised to conduct trades, transactions or investments on behalf of their businesses should be able to be treated as 'sophisticated'. We note that provision of risk management advice and the sale of financial products used to manage business risks, such as foreign exchange risk, interest rate risk, and commodity risk, has been provided by markets without detrimental impact or certain problems that may be associated with other markets as is being targeted by the FOFA reforms. Notwithstanding, the current application of the law is in fact capturing a broader class of investor unnecessarily. It is our view that where a representative 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 'sophisticated business'. In the absence of relief as a 'sophisticated investor' or amendment to the 'small business test', unnecessary compliance costs will continue to be carried by industry and businesses. It is not necessary to set prescriptive rules regarding how the test should be applied by AFSL holders. Licensees have a significant commercial interest in ensuring that the test is applied appropriately and these clients are assessed appropriately. (We note that clause 4.1.9 of the UK Financial Services Authority's Handbook provides for classification of a client as an "intermediate customer". This may offer a workable solution. Arguably a client being warned of the protections they may lose is more important than a statement of the licensee's reasons for being satisfied that the investor has previous experience that enables them to knowledgably assess the trade, transaction or investment.)

2.2 Option 2 – Remove the distinction between wholesale and retail clients

The ABA does not support removing the retail/wholesale client distinction tests from the law. The definition of a 'retail client' in the law is fundamental to the operation of Chapter 7 of the Corporations Act. Removing the definition would have substantial consequences for the Australian markets, all AFSL holders and all investors. While it is important to ensure that retail investors have adequate protections and disclosures available to them, it is also important to recognise that there is a class of investor that does not require these protections and considers these protections to be unnecessary, costly and burdensome. Furthermore, this change would have a significant impact on compliance systems and processes and in practice unwind much of the FSR regime which has been put in place by banks and other financial services providers.

Therefore, we consider that it is not appropriate that all investors should be afforded the protections currently available for retail clients. Increasing the legal and regulatory obligations will unnecessarily increase transaction costs for all participants and investors and unnecessarily complicate the offer of financial products, especially for wholesale clients.

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

The ABA does not support introducing a sophisticated investor test as the only mechanism for distinguishing different classes of investors. Even though the test provides a useful supplement to the other tests, and therefore provides some flexibility to address problems associated with the objective tests, it is only used in limited circumstances as it is a subjective test which carries operational risks (i.e. liability for AFSL holders). AFSL holders and their clients need certainty to ensure the provision of financial services is done in a way that maintains effective protections, promotes efficient transactions, addresses compliance needs and controls liability. Relying solely on a subjective test would increase regulatory risks for all – ASIC, all AFSL holders and all investors – as a subjective test inherently carries with it the risk of inconsistency.

Therefore, we consider that it is necessary for the law to contain a combination of objective and subjective tests that have regard for a clients' knowledge and experience, clients' wealth and assets, and the amount (or size) of the transaction. Imposing a test that solely relied on industry to determine the level of financial literacy of an investor would significantly increase business and operational risks for banks and other financial services providers due to the liability associated with administration of the test and not necessarily achieve consistent outcomes and therefore could significantly undermine protections for investors.

2.4 Option 4 – Do nothing

The ABA does not support doing nothing. We consider that it is timely to revisit the retail/wholesale client distinction tests to ensure that the tests operate in a manner that provides adequate protections for investors that require additional protections and disclosures and allows participation in the financial and capital markets without imposing undue costs and burdens.

2.5 Other issues

2.5.1 Professional investor test

The ABA does not believe that changes need to be made to the professional investor test. This test is important as it allows AFSL holders and institutional investors (e.g. fund managers) to access and support a wider range of products and services at a lower cost.

2.5.2 Section 761G as it applies to local councils

The ABA does not support specifically extending the definition to capture local councils as retail clients. We consider that the underlying causes of the failure of CDO markets around the world and individual investment losses is unrelated to the definition of retail and wholesale clients in Australia. Furthermore, we do not consider that investment losses would have been avoided if these councils had been classified as retail clients. We believe there are adequate remedies available to wholesale clients to address any misleading or deceptive conduct or mis-selling issues. We also believe there have been adequate changes recommended to the governance and control arrangements around the investment of local government funds. Furthermore, extending the definition to capture local councils as retail clients will result in a range of institutional investors being restricted from the wholesale market and therefore reduce local council's access to products and services only in the wholesale market.

2.5.3 Section 761G as it applies to superannuation

The ABA notes that section 761G(6) of the Corporations Act states that if a financial product is a superannuation product or an RSA product, the product is provided to the person as a retail client. However, the law does not identify the circumstances in which an investor is taken to be a retail client when a service is provided which "relates to" a superannuation product or RSA product. Furthermore, section 761G(6)(b) of the Corporations Act specifies that, unless a person is covered by (c)(i) or (ii), the service which "relates to" a superannuation product or an RSA product is taken to be provided to the person as a retail investor. We note that ASIC has published an FAQ (QFS 150) which suggests that an adviser must treat a superannuation fund as a retail client regardless of the product being offered (unless the net assets of the fund exceed the $10 million threshold). There are anomalies between phrases used in the law and QFS 150 and different approaches to definitions in respect of the provision of financial products and services to trustees of a superannuation fund.

Therefore, we consider there is confusion in industry about the application of section 761G as it relates to superannuation. Section 761G should be redrafted so that there is a single test, but in a range of limited situations the test should not apply. Furthermore, we consider that the threshold tests applying to a person should also be applied at a fund level in determining if a SMSF qualifies as wholesale (with certain exclusions)[2]. We note that the current approach is ambiguous and unbalanced and has implications for superannuation funds' access to certain investments (e.g. share placements by ASX listed companies which are limited to wholesale investors only).

2.5.4 International developments

The ABA acknowledges the current deliberations of the International Organization of Securities Commissions (IOSCO) with regards to the treatment of retail clients and wholesale clients. We note that IOSCO Standing Committee 3 has conducted a survey on international practices and definitions. This work follows concerns over mis-selling of financial products (highlighted by the Joint Forum survey on suitability standards), the G20 mandate to IOSCO to promote financial market integrity by reviewing business conduct rules, and the IOSCO final report *Unregulated Financial Markets and Products* recommending review of investor suitability requirements.

The ABA has provided initial input and views on suitability requirements to IOSCO Standing Committee 3 via the International Banking Federation (IBFed). We consider that it is important for any changes to the retail/wholesale client distinction tests to be cognisant of international standards, in particular general principles on suitability requirements, as well as the application of those standards as appropriate and relevant for the Australian markets.

2.5.5 Transitional issues

The ABA believes that any changes will have implications for banks and other financial services providers and their clients. Therefore, we suggest that if there are changes made to thresholds, definitions or other elements of the existing framework, there will need to be appropriate transitional provisions to ensure that arrangements are grandfathered and investors are not inappropriately reclassified or divested; for example, any changes in thresholds should apply to new offers or issuances only and investors deemed wholesale via certification by an accountant should retain this status until the expiry of the existing certificate.

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[2] The ABA notes the submission made by the Financial Services Council.

3. Concluding remarks

The ABA believes that the retail/wholesale client distinction tests should apply in a way that:

- Facilitates retail and wholesale clients' ready access to financial products and investments;
- Enables banks and other financial services providers to offer financial products and services in an appropriate manner to different types of clients;
- Allows banks and other financial services providers to develop innovative financial products and services and leverage technologies;
- Minimises regulatory burden and compliance costs for businesses; and
- Protects consumers and provides retail and wholesale clients with appropriate levels of protection, information and advice to meet their needs.

While the ABA supports improving the levels of financial literacy among all Australians, we are concerned that the legal obligations contained in the Corporations Act should not impose unnecessary and impractical obligations on banks and other financial services providers. We consider that it is important to take a balanced view on the implementation of any changes to the retail/wholesale client distinction tests, including taking account of existing areas of the law and industry practice which ensures the suitability of products offered to retail clients or provides avenues for recourse if these standards are not met. It is essential that banks and other financial services providers are able to continue to provide financial products and services to all their clients via different business models and distribution channels.

The ABA would welcome the opportunity to work with the Federal Government on implementing any changes deemed necessary to the financial services laws to minimise adverse and unintended consequences for banks and their clients.

If you have any queries regarding the issues raised in our letter, please contact me or Diane Tate, Policy Director, on (02) 8298 0410: dtate@bankers.asn.au.

Yours sincerely

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Steven Münchenberg