ARGYLE LAWYERS Pty Ltd

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

PLEASE REPLY TO SYDNEY OFFICE

By Email: futureofadvice@treasury.gov.au

Dear Sir/Madam,

WHOLESALE AND RETAIL CLIENTS
FUTURE OF FINANCIAL ADVICE
RESPONSE TO OPTIONS PAPER

Our Ref: LDC:25069

Please find following our response to the Future of Financial Advice Options Paper on Wholesale and Retail Clients.

Yours faithfully
ARGYLE LAWYERS PTY LTD

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Encl.

Response to "Wholesale and Retail Clients – Future of Financial Advice" Options Paper

Prepared by Argyle Lawyers Pty Ltd

Currently confusion about, and the difficulties associated with, the application of the retail wholesale client distinction places many clients at risk and can have significant negative impacts for the financial services industry.

The financial services industry expends considerable effort, and legal fees, in formulating strategies and business models to circumvent the prescribed tests and facilitate certain business practices.

The result is that some clients who should not be treated as wholesale clients in fact are, while others who do not require the retail client protections are channelled into what is essentially a superfluous advice scenario and are precluded from accessing what might otherwise be appropriate financial products. This situation creates inefficiencies in the planning process, frustration among clients and risks failing to provide the relevant protections to those clients who genuinely require the protections the retail advice process affords.

For the purposes of providing a financial product or service to a client under Chapter 7 of the Corporations Act 2001 (Cth) (Act), the retail and wholesale client provisions are contained in sections 761G and 761GA of the Act (and associated regulations).

The general wholesale tests which include the value test, the business test, the income and assets test and the professional investor test contained at section 761(7)(a) to (d) should be distinguished from the sophisticated investor test found at section 761GA.

While the general wholesale tests relate to objective measurable criteria, the sophisticated investor test relies largely on subjective criteria. It is relevant to address the shortcomings of each of the tests:

(1) the "value test' is applied pursuant to definitions and measurement rules informing its application which run to some 11 Regulations. In practice it often drives the establishment of minimum investment amounts in order to classify all investors in a particular product as wholesale clients on the basis of the value of the investment. Obvious concerns relate to whether those investors would otherwise be classified as not requiring retail client protection and inconsistencies relevant to the treatment of superannuation fund trustees, in particular of self managed superannuation funds ("SMSF), as a consequence of the application of section 761G(6). The concept of a threshold investment value is inconsistent with the requirement for appropriateness of advice and generalises the link between wealth and financial literacy. Further the intent of this test largely overlaps the income and assets test. Indexation does nothing to address the real concerns associated with the test;

(2) the "business test" classifies business clients as retail clients if the business employs less than 100 people, if the business is or includes the manufacture of goods, or 20 people, in all other cases. The test has obvious limited practical application and artificially restricts access to the wholesale regime to business which may properly fit within it;

(3) the "income and assets test" requires clients to produce a certificate (with a 2 year currency period) from a qualified accountant certifying that they meet specified minimum income and asset levels. While this test is widely utilised, it has no regard to the objective financial sophistication of the client meaning that many clients are inappropriately treated as wholesale. Notwithstanding those qualitative shortcomings, the threshold requires realignment having regard to increases in the value, particularly of property and superannuation savings since the test was established;

The Accountant's Certificate is often used as the basis for a client engagement model where the client is required to produce an Accountant's Certificate at the commencement of the relationship and is thereafter treated as a wholesale client with the certificate simply renewed

as required without any ongoing assessment of the client's true financial needs and information requirements.

In addition, inconsistencies arise as a consequence of the treatment of superannuation fund trustees, in particular of SMSFs, as a consequence of the application of section 761G(6). This treatment is inconsistent with section 761G(7)(ca) which allows the trustees of other trusts access to the relevant wholesale definition;

(4) the "professional investor" tests as the name suggests defines a number of professional roles which are excluded from the definition of retail client. In practice, the relevance of the test to individual investors, is limited;

(5) the subjectivity surrounding the application of the "sophisticated investor" test and the risks to which that subjectivity exposes licensees makes its practical application unpalatable to many. Conversely, the subjectivity of the test means it is necessarily open to abuse or misuse.

Response to Option 1 – Retain and update the current system

Our views on the practical limitations of each if the existing tests is set out above.

In order to achieve the consumer protection intent of Chapter 7 of the Act it is necessary to reassess what it is that clients need protection from, which clients truly need that protection and whether the retail/wholesale framework actually protects those clients from the identified risks.

In our view, the current definitions and thresholds do little to protect clients from the headline risk, that is, having their funds invested in products which are inappropriate for them having regard to their personal circumstances, needs and objectives.

Instead, just as a person's objective risk tolerance is accepted as a relevant personal circumstance for the purposes of assessing appropriateness of advice provided to retail clients, so too should an objective assessment of a person's financial sophistication and acuity inform whether financial services should be provided to a client as a wholesale client.

Licensees should be made to account for the manner in which financial services are provided to clients. Currently, the wholesale client provisions of the Act, allow Licensees to effectively avoid responsibility by relying on the artificial constructs of the existing definitions which have no real regard to an individual client. So too must clients accept some responsibility for ensuring that they participate in the financial planning process. If they do not understand the advice being given to them and the features of products being recommended to them, they should be required to acknowledge their lack of financial sophistication.

In our view, having regard to the shortcomings discussed above, the following combination of changes to the existing tests would achieve a more appropriate outcome:

(a) retain the professional investor definition which picks up classes of investors who don't really need the protections offered by the disclosure and dispute resolution mechanisms available to retail clients;

(b) remove the product value test which, while based on the presumption that personal wealth equates to financial sophistication, is one step further removed from the income and assets test in that it does not actually directly link to individual personal wealth, but rather to investible funds which may or may not be indicative of personal wealth;

(c) increase the threshold for personal wealth to $3,000,000 (excluding superannuation) or $4,000,000 (including superannuation) and require the Accountant's Certificate to include an acknowledgement by the qualified accountant that they have explained to the client, and an acknowledgement from the client that they understand, the listed protections to which they will not have access if they are treated as a wholesale client, and that they accept the risks associated with the loss of those protections;

(d) remove the sophisticated investor definition in favour of an objective financial literacy assessment which any retail client is able to elect to undertake in order to be classified as wholesale where they would otherwise be classified as retail.

Response to Option 2 – Remove the distinction between wholesale and retail clients

In practical terms, it is our view that it is not possible to extend all of the retail protections currently available to retail clients to wholesale clients. For example, the current product disclosure regime does not support the treatment of all clients as retail clients. Similarly, the Financial Ombudsman Service (FOS) jurisdictional limits and already existing difficulties experienced by licensees in obtaining adequate Professional Indemnity cover would present barriers to the implementation of Option 2.

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

It is our view that the shortcomings of a subjective test would not be ameliorated simply by requiring that test to be administered by a third party. In addition, this proposal would create administrative inefficiencies, disadvantage clients who are objectively sophisticated and would be practically unworkable having regard to the existing distribution framework.

Superannuation and RSA Products

Section 761G(6) deals separately with superannuation products and RSA products, however, the clumsy use of the terms 'financial product provided to' 'financial service provided to' and 'provision of a financial product' are the cause of significant contention. While the Australian Securities and Investments Commission (ASIC) has expressed a view on the intended breadth of the section, there are widely differing views across the industry. The upshot is, however, that many SMSFs which could (and often should) be able to access wholesale products are unable to do so. This situation is the cause of ongoing frustration for both advisers and clients and investigation would likely indicate that advisers and licensees are using contrived approaches to circumvent the operation of the section. It is relevant to consider dealing in a financial product and the provision of financial product advice separately:

Dealing in a financial product

The use of the term 'financial product provided to' in Section 761G(6)(a) appears to clearly contemplate the issue or sale of an interest in a superannuation fund and requires that the recipient of that service be treated as a retail client.

Consideration must then be given to the use of the term 'financial service provided to' and 'provision of a financial product' as used in section 761G(6)(b) and (c). While the term "financial service" in the Corporations Act is defined to include dealing and advising, the relevant sections specifically exclude services that amount to the "provision of a financial product" which would appear to exclude the sale or issue of financial products (other than superannuation products which are separately dealt with in section 761G(6)(a)).

If the above construction of the section is accepted, the general wholesale tests contained at section 761G(7) and the sophisticated investor test in section 761GA should be available where the financial service in question is, or amounts to, the issue or sale of a financial product, other than a superannuation product.

The provision of financial product advice

If sections 761G(6)(b) and (c) only apply where the financial service amounts to the provision of financial product advice, section 761G(6)(c) of the Act provides that where financial advice is provided to the trustee of a superannuation fund with at least $10 million in net assets, and that service relates to a superannuation product, the client need not be dealt with as a retail client.

Section 761G(6)(b) provides that where the advice is provided to the trustee of a superannuation fund that does not have $10 million in net assets, the service is provided to the person as a retail client.

What is meant by the term “relates to” the superannuation product is therefore critical.

The breadth of the term “relates to”

ASIC’s view on the breadth of the term “relates to” is articulated in ASIC QFS 150: “When financial services are provided to a trustee of a superannuation fund, are they provided to a retail client?”

ASIC’s view is that the words “relates to” has a wide meaning and that any advice provided to a superannuation fund trustee would relate to the interests in the fund issued by the trustee and therefore be caught by the $10 million fund net asset test.

ASIC’s appears to ascribe to the view that any investment by a superannuation fund trustee on behalf of the fund necessarily affects the value of the interests of members in the fund and therefore “relates to” the superannuation products. If that interpretation is accepted, any financial product advice provided to a fund trustee could theoretically relate to the members interests in superannuation products.

The Explanatory Memorandum to the Financial Services Reform Bill 2001 (Cth) provides no basis for this interpretation, nor any specific guidance that would inform such an interpretation.

Consider an alternative interpretation, that financial product advice provided to a superannuation trustee client, relates to the (investment) products issued to that client and not to the superannuation product even if the investments do affect or increase the value of the members’ interests.

ASIC’s interpretation gives rise to anomalies in respect of self managed superannuation funds in particular, where superannuation fund trustee/members who individually might meet the wholesale client test are effectively unable to access wholesale products through their self managed superannuation funds. This is inconsistent with section 761G(7)(ca) which allows the trustees of other trusts access to the relevant wholesale definitions.

The confusion surrounding the construction and intent of this section must be cleared up.

Our view is that where a financial service (advising on or dealing in a financial (investment) product) is provided to the trustee of a superannuation fund that service will ‘relate to’ the investment product and not the superannuation product (that is, the interest in the superannuation fund) or the fund itself.

In our opinion, the definition of financial product advice contained at section 766B(1) of the Act, which refers to a recommendation or statement of opinion intended to influence a person in making a decision in relation to a particular financial product or class of products, or interest in a financial product or class of products, supports our interpretation. It is our view that where financial product advice is being provided to superannuation fund trustees, the decision being influenced is not in relation to the superannuation product but rather, the investment product to which the advice relates.

The contention in relation to this issue could be avoided by distinguishing SMSFs which by their nature should receive separate and distinct treatment.