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28 February 2011

Dear Sir/Madam,

**Re: Wholesale and Retail Clients**

We appreciate the opportunity to respond to the Options paper: Wholesale and Retail Clients developed as part of the Future of Financial Advice (FOFA) reforms package (the "Paper").

We are supportive of the decision to review the distinction between wholesale and retail clients to ensure that retail clients receive adequate regulatory protection. As stated in the Paper, increases in the levels of household wealth since the current definitions were introduced combined with the problems encountered during the recent global financial crisis have shown that the current monetary based thresholds do not necessarily provide appropriate protection to those with limited investment experience. In our view, to do nothing is not an option.

Our preferred method of classification of retail and wholesale clients would involve the introduction of a financial literacy test as set out under Option 3 of the Paper. However we believe that this should be administered by an independent body rather than the industry. We have also included feedback on Options 1 and 2 of the Paper in addition to providing some general comments.

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

We support the introduction of a financial literacy test as suggested in Option 3 of the Paper however; we believe the financial literacy test needs to be administered by an independent body and not by the industry.

If a financial literacy test could be administered by an independent body, we believe this would go part way in addressing one of the main disadvantages outlined in the Paper which is that the industry may adopt an overly cautious approach if it was responsible for the administration of the financial literacy test in order to avoid being exposed to legal liability.

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As set out in Option 3, any test would need to be structured to assess the investor’s ability to understand the merits of, and risks associated with, a particular financial product. Should the investor choose not to sit the financial literacy test (i.e. “opt-out”) then they would automatically be treated as a retail client and receive the necessary protections and disclosures.

In addition when an investor has taken and passed the financial literacy test they should also be given the opportunity to “opt-in” in relation to a particular investment at the wholesale level or to “opt-out” and be treated as a retail investor for a particular investment.

We recognise that the initial and ongoing administrative costs of implementing a new financial literacy test would be high and therefore significant consideration would need to be given to how this could be effectively administered and monitored. However, we believe there could be significant long term benefits of introducing such a test if it was administered by an independent body. We suggest that costs could be partially offset by introducing some form of user pays system whereby the investors would pay a one-off fee to sit a financial literacy test. This would replace the existing situation where investors are required to pay other parties for a certificate when they wish to be treated as a wholesale client.

Some longer-term benefits may include;

- reducing the risk for the financial advisor of incorrectly classifying a client as a wholesale investor;
- improved advice for investors as there would be increased transparency in the market to assess the financial literacy of investors;
- enabling certain financially literate investors to participate in wholesale markets; and
- increased protection for those investors lacking financial literacy.

We understand that this proposal goes further than what had been contemplated in the Paper and therefore that it is likely to require significant consultation with industry bodies and other interested parties. We would be happy to participate in future discussion on it.

**Option 1: Retain and update the current system**

Should the introduction of a financial literacy test not be a viable option, we believe that the implementation of the items set out below would be the most effective way to ensure that there is an enhanced distinction between retail and wholesale clients.

<p>7.4 Update the Product Thresholds &amp; Income/Asset Thresholds</p>	<p>We support increasing the monetary values for the product threshold and the income/asset thresholds. This would maintain the objective element of the existing evaluation, is clear, easy to use and understandable by the market and would take account of market movements. However we believe additional revisions should also be considered. Currently the asset threshold refers to “ownership” of assets and we believe an important consideration in respect of a revision to this threshold should be whether it should refer to “control” of assets rather than “ownership”. For asset protection reasons, some investors who are knowledgeable in markets and financial products hold assets via trusts or other mechanisms and therefore do not “own” them. We believe that it is important to take these assets into consideration when assessing whether or not the individual satisfies the asset threshold.</p> <p>For the same reason, we suggest that there also needs to be a revision of the income threshold. The threshold, as drafted, could</p>
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	<p>be interpreted to mean the gross income, as disclosed in the income tax return for the individual. As noted above, many individuals may “control” but not “own” assets held in trusts etc. Whilst these trusts would lodge an income tax return, unless a distribution is made to the individual in the period it would not be included in their personal income tax return, and they therefore may not exceed the income threshold. If income from assets controlled by the individual were included it may be a better indication of the investment experience of the individual.</p>
7.6 Exclude Illiquid Assets	<p>The Paper considers excluding certain illiquid assets such as the client’s primary residence and externally managed superannuation from the net asset threshold.</p> <p>If, as suggested above, a test of “control” of assets is adopted, we believe there may be a wider range of assets that would fall under the investor’s control e.g. <i>self managed superfunds</i> (“SMSF”). While it may be appropriate for these SMSF’s to be included in the assessment whether an individual satisfies the net asset threshold, certain assets such as investment properties held by SMSF’s may need to be excluded. This would enable the net assets included in the assessment to more accurately reflect those financial products that require financial literacy. It would also allow those clients whose wealth consists mainly of real estate (either their own home and/or investment properties) or externally managed superannuation to be classified as retail clients and therefore receive the appropriate protections and disclosures.</p>
7.8 Two out of Three Requirements	<p>We support introducing a requirement that investors must meet 2 out of the 3 threshold as this would strengthen the objective element of the assessment.</p>

## **Option 2: Removing the distinction between wholesale and retail clients**

This option would eliminate the distinction between wholesale and retail clients which would result in all investors receiving the protections and disclosures currently only afforded to retail clients.

As well as the drawbacks outlined in the Paper, advisors would be unlikely to be able to offer financial products quickly and efficiently to large groups of investors and certain complex products may cease to be offered as it would become cost prohibitive for financial advisors to offer them. This could result in a less than optimal product mix of complex and more straightforward products being available to the market and therefore we are not supportive of this Option.

## **General Comment: Product classifications**

In conjunction with the review of the distinction between retail and wholesale clients, we believe that there should also be a review of the product classifications. At present certain products are deemed to be wholesale products because of the extent of the investment required however, the product itself may be simple. For example products such as term deposit accounts held via custodian arrangements, which for administration purposes require a large investment, may meet the product value test, but should not necessarily be classified as wholesale products.

We would be pleased to discuss our comments with you. If you wish to do so, please do not hesitate to contact me on 02 9322 7288.

Yours sincerely,

Deloitte Touche Tohmatsu

  
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Partner